National Taxpayer Advocate

A Comprehensive Strategy for Addressing the Cash Economy

2007

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Cash Economy Strategy

Executive Summary

The IRS estimates that the gross tax gap – the difference between what taxpayers owe and what they pay voluntarily and timely – amounted to $345 billion in tax year 2001.[1] Underreported income from the "cash economy" – income from legal activities that is not subject to information reporting or withholding – is probably the single largest component of the tax gap, likely accounting for over $100 billion per year.[2]

The National Taxpayer Advocate believes the cash economy deserves special attention because of its size and the likelihood that it will become an even larger problem in the future.[3]

This paper presents a strategy for addressing the cash economy through administrative changes within the IRS and legislative changes to the tax law. The goal is to find solutions for improving voluntary compliance by making it easier for cash economy taxpayers to understand and meet their tax obligations, and to improve the tools available to the IRS for enforcing the tax laws when necessary.

The proposed strategy is a comprehensive approach that addresses numerous interrelated issues that impact taxpayers operating in the cash economy. It includes recommendations in the following areas:

- Overall Recommendation – Establishing a Cash Economy Program Office;
- Making Compliance Easier;
- Improving Income Visibility and the Productivity of Audits;
- Increasing the Focus on Preparers; and
- Conducting Research on Attitudes toward Tax Compliance.

A summary of the principal recommendations follows.

Overall Recommendation

The IRS should establish a Cash Economy Program Office. This office would have responsibility for implementing an overall strategy for addressing the cash economy, coordinating the use of tools for identifying the underreporting of income and nonfilers, and promoting a research agenda that addresses the unique issues associated with the cash economy.

1 IRS, *National Research Program*, tax year 2001. The net tax gap for TY 2001 is estimated at $290 billion, which accounts for another $55 billion of tax revenue as the result of taxpayers paying late or from IRS enforcement actions.

2 *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts). Underreporting makes up about 83 percent of the tax gap ($285 billion of the $345 billion gap). Underreporting of business income by individuals – from sole proprietors, rents and royalties, and passthrough entities – accounted for about $109 billion. *Id.* Associated underreporting of self employment taxes by unincorporated businesses accounts for another $39 billion. *Id.*

3 The IRS projects that the number of individual small business returns will grow by over 13 million by fiscal year 2014. In contrast, individual returns, with their high degree of information reporting, are expected to decrease during the same period. IRS Document 6292, *Fiscal Year Return Projections for the United States: 2007-2014* (June 2007).

Making Compliance Easier

Improve Outreach Efforts to Small Business Owners. The IRS should develop a strategic plan for improving education and outreach to small businesses similar to the Taxpayer Assistance Blueprint. Outreach activities could include workshops for new businesses, and IRS could better craft its education messages by identifying the most common filing and payment errors. The Communications, Liaison and Disclosure (CLD) organization should also ensure that its outreach and education efforts reflect demographic trends. Examples include the increasing number of sole proprietor taxpayers, self-employed individuals with language barriers, and immigrants who wish to pay their taxes but fear that the IRS will share data with immigration authorities.

Simplify Guidance on Tax Rules that Confuse Taxpayers. The IRS should conduct research to identify areas in IRS processes or guidance that cause confusion for small business taxpayers. The IRS could then issue regulations, revenue procedures or other guidance as appropriate to make it easier for taxpayers to understand their obligations and comply with the law.

Encourage More Frequent Estimated Payments through EFTPS. The IRS should encourage taxpayers to schedule weekly or monthly payments through the Electronic Federal Tax Payment System (EFTPS) to avoid the difficulty of saving money to make lump sum quarterly payments, and to avoid late payment penalties. The IRS should also consider abating a late payment penalty as an incentive for taxpayers to use EFTPS, similar to that offered in the past for Federal Tax Deposits.

Send Reminder Notices to Taxpayers for Estimated Payments. The IRS should consider sending reminder notices to taxpayers who have missed payments in the past and to encourage them to enroll in EFTPS.

Allow Voluntary Withholding Agreements Between Independent Contractors and Service Recipients. Congress should specifically authorize voluntary reporting agreements between independent contractors and service recipients.

Use Collection Alternatives. The IRS should more actively use Collection alternatives, such as partial payment installment agreements and improved access to the offer in compromise program, so that taxpayers who can pay some but not all of their liabilities are not pushed into perpetual noncompliance.

Improving Income Visibility and the Productivity of Audits

The report contains a number of recommendations intended to promote higher voluntary compliance by increasing the visibility of income and improving the productivity of audits.

Create an Income Database. The IRS should explore creating a database to combine all gross receipts-related information sources into a single system that would allow the IRS to develop new techniques for identifying potential underreporting and help auditors. In addition to information the IRS currently receives, such as Forms 1099-MISC, Miscellaneous Income Forms 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business), and information on taxpayer bank accounts, it could also include new information sources proposed in this strategy, such as credit card payments to merchant accounts, Forms 1099 for payments to 1120S corporations, and matching information on data from state and local governments.

Initiate Single Issue Gross Receipts Audits. The IRS should develop an audit program focused specifically on gross receipts and train the staff to effectively use available tools and procedures. The combination of faster audits and an enhanced ability to identify noncompliant returns (using the income database described above) should enable the IRS to directly contact the most noncompliant taxpayers in the cash economy.[4]

Require Banks to Report Existence of all Bank Accounts. Eliminating the $10 minimum for reporting interest would allow the IRS to identify the existence of bank accounts, such as non-interest bearing checking accounts, while not expanding the type of information collected. Auditors will be more likely to have full and complete banking information, and to uncover underreporting, if they can request statements using specific bank names and account numbers. Taxpayers may also be less likely to underreport income if they know their bank must report on all of their accounts to the IRS.

Add Line on Schedules C for Form 1099 Income. The IRS should consider redesigning the Schedule C (Form 1040), Profit or Loss From Sole Proprietorship to include two separate lines for reporting income – one line for receipts shown on Forms 1099 and one for other receipts. A related proposal is to ask the taxpayer to affirmatively declare, under penalties of perjury, that he or she filed the required Forms 1099 for all payments of $600 or more to any one individual or partnership during the calendar year.

Develop Ratios of Cash to Credit Card Receipts by Industry. The IRS could develop industry ratios on the average share of sales from cash and payment cards. The IRS could use any unexplained deviations from these ratios in combination with other criteria to select returns for audit.

Conduct Research on the Direct and Indirect Effects of Audits. The IRS should study the impact of audits in the cash economy to help determine how best to deploy limited enforcement resources to maximize compliance.

4 An analysis by GAO found that ten percent of sole proprietors with understated taxes accounted for 61 percent of the total tax liability. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 15 (July 2007).

Simplify the Tax Code. The complexity of the code increases the likelihood that honest taxpayers will make inadvertent mistakes, creates opportunities for taxpayers to avoid paying their fair share of taxes, and makes it difficult for the IRS to administer the tax system. Simplifying the tax law could improve the audit process and allow for less taxpayer burden.

Increasing the Focus on Preparers

The IRS needs additional research to determine the degree to which preparers impact the underreporting of gross receipts and the overstatement of expenses. If research shows that preparers do significantly impact taxpayer compliance, the IRS should investigate creating a preparer database that contains summary data on preparer characteristics, such as the number of client returns that have compliance risk scores outside expected parameters, or contain math errors, etc.

IRS could study compliance at the preparer level, evaluate "soft touch" approaches to address potential compliance issues, and undertake enforcement actions as appropriate.

Conducting Research on Attitudes toward Tax Compliance

The IRS should consider establishing a research unit devoted to exploring the effect taxpayers' attitudes have on voluntary compliance and finding ways to positively influence those attitudes. Existing research shows that a taxpayer's willingness to pay taxes voluntarily is not based exclusively on risk ("how likely am I to get caught if I cheat on my taxes?") but is also influenced by personal values and social norms.[5] Understanding these attitudes can help the IRS determine what types of education and outreach will maintain and increase voluntary compliance.

5 Margorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance, supra.*

Introduction

In recent years, there has been growing consensus that the tax gap is a significant challenge facing our tax system. The National Taxpayer Advocate has addressed the tax gap in testimony before Congress as well as in her Annual Reports to Congress.[6] In 2006, the National Taxpayer Advocate identified the issue as the number two Most Serious Problem facing taxpayers.[7]

The tax gap has been the focus of studies by the Government Accountability Office (GAO) and Treasury Inspector General for Tax Administration (TIGTA).[8] The IRS released "Reducing the Federal Tax Gap – A Strategic Plan to Improve the Level of Voluntary Compliance" in July 2007.[9] This plan expands on the Treasury Department's high-level Comprehensive Strategy for Reducing the Tax Gap and provides additional detail on specific actions to address the problem.[10]

The IRS estimates that the gross tax gap – the difference between what taxpayers owe and what they pay voluntarily and timely – amounted to $345 billion in tax year 2001.[11] Additional revenue collected from late payments and IRS enforcement actions reduces the net gap to $290 billion. ***Dividing the net tax gap of $290 billion by an estimated 108,209,000 U.S. households***[12] ***results in an average "surtax" of $2,680 on every household to subsidize noncompliance.***

Aside from the vast sum of taxes never paid to the government, the tax gap is a serious issue because it undermines confidence in our tax system. Failing to act to reduce the tax gap could further erode compliance if compliant taxpayers decide they are "tax chumps" for meeting their tax obligations when they perceive others do not.

