WRITTEN TESTIMONY OF THE COMMISSIONER OF INTERNAL REVENUE MARK EVERSON BEFORE SENATE HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS COMMITTEE SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT, GOVERNMENTAL INFORMATION AND INTERNATIONAL SECURITY ON DECONSTRUCTING THE TAX CODE: UNCOLLECTED TAXES AND THE ISSUE OF TRANSPARENCY

SEPTEMBER 26, 2006

Good afternoon, Chairman Coburn, ranking member Carper and members of the Subcommittee. It is good to be back before you to update you on the tax gap and our efforts to reduce it. Since I was here almost a year ago, we have updated our tax gap numbers and we have begun a new National Research Program (NRP) study. I will discuss both of those later in my testimony. I would also like to discuss some specific legislative proposals that will assist us in reducing the magnitude of the current tax gap.

Background

Put simply, the tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

It is important to understand, however, that the complexity of our current tax system is a significant reason for the tax gap and that fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions.

History of Estimating the Tax Gap

Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by- line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas.

However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988.

We conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, all of our subsequent estimates of the tax gap have been rough projections that basically assume no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program, which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 returns for Tax Year (TY) 2001. This was less than previous compliance studies, even though the population of individual tax returns had grown over time.

Like the compliance studies of the past, the NRP was designed to allow us to meet certain objectives: to estimate the overall extent of reporting compliance among individual income tax filers and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The first NRP innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. The sources of the “case building” data included third-party information returns from payers of income (e.g., Forms W-2 and 1099) and prior-year returns filed by the taxpayers. Also, for the first time, we added data on dependents from various government sources, as well as data from public records (e.g., current and prior addresses, real estate holdings, business registrations, and employment information). Together, all of these data sources reduced the need to ask taxpayers for information, with some of the selected taxpayers not needing to be contacted at all by the IRS. In effect, this additional information allowed us to focus our efforts where the return information could not otherwise be verified. This new approach was so successful it is being expanded into our regular operational audit programs.

A second major NRP innovation was to introduce a “classification” process, whereby the randomly selected returns and associated case-building data were first reviewed by experienced auditors, referred to as classifiers, who identified not only what issues needed to be examined, but also the best way to handle each return in the sample. In this way, each return was either: (1) accepted as filed, without contacting the taxpayer at all (though sometimes with minor adjustments noted for research purposes); (2) selected for correspondence audit of up to three focused issues; or (3) selected for an in-person audit where there were numerous items that needed to be verified. In addition, the classifiers identified compliance issues that the auditors were required to evaluate, though the examiners had the ability to expand the audit to investigate other issues as warranted.

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including representatives of tax professional associations) in the design and implementation of the study.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among the major tax gap components since the most recent compliance data were compiled (i.e.,1988 or earlier).

Distinguishing the Tax Gap From Related Concepts

The tax gap is not the same as the so-called "underground economy," although there is some overlap (particularly in the legal-sector cash economy). For example, the tax gap numbers do not reflect taxes owed on income generated from illegal activities. This makes up a significant portion of the underground economy. However, what we think of as the underground economy does not include various forms of tax noncompliance, such as overstated deductions or claiming an improper filing status or the wrong number of exemptions. These are all included in our calculations of the tax gap.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, even though we do not have the ability to distinguish clearly the amount of non-compliance that arises from willfulness from the amount that arises from unintentional mistakes. We expect future research to improve our understanding in this area. If all reporting errors were unintentional, we would expect to see a relatively even balance between over reporting and under reporting. However, since taxpayer overstatements of tax appear to be much smaller than understatements of tax, one can reasonably infer that much of the gap is the result of intentional behavior.

Latest Numbers

The results of the NRP individual income tax reporting compliance study were rolled into our overall tax gap estimates and show that for the 2001 tax year there was an overall gross tax gap of approximately $345 billion, corresponding to a noncompliance rate of 16.3 percent. The net tax gap, or what is remaining after enforcement and other late payments, is about $290 billion.

