An hourglass-shaped graphic with a globe inside. The top bulb is dark grey, and the bottom bulb is light blue. The globe is light blue with dark blue outlines of continents. The hourglass is centered on the page.

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February 2, 2009

Congressional Research Service

Report RL33882

Tax Gap and Tax Enforcement

James M. Bickley, Government and Finance Division

November 10, 2008

Abstract. Recent and projected large federal budget deficits have generated congressional interest in the feasibility of raising revenue by reducing the tax gap. The Internal Revenue Service (IRS) defines the gross tax gap as "the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay voluntarily and timely for that year." "The net gap is the amount of the gross tax gap that remains unpaid after all enforced and other late payments are made for the tax year." For tax (calendar) year 2001, the IRS estimates a gross tax gap of \$345 billion, equal to a noncompliance rate of 16.3%. For the same tax year, IRS enforcement activities, coupled with other late payments, recovered about \$55 billion of the gross tax gap, resulting in an estimated net tax gap of \$290 billion.

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Tax Gap and Tax Enforcement

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November 10, 2008

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Congressional Research Service

7-5700

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RL33882

Summary

Recent and projected large federal budget deficits have generated congressional interest in the feasibility of raising revenue by reducing the tax gap. The Internal Revenue Service (IRS) defines the *gross* tax gap as “the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay voluntarily and timely for that year.” “The *net* gap is the amount of the gross tax gap that remains unpaid after all enforced and other late payments are made for the tax year.” For tax (calendar) year 2001, the IRS estimates a gross tax gap of \$345 billion, equal to a noncompliance rate of 16.3%. For the same tax year, IRS enforcement activities, coupled with other late payments, recovered about \$55 billion of the gross tax gap, resulting in an estimated net tax gap of \$290 billion.

The estimated gross tax gap of \$345 billion consists of underreporting of tax liability (\$285 billion), nonfiling of tax returns (\$27 billion), and underpayment of taxes (\$33 billion). (Taxes on illegal activities are excluded from these estimates.) Most of the underreporting of tax liability concerned underreporting of individual income liability (\$197 billion). The percentage of individual income that was underreported varied significantly depending on the degree of information reporting and whether or not withholding was required.

The IRS has replaced the Taxpayer Compliance Measurement Program—a systematic approach for estimating the tax gap—with the National Research Program (NRP). One of the guiding principles for the NRP is to minimize the compliance burden on those taxpayers selected for audit in the NRP sample. The new methodology of the NRP was applied to the underreporting gap for the individual income tax for tax year 2001.

Estimates of the gross tax gap have been heavily publicized; perhaps as a result, some public officials have emphasized better enforcement of tax laws in order to raise revenue. Three factors affect the dollar amount that can be collected by increased enforcement. First, much of the gross tax gap for individual income tax filers is due to types of unreported income that are difficult to detect. Second, some of the detected tax liability cannot be easily collected, particularly from those taxpayers who are currently unable to pay. Third, many detected tax liabilities are so small relative to enforcement costs that it is not cost-effective to pursue collection.

From FY2001 to FY2006, greater tax enforcement efforts by the IRS increased enforcement revenue from \$33.8 billion to \$48.7 billion. For FY2007, the IRS reported an increase in enforcement revenues to \$59.2 billion. The Office of Tax Policy developed a strategy it terms “comprehensive, integrated and multi-year” to reduce the tax gap. In his FY2009 budget, President Bush proposed 16 legislative changes. As of November 6, 2008, 19 bills relevant to the tax gap were introduced in the 110th Congress: S. 335, H.R. 695, S. 396, H.R. 878, S. 601, S. 681, H.R. 1677, S. 1219, H.R. 2136, H.R. 2345, H.R. 3056, H.R. 7082, H.R. 3923, H.R. 4318, H.R. 5523, H.R. 5602, H.R. 5716, H.R. 5719, and S. 2851.

This report will be updated as issues develop or new legislation is introduced.

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Introduction

Recent and projected large federal budget deficits have generated congressional and executive branch interest in raising revenue by reducing the tax gap.¹ Other motivations for reducing the tax gap include adverse effects on (1) public trust in the fairness of the tax system, which may adversely affect voluntary compliance with tax laws, and (2) economic efficiency by providing an incentive for inputs of labor and capital to shift to those sectors of the economy with lower taxes. This report defines tax gap concepts, explains the methodology used to estimate the tax gap, examines the relationship between the tax gap and enforcement, discusses the Internal Revenue Service's (IRS's) strategy to reduce the gross tax gap, describes tax compliance proposals in the FY2008 budget, presents tax compliance proposals in the FY2009 budget, and describes legislation proposed in the 110th Congress relevant to the tax gap.²

Tax Gap Concepts

The IRS defines the *gross* tax gap as “the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay *voluntarily* and timely for that year.”³ And it defines the *net* tax gap as “the amount of the gross tax gap that remains unpaid after all enforced and other late payments are made for the tax year.”⁴ Currently, the measurements of these tax gap concepts exclude illegal activities because the IRS lacks adequate data on these activities.⁵

For tax year 2001, the IRS estimates a gross tax gap of \$345 billion, equal to a noncompliance rate of 16.3%.⁶ For the same year, IRS enforcement activities, coupled with other late payments, recovered about \$55 billion of the gross tax gap, resulting in an estimated net tax gap of \$290 billion.⁷

¹ For the current outlook on the federal budget, see U.S. Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2008 to 2018,” Jan. 2008, 191 p. Available at <http://www.cbo.gov>.

² For a comprehensive review of the literature on tax compliance, see James Adreoni, Brian Erard, and Jonathan Feinstein, “Tax Compliance,” *Journal of Economic Literature*, vol. 36, no. 2, June 1998, pp. 818-860. For an overview of the economics of tax evasion, see Joel Slemrod, “Cheating Ourselves: The Economics of Tax Evasion,” *Journal of Economic Perspectives*, vol. 21, no. 1, winter 2007, pp. 25-48.

³ Alan Plumley, “Preliminary Update of the Tax Year 2001 Individual Income Tax Underreporting Gap Estimates,” Internal Revenue Service, *SOI Tax Stats-Papers-2005 IRS Research Conference*, Washington, June 7-8, 2005, p. 15. Available at <http://www.irs.gov/taxstats/productsandpubs/article/0,,id=130103,00.html>.