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6 The National Taxpayer Advocate has testified at the following congressional hearings focused on the federal tax gap: House Budget Committee (Feb. 16, 2007); Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Sept. 26, 2006); Senate Finance Subcommittee on Taxation and IRS Oversight (July 26, 2006); Senate Budget Committee (Feb. 5, 2006); Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Oct. 26, 2005) (written statement only); Senate Finance Committee (Apr. 4, 2005); Senate Finance Committee (July 21, 2004).

7 National Taxpayer Advocate 2006 Annual Report to Congress 6-9. *See also* National Taxpayer Advocate 2005 Annual Report to Congress 55-75 (discussing the cash economy) and 381-396 (making legislative proposals to improve compliance in the cash economy); National Taxpayer Advocate 2004 Annual Report to Congress 211-263 (discussing IRS examination strategy, IRS collection strategy, and the application of the Federal Payment Levy Program to noncompliant federal contractors) and 478-489 (making legislative recommendations to combat the tax gap, which includes a chart identifying and commenting on 24 options); National Taxpayer Advocate 2003 Annual Report to Congress 20-25 (discussing noncompliance by self-employed taxpayers) and 256-269 (proposing tax withholding on non-wage workers, a position the National Taxpayer Advocate subsequently modified in her 2005 report cited above in this footnote).

8 Examples include Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 18, 2005). Statement of Russell George, Treasury Inspector General for Tax Administration, *A Closer Look at the Size and Sources of the Tax Gap*, U.S. Senate Committee on Finance, Subcommittee on Taxation and IRS Oversight (July 26, 2006). See Bibliography for a more complete listing of GAO and TIGTA reports.

9 IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance* (Aug. 2, 2007).

10 U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap* (Sept. 27, 2006).

11 IRS, *National Research Program*, Tax Year 2001. The net tax gap for TY2001 is estimated at $290 billion which accounts for another $55 billion of tax revenue as the result of taxpayers paying late, or from IRS enforcement actions.

12 U.S. Census Bureau, Population Division (data as of March 2001).

The National Taxpayer Advocate believes the portion of the tax gap attributed to the cash economy deserves special attention because of its size and the likelihood that it will become an even larger problem in the future. This paper presents a strategy for addressing the cash economy component of the tax gap through administrative changes within the IRS and legislative changes to the tax law. The Taxpayer Advocate Service developed this strategy after a comprehensive review of previous studies and other relevant literature from a wide variety of sources.[13]

It is critical that the IRS gain a better understanding of taxpayer behavior and the causes of noncompliance, and many proposals contained in this strategy focus on building a knowledge base in this area. It does not make sense to simply devote additional enforcement resources toward the tax gap if the IRS lacks a broader understanding of why taxpayers are noncompliant, and what approaches will be most effective in encouraging voluntary compliance.[14]

This report is posited on three assumptions. First, taxpayers deserve an effective tax system that allows them to determine with confidence that they arrived at the correct tax through the use of clear instructions and simple processes. Second, taxpayers deserve a system that ensures all taxpayers are paying their share and provides the IRS with the necessary tools to address intentional noncompliance. Third, when ensuring that all taxpayers pay their share, the IRS uses tools that are narrowly targeted to the particular noncompliance at issue (and its causes), that impose the least possible burden on taxpayers, and that respect taxpayers' rights.

Composition of the Tax Gap

The gross tax gap of $345 billion is comprised of three types of noncompliance:

- Failure to report all income;
- Failure to pay all tax due; and
- Failure to file a tax return.

13 Many of the sources were identified during a joint task force effort with the Small Business/Self Employed Division (SB/SE). This strategy, however, solely reflects the views of the Taxpayer Advocate Service. *See* Appendix B for a complete bibliography.

14 Dustin Stamper, *New Findings on the Way from 2001 IRS Research, Mazur Says*, Tax Notes Today, 2007 TNT 121-6 (June 22, 2007) (noting comments of Eric Toder, Urban Institute Senior Fellow, and Mark Mazur, IRS Director of Research, Analysis and Statistics, that better methods for identifying noncompliance and ways to improve voluntary compliance are needed).

FIGURE 1, Tax Year 2001 Federal Tax Gap (In Billions Of Dollars)[15]

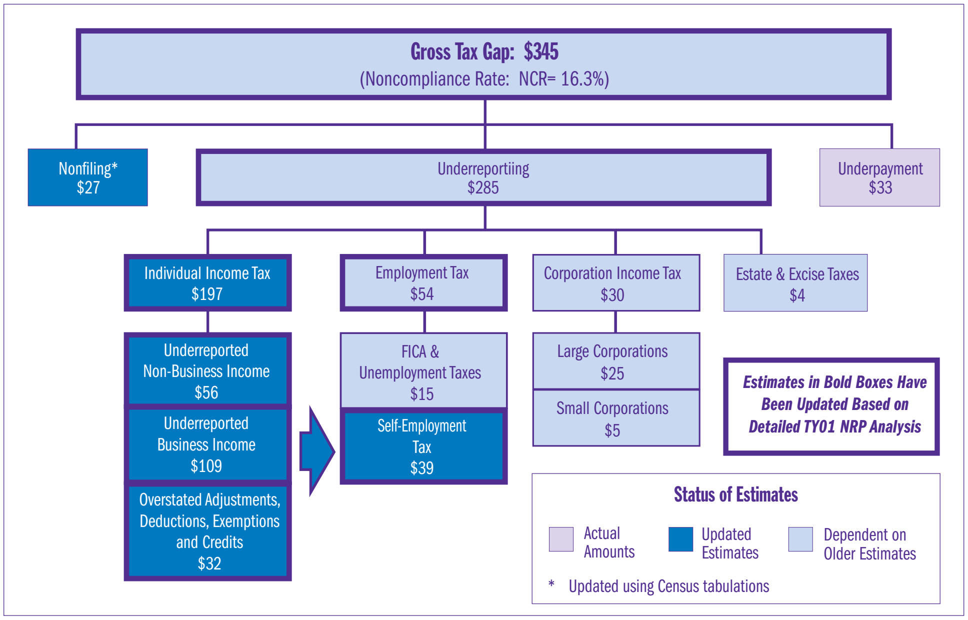

Figure 1 shows that employment tax, corporate income tax, and estate and excise taxes all contribute to the underreporting tax gap. However, the $197 billion underreported by individuals is by far the largest component, accounting for 69 percent of the total dollars attributed to underreporting.

What is the Cash Economy?

Although there is no universally agreed-upon definition of "cash economy," we use the term to mean taxable income from legal activities that is not reported to the IRS by third parties. This definition can include businesses dealing strictly in cash, as well as others that handle a portion of their transactions in cash or receive other payments not subject to information reporting. For example, a retailer who receives most of his revenue through debit and credit cards can be considered part of the cash economy, because these forms of payment are not subject to reporting.

Why Focus on the Cash Economy?

The IRS released a strategy for addressing the tax gap in 2007[16], so why devote special attention to the cash economy? The cash economy is the largest contributor to the tax gap, will continue to grow, and is the area the IRS is least able to address through existing enforcement techniques.

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15 IRS, *National Research Program*, Tax Year 2001. *See* Appendix A for a more detailed chart on the tax gap.

16 IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance* (Aug. 2, 2007).

Cash Economy Businesses Account for Largest Category of Misreporting

Underreported business income by individuals accounts for the largest single segment of the tax gap. As shown in Figure 1, the IRS attributes $109 billion of the $285 billion tax gap from underreporting (38 percent) to underreported business income by individuals. This income segment meets our definition of the cash economy, since it is subject to a low degree of information reporting. An analysis by the Government Accountability Office found only one quarter of sole proprietors' receipts were reported to the IRS on a Form 1099-MISC.[17]

Cash Economy Expected to Grow

Changes in the economy and financial markets suggest a need for additional focus on the cash economy. Income sources not subject to information reporting have grown significantly, and are expected to grow further. In 1980, 8.7 percent of total reported income was not subject to third party reporting. By 2000, this percentage had more than doubled to 18.4 percent. The primary factor in this increase was the faster relative growth in the nonmatchable components of net taxable capital gains and partnership and small business net income.[18]

In addition to these structural shifts in income sources, the IRS projects that the number of individual small business returns will grow by over 13 million by fiscal year 2014. In contrast, other individual returns, with their high degree of information reporting, are expected to decrease during the same period.