Noncompliance takes three forms: not filing required returns on time (nonfiling); not reporting one's full tax liability when the return is filed on time (underreporting); and not paying by the due date the full amount of tax reported on a timely return (underpayment). We have separate tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes nearly 82 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes almost 8 percent and underpayment nearly 10 percent of the gross tax gap.

The individual income tax accounted for about half of all tax receipts in 2001. However, as shown on the chart below, *individual* income tax underreporting was approximately $197 billion or about 57 percent of the overall tax gap. While a comparison with 1988 data would suggest a slight worsening of individual income tax reporting compliance, it is important to remember that the data tell us nothing about the years just before or just after TY 2001 and, as such, cannot tell us whether compliance trends today are improving or worsening. Moreover, much of the data and estimating methodologies used for the NRP are different than those used in earlier studies.

As in previous compliance studies, the NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) of the underreporting gap came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated subtractions from income (i.e. statutory adjustments, non-business deductions, and exemptions) and from overstated tax credits.

NRP-Based Gross Tax Gap Estimates, Tax Year 2001

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**197**	**57%**
Understated non-business income	56	16%
Understated net business income	109	31%
Overstated adjustments, deductions, exemptions and credits	32	9%
Self-Employment tax underreporting gap	**39**	**11%**
All other components of the tax gap	**109**	**33%**
Total Gross Tax Gap	**345**	
Note: Detail does not add due to rounding		

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self employment tax together, then, we see that individual underreporting constitutes approximately two-thirds of the overall tax gap.

It appears that the sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study was done for Tax Year 1988. The amounts least likely to be misreported on tax returns are subject to both third party information reporting and withholding, and are, therefore, the most "visible" (e.g., wages and salaries). The net misreporting percentage for wages and salaries is only 1.2 percent.

Amounts subject to third-party information reporting, but not to withholding (such as interest and dividend income), exhibit a somewhat higher misreporting percentage than wages. For example, there is about a 4.5 percent misreporting rate for interest and dividends.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage of 8.6 percent. As expected, amounts generally not subject to withholding or third party information reporting (e.g., sole proprietor income and the "other income" line on form 1040) are the least "visible" and, therefore, are most likely to be misreported. The net misreporting percentage for this group of line items is 53.9 percent.

Latest NRP Study

In viewing the strategic value of monitoring compliance trends, we now recognize the need to conduct reporting compliance studies more regularly. Each study will address a component of the overall tax gap. By measuring compliance for various types of taxes and taxpayers, we will be better able to target resources to encourage compliance, deter non-compliance, and reduce the burden on taxpayers.

The most recent NRP reporting compliance study focuses on S corporations. Since 1985, S corporation return filings have increased dramatically. In that year, there were 722,444 Form 1120S returns filed. In 2002, that number had grown by over four times, to over 3.1 million. Compare that to other corporate returns, which declined by approximately 450,000 over the same period.

By 1997, S corporations became the most common corporate entity. In 2003, nearly 3.4 million S corporations filed tax returns, accounting for over 58 percent of all corporate returns filed that year. The last time we conducted an S corporation compliance study was 1984. As a result, we do not have reliable reporting compliance data for these entities.

The current NRP study of reporting compliance involves approximately 5,000 Form 1120S returns from a nationwide random sample. We used the asset size of the S corporation in the return selection process. This reporting compliance study involves Tax Years 2003 and 2004. This is the first time the IRS has conducted a reporting compliance study across tax years and it will require us to knit the data together to give a comprehensive picture. This study is underway and we expect it to continue through 2007.

Service + Enforcement = Compliance

Reducing the size of the tax gap guides much of what we do on a daily basis at the IRS. Our goal is to increase the voluntary compliance rate from the current 83.6 percent to 85 percent by 2009.

To achieve that goal, we know we must attack the tax gap from both ends of the spectrum. We must help taxpayers better understand their obligations, and reduce that portion of the tax gap attributable to taxpayers being confused or uncertain about what their true obligations are. Secondly, we must improve our enforcement efforts by concentrating on those taxpayers who intentionally refuse to pay what they owe.

