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**Before the
Subcommittee on Federal Financial Management, Government Information,
and International Security**

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Homeland Security and Governmental Affairs**

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Mr. Chairman and distinguished members of the Subcommittee:

Thank you for inviting me to testify before your subcommittee today about the tax gap. My testimony will focus on one particular aspect of the tax gap -- the cash economy -- and what the IRS is doing and can do about increasing compliance in that area. I will also discuss the important contributions that taxpayer service and the protection of taxpayer rights can make to closing the tax gap.¹

The Tax Gap

The IRS develops estimates of both the “gross tax gap” and the “net tax gap.” The gross tax gap is the amount of tax that is imposed by law for a given tax year, but is not paid voluntarily and timely. The net tax gap is the portion of the gross tax gap that is not collected after all IRS and taxpayer actions have been completed for a given tax year.

The IRS’ most recent estimates, based upon 2001 tax year returns, indicate that the gross tax gap is between \$312 and \$353 billion annually.² After accounting for amounts that the IRS receives as late voluntary payments or as a result of collection activity, the IRS estimates the net tax gap is between \$257 and \$298 billion.³

The collective failure by certain taxpayers to pay their taxes imposes greater burdens on other taxpayers. The IRS receives approximately 130 million individual income tax returns each year.⁴ Given the size of the net tax gap, the average tax return includes a “surtax” of about \$2,000 to make up for tax revenues lost to noncompliance. The tax gap may also impose significant costs on businesses in the form of unfair competition by noncompliant competitors who can pass along a portion of their tax “savings” to customers by charging lower prices.

Most importantly, the tax gap can erode the level of confidence that taxpayers have in the government, thereby reducing federal revenue and increasing the need for more examination and collection actions. The tax gap, then, can produce a vicious cycle of increased noncompliance and increased enforcement.

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute authorizing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS or the Treasury Department. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the Commissioner or the Secretary for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

² IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

³ IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

⁴ IRS, *Statistics of Income Bulletin, Spring 2005*, Publication 1136 (Rev. 2-2004) (Table 22).

Composition of the Tax Gap

The tax gap can be looked at through several lenses. For example, we can view the tax gap by the type of noncompliance – nonfiling, underreporting, and underpayment – or by the type of tax – income, employment, estate or excise. The IRS’s 2001 National Research Program (NRP) study updates its current tax gap estimates for underreported individual income and self-employment taxes, which together are by far the largest component of the tax gap. In fact, the IRS estimates that underreporting accounts for more than 80 percent of the tax gap.⁵

The IRS estimates that individual income and self-employment taxes on unreported business income range from \$134 to \$155 billion, almost one-half of the gross tax gap. Based on earlier 2001 estimates, fully 67 percent of the gross tax gap is attributable to nonpayment of income taxes and employment taxes by self-employed individuals.⁶

The self-employed community always reacts a little defensively to these statistics, and understandably so. So let me emphasize one point here: No one – certainly not I – is suggesting that self-employed persons are any less honest than wage earners employed by businesses. However, there are certain aspects about the way the tax system treats self-employed persons that provide what I call “opportunities for noncompliance.” I use this term because it encompasses both inadvertent and deliberate noncompliance.

While all wages paid to employees are subject to withholding and third-party reporting, payments to self-employed persons are rarely subject to withholding and are often not subject to third-party reporting. Tax withholding and third-party reporting are important tools in the IRS’s effort to increase compliance. For example:

- Where payments are subject to withholding, IRS estimates that compliance is almost 100 percent.⁷
- Where payments are reported to the IRS, IRS estimates that compliance is about 96 percent.⁸

⁵ Individual income and self-employment tax underreporting can arise from a number of sources, including understated income and overstated deductions, expenses, and claims. The preliminary 2001 NRP data estimates that underreporting ranges from \$250 to \$292 billion. IRS National Headquarters Office of Research, *Tax Gap Facts and Figures*, March 29, 2005.

⁶ This estimate includes underreporting, non-filing and non-payment of income and employment taxes by all self-employed taxpayers. IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001).

⁷ IRS National Headquarters Office of Research, (July 2004).

⁸ IRS National Headquarters Office of Research, (July 2004).

- Where payments are not reported to the IRS at all, overall compliance is substantially lower.⁹

The above data tell us what most people intuitively expect: Where a taxpayer knows the IRS is aware of a payment, the taxpayer generally will report it on his or her return. Where a taxpayer thinks the IRS has no clue about the payment, the likelihood that the taxpayer will report the payment is substantially lower. The large majority of the tax gap attributable to self-employed persons does not result from payments reported to the IRS on a Form 1099. Most of that tax gap results from payments not reported to the IRS. In other words, the bulk of the tax gap is attributable to the “cash economy.”¹⁰

The Cash Economy

Although the IRS has no direct estimate of the portion of the tax gap attributable to the so called “cash economy,” unreported income from the cash economy is probably the single largest component of the tax gap.¹¹ Self-employed individuals often receive income from cash economy transactions.¹² As noted earlier, approximately 67 percent of the tax gap is attributable to self-employed individuals.¹³ Underreporting by self-employed individuals represents \$134 to

⁹ The IRS estimates that compliance among informal suppliers is about 20% and one IRS study estimates the compliance rate among self-employed persons overall at about 68%. IRS National Headquarters Office of Research, (July 2004).

¹⁰ The term “cash economy” generally refers to legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting. See *Bridging the Tax Gap: Hearing before the Committee on Finance, United States Senate, 108th Cong.*, 21 (July 21, 2004) (statement of Professor Bankman defining the cash economy as “your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting”).

¹¹ It is important to note that some noncompliance in the self-employed sector may be attributable to inadvertent noncompliance, including noncompliance due to the complexity of the tax law. Self-employed businesses are small and often marginal businesses; cash is very dear to them. Thus, some self-employed underpayments are attributable to a lack of a withholding – or forced saving – mechanism.

¹² According to Professor Bankman:

[O]nce an enterprise gets large, even if it is family-owned, the rate of noncompliance falls. That is because it is thought that either the owners, or their trusted employees, or their families have to cheat, and you cannot if you have nine outlets. You can really only cheat at the one controlled by the family.

Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate, 108th Cong., 23 (July 21, 2004).

¹³ IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001) (indicating that self-employed taxpayers are responsible for about 67 % of the tax gap). This estimate includes underreporting, non-filing and non-payment of income and employment taxes by self-employed taxpayers. It is consistent with prior estimates. See Small Business/Self-Employed, *Strategic Assessment Report FY 2004-2005*, 5 (March 11, 2003) (stating that SB/SE taxpayers are responsible for 68 % of the tax gap and that sole proprietors are responsible for 94 % of SB/SE’s share of the tax gap); SB/SE Research, *Small Business/Self-Employed Compliance*

\$155 billion, or about 43 percent, of the gross tax gap.¹⁴ Over 80 percent of this underreporting is attributable to understated income rather than overstated deductions.¹⁵ These estimates suggest that underreporting by self-employed taxpayers represents the single largest component of the tax gap, accounting for more than a third of the gap and over \$100 billion per year.

