A Comprehensive Strategy for Reducing the Tax Gap

U.S. Department of the Treasury

Office of Tax Policy

September 26, 2006

Executive Summary

In fiscal year 2005, Federal receipts totaled over $2.2 trillion. More than 95 percent of net receipts were collected by the Internal Revenue Service (IRS) through its administration of the income, transfer and excise tax provisions of the Internal Revenue Code. The vast majority of these receipts is collected through our voluntary compliance system, under which taxpayers report and pay their taxes with no direct enforcement and minimal interaction with the government. The overall compliance rate achieved under this system is quite high. In 2001, the compliance rate was over 86 percent, after including late payments and recoveries from IRS enforcement activities. Nevertheless, an unacceptably large amount of the tax that should be paid every year is not, requiring compliant taxpayers to make up for the shortfall and giving rise to the "tax gap."

The Administration is committed to working with Congress to reduce the tax gap. This document outlines the Administration's aggressive strategy for addressing the tax gap. The strategy builds upon the current efforts of the Treasury Department and the IRS to improve compliance. As part of the deliberations in preparing the Administration's fiscal year 2008 budget request to Congress, the Treasury Department and the IRS are working with the Office of Management and Budget to further develop this strategy to reduce the tax gap. This document is intended to provide a broad base on which to build. The more detailed elements of the tax gap strategy are, in part, contingent upon the budget process for fiscal year 2008 and beyond. Accordingly, the Treasury Department and the IRS will provide a more detailed outline of steps they will take to address the tax gap following release of the Administration's fiscal year 2008 budget request early next year.

Four key principles guided the development of this strategy:

- First, unintentional taxpayer errors and intentional taxpayer evasion should both be addressed.

- Second, sources of noncompliance should be targeted with specificity.

- Third, enforcement activities should be combined with a commitment to taxpayer service.

- Fourth, policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

These principles point to the need for a comprehensive, integrated, multi-year strategy to reduce the tax gap. Our practical and effective overall strategy includes the following seven components:

1. <u>Reduce Opportunities for Evasion</u>. The Administration's fiscal year 2007 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 fiscal year 2008 budget process. The Treasury Department and the IRS will also continue to

use the regulatory guidance process to address both procedural and substantive issues to improve compliance and reduce the tax gap.

2. 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. New research is needed on the relationship between taxpayer burden and compliance and the impact of customer service on voluntary compliance. Research is also essential to establish accurate benchmarks and to measure the effectiveness of IRS efforts, including the effectiveness of this comprehensive strategy to reduce the tax gap.

3. 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.

4. Improve Compliance Activities. By improving document matching, examination, and collection activities, the IRS would be better able to prevent, detect, and remedy noncompliance. These activities would increase compliance not only among those directly contacted by the IRS, but also among those who would be deterred from noncompliant behavior as a consequence of a more visible IRS enforcement presence. The IRS continues to reengineer examination and collection procedures and invest in technology, resulting in efficiency gains and better targeting of examination efforts. These efficiency gains translate into higher audit yields, expanded examination coverage, and reduced burden on compliant taxpayers.

5. 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. The statutorily mandated Taxpayer Assistance Blueprint, the next phase of which is expected to be delivered in January, will include a process for assessing the needs and preferences of taxpayers and will develop a decision model to prioritize service initiatives and funding. The IRS is also working to provide service more efficiently and effectively through new and existing tools, such as the IRS web site.

6. 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. For example, the Administration's fiscal year 2007 budget includes six proposals to simplify the tax treatment of savings and families by consolidating existing programs and clarifying eligibility requirements. The Office of Tax Policy is developing other simplification proposals for consideration in the Administration's fiscal year 2008 budget request. In addition, the Treasury Department is evaluating the report of the President's Advisory Panel on Federal Tax Reform and is considering options for reform. These initiatives will continue to be supplemented by IRS efforts to reduce taxpayer burden by simplifying forms and procedures.

7. 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. Through contacts with practitioner organizations, the Treasury Department and the IRS learn about recent developments in tax practice and hear directly from practitioners about taxpayer concerns and potentially abusive practices. Similarly, contacts with taxpayers and their representatives, including small business representatives and low-income taxpayer advocates, provide the Treasury Department and the IRS with needed insight on ways to protect taxpayer rights and minimize the potential burdens of compliance strategies.