Service

The FY 2006 Appropriations Act for the IRS contained report language requesting that we conduct a comprehensive review of our current portfolio of services and develop a five-year plan for taxpayer services. This review was designed to achieve the following objectives:

- Establish a credible taxpayer/partner baseline of needs, preferences, and behaviors;
- Implement a transparent process for making service-related resource and operational decisions;
- Develop a framework for institutionalizing key research, operational, and assessment activities to manage service delivery holistically; and
- Utilize both short-term performance and long-term business outcome goals and metrics to assess service value.

In April 2006, the TAB completed Phase 1 and presented the results of its research to Congress. Phase 1 identified and reported five strategic service improvement themes for enhancing taxpayer and practitioner service needs and preferences:

- Improve and Expand Education and Awareness Activities – Addresses the critical need for making taxpayers and practitioners aware of IRS service offerings and delivery channels and ensuring taxpayers are aware of their tax obligations and benefits;
- Optimize the Use of Partner Services – Emphasizes improving the level of support and direction provided to partners who play a critical role in the delivery of taxpayer services to ensure that they consistently and accurately administer the tax law;
- Elevate Self Service Options to Meet the Expectations of Taxpayers – Continues the process of expanding, simplifying, standardizing, and automating services with a focus on those systems/processes delivering information and basic transactions;
- Improve and Expand Training and Support Tools to Enhance Assisted Services – Ensures the accuracy of information across all channels by improving and

expanding training, technology infrastructure, and support for employees, partners, and taxpayers;

- Develop Short Term Performance and Long Term Outcome Goals and Metrics – Provides for the development of a comprehensive set of short-term performance metrics to evaluate how well the business is meeting taxpayer expectations (education and awareness, access to service, and quality of experience) and how efficiently it is delivering those services (compliance, IRS and taxpayer costs, and productivity);

TAB Phase 2 is in progress and is already yielding significant results. Phase 2 is currently focused on developing refined taxpayer/partner needs and preference data, identifying current planning documents, decision processes, and existing commitments affecting IRS service strategy. It is developing a decision model to prioritize service initiatives and funding proposals, recommending service improvement initiatives, creating short-term performance and long-term outcome metrics, ensuring continued stakeholder, partner and employee engagement, and delivering a multi-year research plan.

Over 27 distinct research initiatives have produced extensive data on how taxpayers perceive, use, and value services. We are in the process of analyzing this significant body of work. Similarly, TAB is integrating cross functional strategic activities reflected in initiatives such as the Modernization Visioning Strategy and Electronic Tax Administration's (ETA) Strategy for Growth. As a consequence of this scope of activity, the Phase 2 report delivery has been delayed until January 2007.

Based on the results of these efforts, improvement initiatives will be recommended by TAB intended to increase voluntary compliance, taxpayer and partner value, and IRS business value.

While TAB remains a work in progress, consideration is also being given to other program initiatives that will address inadvertent, unintentional errors caused by:

- Language barriers - by pursuing strategies that focus on providing tax information in languages other than English;
- Educational barriers - by pursuing strategies that focus on expanding and improving the quality of voluntary assistance though Voluntary Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) centers and similar partnership efforts. In the 2006 filing season, over 12,000 VITA and TCE sites were opened with more than 68,000 volunteers. These sites filed approximately 2.26 million tax returns, of which 82.7% were e-filed;
- Misunderstanding of tax law - by pursuing strategies that focus on clarifying and improving forms, instructions, and publications to reduce the burden that taxpayers experience in attempting to comply;
- Communication barriers - by pursuing strategies that focus on improving the quality, ease of use, and access to printed, electronic, and telephonic assistance

channels; placement of face-to-face assistance resources to cost effectively serve taxpayers unlikely to use other service channels;
- Practitioners' lack of knowledge/understanding of tax law - by pursing strategies designed to enhance the quality and accessibility of practitioner assistance through education, tailored assistance channels, and effective monitoring of practitioner behavior and return preparation quality.