Self-employed individuals and other cash economy participants understate their income primarily because it is not subject to withholding or information reporting. As noted above, IRS research indicates that taxpayers whose wages are subject to withholding report 99 percent of their wage income.¹⁶ Similarly, taxpayers report about 96 percent of their income that is subject to information reporting.¹⁷ In contrast, taxpayers whose income is not subject to withholding or information reporting, report only about 68 percent of their income.¹⁸ This percentage drops to 20 percent for certain sole proprietors (called “informal suppliers”) who operate “off the books” on a cash basis in areas such as street vending, door-to-door sales, child care, or moonlighting in a trade or profession.¹⁹

Research suggests that the cash economy is growing. According to one estimate the “underground economy,” which includes both the cash economy and illegal activities, increased from four percent of the U.S. Gross National Product in 1970 to nine percent in 2000.²⁰ A recent study finds that up to 29

Risk Assessment, FY 04-05 Strategic Planning Cycle, 28 (Jan. 31, 2003) (stating that Schedule C filers are responsible for 59.2 % of the tax gap).

¹⁴ IRS estimates indicate that taxpayers who underreport business income on individual returns account for \$83 to \$99 billion of the tax gap and taxpayers who underreport self-employment taxes accounts for \$51 to \$56 billion. IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005). The IRS’ tax gap estimates may understate the portions of the tax gap attributable to cash economy transactions because such transactions are inherently difficult to detect. See IRS Office of Research, Analysis, and Statistics (RAS), *Preliminary Update of the TY 2001 Individual Income Tax Underreporting Tax Gap Estimates*, 8-16 (June 7, 2005); James Alm & Brian Erard, *Estimating the Informal Supplier Tax Gap*, 2005 IRS Research Conference (June 7, 2005) available at

http://aysps.gsu.edu/people/working/IRS2005ResearchConference-Alm_Erard-Abridged.doc.

See also, Government Accountability Office, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753, 12 (July 2005).

¹⁵ IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001*, (June 7, 2005).

¹⁶ IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

¹⁷ IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

¹⁸ IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

¹⁹ IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

²⁰ See Friedrich Schneider & Dominik Enste, Economic Issues No. 30 -- *Hiding in the Shadows: The Growth of the Underground Economy*, IMF, (March 2002) available at

<http://www.imf.org/external/pubs/ft/issues/issues30/index.htm>.

percent of the workers in Los Angeles County California are paid in cash and do not have federal or state payroll taxes withheld.²¹

IRS Enforcement Priorities

The IRS is currently placing priority emphasis on combating corporate tax shelters and abusive schemes used by high-income individual taxpayers. This approach is justifiable for two reasons. First, corporate tax shelters and abusive schemes have received extensive press coverage, and it is essential that the public not perceive these taxpayers as “getting away with anything.” Second, the direct revenue gains from a single audit are much higher for high-income taxpayers.

In light of the updated tax gap data, however, the IRS needs to develop a broader long-term focus, particularly with respect to the cash economy. Clearly, the Treasury’s and IRS’s emphasis on combating corporate tax shelters and abusive schemes by individuals has had an effect on such activity. The good news, based on our conversations with tax professionals in law and accounting firms, is that the truly abusive deals have largely stopped. The bad news is that the tax revenues to be gained from focusing so heavily on these schemes predictably will dry up in the next few years.

There will always be yet another scheme or shelter that someone is hatching somewhere, and the IRS needs to have a strategic plan for identifying and addressing these products before they gain much ground. At the same time, the IRS must turn its focus to the largest portions of the tax gap, including the self-employed. There is simply no way to make significant progress in reducing the tax gap if we fail to aggressively go after the segment responsible for two-thirds of that gap. Indeed, the perception that the IRS is focusing so heavily on corporate tax shelters and abusive schemes could widen the tax gap if it continues for too long. In particular, if taxpayers operating in the cash economy believe that the IRS is devoting most of its attention to going after others, they may be emboldened to cheat even more.

Notwithstanding that the cash economy is responsible for the largest share of the tax gap, the IRS is currently directing only 14 percent of its examination resources to Schedule C returns,²² and these examinations predominantly focus on high income taxpayers. The IRS’s current examination work plan does not do nearly enough to address the cash economy.

²¹ Pascale Joassart-Marcelli & Daniel Flaming, *Workers Without Rights: The Informal Economy in Los Angeles*, Economic Roundtable Briefing Paper, 2002. Interestingly, the authors of this study conclude that since unions help to formalize the employment conditions of informal workers they may help to reduce the number of workers in the cash economy.

²² IRS, Report to Congress: *IRS Tax Compliance Activities*, July 2003; AIMS Database (closed cases), IRS Examination Table 37 – An Examination activity management report and Automated Financial System (AFS) Database.

The Tax Gap Presents a Challenge to IRS Enforcement

Except for costly field examinations, the IRS' traditional enforcement tools are unlikely to be effective in detecting unreported income from the cash economy because these tools rely on information reporting, and income from the cash economy is not subject to information reporting. IRS focus group discussions by practitioners illustrate how difficult it will be for the IRS to address underreporting by cash economy participants.²³ For example, it suggests that (1) some workers pass along most of their tax "savings" to customers or employers when paid "under the table," (2) underreporting may be rampant, at least in certain areas, (3) underreporting income from cash transactions may expand even faster as those transactions move to the Internet, and (4) the IRS is frequently unable to deter or detect underreporting among cash economy participants.

Traditional Enforcement Tools Are Not Effective in Targeting Cash Economy

Most traditional tools that the IRS uses to address unreported income or unfiled returns are not effective when applied to the cash economy. The IRS typically uses its Examination, Automated Underreporter (AUR, also called Document Matching), and Automated Substitute for Return (ASFR) programs to contact taxpayers to resolve unreported income and nonfiling issues. The AUR Program automatically matches the items reported on a tax return with information reported by payers on information returns.²⁴ Similarly, the ASFR Program relies on data from information returns or prior year returns to prepare substitute returns and assessments for individuals who fail to file after the IRS sends them a notice.²⁵

Correspondence examinations also rely heavily on information reporting. While Correspondence Examiners may request certain documents to identify unreported income, Revenue Agents and Tax Compliance Officers who conduct field and office examinations, respectively, use more sophisticated indirect methods.²⁶ Unlike Correspondence Examiners, Revenue Agents also use a "dynamic" examination strategy and will change the focus of their examination in

²³ SB/SE Research – Brooklyn/Hartford, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups*, Project 01.08.003.04, 12 (Dec. 2004).

²⁴ See, Department of the Treasury, Internal Revenue Service, Report to Congress: *IRS Tax Compliance Activities*, July 15, 2003, 5.

²⁵ See IRM § 5.1.11.6.5 (May 27, 2003).

²⁶ IRM § 4.10.4 (June 1, 2004); IRM § 4.19.1.2.3.1(12) (Oct. 1, 2004); IRM § 4.10.4.3.5 (June 1, 2004). Similarly, when a Revenue Officer (*i.e.*, IRS collection personnel working in the field) files a substitute for return for a high income nonfiler, he or she is required to observe the taxpayer to determine if sufficient income is reflected on the information reporting documents before filing the substitute for return. See IRM § 5.1.11.6.3.1 (May 5, 2003).

response to new information.²⁷ This dynamic approach allows agents to find unreported income that would not be possible in the context of a limited scope correspondence examination.