⁴ Ibid.

⁵ The IRS made tax gap studies for tax years 1979, 1983, and 1987. Each study used a different definition of the tax gap. For a discussion of the changes in the concept of the tax gap, see U.S. General Accounting Office, *Tax Administration: IRS' Tax Gap Studies*, Washington, March 1988, 23 p.

⁶ The noncompliance rate is the percentage of the aggregate tax liability that taxpayers do not pay voluntarily and timely for a given year.

⁷ U. S. Treasury, Internal Revenue Service, Feb. 2007. These data are shown in Error! Reference source not found.. The figures and table in **Appendix** are available at http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf.

The estimated gross tax gap of \$345 billion consists of underreporting of tax liability (\$285 billion), nonfiling of tax returns (\$27 billion), and underpayment of taxes (\$33 billion).⁸ For 2001, the \$285 billion of underreporting of tax liability had the following components: \$197 billion in individual income tax, \$54 billion in employment tax, \$30 billion in corporate income tax, and \$4 billion in estate taxes.⁹ There are no estimates of the underreporting of excise taxes.¹⁰ As indicated in **Figure A-2** and **Table A-1**, the percentage of individual income tax that was underreported varied significantly depending on the degree of information reporting and whether or not withholding was required. For example, as indicated in

<http://wikileaks.org/wiki/CRS-RL33882>

⁸ Ibid.

⁹ Ibid.

¹⁰ Ibid.

Table A-1, only 1.2% of the sum of wages, salaries, and tips was underreported, but 57.1% of nonfarm proprietor income was underreported. These data suggest that increased information reporting and withholding would reduce the tax gap. The increased revenue would have to be weighed against higher administrative costs of the IRS and higher compliance costs of individuals.

Methodology to Estimate the Tax Gap

The IRS has replaced the Taxpayer Compliance Measurement Program (TCMP) with the National Research Program (NRP) to estimate the gross income tax gap.

Taxpayer Compliance Measurement Program

Prior to tax year 1989, the IRS relied on data from the TCMP to estimate the gross tax gap for individual income taxpayers and small corporations (less than \$10 million in assets). The IRS formulated upper- and lower-bound estimates of the gross income tax gap. The IRS completed “line-by-line examinations of several different types of tax returns.”¹¹ The upper-bound estimates of the gross tax gap were calculated from the TCMP and regular audits of large corporations. For larger corporations (\$10 million or more in assets), the IRS relied on regular operational audits of tax returns. If an audit showed an underpayment of taxes, the IRS examiner determined the tax deficiency.¹²

The lower-bound estimate of the gross tax gap was based on the amounts eventually assessed after the appeals and litigation process. Some of the tax deficiency found from audits was negated by taxpayers’ appeals and court decisions leading to a lower estimate of taxes owed but unpaid.¹³ “The eventual assessment may be considered to be the true ‘legal’ liability in the sense that IRS cannot attempt to assess more later, except in unusual cases.”¹⁴ The net tax gap differed depending on whether the upper- or lower-bound estimate of the gross tax gap was used.

National Research Program

The last TCMP was for tax year 1988. Several times in the 1990s, IRS officials attempted to conduct a new TCMP, but some Members of Congress objected because of the high cost to the IRS and the compliance burden placed on taxpayers who were selected in the TCMP sample. Consequently, IRS developed the National Research Program (NRP). According to the IRS,

The goal of National Research Program (NRP) is to design and implement a successful strategy to collect data that will be used to measure payment, filing and reporting compliance and to deliver the data to the IRS Business Operation Division to meet a wide range of needs

¹¹ Internal Revenue Service, *Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates*, Washington, April 1990, p. 2.

¹² Ibid., p. 13.

¹³ Ibid., pp. 13-14.

¹⁴ Ibid., p. 14.

including support for the development of strategic plans and improvements in workload identification.¹⁵

A guiding principle for the NRP was to minimize compliance burden on taxpayers selected in the NRP sample.¹⁶

The NPR methodology was applied to the underreporting gap for the individual income tax for tax year 2001 and consisted of three major processes:

- (1) casebuilding—creating information files on returns selected for the NRP sample;
- (2) classification—using that information to classify the returns according to what, if any, items on the returns cannot be verified without additional information from the taxpayers; and
- (3) taxpayer audits limited to those items that cannot be independently verified.¹⁷

The IRS applied the NRP approach to about 46,000 randomly selected returns. It deliberately oversampled high income returns in order to draw conclusions about important sub-categories of taxpayers.¹⁸

Currently, the IRS is examining subchapter S corporations as part of the NRP. The IRS estimates that a large portion of the tax gap is attributable to small businesses including subchapter S corporations. The random sample consists of approximately 5,000 returns covering two tax years, 2003 and 2004. The case building and classification phases of the study are completed. The examination phase of the study began in October 2005.¹⁹

Tax Enforcement

The estimates of the gross tax gap have been heavily publicized. Perhaps as a result, some public officials have emphasized better enforcement of tax laws to raise revenue. According to some, enforcement alone is likely to have a limited impact on the gross tax gap. Acting on this view, the IRS is implementing what it terms a comprehensive approach to reduce the gross tax gap.

Limitations to Increased Enforcement

Three factors are seen limiting the net revenue potential from increased enforcement. First, much of the gross tax gap for individual income tax filers is due to types of unreported income that are difficult to detect. Usually the income is not covered by third-party information returns (e.g.,

¹⁵ Internal Revenue Service, “National Research Program (NRP), May 24, 2005, p. 1. Available at <http://www.irs.gov/privacy/article/0,,id=139179,00.html>.

¹⁶ Ibid.

¹⁷ United States General Accounting Office, *Tax Administration: IRS Is Implementing the National Research Program as Planned*, GAO-03-614, June 2003, p. 4.

¹⁸ Internal Revenue Service, “Understanding the Tax Gap,” FS-2005-14, March 2005, p. 1. Available at <http://www.irs.gov/newsroom/article/0,,id=137246,00.html>.