TABLE 1, Estimated Number of Returns by Type[19]

Type of Return	FY2006 *Actual*	FY2014 *Projected*	Change	Percent
Individual	93.1M	91.4M	-1.7M	-1.8%
Small Business/Self Employed	40.1M	53.3M	+13.3M	+33.1%

IRS Has Fewer Tools for Addressing the Cash Economy

One of the IRS's primary tools for monitoring compliance is matching the income information on tax returns to information provided by third parties such as employers, banks, and other entities. However, the IRS's ability to verify income levels is not equal for all types of taxpayers.

17 Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 17 (July 2007).

18 Kim Bloomquist, *Trends as Changes in Variance: The Case of Tax Noncompliance*, presented at the 2003 IRS Research Conference, June 2003. Bloomquist notes the stock market bubble of the late 1990s contributed greatly to growth in financial assets. Between 1995 and 2000, the share of taxpayer reported net capital gains increased from four percent to 9.5 percent of total income.

19 IRS Document 6292, *Fiscal Year Return Projections for the United States: 2007-2014* (Rev. Sept. 2007). The Small Business/Self Employed figures reflect taxpayers filing a Form 1040 return with a Schedule C (Profit or Loss From Business), Schedule F (Profit or Loss From Farming); Schedule E (Supplemental Income and Loss); Form 2106 (Employee Business Expenses); or with mailing addresses or forms considered "International." *Id.*

Table 2 below shows the strong correlation between the degree of information reporting and the accuracy of returns. The net misreporting percentage for income is the aggregate amount of income that was not reported correctly on the return divided by the aggregate amount that should have been reported.[20] Income sources with a lower level of information reporting have higher rates of misreporting.

TABLE 2, Net Misreporting Gap by Level of Information Reporting[21]

Level of Information Reporting	Examples	Net Misreporting Gap ($B)	Net Misreporting Percentage
Substantial Reporting and Withholding	Wages, salaries	$10	1%
Substantial Reporting	Interest, dividends, pensions	$9	5%
Some Reporting	Partnerships, alimony, capital gains, deductions	$51	9%
Little or No Reporting	Nonfarm proprietor income, rents, other income	$110	54%

Simply put, compliance is highest where third-party information reporting is highest.

Challenges in Addressing the Tax Gap

The challenges in addressing the cash economy tax gap are many. There are strong interests that argue against any type of increased information reporting due to concerns about increased burden. Limited resources within the IRS also make implementing new initiatives tougher.

Despite these challenges, the National Taxpayer Advocate believes it is unacceptable to do nothing beyond current efforts to address the cash economy tax gap. The goal of this cash economy strategy is to find solutions for improving voluntary compliance by making it easier for cash economy taxpayers to understand and meet their tax obligations, and to improve the tools available to the IRS for enforcing the tax laws when necessary.

Readers should evaluate these proposals in light of the seriousness of the tax gap and should consider both the burden on taxpayers and the benefits to an effective tax system. Benefits should include not just the direct impact on the Treasury, but also the indirect benefits of allowing businesses to compete on a more even footing so honest taxpayers are not placed at a disadvantage to their less scrupulous peers.

The remainder of this strategy presents recommendations for addressing the cash economy tax gap, with the proposals grouped under the major compliance categories:

- Improving Income Reporting Compliance;
- Improving Payment Compliance; and
- Improving Filing Compliance.

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20 For example, a taxpayer reporting only $70 of income when the true figure was $100 would result in a net misreporting percent of 30 percent.

21 IRS, *National Research Program*, Tax Year 2001.

We have grouped individual proposals where we believe they will have the biggest impact, but many have benefits beyond a single category. Before presenting the categories, we first offer an overall recommendation.

Create a Cash Economy Program Office

The IRS should establish a Cash Economy Program Office that would have responsibility for overseeing and coordinating efforts to address noncompliance in the cash economy.[22] A Cash Economy Program Office would be charged with:

- Implementing an overall strategy for addressing the cash economy, including partnerships with state governments;
- Coordinating the use of tools for identifying the underreporting of income and potential nonfilers; and
- Promoting a research agenda that addresses the unique issues associated with the cash economy.

The program office would also consolidate enforcement and outreach efforts to address the cash economy, which are now dispersed throughout the IRS. A Cash Economy Program Office could bring together both existing programs and those proposed in this strategy and provide the direction and oversight needed to reduce this largest component of the tax gap. The head of the office would be responsible for coordinating its activities and championing its initiatives within the IRS.

Improving Income Reporting Compliance

This section presents options for addressing the $109 billion of the tax gap caused by the underreporting of individual business income. Together, these proposals could greatly improve the IRS's ability to detect noncompliant behavior and focus its limited enforcement resources. We present options under the categories of:

- Making reporting compliance easier;
- Improving the visibility of business income;
- Improving the productivity of audits;
- Conducting research on the direct and indirect effects of audits;
- Increasing the focus on preparers; and
- Conducting research on attitudes towards tax compliance.

22 The National Taxpayer Advocate previously recommended creating a Cash Economy Program Office in her 2005 Annual Report to Congress. The IRS did not agree that creating a program office would be an efficient way to address noncompliance in the cash economy. The IRS did acknowledge that a comprehensive and well-coordinated strategy among various IRS offices might be successful in addressing the issue of the cash economy, but that it was premature until the new National Research Program (NRP) data became available. (National Taxpayer Advocate 2005 Annual Report to Congress 73.) The National Taxpayer Advocate believes that NRP tax gap estimates, which suggest that significant noncompliance exists in the cash economy, justify creating a unit devoted to addressing noncompliance in the cash economy.

Making Reporting Compliance Easier

Improve Outreach Efforts to Small Business Owners

The National Taxpayer Advocate believes voluntary compliance can be significantly improved if taxpayers are given the support they need to fully understand and correctly calculate their tax obligations.[23] To achieve this goal, the IRS should enhance its current level of service with outreach and education programs.

The IRS should develop a strategic plan for improving education and outreach to small businesses similar to the Taxpayer Assistance Blueprint.[24] Outreach activities could include providing workshops for new recipients of Employer Identification Numbers (EINs) or first time Schedule C filers. These workshops would educate taxpayers on all the requirements for properly filing and reporting employment taxes, outline payment options, and provide a forum for addressing the concerns of new business owners. The IRS could better craft its educational messages by conducting research to identify the most common filing and payment errors made by small business taxpayers.

Simplify Guidance on Tax Rules that Confuse Taxpayers

The IRS should conduct research to identify areas in IRS processes or guidance that cause confusion for small business taxpayers. The IRS could then issue regulations or revenue procedures as appropriate to make it easier for taxpayers to understand their obligations and comply with the law.[25]

The IRS Office of Chief Counsel regularly requests input from stakeholders in formulating its Priority Guidance Plan. However, more focused efforts to identify issues of concern to small business taxpayers and preparers could produce guidance that positively impacts cash economy taxpayers.

Improving the Visibility of Business Income

Create an Income Database

The information the IRS receives from third party reporting data is used separately in different IRS functions. Combining all information sources into a single information system

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23 For a more detailed description of the challenges faced by small business taxpayers, *see* National Taxpayer Advocate 2006 Annual Report to Congress 172-196 (Most Serious Problem – Small Business Outreach).

24 IRS Pub. 4579, *The 2007 Taxpayer Assistance Blueprint – Phase 2* (April 2007). The Taxpayer Assistance Blueprint is an assessment of how services are delivered to individual taxpayers and provides a strategic plan for future service delivery and research. A cross-functional team, which included representatives from the Taxpayer Advocate Service, the Wage and Investment Operating Division, and Governmental Liaison and Disclosure, recently outlined a research and outreach plan for business taxpayers which included a recommendation that SB/SE should develop a five-year strategic plan to enhace the outreach and education provided to small business taxpayers. Memorandum for Director, Communications Liaison and Disclosure, from Task Force to Enhance Small Business Outreach, *Enhancing Outreach and Education to Small Business Taxpayers* (Sept. 4, 2007).

25 As an example, the IRS Office of Taxpayer Burden Reduction established a team to address simplification of the home office deduction. *See* National Taxpayer Advocate 2007 Annual Report to Congress, Vol. I (Key Legislative Recommendation – Home Office Business Deduction).

would allow the IRS to develop new techniques for identifying potential underreporting and could help auditors improve efficiency.[26]

This database could organize information by taxpayer, and should include all relevant existing information sources on business income, such as Forms 1099-MISC and 8300. It could also include new information sources proposed in this strategy, such as credit card payments to merchant accounts, Forms 1099 for payments to small corporations, matching information on data from state and local governments, and information on taxpayer bank accounts (discussed below).