Field examinations also differ from correspondence examinations because Revenue Agents are required to conduct certain “filing checks” to ensure that taxpayers have filed all of their returns, including information returns. These filing checks often lead to an expansion of the audit to include additional years or other taxpayers, which can uncover unreported income.²⁸ Thus, although correspondence examinations could be slightly more effective than ASFR and AUR in identifying unreported income from the cash economy, field examinations (and possibly office examinations) are likely to be the IRS’ most effective tools for identifying such income.

Unfortunately, field examinations are more expensive than AUR, ASFR and other examinations.²⁹ As a result, the IRS uses them sparingly. In FY 2004, the IRS made AUR adjustments to 1,948,363 individual returns, filed 198,362 individual returns using its ASFR program, and examined 1,007,874 individual returns.³⁰ However, it only examined 195,054 individual returns using either field or office examinations.³¹

The IRS’s Current Efforts to Address the Cash Economy

The IRS is presently pursuing a number of initiatives that could be more effective in addressing noncompliance in the cash economy if it pursued them more aggressively. These efforts include:

²⁷ IRM § 4.10.4.1(2) (June 1, 2004).

²⁸ See IRM § 4.10.5 (May 14, 1999).

²⁹ Typically, Revenue Agents who conduct field examinations are more highly paid than Tax Compliance Officers who conduct office examinations and Correspondence Examiners who conduct correspondence examinations, as well as the IRS employees working ASFR and AUR processes. United States Office of Personnel Management, Operating Manual, Qualification Standards for General Schedule Positions (March 22, 1999); AWSS Human Resources Systems Office (HRSO), Workforce Information by Organization (June 11, 2005).

³⁰ IRS Data Book, Publication 55B, Table 10 – Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, FY 2004; IRS Data Book, Publication 55B, Table 26 - Taxpayer Contact Information, by Type of Math Error and Selected Program, FY 2004 (ASFR and AUR statistics).

³¹ IRS Data Book, Publication 55B, Table 10 – Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, FY 2004.

Refining the Unreported Income Discriminant Function (UI-DIF)

UI-DIF is a tool for identifying returns that are most likely to have unreported income.³² The IRS has begun using and refining this tool.³³

Examining More Sole Proprietors in the Field

Although the likelihood that the IRS will audit a sole proprietor has not changed significantly, the IRS has increased the likelihood that when sole proprietors are examined the examinations will be conducted in the field. The percentage of the non-EITC Schedule C examinations conducted in the field (rather than in an office or by correspondence) increased from 35 percent of the total number of non-EITC Schedule C examinations in FY 2003 to 47.5 percent in FY 2004.³⁴ As discussed above, field examinations are the most effective types of examination for detecting unreported income generated by cash economy transactions.

Obtaining State and Local Tax Information

The IRS is working with state and local governments, with a primary focus on using state information to identify business non-filers and tax shelter investors.³⁵ As of February 2004, the IRS had 1,925 agreements and initiatives in place to share data with federal, state and local government agencies, including the following:³⁶

- The State Revenue Agent Report Initiative. The IRS receives examination reports from some states on a monthly basis. These reports provide state tax examination results that the IRS can and sometimes does use as leads to make federal tax adjustments.
- The State Sales Tax Matching Project. Some states provide the IRS with sales tax records that it can and sometimes does use to match against income tax records to identify potential unreported income.

³² See generally, Treasury Inspector General for Tax Administration, Ref. No. 2003-30-146, *Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program*, (July 2003).

³³ See Publication 3744, *IRS Strategic Plan 2005-2009*, 19 (June 2004); SB/SE Strategy and Program Plan FY 2004 – FY 2005, (Sept. 25, 2003); SB/SE Strategy and Program Plan FY 2004–FY 2005, 28 (Sept. 25, 2003). IRS research recently concluded that a high UI-DIF score is a good predictor of unreported income by certain types of sole proprietorships. Denver SB/SE Research, *Research Report: Utilize Exam Results to Further Evaluate UI DIF Scores*, Project 03.08.002.03, iii (March 2005).

³⁴ SB/SE, AIMS Database (Closed Cases), IRS Examination Table 37 (Apr. 2005).

³⁵ See Publication 3744, *IRS Strategic Plan 2005-2009*, 20 (June 2004); *Bridging the Tax Gap: Hearing before the Committee on Finance, United States Senate*, 108th Cong., 50 (July 21, 2004) (statement of Commissioner Everson). See also IR-2004-77 (June 7, 2004).

³⁶ IRS Office of Governmental Liaison, Response to TAS Information Request (July 27, 2005).

- Ad Hoc Initiatives. The IRS has a variety of ad hoc information sharing initiatives with various states and localities. For example, IRS obtains some lists of business license applicants to identify nonfilers.

Obtaining Information on Cash Transactions in Excess of \$10,000

Any person engaged in a trade or business and who, in the course of that trade or business, receives more than \$10,000 in cash in one transaction (or two or more related transactions) is required to inform the IRS by filing Form 8300, *Report of Cash Payments Over \$10,000 Received in a Trade or Business*.³⁷ The IRS uses information from Form 8300 to identify returns that may have unreported income.³⁸

Entering Into Voluntary Compliance Agreements

The IRS sometimes enters into voluntary compliance agreements, including TIP agreements, to improve reporting compliance.³⁹ Instead of auditing the tax returns of employers and tipped employees, which burdens the employees and employers as well as IRS, the IRS negotiates two basic types of agreements with employers (who are generally in the food and beverage, cosmetology or gaming industries) to improve compliance by their individual employees in reporting tip income: Tip Rate Determination Agreements (TRDAs) and Tip Reporting Alternative Commitments (TRACs).⁴⁰

Under a TRDA, the IRS and the business agree upon a tip rate for various occupations in the business and at least 75 percent of the business' employees agree to report at that rate on their income tax return. Under a TRAC, the business educates all of its employees about their obligation to report tip income and establishes procedures to promote reporting. These agreements are attractive to businesses because the IRS generally will not audit them while the TIP agreement is in effect.⁴¹ In FY 2005, the IRS expected to secure over 180 new agreements.⁴² The TIP agreements generally increase the amount of tip

³⁷ See IRC § 6050I.

³⁸ See IRM § 4.26.15.4 (Jan. 1, 2003).

³⁹ SB/SE Strategy and Program Plan FY 2004 – FY 2005, 21 (Sept. 25, 2003).

⁴⁰ For useful background information about TIP agreements, see IRM § 4.23.7.3 (Mar. 1, 2003); Publication 1875, *Tips on Tips* (Apr. 2004); SB/SE Research, Brooklyn/Hartford, Project No. 01.08.004.03, *Update the Report on 'The Effect of Tip Compliance Efforts on Tip Reporting,'* (July 2003); General Accounting Office, GAO-03-378, *IRS Should Continue to Expand Reporting on Its Enforcement Efforts*, 49 (Jan. 2003); Treasury Inspector General for Tax Administration, Ref. No. 2001-30-076, *Opportunities Exist to Improve the Tip Rate Determination and Education Program* (May 2001). One variation of a TRAC, called an Employer-designed Tip Reporting Alternative Commitment Agreement (EmTRAC) allows employers to modify the TRAC agreement.