On April 30, 2006 we established the Tax Forms and Publication's Virtual Translation Office (VTO). This office will allow IRS to increase service to Limited English Proficient taxpayers and expand the amount of tax materials in languages other than English. Initially, VTO will focus on expanding Spanish language materials, including the development of tax information for small business. Expansion of tax information for 4 targeted languages (Mandarin/Cantonese, Korean, Vietnamese and Russian) is anticipated in Fiscal Years beyond 2007.

Another major service initiative is the continued enhancement of IRS.gov with the goal that this site will become the first choice of individual taxpayers and their preparers when they need to contact IRS for help. In 2006, there have been more than 163 million visits to the site, up 8.6 percent from 2005.

Services now provided on IRS.gov include:

- An Alternative Minimum Tax (AMT) Assistor to help taxpayers in determining whether they may be subject to the AMT and whether they need to complete Form 6251;
- EITC Assistant that allows individuals to determine whether they qualify for the Earned Income Tax Credit and is available in both English and Spanish;
- The IRS Withholding Calculator which allows employees to determine how much should be withheld from their paycheck;
- The Small Business/Self Employed division provides online learning and educational products which allows business owners to view a streaming video of an IRS Small Business Workshop, take an IRS course, or complete an online, self-directed version of a workshop taught live around the country;
- Online ordering capability for numerous tax forms and products, which give customers access to free products that help them meet their tax requirements. They can choose from a variety of products, as well as get updated information relating to any of those products;

"Where's My Refund" is another important feature of IRS.gov. It allows taxpayers to track their refund. Over 22 million taxpayers used this feature in our most recent filing season, a 2.7 million increase from 2005. The increased use of "Where's My Refund?" has reduced the number of phone calls from taxpayers seeking their refund status.

Another key component of our overall strategy to increase taxpayer use of electronic options is electronic filing. The present e-filing system has demonstrated measurable success with regard to individual taxpayer satisfaction. From its modest beginning as a pilot program in 1986, when 25,000 returns were filed electronically, the number of e-filed returns has dramatically increased, with more than 71 million returns filed electronically in the last filing season. The benefits to these taxpayers include:

- *Faster refunds*: Direct deposit can speed refunds to e-filers in about two weeks or less. Through early September, 2006, 56.3 million refunds were direct deposited, up from the 52.4 million refunds for the same period in 2005. The average direct deposit refund in 2006 is $2,601.
- *More accurate returns*: E-filed returns are automatically checked for errors or missing information. Processing is more accurate and the likelihood that a taxpayer might receive an error letter from the IRS is reduced.
- *Quick electronic confirmation*: E-filers receive an electronic acknowledgement that their return has been received.
- *Free Internet Filing*: Now in its fourth year, Free File allows millions of taxpayers to prepare and file their federal tax returns on-line for free. The program is a partnership between the IRS and an alliance of tax software companies that offers free on-line tax return preparation and e-filing services to 70 percent of the nation's taxpayers. Free File volume for the 2006 filing season was almost 4 million returns.
- *Easy payment options*: E-filers with a balance due can file early and schedule a safe and convenient electronic funds withdrawal from their bank account, or pay with a credit card.
- *Federal/State e-filing*: Taxpayers in 37 states and the District of Columbia can e-file their Federal and state tax returns in one transmission to the IRS. The IRS forwards the state data to the appropriate state agency.