Creating a new database without diverting resources from the IRS's current modernization efforts would be a significant challenge. Before committing to a new system, the IRS should conduct a pilot study that pulls together a limited number of records from the data described above, and should explore development of algorithms and procedures for identifying potential noncompliance. In the pilot, the IRS should address the following questions:

- Can the IRS develop algorithms that identify potential underreported income?
- Can the algorithms work using existing IRS data, or is additional information reporting data necessary?
- Does the information in the system result in more efficient and accurate audits when supplied to the auditor?

Before implementing new reporting requirements, the IRS must also weigh taxpayer burden against the potential compliance impact. The IRS should not impose new reporting requirements if the pilot does not demonstrate the potential to significantly improve compliance.[27]

Require Reporting on Credit Card Payments to Merchants

The U.S. economy is increasingly becoming a cashless system. A 2005 survey of consumers revealed that cash and checks accounted for 45 percent of payments, down from 57 percent in 2001, and that the rate of change from cash to other methods is quickening.[28] The term "payment cards" describes the general category of "plastic" payments, which includes credit cards, debit cards, gift cards, and prepaid cards. These types of cards handled purchases of $2.6 trillion in 2005, with the total expected to rise to over $4.7 trillion in 2010.[29]

Cash Economy Strategy

26 The IRS developed the Unreported Income Discriminant Function (UIDIF) program in FY 2004 which scored tax returns according to the potential for understated income. After a pilot phase, the program was discontinued due to its limited utility, delays in selecting cases, and cost of classifying returns. IRS response to TAS for 2005 Annual Report to Congress (Dec. 23, 2005).

27 If the pilot is successful, the IRS may need to request additional resources through the budget process to build the income database.

28 American Bankers Association and Dove Consulting, *Consumer Payment Preferences*, reporting on the *2005/2006 Study of Consumer Payment Preferences* (Oct. 2005). Results are based on a survey of 3,008 respondents.

29 *The Nilson Report, Issue 865* 7 (Sept. 2006).

Payments to a merchant should be reported to the IRS in the same fashion as banks report interest payments. While not all merchants are paid using payment cards, this data would allow the IRS to identify instances where a merchant may be underreporting gross sales and should capture a great deal of commercial activity, including much of the rapidly growing Internet economy.[30]

The Department of the Treasury recommended a legislative change requiring information reporting on merchant payment card reimbursements in its fiscal year 2008 revenue proposals.[31] While the specifics of the proposal remain to be fleshed out, the National Taxpayer Advocate supports the thrust of the proposal and urges Congress to enact it.

Require Banks to Report Existence of All Individual and Merchant Bank Accounts

A common request by the IRS during an audit is for the taxpayer to provide copies of bank statements, which include critical information for analyzing deposits and investigating income issues. Auditors would be more likely to have full and complete banking information, and to uncover underreporting, if they could request statements using specific bank names and account numbers. While it is possible to avoid using a bank account when operating on a purely cash basis, this option is not practical for the vast majority of businesses.

In addition, reporting the existence of all bank accounts would likely have a positive impact on voluntary compliance. Taxpayers may be less likely to underreport income if they know their bank must report on all of their accounts to the IRS.

Implementing a requirement for banks to report on the existence of a bank account to the IRS involves no additional burden for individual or business taxpayers. Banks must already report interest income of $10 or more annually to the IRS.[32] Eliminating the $10 minimum would allow the IRS to identify the existence of bank accounts, such as non-interest bearing checking accounts, while not expanding the type of information collected.

Require 1099 Reporting for Small Corporations

Businesses must report monies paid to non-employees – above $600 annually – to the IRS,[33] unless the recipient is a corporation.[34] Eliminating this exception for small corporations would subject them to the same requirements as employees and non-corporations.[35] We

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30 Credit and debit cards account for 80 percent of internet payments, with an additional nine percent from peer-to-peer services such as PayPal. American Bankers Association and Dove Consulting, *Consumer Payment Preferences*, reporting on the *2005/2006 Study of Consumer Payment Preferences* (Oct. 2005).

31 Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* 66 (Feb. 2007).

32 IRC § 6049.

33 IRC § 6041. Monies paid to employees in the form of wages and salaries are reported to the IRS on Form W-2. Payments to businesses are reported to the IRS on Form 1099-MISC.

34 Treas. Reg. § 1.6041-3(p)(1).

35 *See* Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy*, vol. 1, *supra*.

see no reason to provide an exception for closely held corporations given the strong correlation between third party information reporting and voluntary compliance.

This proposal should be implemented contingent on evidence that substantial noncompliance exists among small corporations. Tax gap estimates for corporations are based on older data, and thus may not be reliable. The IRS's National Research Program is researching noncompliance on Form 1120S returns to obtain more current estimates.[36]

The IRS should consider developing an online system that identifies whether an entity is subject to the Form 1099 reporting requirement. This interactive system would enable payors to determine which entities they need to report on, and allow the selective extension of Form 1099 reporting to other corporate entities if necessary. The IRS may be able to add the reporting requirement feature to its existing e-Services Online TIN (Taxpayer Identification Number) Matching Program.[37] It might also be possible to deploy a similar system accessible over the phone to service taxpayers who do not have internet access.

Reverse Matching against State and Local Data

The IRS should expand data sharing with state revenue agencies. Sales tax data reported to the states can be used to determine if the taxpayer is consistent in reporting gross receipts to the state and the IRS.[38] The IRS could also explore matching against other data such as business license tax filings, real estate, and motor vehicle registry information.[39]

One IRS study matched sales tax data from Iowa against gross receipts reported to the IRS. The study found 2,607 instances where the gross sales reported to the state exceeded the gross receipts reported to IRS by $100,000 or more, and 304 cases where the difference was greater than $1 million.[40] While there may be valid reasons why the figures differ, this research demonstrates the potential for more active data sharing.[41]

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36 The administration made a similar proposal to require Form 1099 reporting for corporations. The proposal notes," Although the exception for information reporting to corporations is set forth in existing regulations, because it has been in place for many years and because Congress, during that time period, has made numerous changes to the information reporting rules, elimination of the exception should be made by legislative change." Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* (a.k.a., 2007 Blue Book) 63 (Feb. 2007).

37 The e-Services Online TIN Matching Program allows authorized payers to verify taxpayer identification numbers. See IRS Pub. 2108-A, *e-Services On-Line TIN Matching Program* (May 2004).

38 All but five states have a sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon. Federation of Tax Administrators, *2006 State Tax Collection by Source, at* http://www.taxadmin.org/fta/rate/06taxdis.html (last visited Sep. 14, 2007). IRS data sharing arrangements have generally focused on audit data. *See* IRS Seeking Increased Taxpayer Data Sharing With States, 2007 TNT 177-4 (Sept. 12, 2007) *and* IRS and States to Share Employment Tax Examination Results, 2007 TNT 216-12 (Nov. 6, 2007).

39 The IRS should consider getting lists of license holders in industries where there is a sizeable cash economy component, even if the state or locality does not collect gross receipts information in connection with the license. The IRS could use lists of licenses that help taxpayers generate income to identify potential nonfilers. Examples include liquor licenses, contractor licenses, cosmetology licenses, real estate licenses, taxi medallions, and street vending licenses (this list is for explanatory purposes only and is not meant to suggest a high degree of noncompliance in these segments).

40 IRS, Small Business/Self-Employed Division Research, Project BKN0048, *Matching State of Iowa Sales Tax Data Against Gross Receipts Reported to IRS* (Feb. 2007). The figures cited include taxpayers who filed Schedule C's, Form 1065 U.S. Return of Partnership Income, Form 1120 U.S. Corporation Income Tax Return, or Form 1120S (S Corporation).

41 State and federal tax laws may differ in the definition of what revenue sources are counted in gross receipts.

The IRS could also use information on licenses to determine if taxpayers are filing their required federal returns. For example, many states license construction contractors. Another option is to encourage states and local governments to make compliance with the federal tax laws a prerequisite for obtaining or renewing a license.[42]

It is no small challenge to develop a matching program capable of handling data exchanges from multiple jurisdictions.[43] The National Taxpayer Advocate urges the IRS to continue to expand its efforts in this area and to build the program over time, so that the IRS addresses these challenges in a way that is efficient, accurate, and imposes the least burden on taxpayers.[44]

Add Line on Schedules C for Form 1099 Income

Sole proprietors report their business income by attaching Schedule C (Profit or Loss From Business) to their Forms 1040 (Individual Income Tax Return) and report gross receipts on Line 1 of Schedule C. However, the form does not distinguish among types and sources of income. The IRS should consider redesigning the Schedule C to include two separate lines for reporting income – one line for receipts shown on Forms 1099 and one for other receipts.