⁴¹ IRM § 4.23.7.3(4) (Mar. 1, 2003).

⁴² SB/SE Strategy and Program Plan FY 2004 – FY 2005, 21 (Sept. 25, 2003).

income reported by employees who receive tips and the amount of FICA taxes paid by employers on employee wages received as tips.⁴³

Making it Easier to Pay Taxes Electronically or by Phone

Taxpayers may use an Electronic Funds Transfer Payments System (EFTPS) to make estimated tax payments or deposits electronically or by telephone.⁴⁴ EFTPS makes it easier for all taxpayers, including cash economy participants, to pay their taxes. For new enrollees the IRS will even waive one prior failure to deposit penalty.⁴⁵ However, IRS efforts focus on encouraging taxpayers to use EFTPS for depository taxes such as employment taxes rather than for estimated tax payments. In FY 2004, the IRS received 61 percent of all employment tax payments (and 95 percent of all employment tax dollars) through EFTPS, but in TY 2004 it received less than one percent of all estimated individual income tax payments (and less than one percent of all individual estimated tax payment dollars) through EFTPS.⁴⁶ The IRS may be focusing its efforts on depository receipts because the IRS is required by law to use an electronic system to collect 94 percent of all depository taxes.⁴⁷ No such requirements exist for estimated tax payments.

What Else Can We Do to Address the Cash Economy?

At a Senate Finance Committee hearing on the tax gap in July 2004, Senator Baucus asked the Commissioner to develop a list of options to address the tax gap and asked that they be characterized as “most stringent,” “most lenient,” and “moderate.”⁴⁸ In my 2004 Annual Report to Congress, I listed 24 steps that could

⁴³ See IRC § 3121(q); Treas. Reg. § 31.3102-3. Employers have an incentive to enter into TIP agreements because when employees fail to report tip income, which is considered a wage, the employer also fails to pay its share of the FICA taxes due on employee wages. In the absence of a TIP agreement, the IRS could assess additional FICA taxes against the business on audit. In contrast, businesses that properly classify their service providers as independent contractors have less incentive to enter into TIP agreements because they are not required to pay FICA taxes on amounts paid to independent contractors. Furthermore, since service providers often pass along some of their tax “savings” from underreporting to their “employer” by charging less for their services, the benefit of paying service providers “under the table” may, in many cases, exceed the cost of complying with information reporting requirements.

⁴⁴ EFTPS is the Treasury’s electronic remittance processing system for making federal tax deposits and payments. Once enrolled in EFTPS, a taxpayer may initiate electronic payments with a telephone call or by using a computer. See IRM Exhibit 3.0.273-2 (Jan. 1, 2005) and <http://www.EFTPS.gov>.

⁴⁵ Publication 4048, *EFTPS: Special IRS Penalty Refund Offer for Businesses* (Feb. 2004).

⁴⁶ Senior Tax Analyst – IRS, Wage & Investment Division, Customer Account Services, Submission Processing, Response to TAS Information Request (Oct. 5, 2005).

⁴⁷ See IRC § 6302(h).

⁴⁸ U.S. Senate Committee on Finance, Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (Release Date: July 8, 2004) (Doc 2004-15394), (Q&A of Commissioner Mark W. Everson), 56.

address the tax gap, and without expressing an opinion about the wisdom of any particular item, I identified key benefits and burdens associated with each.

One principle underlying many of these options is that their goal should be to *reduce opportunities for noncompliance*. This principle is important for two reasons. First, by reducing opportunities for noncompliance, we will bring in more revenue with a minimal direct expenditure of IRS resources. Second, fewer taxpayers will get caught up in audits, requests for substantiation, and claims for interest and penalties. Audits are burdensome and frustrating for taxpayers, so everyone benefits if we can make the liability clear on the front end and avoid the need for compliance actions on the back end.

With this concept in mind, I attach a full list of these options at the end of my written statement, and I will highlight a few of the key proposals here.⁴⁹

IRS Must Conduct or Sponsor Much More and Better Research

The IRS needs research to show the most effective use of its resources after taking into account the direct and indirect effects of its activities.⁵⁰ IRS activities have indirect revenue effects, which in most cases are probably greater than the direct effects. Assume, for example, that the IRS increases the rate at which it audits a cash-based industry like construction and conducts the audits effectively so that it discovers any unreported income. The indirect revenue gains resulting from these audits would probably exceed the direct revenue gains by a large margin as word spreads throughout the industry that cash income is actually subject to tax and as each industry participant realizes that the IRS is examining taxpayers just like him or her. IRS economists have estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment.⁵¹

However, not all audits have the same effect on compliance. One dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing a corporate tax shelter. A dollar spent on an ineffective audit may actually have a negative effect on compliance if it teaches taxpayers that they will not be caught even if audited. On the other hand, one dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax

⁴⁹ The table included with this written statement includes references to text contained in the *National Taxpayer Advocate's 2004 Annual Report to Congress*. The report, in its entirety, is available at <http://www.irs.gov/advocate/article/0,,id=133967,00.html>

⁵⁰ See generally, Government Accountability Office, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (July 2005).

⁵¹ Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), 35-36; Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986*, 43 Nat. Tax J. 395, 396, 405 (1990).

law questions, has a positive indirect effect on compliance.⁵² The IRS does not have current research to show where the next dollar is best spent. We do not even know whether the next dollar is best spent on enforcement or for taxpayer service.⁵³ Thus, in the absence of better research, it is important to emphasize that current decisions about how much to increase or decrease certain activities represent merely a policy call based on educated guessing.

Each taxpayer is compliant or noncompliant for a different reason, and a comprehensive approach to reducing the tax gap must recognize these differences.⁵⁴ Because unreported income from the cash economy is so difficult and costly for the IRS to detect and deter through traditional enforcement methods, the indirect effect of the IRS' activities is even more important in fostering compliance among these taxpayers than for the general population.

Revise Tax Forms

The IRS should revise Form 1040, Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, to include separate lines showing (1) the amount of income reported on Forms 1099 and (2) other income not reported on Forms 1099. IRS research shows that taxpayers are more likely to report income if it was reported to the IRS on information-reporting documents, such as Form 1099.⁵⁵ Some taxpayers appear to believe that income not reported on information returns is not subject to tax or at least that the IRS will not notice if they do not report it.⁵⁶ Breaking out gross receipts on the income tax form would likely improve compliance by emphasizing that income not reported on information reporting documents is still subject to tax. It may also suggest to taxpayers that the IRS will notice if they do not report any other income. Another benefit of such a revision is that it would allow the IRS to match the income reported on Schedule C with income reported on Forms 1099 more easily.

⁵² IRS researchers previously estimated that every dollar the IRS spent on return preparation generated \$396 dollars of additional tax revenue. See Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), 41.

⁵³ See Government Accountability Office, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (July 2005); Treasury Inspector General for Tax Administration, Ref. No. 2005-10-159, *A Better Model Is Needed to Project the Return on Additional Investments in Tax Enforcement* (Sept. 2005); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap (April 14, 2005); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies (April 7, 2005).

⁵⁴ For a discussion of the categories of taxpayer noncompliance, see Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003).

⁵⁵ IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

⁵⁶ See SB/SE Research – Brooklyn/Hartford, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups*, Project 01.08.003.04, 9 (Dec. 2004).