¹⁹ Internal Revenue Service, “Federal Tax Gap: New Estimates, New Approaches,” 2006, p. 8.

income earned by informal business proprietors who operate on a cash basis). Second, even when the unreported income is detected, some of the resulting tax liability cannot be easily collected, particularly from those taxpayers who are currently unable to pay. Third, many detected tax liabilities are so small relative to enforcement costs that it is not cost effective to pursue collection.

Tax Enforcement Efforts FY2001-FY2007

Some analysts contend that empirical data suggest that additional tax enforcement actions alone will have a limited effect on the gross tax gap. Between fiscal years 2001 and 2006, the IRS increased its enforcement efforts, and the enforcement revenue collected rose from \$33.8 billion to \$48.7 billion.²⁰ And, while \$14.9 billion represents a 44% increase, it is only 4.3% of the estimated \$345 billion gross tax gap in 2001. During the period FY2001-FY2006, staffing for key enforcement occupations rose from 20,203 to 21,185 (4.8%); examinations of individual tax returns increased from 731,756 (or 0.58% of returns) to 1,293,681 (or 0.98% of returns); examinations of business returns rose from 7,384,600 (or 0.55% of returns) to 8,722,410 (or 0.60% of returns); and examinations of tax-exempt-organization returns increased from 5,342 to 7,079.²¹

In FY2003-FY2005, some of the most abusive domestic tax shelters were eliminated by the passage of legislation and expanded IRS enforcement.²² Tax shelters are structured transactions with little or no clear business purpose.²³ In the 110th Congress, legislation was introduced to curtail tax shelters.²⁴

On January 17, 2008, the IRS reported that in FY2007 enforcement revenue reached \$59.2 billion from \$48.7 billion in FY2006.²⁵ In FY2007, audit rates for individuals increased both overall and for higher-income individuals. The number of audits for individuals with incomes over \$200,000 reached 113,105 or 29.2% more than in FY2006.²⁶ From FY2006 to FY2007, in the business sector, the audit rate rose, particularly for flow-through entities—partnerships and S Corporations.²⁷ The number of partnerships audited increased almost 25%, and the number of S Corporations audited increased 26%.²⁸

²⁰ Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results*, Nov. 20, 2006, p. 2.

²¹ *Ibid.*, pp. 2-7.

²² For an examination of tax shelters, see CRS Report RL32193, *Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals Considered in the 108th Congress*, by Jane G. Gravelle, “The Tax Shelter Battle,” in *The Crisis in Tax Administration*, Henry J. Aaron and Joel Slemrod, editors, (Washington: Brookings Institution Press, 2004), pp. 9-28.

²³ The Joint Tax Committee published two reports concerning tax compliance. Some of the options examined in its first report were enacted into law. In the 110th Congress, some options in these reports may be proposed in legislation. See U.S. Congress, Joint Committee on Taxation, “Options to Improve Tax Compliance and Reform Tax Expenditures,” Report no. JCS-02-05, 109th Congress, 1st sess., (Washington, Jan. 27, 2005), 430 p.; and U.S. Congress, Joint Committee on Taxation, “Additional Options to Improve Tax Compliance,” 109th Congress, 2nd sess., (Washington, Aug. 3, 2006), 43 p.

²⁴ For example, see S. 681, H.R. 2136, H.R. 2345, H.R. 4318, and S. 2851.

²⁵ Internal Revenue Service, “Fiscal Year 2007 Enforcement and Services Results,” Jan. 17, 2008, p. 1. Available at <http://www.irs.ustreas.gov/newsroom/article/0,,id=177701,00.html>.

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ *Ibid.*

Rather than focusing only on enforcement, the Treasury Department and the Government Accountability Office (GAO)²⁹ argued that a comprehensive strategy was needed to reduce the tax gap.

Comprehensive Strategy for Reducing the Tax Gap

The Office of Tax Policy at the Treasury developed what it considered a comprehensive strategy for reducing the tax gap, guided by the following four key principles:³⁰

- Unintentional taxpayer errors and intentional taxpayer evasion should both be addressed.
- Sources of noncompliance should be targeted with specificity.
- Enforcement activities should be combined with a commitment to taxpayer service.
- Policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.³¹

The resulting strategy developed by the Treasury (a strategy it terms “comprehensive, integrated and multi-year”) included the following seven components:

- **Reduce Opportunities for Evasion.** The Administration’s FY2007 budget includes five legislative proposals to reduce evasion opportunities and improve the efficiency of the IRS. The Treasury Department’s Office of Tax Policy is working with the IRS to develop additional legislative proposals for consideration as part of the FY2008 budget process.
- **Make a Multi-Year Commitment to Research.** Research is essential to identify sources of noncompliance so that IRS resources can be properly targeted. Regularly updating compliance research ensures that the IRS is aware of vulnerabilities as they emerge.
- **Continue Improvements in Information Technology.** Continued improvements to technology would provide the IRS with better tools to improve compliance through early detection, better case selection, and better case management.

²⁹ U.S. Government Accountability Office, *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap*, Statement of Michael Brostek, Director, Tax Issues Strategic Issues Team, before the Senate Committee on the Budget, Jan. 23, 2007, 21 p.

³⁰ This section of the report consists of excerpts from U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap*, Sept. 26, 2006, 18 p. This report was updated with more detailed information about the tax gap and components of the strategy to reduce the tax gap. This updated report is U.S. Department of the Treasury, Internal Revenue Service, *Reducing the Federal Tax Gap, Report on Improving Voluntary Compliance*, Aug. 2, 2007, 100 p.

³¹ U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap*, pp. 1-2.