We are also continuing our efforts to reduce taxpayer burden through the efforts of our Office of Taxpayer Burden Reduction (OTBR). Recent improvements in IRS forms, processes, and procedures coordinated through TBR include:

- *Simplified Tax Filing Requirements for Form 944:* Beginning January 1, 2006, certain employment tax filers are able to file the new Form 944 (Employer's Annual Federal Tax Return) once a year rather than filing Form 941 (Employer's Quarterly Federal Tax Return) four times a year. The first Form 944 is due January 31, 2007. Form 944 will also be available in Spanish (944SP and 944PR);
- *Revised Schedule K-1 for Partnerships, S-corporations and Trusts:* Form 1041 Schedule K-1 was revised for filing season 2006. The Schedule K-1has been simplified to reduce common errors and the burden associated with the preparation and filing requirements. Schedule K-1 for Forms 1065 and 1120S was revised last year;
- *Extension of Time to File:* We eliminated the need for filing Form 2688, Application for Additional Extension of Time to File U.S. Individual Income Tax Return, by allowing the taxpayer to get a 6 month extension to file initially. This change eliminates over 3.7 million forms and 2.2 million hours of taxpayer burden;

- *Disaster-related Burden Reduction:* As a result of recent disaster legislation, victims of hurricanes Katrina, Rita, and Wilma who experienced smaller earned incomes in 2005, can elect to compute their EITC and Additional Child Tax Credit using their larger 2004 earned income. A new IRS.gov feature – *Your 2004 Earned Income Option* – gives hurricane victims who lost their tax records immediate, 24/7, access to their 2004 earned income, allowing them to take advantage of this special election without filing delays. Taxpayers can access their 2004 earned income amount by entering two shared secrets to protect their confidential data. Hurricane victims without Web access can retrieve the same information through an automated phone application via a disaster hotline. Additionally, the EITC Assistant on IRS.gov helps hurricane victims estimate which year's earned income results in a larger EITC credit.

IRS.gov, electronic filing, and the efforts of OTBR are just three examples of a number of initiatives we have underway to utilize the latest technology to assist taxpayers in meeting their obligations. An underappreciated benefit of all of our e-service initiatives is that every electronic interaction we have with a taxpayer is one less human interaction. That means that those human resources can be devoted to other, more labor intensive activities that will help reduce the tax gap.

Enforcement

While we know that confusion and a lack of understanding are two contributors to the tax gap, we also know that some taxpayers consciously avoid paying what they owe. It is one thing for a small business to unknowingly apply incorrect depreciation rules to an asset, but it is something different for the same small business to fail to report income that it earned.

We have four enforcement priorities, which are to:

- Discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individual taxpayers, and other contributors to the tax gap;

- Assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law;

- Detect and deter domestic and offshore-based tax and financial criminal activity; and,

- Discourage and deter non-compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance. Detecting and investigating money laundering activity is an important part of tax

We are making progress on all four priorities but we are especially pleased with the first two as we are seeing evidence of changed behavior in the marketplace on the part of tax professionals, including accountants and lawyers. No longer are abusive tax shelters being marketed by top level accounting firms.

A prime focus of our enforcement efforts in recent years has been high income individuals, those with incomes in excess of $100,000, and corporations. In FY 2000, we audited 99,457 high income individuals. By FY 2005, that number had risen to almost 220,000. Similar increases can also be seen in the coverage rates. The rate in FY 2000 for high income individuals was 0.96 percent, as opposed to 1.57 percent in FY 2005. The coverage rate for those with incomes over $1 million is 5 percent. Our plan in FY 2006 is to complete 234,000 high income individual audits. We are well ahead of that schedule currently and may reach as many as 240,000 or more.

Over the last several years, the Service has also, by design, increased the coverage rate of corporations that we audit. In Fiscal Year (FY) 2005, we audited 10,800 corporations with assets over $10 million compared to approximately 9,500 in 2004. There was a coverage rate of 20 percent in FY 2005, a coverage rate of 16.7 percent in FY 2004, and a coverage rate of 12.1 percent in FY 2003. Based on year to date data we anticipate we will maintain the same level of audits in FY 2006 and the same coverage rate as in FY 2005.

For corporations with assets under $10 million, the coverage rate has increased as well. In FY 2005, we examined 17,858 small corporations, a coverage rate of 0.79 percent. This is more than double the audit rate in FY 2004 (0.32 percent). We expect our FY 2006 numbers to be similar to the 2005 numbers.