The IRS should also require all businesses (*i.e.*, sole proprietors, corporations and partnerships) to answer two questions on their income tax returns:

- Did you make any payments over \$600 in the aggregate during the year to any unincorporated trade or business?
- If yes, did you file all required Forms 1099?

These two questions would alert uninformed taxpayers of their reporting obligations and encourage them to comply. The questions would also alert taxpayers that the IRS is looking at information reporting compliance and that there is some additional risk to avoiding the information reporting requirements by paying contractors “under the table.” Since taxpayers must sign tax returns under penalty of perjury, they may be hesitant to answer such direct questions inaccurately.

Use Available Information

The IRS should aggressively use information available from state and local governments, from Forms 8300, and its UI-DIF tools to effectively audit taxpayers operating in the cash economy who are underreporting their income. Although the IRS has access to state and local tax information, reporting on large cash transactions and computer-based tools to identify underreporting, it uses very little of these resources. Moreover, use of TIP agreements could be extended beyond food, beverage, and gambling establishments to other industries such as barbers and hair and nail salons, adult entertainment, and parking attendants.

Use Filings with State and Local Governments to Identify Gross Receipts Not Reported on Federal Income Tax Returns.

Many states and localities impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts.⁵⁷ The IRS should obtain access to business license tax filings and compare a taxpayer’s gross receipts, as reported on state and local filings, with a taxpayer’s gross income reported on his or her federal income tax return. This comparison could help the IRS identify businesses that may be underreporting income.

Compare State and Local Property Tax Records to Income Reported on Federal Income Tax Returns.

Many states and localities impose property taxes based on the value of real and personal property. The IRS should obtain access to property tax records and

⁵⁷ See, *e.g.*, Fairfax County Code §§ 4-7.2-1 through 4-7.2-36 (2005). See also 18 VAC 50-22-10 (2005) through 18 VAC 50-22-270 (2005), available at <http://www.state.va.us/dpor/Contractors%20Web.pdf> (requiring contractors to obtain different contractor’s license classes based on the value of the contractor’s jobs).

compare taxpayer property holdings with income reported on federal income tax returns. The IRS should use such information in conjunction with other factors to select returns for examination.⁵⁸

Educate Cash Economy Participants about the Benefits of Reporting

The IRS should educate certain cash economy participants about the benefits of reporting their income. In addition to the satisfaction of obeying the law and avoiding potential civil and criminal penalties and interest charges, such benefits may include, for example, an increase in:

- retirement benefits,
- disability benefits,
- survivors benefits,
- Medicare benefits,
- access to credit,
- earned income tax credit, and
- ability to gain admission to the U.S. or a visa status adjustment for family members or employees.⁵⁹

The IRS could test this concept by educating taxpayers through outreach and various media targeting cash economy participants in local communities where compliance is low. Publicizing such benefits, which may not be well known among cash economy participants, when combined with other enforcement initiatives in a given community, may significantly improve local reporting compliance.⁶⁰ The IRS should study the effect of such efforts to determine if they are cost effective.

Reestablish Local Compliance Planning Councils

Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to effectively address them without local feedback about how its strategies are affecting taxpayers in a given community so that it can adjust its local strategy accordingly. The IRS previously recognized this when it created

⁵⁸ See *Bridging the Tax Gap: Hearing before the Committee on Finance, United States Senate*, 108th Cong., 23 (July 21, 2004) (making a similar suggestion).

⁵⁹ See, e.g., Social Security, Survivors Benefits, Publication No. 05-10084, 5 (Jan. 2005) (indicating that survivors benefits are based on average lifetime earnings); Social Security, What Every Woman Should Know, Publication No. 05-10127, 1, 6 (Apr. 2003) (indicating that Medicare, death and disability benefits are based on earnings); IRC § 32 (earned income tax credit); 8 USC § 1182(a)(4) (requiring a sponsor to provide an affidavit of support for persons seeking admission to the U.S. or a visa status adjustment); 8 USC § 1183a (defining affidavit of support); Form 1-864, *Affidavit of Support Under Section 213A of the Act*, (Oct. 5, 2001) available at <http://uscis.gov/graphics/formsfee/forms/files/l-864.pdf> (requiring sponsors to attach three tax returns to the Affidavit of Support).

⁶⁰ Accord Joshua D. Rosenberg, *The Psychology Of Taxes: Why They Drive Us Crazy, And How We Can Make Them Sane*, 16 Va. Tax Rev. 155, 227-232 (Fall 1996).

local Compliance Planning Councils in the mid-1990s and gave them the authority to allocate local compliance resources and research.⁶¹

If noncompliance is so commonplace in a local market that the price of a good or service does not reflect tax compliance costs, suppliers may be unable to both pay their taxes and compete.⁶² However, if the IRS could convince a critical number of market participants to report their income to obtain the benefits described above and avoid the risk of detection by the IRS, then the market price for their goods or services would increase so that taxpayers could both compete and pay their taxes. Just a few market participants usually cannot change the market price by themselves. Such a change generally requires collective action, which is difficult to achieve without some form of organization or a credible threat that the IRS will enforce the law.⁶³ If the IRS could focus its enforcement and educational efforts on a particular local market, however, it may be able to shift market prices and improve tax compliance among large numbers of market participants. Compliant taxpayers might also be more likely to inform the IRS of noncompliance by their competitors. As the IRS's activity starts to affect market prices, it could produce a dramatic increase in voluntary tax compliance in the local cash economy as it changes local norms.⁶⁴ Local Planning Councils could work to identify local compliance challenges, direct the IRS' local response and measure whether its response has been effective.

Make It Easy to Pay Estimated Taxes

The IRS should make it just as easy for taxpayers to make their estimated tax payments as to pay other bills.⁶⁵ Most other creditors send customers a bill to

⁶¹ See General Accounting Office, *Tax Research: IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109, 30 (June 1996); IRS, District Office of Research and Analysis (DORA), *Phase I Training Material: IV. Framework; NORA, DORA roles*, 8.

⁶² See, e.g., *Tax Enforcement: Tax Shelters, The Cash Economy, and Compliance Costs*, 2004 TNT 134-43, 189 (July 12, 2004). IRS focus group discussions suggest that workers sometimes pass along much, if not all, of their tax "savings" from underreporting to their customers or employers. See SB/SE Research – Brooklyn/Hartford, TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups, Project 01.08.003.04, 12 (Dec. 2004) (noting that workers will work for "half wages" if they are paid in cash).

⁶³ Interestingly, the author of a study on the cash economy concludes that unions may help to reduce the number of workers in the cash economy by formalizing the employment conditions of informal workers. See Pascale Joassart-Marcelli & Daniel Flaming, *Workers Without Rights The Informal Economy in Los Angeles*, Economic Roundtable Briefing Paper, 2002.

⁶⁴ Accord Jon S. Davis et. al., *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 THE ACCOUNTING REVIEW 39 (2003) (finding that noncompliant populations respond to increasing enforcement by gradually increasing compliance until enforcement reaches a threshold level and then suddenly shifting to very high levels of compliance).