- **Improve Compliance Activities.** By improving document matching, examination, and collection activities, the IRS would be better able to prevent, detect, and remedy noncompliance.
- **Enhance Taxpayer Service.** Service is especially important to help taxpayers avoid unintentional errors. Given the increasing complexity of the tax code, providing taxpayers with assistance and clear and accurate information before they file their tax returns reduces unnecessary contacts afterwards, allowing the IRS to focus enforcement resources on taxpayers who intentionally evade their tax obligations.
- **Reform and Simplify the Tax Law.** Simplifying the tax law would reduce unintentional errors caused by a lack of understanding. Simplification would also reduce the opportunities for intentional evasion and make it easier for the IRS to administer the tax laws.
- **Coordinate with Partners and Stakeholders.** Closer coordination is needed between the IRS and state and foreign governments to share information and compliance strategies. Closer coordination is also needed with practitioner organizations, including bar and accounting associations, to maintain and improve mechanisms to ensure that advisors provide appropriate tax advice.³²

Tax Compliance Proposals in FY2008 Budget

In his FY2008 budget, President Bush proposed legislation in four categories consisting of 16 changes in order to improve tax compliance.³³ These proposals are characterized as assisting implementation of the Treasury's comprehensive strategy for reducing the tax gap.³⁴ The estimated dollar amounts of receipts in each tax compliance category for FY2008-FY2012 and FY2008-FY2017 are indicated.³⁵

- **Expand information reporting.** The Administration estimates that proposed expansion of information reporting would yield total receipts of \$8.546 billion for 2008-2012 and \$28.849 billion for 2008-2017. Specific information reporting proposals would (1) require information reporting on payments to corporations—\$2,700 million for 2008-2012 and \$7,736 million for 2008-2017; (2) require basis reporting on security sales—\$1,035 million for 2008-2012 and \$6,709 million for 2008-2017; (3) expand broker information reporting—\$639 million for 2008-2012 and \$1,974 million for 2008-2017;³⁶ (4) require information

³² Ibid., pp. 2-3.

³³ The subsequent bulleted entries are excerpted from U.S. Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2008* (Washington: GPO, 2007) pp. 261-262.

³⁴ Explanations of each of these 16 changes are available in the following source: Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* (Washington: GPO, Feb. 2007) pp. 63-82. Each explanation consists of current law, reasons for the proposed change, the proposal, and the estimated revenue effect.

³⁵ Ibid., p. 267 and Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals*, pp. 63-82.

³⁶ For an examination of this reporting issue in the 110th Congress, see CRS Report RL34216, *Tax Gap: Proposals in the 110th Congress to Require Brokers to Report Basis on Publicly Traded Securities*, by James M. Bickley. On (continued...)

reporting on merchant payment card reimbursements—\$3,334 million for 2008-2012 and \$10,745 million for 2008-2017; (5) require a certified tax identification number (TIN) from non-employee service providers—\$275 million for 2008-2012 and \$749 million for 2008-2017;³⁷ (6) require increased information reporting for certain government payments for property and services—\$390 million for 2008-2012 and \$390 million for 2008-2017; and (7) increase information return penalties—\$173 million for 2008-2012 and \$546 million for 2008-2017.³⁸ All of these specific information reporting proposals would be effective for payments on or after January 1, 2008, except requiring basis reporting on security sales, which would apply to securities acquired after December 31, 2008.³⁹

- **Improve compliance by businesses.** Specific Administration proposals to improve compliance by businesses would (1) require electronic filing by certain large businesses, (2) implement standards clarifying when employee leasing companies can be held liable for their clients' federal employment taxes, and (3) amend collection due process procedures applicable to employment tax liabilities. The proposed improvement in compliance by businesses would yield estimated receipts of \$313 million for 2008-2012 and \$421 million for 2008-2017.
- **Strengthen tax administration.** Specific tax administration proposals would (1) expand IRS access to information in the National Directory of New Hires database, (2) permit the IRS to disclose to prison officials return information about tax violations, and (3) make repeated failure to file a tax return a felony. Strengthening tax administration would yield estimated receipts of \$3 million for 2008-2012 and \$17 million for 2008-2017.
- **Expand penalties.** Specific proposals to expand penalties would (1) expand preparer penalties, (2) impose a penalty on failure to comply with electronic filing requirements, and (3) create an erroneous refund claim penalty. Expanding penalties would yield estimated receipts of \$57 million for 2008-2012 and \$178 million for 2008-2017.

Thus, according to the Treasury estimates, the category of expanding information reporting would account for 95.8% of the total increase in compliance receipts of \$8.919 billion for 2008-2012 and 97.9% of the increase in compliance receipts of \$29.465 billion for 2008-2017.

(...continued)

October 3, 2008, President George W. Bush signed H.R. 1424 into law (P.L. 110-343), which included as a revenue offset, Section 403, "Broker Reporting of Customer's Basis in Securities Transactions."

³⁷ For an examination of this reporting issue in the 110th Congress, see CRS Report RL34464, *Tax Gap: Administration Proposal to Require Information Reporting on Merchant Payment Card Reimbursements*, by James M. Bickley. On July 30, 2008, President George W. Bush signed H.R. 3221 into law (P.L. 110-289), which included as a revenue offset, a requirement for information reporting to the IRS on merchant payment card reimbursements.

³⁸ Data for specific information reporting proposals are from the following source: Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* (Washington: GPO, Feb. 2007) pp. 63-72.

³⁹ Ibid.

On April 18, 2007, at a Senate Finance Committee hearing, Treasury Secretary Henry M. Paulson, Jr. stated

Our legislative proposals [in FY2008 Budget] attempt to balance the burden they impose on taxpayers against the impact they will have on improving compliance. Even so, some of the proposals have generated concern from those who could be affected by them. We must consider the impact of any new rules on the vast majority of Americans who already pay what they owe, and better target our enforcement efforts to minimize additional burdens.⁴⁰

On May 25, 2007, P.L. 110-28, U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 became law. Title VIII of this law enacted three of the 16 tax compliance proposals in the FY2008 Budget: amending the collection due process procedures applicable to employment tax liabilities, expanding preparer penalties, and creating an erroneous refund claim penalty.⁴¹

Tax Compliance Proposals in FY2009 Budget

In his FY2009 budget, President Bush proposed legislation in four categories consisting of 16 changes in order to improve tax compliance.⁴² These four categories for the FY2009 budget are the same as for the FY2008 budget and most of the specific proposals in each category are also the same. These proposals are characterized as assisting implementation of the Treasury's comprehensive strategy for reducing the tax gap. The estimated dollar amounts of receipts in each tax compliance category for FY2009-FY2013 and FY2009-FY2018 are indicated.⁴³

- **Expand information reporting.** Compliance with the tax laws is highest when payments are subject to information reporting to the IRS. Specific information reporting proposals would (1) require information reporting on payments to corporations—\$2,849 million for FY2009-FY2013 and \$8,225 million for FY2009-FY2018; (2) require basis reporting on security sales—\$1,203 million for FY2009-FY2013 and \$7,480 million for FY2009-FY2018; (3) require information reporting on broker and merchant payment card reimbursements—\$5,735 million for FY2009-FY2013 and \$18,730 million for FY2009-FY2018; (4) require a certified tax identification number (TIN) from non-employee service providers—\$248 million for FY2009-FY2013 and \$661 million for FY2009-FY2018; (5) require increased information reporting for certain government payments for property and services—\$266 million for FY2009-FY2013 and \$266 million for FY2009-FY2018; (6) increase information return penalties—\$174 million for FY2009-FY2013 and \$391 million for FY2009-FY2018; and (7)

⁴⁰ Henry M. Paulson, Jr., Testimony before the Senate Finance Committee, April 18, 2007, p. 2.