Overall, the enforcement dollars we collect has continued to rise. In FY 2001 we collected $33.8 billion. In FY 2005, that had risen to $47.3 billion. We expect when FY 2006 closes in a few days the enforcement revenue will rise again to approximately $49.1 billion.

While we are doing more, we are not yet where we want to be or need to be. Compliance by large businesses and high-wealth individuals remain two of the Service’s strategic priorities.

In general, we are attempting to take a proactive approach to dealing with the challenges of effective tax administration. Overall, our strategy depends on making compliance checks as much as possible on a real-time or near-real-time basis, being as current in our examinations as possible, and having as much transparency to book-tax differences and other indicators of risk as possible. To that end, we have initiated several programs that foster transparency, currency, pre-filing compliance opportunities, and improved efficiencies in issue and risk identification.

We have found that on particularly complex compliance issues cross-functional Issue Management Teams (IMTs) can be successful when we employ them to provide executive oversight and focus upon areas of high risk. We have used IMTs to combat tax shelters, and have expanded their use to include other areas of high compliance risk. We have also used special teams of experienced personnel to assist with the examination of specific issues in the tax shelter arena and plan to use similar teams to address other compliance issues. Additionally, we are working to enhance the use of internal web site information to better inform examiners of high risk areas and the steps they must take to ensure consistent application of the law. Let me mention some of our key efforts. First, to improve transparency on corporate tax returns, we introduced a new Schedule M-3. The Schedule M-3 provides transaction-specific detail on book-tax differences, enabling us to identify and focus more quickly and precisely on those tax returns and issues that present the highest potential compliance risk.

Second, we introduced the Compliance Assurance Program (CAP), to improve both currency and transparency. CAP is a real-time approach to compliance review that allows us, working in conjunction with the taxpayer, to determine tax return accuracy prior to filing. We believe CAP is more efficient than a post-filing examination–we are currently piloting the model and will refine it as necessary–as it provides corporations certainty about their tax liability for a given year within months, rather than years, of filing a tax return. This win-win program greatly reduces taxpayers' compliance burden and the need for reserving contingent tax liabilities on their financial statements, while increasing currency and allowing for more efficient use of our resources.

Third, we are conducting the Pre-Filing Agreement (PFA) program to provide taxpayers an opportunity to request that revenue agents examine and resolve potential issues before tax returns are filed. We continue to explore ways to improve and create additional pre-filing compliance opportunities.

Fourth, we are also attempting to identify emerging high risk issues as early as possible, issuing guidance to taxpayers and examiners on the proper treatment of these issues, and efficiently and vigorously examining those returns where taxpayers engage in that behavior.

Fifth, we are mandating, in stages, the electronic filing of large corporate returns *(E-filing)* in order to improve issue identification and the selection for examination of high risk returns. Large corporations are required now to file their tax returns electronically and this mandate will expand in future tax years. *E-filing* will provide more consistent treatment and data analysis for efficient, near real time identification of high risk issues and taxpayers. *E-filing* and Schedule M-3 together also allow us to more efficiently identify and exclude lower risk taxpayers from consideration for examination.

Two of the key challenges facing revenue bodies around the world in the 21st century are international non-compliance and organizational reforms for more effective tax administration. I just returned 10 days ago from chairing the meeting of the Organization for Economic Co-operation and Development's (OECD) Forum on Tax Administration held in Seoul, South Korea. The leaders of tax administrations in 30 countries were in attendance.

One of the things we concluded was that enforcement of our respective tax laws has become more difficult as trade and advances in communication technologies have opened the global marketplace to a wider spectrum of taxpayers. While this more open economic environment is good for business and global growth, it can lead to structures which challenge tax rules, and schemes and arrangements by both domestic and foreign taxpayers to facilitate non-compliance with our national tax laws. We agreed to improve practical co-operation between revenue bodies and other law enforcement agencies of governments to counter non-compliance.