The success of this comprehensive strategy will depend, in significant part, on IRS resources and the agency's efficient and effective use of such resources. The IRS has made significant progress toward improving the efficient use of its allocated resources, especially in targeting enforcement efforts to areas where they will have the greatest direct and indirect impact on compliance. The IRS will continue to seek ways to make its operations more efficient and thus free resources to fund new compliance initiatives. In implementing this strategy, the Treasury Department and the IRS recognize that it will be important to establish benchmarks against which progress on each element of the strategy can be measured.

I. The Size and Source of the Tax Gap

The "gross tax gap" is the difference between the amount of tax that taxpayers should pay under the tax law and the amount they actually pay on time. In February 2006, the IRS released updated compliance estimates, showing that the gross tax gap was $345 billion in tax year 2001.[1] As a percentage of tax liability for tax year 2001, this represents a compliance rate of about 83.7 percent.

This estimate, however, does not take into account taxes that were paid voluntarily but paid late, or recoveries from IRS enforcement activities. Taking these factors into account, the "net tax gap" was an estimated $290 billion in tax year 2001, which represents a net compliance rate of 86.3 percent.

There are three key characteristics of the tax gap:

- Over 70 percent of the gross tax gap is attributable to the individual income tax, which is the largest single source of Federal receipts.
- Over 80 percent of the gross tax gap is caused by underreporting of tax (i.e., by underreporting income or overstating deductions and credits), with roughly half this amount (including self-employment tax) attributable to underreporting of net business income by individuals. Eighteen percent of the gross tax gap is attributable to underpayments of taxes or failure to file tax returns.
- Noncompliance is highest among taxpayers whose income is not subject to third-party information reporting or withholding requirements.

These characteristics suggest a targeted response designed to address the most significant areas of noncompliance. The following overview discusses these characteristics in more detail.

<u>Type of Tax</u>

As indicated above, the IRS estimates that over 70 percent of the gross tax gap is attributable to the individual income tax. As Table 1 below shows, the remainder of the tax gap is associated with employment taxes (chiefly self-employment taxes), corporate income taxes, and estate taxes.

[1] The estimates of underreporting of individual income and self-employment taxes were derived from analysis of the 2001 National Research Program (NRP). Most of the other estimates are projections derived from older compliance studies.

Table 1 Gross Tax Gap by Type of Tax		
Type of Tax	**Gross Tax Gap ($ Billions)**	**Share of Gross Tax Gap (%) [1]**
Individual Income	245	71
Corporate Income	32	9
Employment	59	17
Estate	8	2
Excise	Not Available	
TOTAL	**345**	**100**

[1] Totals may not add up to 100 percent due to rounding.

Type of Error

The IRS estimates that over 80 percent of the gross tax gap is caused by underreporting of tax (i.e., underreporting of income or overstating deductions and credits). Over 40 percent of the gross tax gap is attributable to underreporting of net business income by individuals (affecting both income and self-employment taxes). (See Table 2).

The remainder of the gross tax gap is split between two sources of errors:

- Roughly 10 percent of the gross tax gap is attributable to underpayments, a significant portion of which is due to employer failures to deposit withheld income and employment taxes.
- The remainder of the tax gap is due to failure to file tax returns, mostly for individual income taxes.

Table 2 Gross Tax Gap by Type of Error				
Type of Error			**Gross Tax Gap ($ Billions)**	**Share of Gross Tax Gap (%)[1]**
Underreporting[2]	**Individual Income Tax**			
		Non-Business Income	*56*	*16*
		Business Income	*109*	*32*
		Adjustments, Deductions, Exemptions, and Credits	*32*	*9*
		Total	**197**	**57**
	Corporation Income Tax		**30**	**9**
	Employment Tax			
		FICA	*14*	*4*
		Self-Employment Income Tax	*39*	*11*
		Total	**54**	**16**
	Estate Tax		**4**	**1**
	Total Underreporting		**285**	**83**
Underpayments[3]	*Individual Income Tax*		23	7
	Employment Tax		5	1
	Other		5	3
	Total Underpayments		**34**	**10**
Nonfiling[4]	*Individual Income Tax*		25	7
	Estate		2	1
	Total Nonfiling		**27**	**8**

[1] Totals may not add up to 100 percent due to rounding.
[2] Information regarding underreporting of excise taxes is not available.
[3] Underpayments include employer failures to deposit withheld income and employment taxes.
[4] Information regarding the nonfiling gap associated with corporate income taxes, employment taxes, or excise taxes is not available.