⁶⁵ The IRS should also make it possible for taxpayers to sign up for EFTPS and make a payment on the same day. Under its current process, taxpayers must wait at least seven to 10 days to use EFTPS, even if they are in the "Express Enrollment" program. See Publication 4276, *Express Enrollment Q & A's* (Jan. 2004). Taxpayers must wait two weeks if they do not participate in the "Express Enrollment" program.

remind them when a payment is due and offer them the option to make automatic monthly withdrawals from the customer's bank account free of charge.⁶⁶ Similarly, the IRS should send letters to self-employed taxpayers on a quarterly basis to remind them to make their estimated tax payments. These reminders should point out that taxpayers can use EFTPS, a free service, to make estimated tax payments electronically or by phone and to schedule them in advance, just like automatic payments to a mortgage or utility.⁶⁷ The letters should also offer to accept estimated payments on a monthly or even bi-weekly basis just like most other recurring bills.⁶⁸

Taxpayers may fall behind on their estimated tax payments inadvertently because the payment process is cumbersome. Estimated tax payments are due on the following oddly-spaced dates: April 15, June 15, September 15 and January 15.⁶⁹ These dates do not consistently coincide with calendar quarters, and some taxpayers do not believe the dates make sense.⁷⁰ It may also be difficult for taxpayers to save enough to pay their taxes on a quarterly basis. One study for TY 1999 showed that 31 percent of the taxpayers who made (or were required to make) estimated tax payments were assessed estimated tax penalties.⁷¹ A year 2000 telephone survey found that approximately two-thirds of taxpayers with a balance due prior to filing their return did not plan to owe a balance upon filing.⁷² Taxpayers who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income, remembering odd payment dates, and saving enough on a quarterly basis is cumbersome, especially for self-employed taxpayers who are juggling many different duties.

⁶⁶ TIGTA previously recommended that IRS clearly communicate to taxpayers that EFTPS is free. See Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 24 (Feb. 2004). This recommendation was based on a taxpayer focus group consensus indicating that taxpayers would not use credit cards to make estimated tax payments because credit card companies charge a convenience fee. *Id.*

⁶⁷ Mortgage lenders often require borrowers to pay property taxes into escrow on a monthly basis to ensure that borrowers do not forget to make quarterly property tax payments or spend the funds elsewhere.

⁶⁸ Some mortgage companies offer programs to electronically deduct mortgage payments bi-weekly rather than monthly.

⁶⁹ Publication 505, *Tax Withholding and Estimated Tax Payments* 24 (Dec. 2004).

⁷⁰ See Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004).

⁷¹ See Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004).

⁷² See Wage & Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004), citing W&I Customer Research Group 5, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments*, (2000).

Anything that the IRS can do to help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make such payments is likely to increase compliance.⁷³ A recent IRS study found that “investors” receiving reminder letters increased both estimated tax payments and withholding by a statistically significant amount.⁷⁴ The study recommended that the IRS consider a large-scale “soft notice” program (*i.e.*, send reminder letters).⁷⁵ According to IRS research, taxpayers who owe a balance upon filing their return are **more likely to understate their tax liability** than other taxpayers.⁷⁶ Moreover, more than 20 percent of such taxpayers with a balance due fail to pay it in full.⁷⁷ Self-employed taxpayers are often participants in the cash economy and need to make estimated tax payments. Thus, if the IRS could reduce estimated tax payment shortfalls it could increase both reporting and payment compliance by cash economy participants.

Utilize Reporting and Withholding to Develop a Comprehensive Approach to Helping Taxpayers Become Compliant and Remain Compliant

Since we know that the compliance rate is approximately 96 percent when payments are reported to the IRS, we should explore ways to ensure that a broader array of payments is subject to 1099 reporting. Moreover, since we know that compliance is nearly 100 percent when payments are subject to withholding, we should require withholding in limited circumstances. Withholding

⁷³ Signing taxpayers up for EFTPS could make estimated tax payments almost as automatic as withholding. As previously noted, taxpayers subject to withholding report 99 % of their income. IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

⁷⁴ See Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 6-7 (Jan. 16, 2004). The study defined “investors” as taxpayers with a balance due of between \$100 and \$1000 with non-wage income in excess of \$4,000 and wages less than \$500,000. *Id.* at 8.

⁷⁵ Both GAO and TIGTA had previously recommended that the IRS test a soft notice program to improve estimated tax payment compliance. See General Accounting Office, GAO/GGD-99-18, *Billions In Self-Employment Tax Are Owed*, 8 (Feb. 1999) and Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements*, 19 (Feb. 2004) (recommending that IRS implement a soft notice for estimated tax payments and noting that although IRS planned to implement GAO’s soft notice recommendation, it delayed and then canceled the planned implementation based on a June 2000 initiative that tested the effect of a pre-filing notice on repeat high-income nonfilers).

⁷⁶ Wage & Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

⁷⁷ Wage & Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

imposes significant burdens on the payor, so I am not advocating universal withholding. However, we should at least consider the feasibility of the following:

- Enter into voluntary withholding agreements under IRC § 3402(p)(3) with industries or trades that have established payor-payee mechanisms, *e.g.*, travel agencies and travel agents, or hair salons and stylists. The IRS, on a case-by-case basis, could agree to provide a safe harbor worker classification where the payor enters into a voluntary withholding agreement.⁷⁸
- Actively encourage self-employed taxpayers to make monthly or even bi-weekly payments toward their estimated taxes through the Electronic Funds Transfer System (EFTS). Where a self-employed taxpayer has been noncompliant for several years running, the IRS could require that taxpayer to make these deposits and could monitor compliance with this requirement closely so as to intervene when the taxpayer misses a required payment. If the taxpayer consistently fails to make required payments, impose a back-up withholding requirement, as described below.
- Amend IRC § 3406 to require a form of “backup withholding” by the payor in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.

Balancing Tax Law Enforcement with Taxpayer Service and Taxpayer Rights

In developing a long-term strategic approach toward noncompliance, the IRS must remember that the “stick” is not the only effective tool for addressing the tax gap; the “carrot” has a critical role to play, too. For taxpayers who will make reasonable but not Herculean efforts to comply with the tax laws, taxpayer service makes all the difference. If we make it easy for taxpayers to get forms, get answers to tax law questions, file returns, and get assistance if they run into problems, the vast majority of taxpayers will meet their tax obligations. If, instead, we increase the burdens of compliance too much, we will lose some of these taxpayers. Just as with indirect revenues on the enforcement side, the indirect revenue gains on the taxpayer service side are not easily measurable. But these gains exist, and they are significant. If we start emphasizing enforcement at the

⁷⁸ For over thirty years in the United Kingdom, contractors in the construction industry have been required to withhold on payments to independent contractors unless Her Majesty’s Revenue and Customs (HMRC, formerly Inland Revenue) declares the independent contractor to be exempt from withholding. Independent contractors can obtain exemption certificates from HMRC by demonstrating compliance. This approach has the advantage of making it in the contractor’s best interest to employ compliant subcontractors, since most contractors want to minimize their paperwork burden and avoid withholding requirements.

expense of taxpayer service, we ultimately will not achieve the overall revenue gains that we are seeking.