Including separate lines will make clear to the taxpayer that he or she must account for all types of income, both cash and 1099 income. The change will also enable the IRS to conduct more accurate income matching. Line 1 now includes all types of income, which in many cases will not match the income reported on Forms 1099.

A related proposal is to ask the taxpayer to affirmatively declare, under penalties of perjury, whether he or she paid more than $600 to any one individual or partnership during the calendar year. An affirmative answer would require the taxpayer to indicate whether he or she reported these payments on the appropriate Forms 1099.

Adding these two questions directly confronts the taxpayer with the requirement to file income reports. Taxpayers who are unaware of the requirement or do not believe it applies to them would at least have to determine how these questions apply to them.

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42 Some states require compliance with the state tax authority. For example, Pennsylvania requires certification that all state tax returns have been filed and paid in full before issuing certain licenses. *See* http://www.dli.state.pa.us/landi/cwp/view.asp?a=362&q=238059#llc. We would ask states to implement a similar requirement that license holders be compliant with their federal taxes.

43 A significant challenge will be determining how to analyze corporation data where there may be subsidiaries that file state returns but their income is reported in the parent corporation at the federal level.

44 The IRS has investigated the potential for using state tax amnesty data. *See* Small Business/Self-Employed Division Research – Brooklyn/Hartford, Project BKN0029, *Closing the Tax Gap with State Tax Amnesty Data* (May 2006).

The IRS previously rejected these proposals. However, the National Taxpayer Advocate encourages the IRS to implement these recommendations immediately.[45]

Develop Ratios of Cash to Credit Card Receipts by Industry

As noted earlier, not all transactions are completed using payment cards. The IRS could develop industry ratios on the average share of sales from cash and payment cards, with appropriate breakouts that account for the size of the business. The IRS could use any unexplained deviations from these ratios in combination with other criteria to select returns for audit. For example, online sellers may receive 90 percent or more of their revenue through payment cards while other retail shops may receive only 60 percent.

Capture Information from Forms 8300

Retailers are required to report cash payments of over $10,000 to the IRS on Form 8300, of which the IRS received nearly 162,000 in calendar year 2006.[46] These forms help the IRS detect the possible existence of income for the person or business making a cash purchase even if it is not covered by other reporting. The Form 8300 data can be particularly useful in identifying taxpayers dealing solely in cash even when they do not have bank accounts.

The IRS currently uses this information for investigating possible violations of the Bank Secrecy Act.[47] Adding this information to the business income database described earlier could improve the system's ability to identify unreported income and provide better information to examiners should an audit take place. The IRS should also study whether other currency reporting sources included in the Currency and Banking Retrieval System should be added to the income database.[48]

Improving the Productivity of Audits

A significant challenge in addressing the cash economy is that traditional enforcement actions are either ineffective or costly in time and resources.[49] Currently, the IRS has two programs for investigating suspected noncompliance.

The Automated Underreporter (AUR) program uses third party reporting documents to identify returns where income is understated. The strength of the program is that it can "touch" a large number of taxpayers using minimal resources. However, while AUR is ef-

45 National Taxpayer Advocate 2005 Annual Report to Congress 55-75. The IRS disagreed with the proposals citing that accounting systems ordinarily do not separate Form 1099 and non-Form 1099 income, it would be costly and burdensome for taxpayers, adding lines runs counter to the Paperwork Reduction Act, and that the Form 1040 Schedule C instructions already inform the taxpayer of the filing requirements and refer the taxpayer to the General Instructions for Forms 1099, 1098, 5498 and W-2G, catalog # 11409F.

46 IRS, *Currency Reporting – Money Laundering*, at http://www.irs.gov/compliance/enforcement/article/0,,id=113003,00.html (last visited 9/10/2007).

47 IRM 4.26.4.

48 Other documents included in the Currency and Banking Retrieval System include Currency Transaction Reports, Casino Currency Transaction Reports, and Foreign Money Instrument Reports. IRM 4.26.4 (Nov. 17, 2006).

49 Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* (July 2007).

fective for wage earners with a high degree of information reporting and withholding, it is much less effective in addressing understated gross receipts.[50]

The Examination program conducts two types of audits. Correspondence audits account for the majority of examinations – 62 percent of individual non-farm business return examinations in FY 2006[51] – and deal with simple issues that exclude many of the more complex Schedule C matters. Field (face-to-face) audits handle more complex issues, but take longer to complete and "touch" fewer businesses.[52]

Initiate Single Issue Gross Receipts Audits

The National Taxpayer Advocate recommends that the IRS develop an audit program focused specifically on gross receipts and train the staff to effectively use the available tools and procedures to probe this issue.

Audits devoted solely to gross receipts offer the IRS an opportunity to effectively address the cash economy tax gap. An analysis by GAO found that ten percent of sole proprietors with understated taxes accounted for 61 percent of the total tax liability.[53] The combination of faster audits and an enhanced ability to identify noncompliant returns (using the income database described earlier) should enable the IRS to directly contact the most noncompliant taxpayers in the cash economy.

A risk of "single issue" audits is that they ignore other possible issues on the tax return, which can have the effect of giving the taxpayer a "green light" to continue noncompliant behavior. The IRS must balance that risk with the critical need to address the large cash economy tax gap. This proposal aims to address the tax gap by focusing resources on a known problem area.

If the IRS initiates single-issue gross receipts audits, it will need to make policy decisions on how to handle additional issues that may surface. For example, if a business restates its expenses once the IRS uncovers a new tax liability, should the IRS accept the expenses without further investigation or expand the audit?[54]

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50 GAO reports that only 25 percent of sole proprietor receipts appear on a Form 1099. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 17 (July 2007). *See also* Most Serious Problem, *Automated Underreporter, supra.*

51 IRS, *2006 Data Book*, Pub. 55B, Table 9 (Mar. 2007). "Field audits" include audits conducted in an IRS office or at the taxpayer's place of business.

52 The IRS has increased examinations of non-farm businesses in recent years, and field examinations are a greater share. There were approximately 113,000 field examinations of non-farm businesses in FY 2006, accounting for 38 percent of audits in this segment. IRS, *2006 Data Book*, Pub. 55B, Table 9 (Mar. 2007). This is up from 43,000 in FY 2004 (23 percent of audits) (IRS, *2004 Data Book*, Pub. 55B, Table 10 (Mar. 2005)), and 26,000 in FY 2002 (19 percent of audits) (IRS, *2002 Data Book*, Pub. 55B, Table 9 (Nov. 2003)).

53 Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 15 (July 2007).

54 The IRS might consider the type of issue in determining a course of action. For example, GAO found that while misreporting of expenses was spread over 23 expense categories on the Schedule C, 55 percent was concentrated in four categories: car and truck, depreciation, supplies, and other. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 10 (July 2007).

Simplify the Tax Code

The National Taxpayer Advocate designated the complexity of the tax code as the single most serious problem facing taxpayers in the 2004 Annual Report to Congress,[55] and believes complexity is a real and significant barrier to reducing the tax gap. The complexity of the code has created three unintended consequences.

1. Complexity increases the likelihood that honest taxpayers will make inadvertent mistakes;
2. Complexity creates opportunities for taxpayers to avoid paying their fair share of taxes; and
3. Complexity makes it difficult for the IRS to administer the tax system.

Much of the debate on complexity appropriately focuses on taxpayer burden but gives less attention to the challenges created for the IRS. The IRS must help taxpayers understand the nearly 1.4 million word tax code,[56] train employees to assist taxpayers seeking help, and identify and pursue noncompliant taxpayers.

Where an examination is necessary, simpler rules can produce more efficient audits that require less time for the taxpayer and the IRS. Former Assistant Treasury Secretary for Tax Policy Pam Olson has noted, "…Complexity in the tax law makes audits inefficient, slow, and difficult. Simplifying the tax law would improve the audit process immeasurably."[57] In 2006, the average field audit of an individual taxpayer consumed nearly 30 hours of IRS staff time.[58]

The benefits of simplification have been addressed by the GAO[59] and TIGTA,[60] and were a core tenet of the proposals from the President's Advisory Panel on Federal Tax Reform.[61]

55 National Taxpayer Advocate 2004 Annual Report to Congress, 2-7. The report describes the impact of complexity on all aspects of tax administration – customer service, tax return preparation, IRS processing, tax law and the tax gap, and taxpayer rights – and served as an overall theme of the entire report.

56 The Internal Revenue Code consists of approximately 1,395,000 words. Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendation for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume I: Study of the Overall State of the Federal Tax System* 4 (April 2001).

57 Comments of Pamela F. Olson, at tax gap conference sponsored by the American Bar Association, American Institute of Certified Public Accountants, American Tax Policy Institute, Tax Executives Institute, and the American College of Tax Counsel (June 22, 2007). *Tax Gap: Speakers Support Multifaceted Approach, Incremental Steps to Combat the Tax Gap*, BNA Daily Tax Report, June 25, 2007, and information received from Pamela Olson (Aug. 30, 2007).