Level of Transparency

Tax compliance is greatest for income subject to mandatory withholding by the payer. Only one percent of the tax due on wage income (reported by employers) was not reported to the IRS by return filers in 2001.

Noncompliance rates are higher for income that is not subject to withholding, but that is reported separately to the IRS by a third party when payments are made. The net misreporting percentage is about 4.5 percent for interest income, dividends, social security benefits, pensions, and unemployment insurance, all of which are generally subject to third-party reporting. The net misreporting percentage is somewhat higher for income items that are subject to some, but not substantial, information reporting. For partnership and S corporation income, alimony, reportable exemptions and deductions, and capital gains, the net misreporting percentage is 8.6 percent.

Noncompliance rates are highest for income that is not subject to either withholding or third-party reporting requirements. About 54 percent of net income from proprietors (including farms), rents, and royalties is misreported. Underreporting of self-employment income also results in high noncompliance for self-employment taxes for social security and Medicare.

Intentional Versus Unintentional Errors

A common question is the extent to which the tax gap results from intentional evasion rather than unintentional errors by confused taxpayers. Determining taxpayer intent under a regular examination is very difficult. For obvious reasons, taxpayers do not concede that their erroneous reporting is intentional, and any analysis of the nature of the error by IRS examiners is inherently subjective. Some researchers have applied econometric techniques to compliance data to measure intentional evasion, but the results have been inconclusive. In all events, complexity provides those taxpayers who are predisposed to taking aggressive reporting positions the opportunity to argue that their errors are unintentional.

It is safe to conclude that both intentional and unintentional errors contribute to the tax gap and that any strategy to reduce the gap must address both intentional evasion as well as taxpayer confusion due to the complexity of the code.

II. Challenges to Reducing the Tax Gap

Addressing the tax gap involves improving voluntary compliance, reducing opportunities for evasion, and making it easier for the IRS to administer the tax laws. We must, however, have realistic expectations about the magnitude and timing of the impact of any reasonable strategy to reduce the tax gap, particularly if it is not accompanied by broader simplification and reform of the tax code, or significant advances in compliance technology.

Implementing a strategy to reduce the tax gap will take time. As a result, it will take time to realize the anticipated benefits. As part of this strategy, the IRS will, for example, acquire and analyze new data, improve document matching programs, refine examination selection criteria, purchase and test new technology, and train employees to handle new enforcement and customer service responsibilities.

Moreover, while it may be possible to develop a comprehensive strategy that reduces the tax gap, it is not possible to implement a policy that would come close to eliminating the tax gap without an unacceptable change in the fundamental nature of our tax compliance system.

III. A Comprehensive Strategy to Reduce the Tax Gap

With an estimated net tax gap of $290 billion, no single approach will be successful at substantially reducing noncompliance. A comprehensive, integrated, multi-year strategy is necessary, within the context of an annual budget process.

1. Reduce Opportunities for Evasion

Without reliable third-party data, the IRS cannot easily detect errors in the absence of expensive and intrusive audits. The IRS receives over 1.5 billion information returns a year, reporting income from employers, financial institutions, third party payers, and state and Federal governments. However, the IRS still lacks reliable information on certain types of income, most notably income earned by the self-employed.

Penalties can deter noncompliance, but they may be set at the wrong level. Some penalties may be too low under current law to change behavior. Other penalties may be so high that examiners have been unable or unwilling to assert them, particularly when they believe that taxpayers may have made inadvertent errors.

The Administration's fiscal year 2007 budget contains five legislative proposals that would reduce evasion opportunities by focusing on employment taxes, information reporting, streamlining collection procedures, and problem return preparers. The legislative proposals in the Administration's fiscal year 2007 budget are an important step in reducing the tax gap. The Treasury Department is developing other proposals for consideration during the deliberations on the fiscal year 2008 budget, which would further reduce opportunities for evasion without unduly burdening honest taxpayers.

During these deliberations, we are exploring a number of different options including ways to:

- Strengthen reporting requirements;
- Expand IRS access to reliable data;
- Enhance examination and collections authority;
- Enable the IRS to detect and prevent multi-year noncompliance; and
- Set penalties at more appropriate levels.