⁴¹ P.L. 110-28, Title VIII, Section 8201; Subtitle: Small Business and Work Opportunity Act; Part 2: Revenue Provisions.

⁴² The subsequent bulleted entries are excerpted from U.S. Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009* (Washington: GPO, 2008) pp. 259-260.

⁴³ Data for specific information reporting proposals are from the following source: Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2009 Revenue Proposals* (Washington: GPO, Feb. 2008) pp. 61-86.

improve the foreign trust reporting penalty—no additional revenue for FY2009-FY2013 but \$3 million for FY2009-FY2018.

- **Improve compliance by businesses.** Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would (1) require electronic filing by certain large organizations—no revenue effect; and (2) implement standards clarifying when employee leasing companies can be held liable for their clients' federal employment taxes—\$24 million for FY2009-FY2013 and \$57 million for FY2009-FY2018.
- **Strengthen tax administration.** The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would (1) expand IRS access to information in the National Directory of New Hires for tax administration purposes—no revenue effect; (2) permit the IRS to disclose to prison officials return information about tax violations—no revenue effect for FY2009-FY2013 but \$3 million for FY2009-FY2018; (3) make repeated willful failure to file a tax return a felony—\$2 million for FY2009-FY2013 and \$7 million for FY2009-FY2018; (4) facilitate information sharing with local jurisdictions for purposes of tax compliance—no revenue effect from FY2009-FY2013 but \$5 million from FY2009-FY2018; (5) extend the statute of limitations for assessing additional federal tax liability on state/local adjustments or amended returns—\$12 million from FY2009-FY2013 and \$47 million for FY2009-FY2018; and (6) improve the investigative disclosure statute—\$3 million from FY2009-FY2013 and \$10 million from FY2009-FY2018.
- **Expand penalties.** Penalties play an important role in discouraging intentional non-compliance. The Administration proposes to impose a penalty on failure to comply with electronic filing requirements—\$1 million from FY2009-FY2013 and \$6 million from FY2009-FY2019.

Thus, according to the Treasury estimates, the category of expanding information reporting would account for 99.60% of the total of \$10,517 million raised from proposals to improve tax compliance from FY2009-FY2013 and 99.62% of the \$35,891 million raised from proposals to improve tax compliance from FY2009-FY2018.⁴⁴

Legislation Proposed in the 110th Congress

As of November 6, 2008, 19 bills relevant to the tax gap had been introduced in the 110th Congress. These bills in chronological order of their dates of introduction were S. 335, H.R. 695, S. 396, H.R. 878, S. 601, S. 681, H.R. 1677, S. 1219, H.R. 2136, H.R. 2345, H.R. 3056, H.R. 7082, H.R. 3923, H.R. 4318, H.R. 5523, H.R. 5602, H.R. 5716, H.R. 5719, and S. 2851.

S. 335. To prohibit the Internal Revenue Service from using private debt collection companies, and for other purposes. On January 18, 2007, this act was introduced by Senator Byron L. Dorgan and referred to the Senate Finance Committee. This act would require the Internal Revenue Service (IRS) to suspend the use of private debt collection companies to collect

⁴⁴ *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009*, p. 266.

unpaid taxes and prohibit the use of any IRS funds for tax collection contracts with private companies.

H.R. 695. Taxpayer Abuse and Harassment Prevention Act of 2007. On January 24, 2007, this act was introduced by Representative Chris Van Hollen and referred to the House Ways and Means Committee. This act would amend the Internal Revenue Code to repeal the authority of the Secretary of the Treasury to enter into contracts with private collection agencies to collect unpaid taxes.

S. 396. A bill to amend the internal revenue code of 1986 to treat controlled foreign corporations in tax havens as domestic corporations. On January 25, 2007, this act was introduced by Senator Byron L. Dorgan and referred to the Senate Finance Committee. This act would amend the Internal Revenue Code to treat certain controlled foreign corporations created or organized under the laws of a tax-haven country as domestic corporations for tax purposes. This act sets forth a list of “tax-haven countries” and grants the Secretary of the Treasury authority to remove or add a country from such list.

H.R. 878. Simplification Through Additional Reporting Tax Act of 2007. (Note: This act is identical to S. 601, which immediately follows.) On February 7, 2007, this act was introduced by Representative Rahm Emanuel and referred to the House Ways and Means Committee. This act would require brokers to report customers’ basis in securities transactions. The Secretary of the Treasury would be responsible for issuing regulations implementing this requirement or allowing exemptions from this requirement in cases in which the brokers lack sufficient information to report basis. This act would be applicable to returns due after December 31, 2009, with respect to securities acquired after December 31, 2008.

S. 601. Simplification Through Additional Reporting Tax Act of 2007. (Note: This act is identical to H.R. 878, which is the preceding bill.) On February 14, 2007, this act was introduced by Senator Evan Bayh and referred to the Senate Finance Committee. This act would require brokers to report customers’ basis in securities transactions. The Secretary of the Treasury would be responsible for issuing regulations implementing this requirement or allowing exemptions from this requirement in cases in which the brokers lack sufficient information to report basis. This act would be applicable to returns due after December 31, 2009, with respect to securities acquired after December 31, 2008.

S. 681. Stop Tax Haven Abuse Act. (Note: This act is identical to H.R. 2136, which is subsequently described.) On February 17, 2007, this act was introduced by Senator Carl Levin and referred to the Senate Committee on Finance. This bill would “restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid federal taxation.” The purposes of this act are deterring the use of tax havens for tax evasion, combating tax haven and tax shelter abuses, combating tax shelter promoters, and requiring economic substance in tax transactions.