58 Small Business/Self-Employed *Business Performance Review* 8, January 31, 2007. The FY 2006 average revenue agent hours per return of 29.6 is down from 37.7 in FY 2005, and 44.3 in FY 2004. Small Business/Self-Employed *Business Performance Review* 7, February 1, 2006. This decrease may suggest the typical audit is being conducted less intensively in order to increase the number of returns examined. *See* Eric Toder, *Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction*, 12 (July 2007). Additionally, we note that the IRS does not collect statistics on the number of hours *taxpayers* spend on an audit.

59 *See, for example*, Statement of David M. Walker, Comptroller General of the United States, *Business Tax Reform: Simplification and Increased Uniformity of Taxation Would Yield Benefits*, before the Committee on Finance, U.S. Senate, GAO-06-1113T (Sept. 20, 2006), and Statement of Michael Brostek, Director, Tax Issues, Government Accountability Office, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate, GAO-06-1000T (July 26, 2006).

60 *See, for example*, Statement of Russell George, Treasury Inspector General for Tax Administration, *A Closer Look at the Size and Sources of the Tax Gap*, before the U.S. Senate Committee on Finance, Subcommittee on Taxation and IRS Oversight (July 26, 2006).

61 President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005). The panel recommended simplifying recordkeeping for small businesses by basing it on receipts and expenses, and expanding expensing of assets.

The burden created by complexity hits small business owners particularly hard. A Small Business Administration study notes the cost of tax compliance is 67 percent higher for small firms than large corporations.[62]

The National Taxpayer Advocate frequently makes legislative proposals that would simplify the Internal Revenue Code and make it easier for businesses to meet their tax obligations. To illustrate, she has recommended that Congress:

- Allow married couples operating a business as co-owners to elect out of subchapter K of the Code and file one Schedule C to avoid the complex recording-keeping requirements for Form 1065;[63]
- Repeal the Alternative Minimum Tax (AMT) for individuals because it is impacting taxpayers it was never intended for, and the complexity of the AMT is such that many taxpayers are caught unaware until they prepare their returns;[64]
- Eliminate or simplify phase-outs because they create confusion and have unintended policy implications;[65] and
- Allow a small business corporation to elect to be treated as a subchapter S corporation in conjunction with timely filing its first Form 1120S.[66] This change will eliminate the drastic consequences for late filed elections in the first year of operations.

Conducting Research on the Direct and Indirect Effects of Audits

Past research has attempted to estimate the effects of audits.[67] The direct effects are the adjustments to tax liabilities as a result of audits. Indirect effects cover the estimated "ripple effect" of the audit on the taxpayer in subsequent years and on the taxpayer's family and associates. To address the tax gap, the IRS needs to determine:

- How does the fear of an audit (*i.e.,* the indirect effect) influence the behavior of those in the various business segments that comprise the cash economy?
- Is the direct impact of correspondence and field audits in the cash economy similar, or is one of those approaches clearly more effective?
- How does the impact of these audits compare between industries? For example, are correspondence audits effective for retail businesses, but ineffective in the construction industry?

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62 W. Mark Crain, under contract with the Small Business Administration, *The Impact of Regulatory Costs on Small Firms* (Sept. 2005).

63 National Taxpayer Advocate 2004 Annual Report to Congress 401-402 (Key Legislative Recommendation – Small Business Burdens). Congress enacted this proposal May 25, 2007. *See* U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, Pub. L. No. 110-28, § 8215(a), 121 Stat. 193 (2007).

64 National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem #1 – Alternative Minimum Tax for Individuals), National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Key Legislative Recommendation – Alternative Minimum Tax).

65 National Taxpayer Advocate 2006 Annual Report to Congress 470-482 (Key Legislative Recommendation – Eliminate (or Simplify) Phase-outs).

66 National Taxpayer Advocate 2004 Annual Report to Congress 390-393, and National Taxpayer Advocate 2002 Annual Report to Congress 246.

67 *See* Alan H. Plumley, IRS Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness 35-36 (Nov. 1996).

- If the impact of audits varies by the type of audit and by industries, what does this mean for IRS enforcement policy?
- Are "soft notices" effective at improving voluntary compliance in certain situations, thereby reducing the need for more costly audits?[68]

The IRS should study the impact of audits in the cash economy to help determine whether the recent increase in the small business examination rate is likely to affect the tax gap,[69] or whether an entirely new approach is warranted.

Increasing the Focus on Preparers

Return preparers play a key role in our tax system. Paid preparers handled 61 percent of all tax returns and 73 percent of sole proprietor returns in 2006.[70] Research suggests preparers can significantly influence the compliance behavior of small businesses.[71] The IRS needs more research, however, to determine the degree to which preparers impact the underreporting of gross receipts and the overstatement of expenses.[72]

Especially if research shows that preparers do significantly impact taxpayer compliance, the IRS should consider new approaches to help ensure that preparers diligently promote tax compliance among their clients. Because a return preparer may have multiple small business clients, the ability to identify preparers who understate gross receipts or inflate expenses would leverage the IRS's limited enforcement resources. One approach is to combine the TAS proposal to regulate preparers[73] with new initiatives to identify potentially problematic preparers.

Hairdressers and cab drivers must be licensed before they perform their services, but there is no such requirement for tax preparers. The National Taxpayer Advocate has proposed in the past that preparers be regulated so that taxpayers have assurance that the person preparing their tax return has some minimum level of qualifications.[74]

The IRS should investigate creating a preparer database that would allow enforcement personnel to identify potentially problematic preparers. By organizing summary tax return information on clients and preparer characteristics, the database would allow IRS research-

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68 "Soft notices" are informational or educational notices.

69 The examination rate for non-farm business returns was 3.1 percent in FY 2006, up from 2.1 percent in FY 2004, and 1.7 percent in FY 2002. IRS, *2006 Data Book*, Pub. 55B, Table 9 (Mar. 2007), *2004 Data Book*, Pub. 55B, Table 10 (Mar. 2005), *2002 Data Book*, Pub. 55B, Table 9 (Nov. 2003).

70 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2005).

71 A study conducted for the IRS found, "...the taxpayer-preparer relationship is an unusually close business relationship, with the taxpayer trusting and relying on preparer advice." Russell Marketing Research, *Findings from One-On-One efile Research Among Taxpayers and Preparers*, Pub. 4350 (June 2004). When taxpayers were asked for their perception of their preparer, 97 percent said the preparer was extremely or very experienced and knowledgeable, and 98 percent said they trusted their preparer completely or very much. *Id.* The study was targeted at taxpayers who were offered electronic filing but declined. However, the authors note that this finding provides insight into the taxpayer-preparer relationship for all taxpayers.

72 *See* Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws, infra.*

73 National Taxpayer Advocate 2006 Annual Report to Congress 197-221.

74 *See* National Taxpayer Advocate 2006 Annual Report to Congress 197-221.

ers to study voluntary compliance at the preparer level. Examples of the type of questions that could be explored include how many of the preparer's returns:

- Contain a math error;
- Have compliance risk scoring outside expected parameters;[75]
- Have had an audit and tax change; or
- Include a condition that has historically led to compliance issues.[76]

The IRS could thus create a compliance risk score that would identify preparers who may be permitting or actively fostering noncompliance. Such a risk score will need thorough review to ensure that compliant preparers are not falsely targeted.

In many cases a "soft touch" such as soft notices[77] or outreach might be sufficient to redress compliance issues.[78] The National Taxpayer Advocate recommends that the IRS conduct a test of soft notices to determine their effectiveness in improving compliance. The IRS should also initiate audits where merited, *i.e.,* when preparers are non-responsive.[79]

Conducting Research on Attitudes toward Tax Compliance

The IRS should consider establishing a research unit devoted to exploring the effect taxpayer attitudes have on voluntary compliance and finding ways to positively influence those attitudes. Existing research suggests a taxpayer's willingness to pay taxes voluntarily is not based exclusively on risk ("how likely am I to get caught if I cheat on my taxes?") but is also influenced by personal values and social norms.[80] Understanding these attitudes can help the IRS determine what types of education and outreach will maintain and increase voluntary compliance.

For example, it may be appropriate to conduct an education campaign among cash economy taxpayers emphasizing how tax revenues fund popular federal programs, including those that benefit the particular business sector. For taxpayers who have emigrated from a

75 IRS computers assign a score to returns which indicates the potential for inaccurate information on the return. The algorithms are developed based on past experience with similar returns.

76 The IRS is currently exploring automated means for identifying potential issues on tax returns. *See* IRS Small Business/Self-Employed Division Research – Seattle/San Jose, Project SEA0016, *Blaze Advisor Proof of Concept*, April 7, 2006.