Taxpayer service and enforcement activities work hand-in-hand to promote high levels of compliance. Both are responsible for the estimated 84 percent compliance rate we have today, and both must be strengthened if we are to increase the compliance rate meaningfully. Importantly, in attempting to reduce noncompliance on the part of taxpayers responsible for the 16 percent noncompliance rate, we must be careful to avoid steps that could reduce compliance among taxpayers who are currently responsible for our 84 percent compliance rate.

Recently, the IRS's approach to combating the tax gap has focused almost exclusively on enforcement. Noncompliant taxpayers are often characterized as "cheaters." In my view, this is a mistake. The carrot and the stick are inextricably intertwined.

We can categorize taxpayers – somewhat simplistically – into three groups. They are either currently complying with the tax laws, or trying to comply, or not trying to comply at all. The taxpayers who aren't trying to comply may respond only to enforcement, but taxpayers who are seeking to comply will do so if we make compliance easy to achieve. These taxpayers will be much less likely to comply if we make it difficult. Thus, there should be minimal barriers for these taxpayers to get forms and answers to tax law questions, file returns, and obtain assistance if they run into problems. Even enforcement problems.

Today, all we know about noncompliant taxpayers is the nature of their noncompliance, not the underlying reasons for it. We know whether taxpayers are nonfilers, or underreporters, or non-payers. If we don't understand the reasons for noncompliance, we run the risk of a shotgun approach. We may hit someone with serious enforcement actions when a less drastic approach might work and might have better long-term compliance effects.

Conclusion

The IRS faces significant challenges in the next few years as it attempts to increase taxpayer compliance. I believe the IRS is doing the right thing in targeting corporate tax shelters and high-end cheating in the short-term, but I believe that with two-thirds of the tax gap attributable to the self-employed, the IRS needs to develop a thoughtful and comprehensive strategy to address noncompliance in the cash economy. The strategy should consider not only direct revenue benefits but the indirect effects (*i.e.*, the multiplier) generated by IRS activity.

Among areas for consideration, IRS and Congress should reduce opportunities for noncompliance through increased information reporting and limited non-wage

withholding, increase information sharing with state and local governments, develop targeted local initiatives, revise tax forms, and put more IRS agents “on the street” to focus on industries that are particularly noncompliant. At the same time, the IRS should keep in mind that taxpayer service is central to maintaining and improving the compliance rate and it should do more to study taxpayer needs, particularly with respect to face-to-face service, and to meet them.

To achieve these objectives, the IRS needs to do a better job of identifying and balancing both taxpayer needs and enforcement efforts. Rather than making resource-driven decisions that are based on inadequate research and that fail to identify equivalent alternatives, the IRS must develop a world-class research function that is the foundation for all of its customer service and enforcement activities. Research – and truly strategic planning – should inform the IRS’s allocation of resources so that we achieve the maximum compliance possible by obtaining the optimal balance between service and enforcement.

Tax Gap Reductions Options

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Form 1099-MISC	Increase the Penalty for failing to issue a required Form 1099-MISC (currently the penalty is \$50 per return). ⁷⁹	SI MI	Increased Form 1099-MISC reporting would reduce some income that currently escapes information reporting (sometimes referred to as the “cash economy”.) Increased information reporting results in higher compliance. ⁸⁰	Increased 1099-MISC reporting would impose additional burdens on service-recipients that would be required to process and file more paperwork to comply with any additional compliance. Eliminating the “trade or business” requirement for issuing a Form 1099-MISC would impose a new burden on non-business service-recipients, requiring individuals to file information returns on payments for such items as home repairs and yard care.
	Reduce or eliminate the \$600 per year threshold for requiring a service recipient to issue a Form 1099-MISC. ⁸¹	MI		
	Reduce or eliminate the \$5,000 per year threshold for requiring a Form 1099-MISC to be filed in the case of a direct seller. ⁸²	LI		
	Require Forms 1099-MISC to be issued to incorporated service providers. ⁸³	SI		
	Eliminate the “trade or business” requirement for issuing a Form 1099-MISC, but also introduce a high dollar threshold for requiring a service recipient to issue a Form 1099 for non trade or business payments. ⁸⁴	MI		

⁷⁹ Up to a maximum of \$250,000 per year. IRC § 6721(a).

⁸⁰ See Alan Plumley and C. Eugene Steuerle, “An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service,” 4. See also, Most Serious Problem, IRS Examination Strategy, *supra*.

⁸¹ See IRC § 6041A(a)(2).

⁸² See IRC § 6041A(b).

⁸³ Incorporated service providers are currently exempt from Form 1099-MISC reporting in most cases. See Treas. Reg. § 1.6041-3(p)(1).

⁸⁴ See IRC § 6041A(a)(1).

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Non-Wage Withholding	Require withholding on all payments to service providers that are currently subject to Form 1099-MISC reporting. ⁸⁵	MI	Nearly 100 percent of income subject to with-holding is reported. ⁸⁶	Withholding on current Form 1099-MISC payments would effectively impose employment tax compliance requirements on service recipients for payments to non-employees. Withholding on current Form 1099 MISC payments would require both independent contractors and service recipients to calculate profit margins to estimate the applicable withholding rate. This could impose significant administrative burdens on service
	Require withholding on all payments to service providers that are currently subject to Form 1099-MISC reporting, and specify that service providers that fail to withhold under this requirement are subject to the Federal Trust Fund Recovery Penalty. ⁸⁸	MI		

⁸⁵ See National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003) 256-269, where this proposal is explained in detail. Several other Federal agencies have also recommended non-wage withholding: see Hearings on H.R. 3245, The Independent Contractor Tax Status Clarification Act of 1979, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, 96th Cong. 11 (1979) (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy); Hearing on Compliance Problems of Independent Contractors, GAO-109909, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, 96th Cong. 7 (1979) (statement of Richard L. Fogel, Associate Director, General Government Division, General Accounting Office); GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Federal Contractor Compliance*, GAO/GGD-92-108, 4 (July 1992), General Accounting Office, *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, 37 (May 11, 1994); GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners*, GAO/General Government Division, GGD-96-165, 12 (August 1996); Treasury Inspector General for Tax Administration, *Significant Tax Revenue May be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors*, Reference No. 2001-30-132, ii (Aug. 2001) see also, *Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript*, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Pamela J. Gardiner, Acting Inspector General, Treasury Inspector General for Tax Administration), and Q&A of Mike Brostek, Director Strategic Issues, Government Accountability Office.

⁸⁶ See Alan Plumley and C. Eugene Steuerle, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," 4. See also, Most Serious Problem, IRS Examination Strategy, *supra*.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
	Encourage service recipients and independent contractors to enter into voluntary withholding agreements.	LI		recipients that use independent contractors for various kinds of work. It could also impose significant burdens on independent contractors that operate at narrow profit margins. ⁸⁷
	Provide tax or reduced compliance incentives for service recipients that enter into voluntary withholding agreements with independent contractors.	LI		

⁸⁷ See generally, Russell A. Hollrah, Home Care Representative Opposes NTA's Plan to Target Underreporting by Self-Employed, 2004 T.N.T. 73-37, March 22, 2004.