H.R. 1677. Taxpayer Protection Act of 2007. On March 26, 2007, this act was introduced by Representative Charles B. Rangel. On April 17, 2007, it passed in the House and on April 18, 2007, it was referred to the Senate Finance Committee. This bill would allow the IRS to disclose the return information of federal inmates to the head of the Federal Bureau of Prisons, modify reporting requirements on dispositions of U.S. real property interests, prohibit the IRS from giving providers of refund-anticipation loans debt indicators if the providers are deemed predatory, simplify tax reporting for couples who operate a joint business venture, prohibit the

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misuse of Treasury names and symbols on the Internet, and require the IRS to notify taxpayers who may be eligible for the earned income tax credit.⁴⁵

S. 1219. Taxpayer Protection and Assistance Act of 2007. On April 25, 2007, this act was introduced by Senator Jeff Bingaman and referred to the Senate Finance Committee. This act would authorize the Secretary of the Treasury to make grants for tax return preparation clinics for low-income taxpayers, allow enrolled agents licensed to practice before the IRS to use the designation of “EA” [Enrolled Agent] or “E.A.,” regulate and test paid income tax preparers, contract for the development or administration of examinations for paid income tax preparers, require the registration of refund-anticipation loan facilitators, and award demonstration project grants to assist low-income taxpayers without bank accounts to obtain such accounts with federally insured depository institutions. This act would establish in the IRS the Office of Professional Responsibility to administer the regulation of paid income tax preparers and would require this office to make public any sanctions imposed on these preparers. This act would require refund-anticipation loan facilitators to make specified disclosures to taxpayers about refund loan transactions. This act would grant the National Taxpayer Advocate authority to issue taxpayer assistance orders in cases involving closing agreements and compromises. This act would grant the Secretary of the Treasury authority to consider all facts and circumstances involving a taxpayer in evaluating an offer in compromise of tax liability.

H.R. 2136. Stop Tax Haven Abuse Act. (Note: This act is identical to S. 681, above.) This act was introduced on May 3, 2007, by Representative Lloyd Doggett and referred to the House Ways and Means Committee, the House Financial Services Committee, and the House Judiciary Committee. This bill would “restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid federal taxation.” The purposes of this act are deterring the use of tax havens for tax evasion, combating tax haven and tax shelter abuses, combating tax shelter promoters, and requiring economic substance in tax transactions.

H.R. 2345. Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2007. On May 16, 2007, this act was introduced by Representative Lloyd Doggett and referred to the House Committee on Ways and Means. This bill would “curb tax abuses by disallowing tax benefits claimed to arise from transactions without substantial economic substance.” This bill includes provisions to define “economic substance” for purposes of evaluating tax shelter transactions; increase penalties for large entities and high net-worth individuals for failure to disclose certain tax shelter transactions; impose penalties for understatements of tax due to transactions lacking economic substance; deny material tax advisors a claim of privilege as to the identity of a client; revise standards for the penalty for understatement of tax liability by income tax return preparers and increase the penalties for such understatements; revise and increase the penalties for frivolous tax submissions; deny a tax deduction for interest on underpayments of tax due to nondisclosed reportable transactions and transactions lacking economic substance; expand the authority of the Secretary of the Treasury to disallow certain tax benefits arising from the acquisition of corporate stock; modify certain passive loss rules for controlled foreign corporations; and provide a rule for the reduction in basis of corporate stock for which certain extraordinary dividends are received.

H.R. 3056. Tax Collection Responsibility Act of 2007. On July 17, 2007, this act was introduced by Representative Charles B. Rangel and referred to the House Committee on Ways

⁴⁵ This summary of the act’s contents is edited from: Congressional Budget Office, H.R. 1677, *Taxpayer Protection Act, CBO Cost Estimate*, April 13, 2007, p. 1.

and Means. On July 31, 2007, this act was reported, H.Rept. 110-281, by the Committee on Ways and Means. This act would repeal the authority for the Internal Revenue Service to enter into private debt collection contracts; delay until 2012 the requirement for federal, state, and local agencies to withhold 3% of payments for goods and services provided to such agencies; treat tax returns filed by residents of the Virgin Islands as filed in the United States for certain tax administration purposes; revise certain tax rules applicable to persons revoking their U.S. citizenship or permanent residency (expatriates) to avoid payment of U.S. taxes; repeal the suspension of penalties and interest for underpayments of tax for taxpayers who had not been notified of an underpayment; increase penalties for failing to file correct information returns, failing to furnish correct payee statements, and failing to comply with other information reporting requirements; and increase the rate of estimated tax applicable to certain large corporations for the third quarter of 2012.

H.R. 7082. Inmate Tax Fraud Prevention Act of 2008 (P.L. 110-428). On September 25, 2008, this act was introduced by Representative Jim Ramstad and referred to the House Committee on Ways and Means. This act amends the Internal Revenue Code to authorize the Secretary of the Treasury to disclose to the head of the Federal Bureau of Prisons, subject to certain restrictions, tax return information of prisoners whom the Secretary has determined may have filed or facilitated the filing of a false tax return. On October 15, 2008, President Bush signed this bill as P.L. 110-428.

H.R. 3923. Offshore Deferred Compensation Reform Act of 2007. On October 22, 2007, this act was introduced by Representative Rahm Emanuel and referred to the House Committee on Ways and Means. This act would amend the Internal Revenue Code to require the inclusion in gross income for income tax purposes of employee compensation deferred under a nonqualified deferred compensation plan of a nonqualified foreign corporation when there is no substantial risk of forfeiture of the rights to such compensation. Defines “nonqualified foreign corporation” as any foreign corporation unless substantially all of its income is: (1) effectively connected with a trade or business in the United States; or (2) subject to an income tax imposed by a foreign country that has a comprehensive tax treaty with the United States.

H.R. 4318. (Official Title as Introduced) To Amend the Internal Revenue Code of 1986 to Modify the Penalty on the Understatement of Taxpayer’s Liability by Tax Return Preparers. (S. 2851 is a companion bill) On December 6, 2007, this act was introduced by Representative Joseph Crowley and referred to the House Committee on Ways and Means. This act would amend the Internal Revenue Code to modify the standards for imposing penalties on tax return preparers for understatements of tax to require: (1) substantial authority for a position with respect to an item on a tax return; and (2) a reasonable basis for a position which was disclosed with the return. Also, this act would require tax return preparers to have a reasonable belief that a position with respect to a tax shelter or a reportable transaction (a transaction having a potential for tax avoidance or evasion) would more likely than not be sustained on its merits.