77 "Soft notices" are informational or educational notices. In this situation, the notice might inform the preparer that the IRS has noticed a pattern in the preparer's returns that is often an indication of inaccurate reporting. Ideally the notice would identify specific issues that appear to be problematic. The notice could then explain the responsibilities of preparers and the possible penalties if it is determined a preparer is submitting inaccurate returns.

78 The effectiveness of a soft notice approach will depend on how the preparers react. Do notices describing concerns about a preparers' returns result in improved compliance similar to what we expect from audits? Do audits on a couple of clients result in the preparers changing behavior on all clients?

79 The IRS Small Business/Self-Employed division and the Office of Professional Responsibility co-sponsored a "Return Preparer Summit" in September 2007, with the goal of creating a servicewide preparer strategy. IRS expects the strategy and supporting action plan to be released in March 2008.

80 Margorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers, infra* (recommending the IRS implement long and short term educational and media programs to encourage voluntary compliance that incorporate the findings of behavioral research)..

country where there was wide mistrust of the government, an education campaign might emphasize the integrity of the tax system, taxpayer rights, and privacy laws.

Improving Payment Compliance

The IRS estimates the portion of the tax gap attributable to underpaying tax to be $33 billion, or about ten percent of the gross tax gap.[81] Some of this deficit is due to taxpayers intentionally avoiding their tax obligations, which traditional enforcement approaches such as liens and levies can address. However, the IRS should use other approaches to assist taxpayers who are trying to meet their obligations.

Making Payment Compliance Easier

It is possible that the underpayment component of the tax gap may grow if the IRS is successful in closing the underreporting portion of the tax gap. The National Taxpayer Advocate believes it is critical that the IRS make payment compliance easier and more effective in the future.

Encourage More Frequent Estimated Payments Through EFTPS

Self-employed individuals are required to make quarterly estimated tax payments to the IRS and are subject to a penalty for failing to make these payments by April 15, June 15, September 15, and January 15.[82] These due dates fall at irregular intervals ranging from two to four months and may result in payments being late.

One payment option available to taxpayers is the Electronic Federal Tax Payment System (EFTPS) which allows users to schedule electronic payments up to six months in advance for businesses and one year in advance for individuals, as frequently as the user wishes. The IRS should encourage taxpayers to schedule weekly or monthly payments to avoid the trouble of saving money to make lump sum payments, and to avoid penalties.

The IRS should also consider abating an estimated tax late payment penalty as an incentive for taxpayers to use EFTPS. In 2004, the IRS offered to abate one late filing penalty on missed Federal Tax Deposit (FTD) payments to encourage employers to enroll in and use EFTPS.[83] Extending this incentive to taxpayers making estimated tax payments will further increase usage of EFTPS.[84]

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81 IRS, *National Research Program*, Tax Year 2001.

82 IRC § 6654(c)(2).

83 IRS News Release, IRS Offers Penalty Refund for EFTPS Enrollment (May 24, 2004). The IRS discontinued the abatement at the end of 2006. Businesses receiving a penalty for a late FTD for any quarter after January 1, 2007 are no longer eligible for an FTD penalty refund. IRS Headliner Volume 184, IRS *To End EFTPS FTD Penalty Refund Offer* (Nov. 9, 2006). Federal Tax Deposits are the income and employment taxes withheld by employers and submitted to the IRS.

84 *See* Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy,* vol. 1, *supra* (requesting Congress to establish a goal of collecting at least 75 percent of all estimated taxes electronically by fiscal year 2014). The National Taxpayer Advocate made similar proposals in 2005. *See* National Taxpayer Advocate 2005 Annual Report to Congress 55, 64-65 (Most Serious Problem – The Cash Economy), 381, 389-391 (Key Legislative Recommendation – Measures to Reduce Noncompliance in the Cash Economy).

Send Reminder Notices to Taxpayers for Estimated Payments

For small business taxpayers not enrolled in EFTPS, the irregularly-spaced dates for estimated tax payments (see above) increase the likelihood the taxpayer will miss a deadline. The IRS should consider sending reminder notices to taxpayers who have missed payments in the past. These notices are also a prime opportunity to encourage taxpayers to enroll in the system and schedule monthly or weekly payments.[85]

Allow Voluntary Withholding Agreements between Independent Contractors and Service Recipients

As discussed earlier in this strategy, voluntary compliance is highest where there is both information reporting and withholding. Some independent contractors may wish to have a withholding agreement with one or more payors to avoid making estimated tax payments. However, it is unclear whether statutory authority exists to enter into such agreements.[86]

Congress should amend IRC § 3402(p)(3) to specifically allow voluntary reporting agreements between independent contractors and service recipients (as defined in IRC § 6041A(a)(1)).[87]

Using Collection Alternatives

For taxpayers who lack the financial means to pay the taxes they owe, traditional enforcement approaches are not effective in the long run. Collection alternatives, such as partial payment installment agreements and improved access to the offer in compromise program, should be available to taxpayers who can pay some but not all of their liabilities.[88] Otherwise, the IRS risks pushing these taxpayers into perpetual noncompliance.[89]

If the proposals in this strategy effectively identify underreporting, many taxpayers may face assessments they cannot pay. As in all situations where a taxpayer is unable to pay the full amount due, the IRS should consider collection alternatives that allow the taxpayer to quickly return to the tax system.

Exploring and implementing approaches that help resolve accounts earlier in the collection process will also make it easier for taxpayers to become compliant.[90] For example, some

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85 Both GAO and TIGTA 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).

86 For a detailed description of this issue, *see* National Taxpayer Advocate 2005 Annual Report to Congress 391-394.

87 Changes to the Code should specify that independent contractors who enter into voluntary agreements with payor service recipients will be treated as employees only to the extent specified in the agreement, and allow them to continue to deduct ordinary and business expenses under IRC § 162(a). *See* Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy,* vol. 1, *supra*.

88 *See* Most Serious Problems, *Offer In Compromise, and Status Update; Collection Strategy*, vol. I, *supra.*

89 *See* Most Serious Problem, *Offer In Compromise*, *supra.*

90 *See* National Taxpayer Advocate 2006 Annual Report to Congress 62-82.

taxpayers do not respond to IRS notices but might respond to other approaches. The IRS should consider conducting research to identify taxpayers who likely will not respond during the notice process and why they will not respond, and should investigate alternative treatments.

Other approaches may be needed to encourage taxpayers to come back into the system, such as:

- Encouraging states (through partnerships) to require taxpayers to certify tax compliance to obtain or retain business licenses;
- Requiring backup withholding for independent contractors with a history of noncompliance;[91]
- Waiving backup withholding once taxpayers demonstrate they have become compliant and agree to schedule and make future payments through EFTPS;[92] and
- Requiring federal contractors to demonstrate tax compliance.

Improving Filing Compliance

The IRS estimates the tax gap attributable to failure to file tax returns to be at least $27 billion, or about eight percent of the gross gap.[93] Reducing nonfiling is critical to reducing the gap in the long term because taxpayers must first be in the tax system before the IRS can address other compliance issues.

Unlike underreporting estimates which are based on audit results and underpayment estimates which are based on actual payment behavior, the IRS has less hard data on which to estimate the nonfiling tax gap. Current enforcement efforts to identify nonfilers, such as the Automated Substitute for Return (ASFR) program, rely heavily on third party information reporting and are limited in their reach.

Making Filing Compliance Easier

Educate Taxpayers about Filing Requirements

Table 1 presented earlier in this strategy projected a significant increase in the number of taxpayers served by SB/SE. Other IRS research notes the following trends:[94]

- U.S. Internet retail sales are expected to grow to $316 billion by 2010 at an annual rate of 14 percent;
- About one in six baby boomers plans to start his or her own business in retirement;

91 *See* Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy* Vol. I, *supra. and* National Taxpayer Advocate 2005 Annual Report to Congress 383-389.

92 *Id.*

93 IRS, *National Research Program*, Tax Year 2001.

94 Wage and Investment Research, Project 7-04-16-3-004N, *A Profile of W&I and SBSE 1040 Tax Returns for Tax Year 2001 and Trends in Self-Employment* (2004).

- Immigrants are more likely to be self-employed than U.S.-born citizens;
- The number of one-person businesses grew twice as fast between 1997 and 2002 as the number of companies with paid employees; and
- Employer buy-out offers are growing, with the former employee sometimes hired back as a contractor.