Our discussions also revealed continued concerns about corporate governance and the role of tax advisors and financial and other institutions in relation to non-compliance and the promotion of unacceptable tax minimization arrangements. We also noted the increased flows of capital into private equity funds and the potential issues this may raise for revenue bodies.

We identified four areas in which we will intensify existing work or initiate new work under the auspices of the OECD:

- Further developing the directory of aggressive tax planning schemes so as to identify trends and measures to counter such schemes.
- Examining the role tax intermediaries (e.g., law and accounting firms, other tax advisors and financial institutions) in relation to non-compliance and the promotion of unacceptable tax minimization arrangements with a view to completing a study by the end of 2007.
- Expanding the OECD 2004 Corporate Governance Guidelines to give greater attention to the linkage between tax and good governance.
- Improving the training of tax officials on international tax issues, including the succession of officials from one administration to another.

Legislative Initiatives

While fundamental tax reform is the only comprehensive solution to reducing the tax gap, until that is achieved, we must work within the current system to reduce the tax gap as much as possible. Allow me to discuss five specific legislative proposals that were offered as part of the FY 2007 budget and designed to reduce the tax gap. Collectively, these five changes should generate $3.6 billion over the next ten years.

The first, and perhaps most important, proposal would increase reporting on payment card transactions. Our tax gap study shows clearly that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. More than 150 million wage earners already have their information reported directly by their employer to the IRS and the noncompliance rate for this group is approximately 1 percent. All of these wage earners are also subject to mandatory withholding of taxes.

Payment cards (including credit cards and debit cards) are being used increasingly in retail business transactions. The failure of some merchants to report accurately their gross income, including income derived from payment card transactions, accounts for a significant portion of the tax gap and creates an unfair competitive advantage for those businesses that underreport.

The Administration proposes that the Treasury Secretary be given the authority to promulgate regulations requiring annual reporting of the aggregate reimbursement payments made to merchants in a calendar year. Withholding would only be required as a backup in the event that a merchant payee fails to provide a valid taxpayer identification number.

Because reimbursement information is already provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on payment card companies and no burden on the affected merchants. Finally, the IRS will be able to use payment card reporting information to better focus its resources and relieve the burden that existing audits place on businesses that accurately report their gross income.

The second legislative proposal would clarify when employee leasing companies can be held liable for their clients' Federal employment taxes. Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Typically, these firms prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of the clients' workers.

Noncompliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, it may be unclear whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to the wages paid by a company that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes should be assessed and collected.

The Administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also allow employee leasing companies to qualify to be solely liable if they met certain specified standards.

Our third proposal would amend collection due process procedures for employment tax liabilities. Currently, we are authorized to take various collection actions including issuing Federal tax levies to collect past-due taxes. Before a Federal tax levy can be issued, however, the IRS generally must provide the taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing and judicial review.

Frequently, an employer who fails to satisfy its Federal employment tax liabilities for one period will also fail to satisfy them for later periods, resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing or judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities during the CDP proceedings. Liabilities for the subsequent periods cannot be collected by levy until the employer has been given notice and opportunity for a hearing and judicial review for each period. The existing CDP framework compounds the pyramiding problem by depriving the government of enforced collection as a tool to encourage employers to satisfy their current Federal employment tax obligations.

Our proposal would allow the levy to be imposed prior to a CDP hearing in a fashion similar to current law provisions for levies issued to collect a federal tax liability from a state tax refund. Taxpayers would have the right to a CDP hearing with respect to employment tax liabilities within a reasonable time after the levy. Taxpayers would also continue to have access to existing pre-collection administrative appeal rights other than CDP.

The fourth proposal would require increased information reporting and backup withholding for certain government payments for property and services. While the dollar amount of the tax gap attributable to non-compliant government vendors may be relatively small, recent Congressional hearings have highlighted the significant indirect impact on compliance of government payments being made to taxpayers who fail to meet their own tax obligations. A modified version of this proposal was enacted in the Tax Increase Prevention and Reconciliation Act of 2006. Under that Act, those payments will be subject to withholding at a 3 percent rate, beginning in 2010.