H.R. 5523. Internet Gambling Regulation and Tax Enforcement Act of 2008. On March 4, 2008, this act was introduced by Representative Jim McDermott and referred to the House Committee on Ways and Means. This act would amend the Internal Revenue Code to: (1) impose an Internet gambling license fee on Internet gambling operators; (2) require such operators to file informational returns identifying themselves and the individuals placing wagers with them; (3) require withholding of tax on annual Internet gambling winnings of more than \$5,000; (4) impose a 30% tax on the Internet gambling winnings of nonresident aliens; and (5) impose the excise tax on wagers on any individual who places a wager with an unlicensed Internet gambling operator.

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H.R. 5602. Fair Share Act of 2008. On March 13, 2008, this act was introduced by Representative Brad Ellsworth and referred to the House Committee on Ways and Means Committee. This act would amend the Internal Revenue Code and title II (Old Age, Survivors, and Disability Insurance Benefits) of the Social Security Act to treat certain foreign subsidiaries of U.S. companies performing services under a contract with the U.S. government as U.S. employers for purposes of Social Security and Medicare employment taxes.

H.R. 5716. Taxpayer Bill of Rights Act of 2008. On April 8, 2008, this act was introduced by Representative Xavier Becerra and referred to the House Committee on Ways and Means and the House Financial Services Committee. This act would amend the Internal Revenue Code to require the Secretary of the Treasury to publish a summary statement of specified taxpayer rights and obligations. The act would authorize the Secretary of the Treasury to (1) make grants to provide matching funds for qualified return preparation programs that provide volunteer income tax preparation assistance to low-income taxpayers; and (2) refer such taxpayers to taxpayer clinics funded by the federal government. This act would require the Secretary of the Treasury to establish a system for regulating and testing federal income tax return preparers. This act would require refund loan facilitators to file annual registrations with the Secretary of the Treasury and make certain disclosures to borrowers about refund anticipation loans. This act would require the Secretary of the Treasury to furnish to the public the identity of enrolled agents and registered refund loan facilitators.

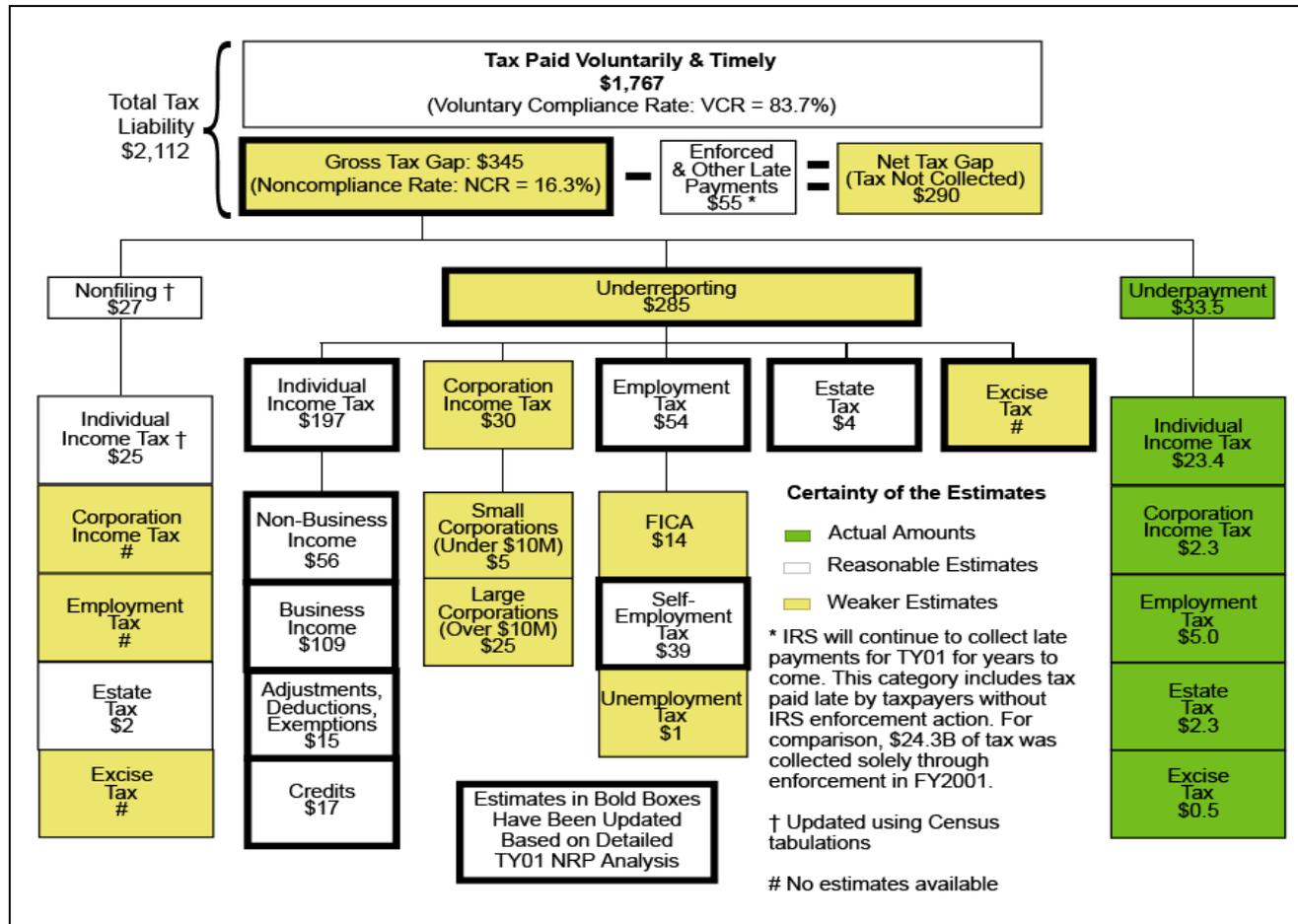
H.R. 5719. Taxpayer Assistance and Simplification Act of 2008. On April 8, 2008, this act was introduced by Representative Charles B. Rangel. On April 14, it was referred to the House Committee on Ways and Means and passed the House of April 15, 2008. On April 16, 2008 this act was referred to the Senate where was in turn referred to the Senate Committee on Finance. This act would amend the Internal Revenue Code of 1986 to conform return preparer penalty standards, delay implementation of withholding taxes on government contractors, enhance taxpayer protections, and assist low-income taxpayers.