⁸⁸ See IRC § 6672. See also Key Legislative Recommendation, Small Business Burden Reduction, Protection from Payroll Service Misappropriation, *supra*.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Backup Withholding	Institute “real time” Taxpayer Identification Number (TIN) verification for service recipients and institute immediate backup withholding on those with invalid TINs.	SI	Expanding the current backup withholding provisions ⁸⁹ to target specific noncompliance would be less burdensome than general non-wage withholding. Nearly 100 percent of income subject to withholding is reported.	“Real time” TIN verification presents taxpayer information confidentiality concerns. ⁹⁰ Withholding targeted at noncompliant service providers would still place compliance burdens on the service-recipients that use these service providers. Establishing standards for “demonstrated noncompliance” for both individuals and specific industries could be difficult.
	Require immediate backup withholding on individual service providers who have demonstrated a history on noncompliance.	SI		
	Require immediate backup withholding in specific service industries that have demonstrated a history of noncompliance.	SI		

⁸⁹ See IRC § 3406.

⁹⁰ See IRC § 6103.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Frequency of Estimated Tax Payments	Mandatory Increase	SI	More frequent payments would reduce the likelihood of a self-employed taxpayer expending funds earmarked for taxes on other business or personal expenses and consequently falling out of compliance. ⁹¹	More frequent payments would increase self-employed paperwork and compliance burdens. More frequent payments could impose cash flow constraints on self-employed taxpayers that operate at narrow profit margins.
	Voluntary Increase.	LI		
Voluntary Electronic Estimated Tax Payments	Provide system to allow self-employed taxpayers to electronically submit estimated taxes.	LI	Reduces paperwork and compliance burdens associated with nonelectronic payments. Provides a simple means for on-time estimated tax payments, reducing the likelihood of a self-employed taxpayer expending funds earmarked for taxes on other business or personal expenses and consequently falling out of compliance.	Minimal, if any, taxpayer burden.
	Provide system that would allow the IRS to automatically withdraw estimated taxes from a self-employed taxpayer's business checking account. Self-employed taxpayers could participate in this system voluntarily. ⁹²	LI		

⁹¹ Valerie Chambers, Evidence of Significant Excess Intangible Utility of Increased Intertemporal Payments over Financial Investment Gain Opportunity in a Tax Budgeting Situation (unpublished paper, on file with the National Taxpayer Advocate), see also, Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Pamela J. Gardiner, Acting Inspector General, Treasury Inspector General for Tax Administration).

⁹² This system could be expanded to impose mandatory withholding through a self-employed taxpayer's business checking account if that taxpayer had demonstrated a history of noncompliance.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
IRS Audit and Exam Initiatives	Increase “Required Filing Checks” (a.k.a., package audits). Required Filing Checks are part of an IRS field audit and require the IRS agent(s) to examine the records of a business taxpayer to determine such things as whether the taxpayer has filed all required returns – including information returns, if it has submitted questionable Forms W-4, and if it is a “cash business” that may be subject to additional scrutiny. ⁹³	SI	Increased enforcement increases both direct and indirect compliance. ⁹⁴ Increased IRS and taxpayer focus on gross receipt sources and Form 1099-MISC reporting. Compliance would increase directly for those taxpayers selected for audits, both for the tax years at issue and for future years.	Taxpayers selected for audits would need to go through IRS examination procedures. Concerns that taxpayers affected by local and national compliance initiatives and receiving disparate treatment compared to non-affected taxpayers.
	Implement local audit initiatives that are focused on income reporting for specific groups of taxpayers with demonstrated histories of noncompliance (for example, contractors in a particular city). ⁹⁵	SI		

⁹³ See IRM 4.10.5 (July 13, 2001). On June 27, 2003, the Deputy Director of Compliance Policy for the IRS SB/SE division issued a memorandum limiting the scope of Required Filing Checks by eliminating information return and employment tax return reconciliations and mandatory inspections for questionable Forms W-4. The procedures set forth in this memorandum were to expire on April 15, 2004, but no memorandum to that effect has been issued. Memorandum from SB/SE Deputy Director, Compliance Policy re Required Filing Checks (package audit) – IRM 4.10.5, June 27, 2003.

⁹⁴ See Most Serious Problem, Examination Strategy, *supra*.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
	Implement industry segment compliance initiatives (including, audits, research, education and outreach, and other compliance initiatives) aimed at increasing voluntary compliance within specific market and industry segments nationwide. ⁹⁶	SI	Compliance would increase indirectly as word of these audits spread throughout the respective industries and communities.	
	Fully utilize IRS Financial Status Analysis and Financial Status Audit techniques to the extent permitted by IRC §7602(e). These techniques seek to identify unreported income by analyzing a taxpayer's cash flows to estimate whether there are sufficient funds to cover the taxpayer's expenses. ⁹⁷	SI	Outreach, education and research efforts would increase voluntary compliance in selected local areas and market and industry segments.	

⁹⁵ See also discussion in Most Serious Problem, Examination Strategy, *supra*.

⁹⁶ These initiatives could be structured to fit within the IRS' Compliance Initiative Projects program. See IRM 4.17.1 (Feb. 1, 2004).

⁹⁷ IRM 4.10.4.3.3.1 and IRM 4.10.4.6.1 (June 1, 2004). IRC § 7602(e) limits financial status or economic reality examination techniques to cases where the IRS has a reasonable indication that there is a likelihood of unreported income. The IRM Financial Status Analysis procedures are designed to determine whether such a reasonable indication exists to permit the IRS to implement its Financial Status Audit procedures.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
IRS Forms Revisions	Revise Form 1040, Schedule C, to include a line item showing the amount of self-employment income that was reported on Forms 1099-MISC.	LI	Receiving specific Form 1099-MISC income information would allow the IRS to better track self-employment income sources and develop measures to reduce the cash economy.	Minimal recordkeeping burden.
	Supplement Form 1099-MISC with a required statement that the issuer must sign, under penalties of perjury, declaring that all required Forms 1099-MISC have been issued for the tax year. ⁹⁸	LI	<p>Specifically requiring Form 1099-MISC income to be separately reported would increase the likelihood that taxpayers would report such income and also increase tax-payer awareness of income sources that should be re-reported on Forms 1099-MISC.</p> <p>A “penalties of perjury” statement would make issuers aware of the significance of the Form 1099-MISC requirements and increase awareness that the IRS is actively monitoring accurate Form 1099-MISC compliance and reporting.</p>	

⁹⁸ Only one statement would be required per issuer per year. In other words, a Form 1099-MISC issuer would not be required to sign a statement for each Form issued.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Information Sharing Initiatives	Establish local Compliance Planning Councils, involving the IRS (including both compliance and noncompliance division chiefs and local research offices) and state and local taxing authorities, that would focus on improving self-employed and cash economy compliance in their respective areas. ⁹⁹	LI	Self-employed noncompliance and the cash economy affect all levels of government. Information sharing and partnering efforts will allow all government participants to enhance compliance in these areas. ¹⁰⁰	Minimal, if any, taxpayer burden.
	Information sharing between the IRS and state and local taxing, compliance and licensing authorities. These sharing efforts could involve such information as business licenses and property tax records. ¹⁰¹	LI		

⁹⁹ See also Most Serious Problem, IRS Examination Strategy, *supra*.

¹⁰⁰ See Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School).

¹⁰¹ See Testimony of Nina E. Olson, National Taxpayer Advocate, Hearing on Bridging the Tax Gap before the Senate Committee on Finance, July 21, 2004, 10.