All of these trends represent opportunities to educate taxpayers on their filing requirements. The IRS should use all available research on small business trends to formulate and target its education and outreach efforts.[95] The SB/SE CLD organization should ensure that its activities address these trends and the particular needs of taxpayers in the cash economy.[96]

New entrepreneurs may be unaware of the tax implications of being self-employed and the corresponding filing obligations. Self-employed immigrants present a particular challenge. Issues affecting compliance include language barriers and cultural attitudes toward taxes.[97] Where citizenship may be an issue, immigrants who wish to pay their taxes may fear that the IRS will share data with immigration authorities.[98]

Additional Research on Nonfilers

Many of the tools that identify the underreporting of gross receipts can also be used to identify nonfilers. Evidence of income or cash expenditures, along with better use of data matching with state revenue agencies, carries enormous potential for identifying taxpayers who fail to file.

Success in improving reporting compliance will involve more than simply increasing computer matching techniques. Through careful research, the IRS should develop algorithms that increase the likelihood that potential nonfilers do in fact have a filing requirement.[99] Other research questions the IRS could pursue include:

- Have the characteristics of nonfilers changed in recent years?[100]

95 Additional research may be needed to determine when to target education messages during the business life cycle. For example, should business owners receive tax information about employees when the business is first formed or when the first employee is hired? Is repetition more effective than the timeliness of the message?

96 SB/SE convened a task force to develop recommendations for enhancing outreach and education to small business taxpayers. In September 2007, the task force provided nine recommendations which included developing a five-year strategic plan for delivering outreach and education, developing a campaign to educate first-time Schedule C filers, reducing cultural and language barriers to tax compliance, and continuing research efforts to better understand small business taxpayers.

97 National Taxpayer Advocate 2006 Annual Report to Congress, 333-354 (Most Serious Problem – Limited English Proficient Taxpayers: Language and Cultural Barriers to Tax Compliance).

98 Disclosure of federal tax data to Immigration and Customs Enforcement for nontax violations of civil law is generally not allowed under IRC § 6103. For additional information *see* IRS, *Disclosure Litigation and Reference Book*, *available at* http://www.irs.gov/pub/irs-utl/dlrbook.pdf.

99 IRS Research found that only one of four taxpayers who was sent a notice for failure to file was in fact liable for filing a return. Small Business/Self-Employed Research – Fort Lauderdale/Greensboro, Project 04.01.014.06, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Non-filers* (Jan. 2006).

100 For example, the aging of baby boomers means there will be an increasing number of older self-employed taxpayers.

- What IRS enforcement actions or services are best at restoring compliant behavior over time? For example, past research has shown that some taxpayers become nonfilers when faced with a tax debt they cannot afford to pay.[101] Which IRS responses are most associated with taxpayers becoming compliant and staying compliant – offers in compromise, installment agreements, or abating interest and penalties?
- To maximize the coverage of tax gap issues, should the IRS devote more resources to identifying and pursuing nonfilers? In other words, where should the IRS spend its next dollar to have the biggest impact in reducing the cash economy tax gap?

Conclusion

The tax gap recently has received more congressional and public attention than any other issue in tax administration — and that's appropriate. In 2001, the most recent year for which estimates are available, the net tax gap stood at $290 billion.

The largest single component of the tax gap is the cash economy. Where wages are subject to withholding or payments are subject to third-party information reporting, compliance is very high. Where there is no reporting or minimal reporting to the IRS, compliance rates plummet.

The seemingly easy answer is to require that all payments be reported to the IRS or that the IRS should move aggressively against persons who receive payments that are not reported to the IRS. In reality, however, there are no easy answers. Broadly expanding withholding or third-party information reporting will clearly close the tax gap, but will also impose significant burden on third-party payors, even where there is no compliance problem currently.

Moving aggressively against persons who receive payments that are not reported to the IRS could improve compliance rates, but the IRS does not necessarily know who receives cash payments (if it did, the problem wouldn't exist). Moving "aggressively" carries with it an assumption that taxpayers are intentionally under-reporting their income. In many cases, noncompliant taxpayers are not deliberately "cheating," but are unable or unwilling to comply with extensive tax filing and reporting rules. We must ensure that the rush to collect more revenue does not trample basic taxpayer rights.

At present, we are concerned that the IRS is addressing elements of cash economy transactions in discrete pieces. To balance the competing concerns described above, we recommend that the IRS create a Cash Economy Program Office to think through these issues and develop a comprehensive, coordinated approach.

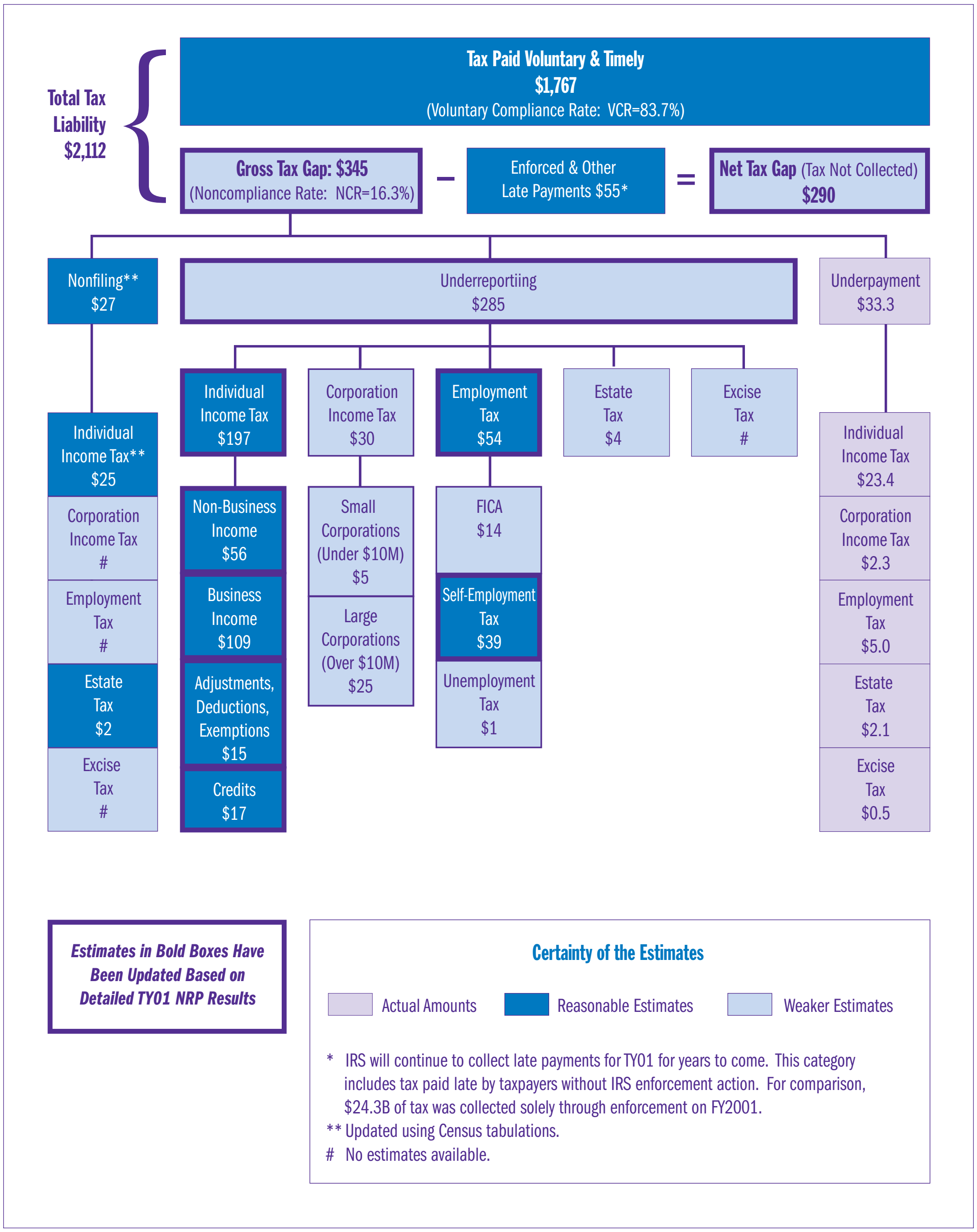
[101] Small Business/Self-Employed Research Division – Fort Lauderdale/Greensboro, Project 04.01.014.06, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Non-filers* 10 (Jan. 2006).

Among other steps, the IRS should update its procedures wherever possible to make compliance easier for taxpayers and should provide the services and outreach needed by taxpayers who are doing their best to comprehend and meet their tax obligations. The IRS should also implement new techniques for identifying and addressing noncompliance and conduct the research necessary for choosing and targeting enforcement actions while minimizing burden to the greatest extent possible and protecting taxpayer rights.

In addition, we recommend that Congress act to simplify the myriad tax requirements affecting small businesses and, where appropriate, require increased information reporting. Together, these actions should go a long way toward reducing the tax gap without imposing unreasonable burdens on taxpayers.

Appendix A – Tax Gap Map

Tax Gap Map for Tax Year 2001 (in $ Billions)



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