The final legislative proposal would expand the signature requirement and penalty provisions applicable to paid tax return preparers. Under current law, a paid tax return preparer is required to sign and include his/her taxpayer identification number (TIN) on an income tax return and related documents that he/she prepares for compensation. Paid return preparers, however, are not required to sign and include their TINs on non-income tax returns, such as employment tax returns, excise tax returns, and estate and gift tax returns, and tax return related documents filed with the IRS. The Administration's proposal would expand preparer identification and penalty provisions to non-income tax returns and tax return-related documents prepared for compensation. Further, it would impose penalties for preparing tax return related documents that contain false, incomplete, or misleading information or certain frivolous positions that delay collection.

These legislative proposals strategically target areas where (1) research reveals the existence of significant compliance problems, (2) improvements will burden taxpayers as little as possible, and (3) the changes support the Administration's broader focus on identifying legislative and administrative changes to reduce the tax gap.

FY 2007 Budget

A critical element in our ability to make a serious dent in the tax gap is to have the necessary resources available to fund our service, enforcement, and information technology programs. We are grateful that Congress saw fit to fully fund the IRS in FY 2006. This allowed us to focus additional resources on the following key initiatives:

- Increased coverage of high-risk compliance problems to address the largest portion of the tax gap --- the underreporting of tax--- across all major compliance programs;
- Complex, high-risk issues in abusive tax avoidance transactions, promoter activities, corporate fraud, and aggressive transactions, resulting in increased corporate and high income audit coverage;
- Efforts aimed at reversing the erosion of individual tax compliance and support of the strategy to implement a balanced compliance program;
- Improved ability to identify compliance risks and significantly expanded coverage of tax-exempt organizations;
- Safeguarding compliant customers from unscrupulous promoters through earlier detection of abusive schemes and heightened efforts to prevent their proliferation; and
- Increased vigilance to ensure the assets of tax-exempt organizations are put to their intended tax-preferred purpose and not misdirected to fund terrorism or for private gain, including enhanced processing of questionable exemption applications and increased technical support to the examination process.

Our total budget request for FY 2007 is $10.6 billion in direct appropriations, supplemented by $135 million in new user fee revenue, for a total operating level of $10.7 billion. This request represents a total increase of 1.4 percent from the FY 2006 enacted level. The FY 2007 Budget sustains the enforcement funding increase provided in FY 2006 to improve tax compliance. More importantly, the budget maintains the balance between service and enforcement.

Unfortunately, the House Appropriations bill reduces the President's request for IRS by nearly $105 million. If this were to be enacted, it would represent a serious setback for our overall efforts to reduce the tax gap.

The bill approved by the Senate Appropriations committee is much more reflective of the President's request and the resource needs of the IRS in the coming fiscal year.

Conclusions

On the whole, our system of self-assessment of tax liabilities works well. Most countries would be thrilled to have a voluntary compliance rate of almost 84 percent.

We owe it, however, to compliant taxpayers to do everything we can to make sure we collect as much as possible of the other 16 percent. Otherwise, honest taxpayers are asked to carry an unfair and unnecessary burden.

It is clear that consistent efforts to keep the complexity and unnecessary burden of the tax system to a minimum, to provide the excellent service that the taxpaying public deserves, and to maintain a strong and well targeted enforcement presence are necessary to improve compliance rates. We also know that transparency and third party reporting are critical components to ensuring compliance

We will continue our efforts to maintain the balance between service and enforcement. In addition to providing excellent service and maintaining a strong respect for taxpayer rights, we must have the resources and the tools to enforce the laws. Adoption of the President's budget request for our agency, along with the legislative proposals, will make sure we have those tools for another year.

Thank you for the opportunity to discuss the tax gap and our efforts to combat it. I am happy to take your questions.