S. 2851. (Official Title as Introduced) To Amend the Internal Revenue Code of 1986 to Modify the Penalty on the Understatement of Taxpayer's Liability by Tax Return Preparers. (H.R. 4318 is a companion bill) On April 14, 2008, this act was introduced by Senator Jim Bunning and referred to the Senate Committee on Finance. This act would amend the Internal Revenue Code to modify the standards for imposing penalties on tax return preparers for understatements of tax to require: (1) substantial authority for a position with respect to an item on a tax return; and (2) a reasonable basis for a position which was disclosed with the return. Also, this act would require tax return preparers to have a reasonable belief that a position with respect to a tax shelter or a reportable transaction (a transaction having a potential for tax avoidance or evasion) would more likely than not be sustained on its merits.

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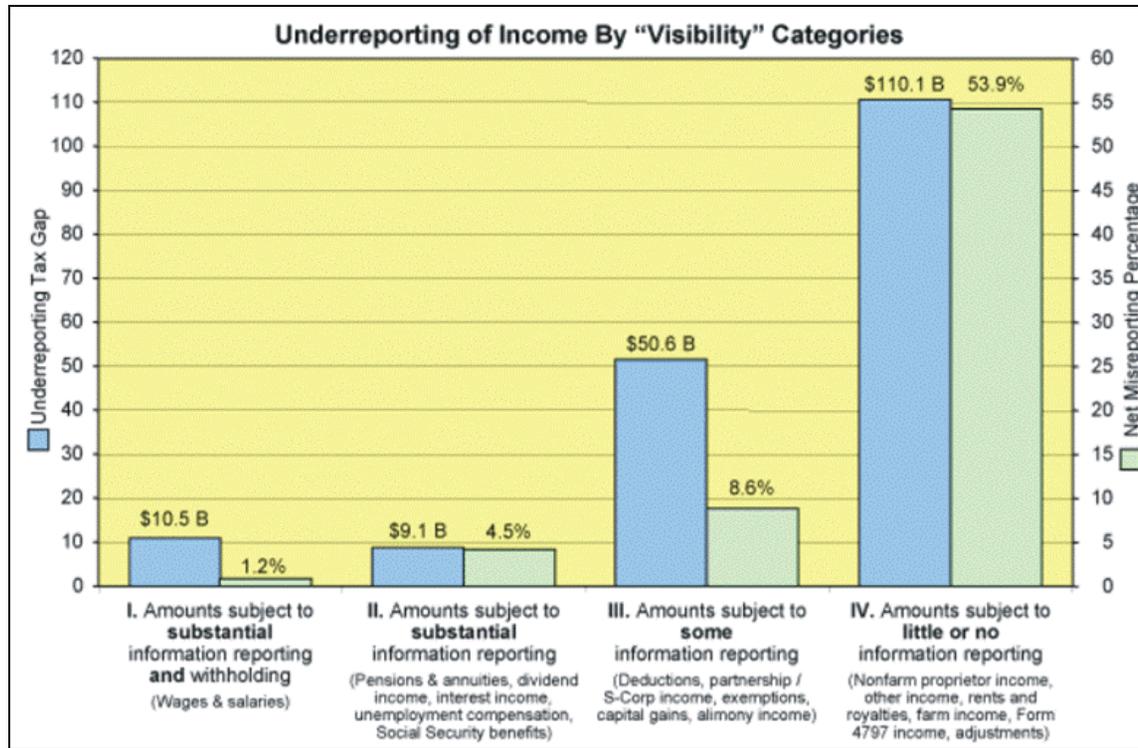
Appendix. Tax Gap Data for 2001

Figure A-1. Tax Year 2001
(in \$billions)



Source: U.S. Treasury, Internal Revenue Service, February 2007.

Figure A-2. Individual Income Tax Underreporting Gap, 2001



Source: U.S. Treasury, Internal Revenue Service, February 2007.

Note: Based on updated estimates derived from the National Research Program underreporting compliance study.

Table A-1. Individual Income Tax Underreporting Gap, 2001

| Category | Tax Gap (\$B) | NMP ^a |
|---|---------------|------------------|
| Items Subject to Substantial Information Reporting and Withholding | 10.5 | 1.2% |
| Wages, salaries, tips | 10.5 | 1.2% |
| Items Subject to Substantial Information Reporting | 9.1 | 4.5% |
| Interest income | 1.6 | 3.6% |
| Dividend income | 1.1 | 3.7% |
| State income tax refunds | 0.6 | 11.6% |
| Pensions & annuities | 4.2 | 4.1% |
| Unemployment Compensation | ^b | 11.1% |
| Social Security benefits | 1.1 | 5.8% |
| Items Subject to Some Information Reporting | 50.6 | 8.6% |
| Partnership, S-Corp, Estate & Trust, etc. | 22.0 | 17.8% |
| Alimony income | ^b | 7.2% |
| Capital gains | 11.0 | 11.8% |
| Deductions | 13.5 | 5.4% |
| Exemptions | 4.2 | 5.4% |
| Items Subject to Little or No Information Reporting | 110.1 | 53.9% |
| Form 4797 income | 3.3 | 64.4% |
| Other income | 22.6 | 63.5% |
| Nonfarm proprietor income | 68.0 | 57.1% |
| Farm income | 5.8 | 72.0% |
| Rents & royalties | 13.4 | 51.3% |
| Total Statutory Adjustments | -3.0 | -21.1% |
| Not Shown on Visibility Chart | 17.1 | 26.3% |
| Credits | 17.1 | 26.3% |
| Total | 197.4 | 18.0% |

Source: U.S. Treasury, Internal Revenue Service, February 2007.

a. NMP = Net Misreporting Percentage, the net amount of income or offset misreported divided by the amount that should have been reported.

b. Less than \$0.5 billion.

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