The issuance of regulations and administrative guidance by the Treasury Department and the IRS will also continue to play an important role in effectively administering the tax law and responding to the tax gap problem. Guidance clarifies ambiguous areas of the law, increasing voluntary compliance. Guidance also targets specific areas of noncompliance, and prevents abusive behavior, such as tax shelters. Each year, the Treasury Department and the IRS publish a Priority Guidance Plan. The 2006-2007 plan includes 264 guidance projects scheduled for completion between July 2006 and June 2007. Many of the 264 guidance items included in this year's plan address potential areas of noncompliance. A representative sample of these items includes:

- Guidance regarding transfer-pricing arrangements involving cost-sharing under section 482;

- Guidance under section 671 regarding information reporting by widely-held fixed investment trusts (WHFITs);

- Final regulations under section 860G(b) regarding withholding obligations of partnerships allocating income from real estate mortgage investment conduit (REMIC) residual interests to foreign persons; and

- Final regulations under section 6655 regarding estimated tax payments by corporations.

The Treasury Department and the IRS have also successfully used the guidance process to help curb the involvement of taxpayers and practitioners in abusive tax avoidance transactions. For example, following enactment of the American Jobs Creation Act of 2004 ("AJCA"), the Treasury Department and the IRS released eleven separate guidance items to put into effect new reportable transaction disclosure and penalty rules. A major guidance project is currently underway to incorporate these rules into regulations. In addition, building on provisions in the AJCA, the Treasury Department and the IRS have taken significant steps to tighten and enforce the ethical rules that apply to tax practitioners, targeting improper tax advice as a significant contributor to noncompliance and the tax gap.

The publication of instructions and forms also contributes to increased efficiencies in tax administration. For example, the IRS and the Treasury Department developed the Schedule M-3 for large business taxpayers to disclose and reconcile book-tax differences. The Schedule M-3 increases the transparency of book-tax differences, resulting in a material increase in the IRS's ability to detect sources of noncompliance. The Treasury Department and the IRS are expanding Schedule M-3 coverage to S corporations and partnerships.

Following release of the Administration's fiscal year 2008 budget request, the Treasury Department and the IRS will issue a more detailed outline of the steps we will take to reduce opportunities for evasion and address the tax gap. In addition, the Treasury Department and the IRS will continue to identify guidance projects targeted to compliance and include them in regular updates to the Priority Guidance Plan.

2. Make a Multi-Year Commitment to Research

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, allocate resources more effectively, and reduce the tax gap.

The National Research Program (NRP) demonstrates the importance of comprehensive compliance data. As part of the NRP, the IRS reviewed approximately 46,000 randomly sampled individual income tax returns from tax year 2001 – the first comprehensive compliance study for individual income tax returns since 1988. Returns for which reported information could not be independently verified were audited. An NRP reporting compliance study of 5,000 S corporation tax returns filed in 2003 and 2004 is currently underway.

Data from the NRP reporting compliance study have been used to estimate the individual income tax component of the tax gap and to identify sources of noncompliance. Accurate NRP data provides a critical benchmark for determining the sources of noncompliance and for measuring changes in compliance rates over time. The IRS is also using the findings from the NRP to target examinations and other compliance activities better, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

More compliance research is needed. Without new reporting compliance studies, the IRS is forced to rely on old studies, conducted over 20 years ago, to estimate compliance for areas other than individual income tax or S corporations. Moreover, with each passing year, the data from the 2001 study on individual income tax compliance becomes more outdated. Without up-to-date studies in all areas, the IRS is hampered in its ability to respond rapidly to emerging vulnerabilities in the tax system. A multi-year commitment to research would ensure that the IRS can efficiently target its resources and effectively respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas because this reduces the burden of unnecessary taxpayer contacts. Research is also critical in helping the IRS to establish benchmarks against which to measure progress in improving compliance.

The IRS is considering new research projects in the following areas:

- *Regularly update NRP reporting compliance studies*. NRP studies (such as the 2001 reporting compliance study of individual taxpayers) must be regularly and frequently scheduled to ensure that the IRS has the most up-to-date compliance data.

- *Initiate new NRP reporting compliance studies*. To provide the IRS with more comprehensive data on the magnitude and sources of noncompliance, NRP studies could extend to partnerships, other business entities, employment taxes, exempt organizations, and government entities.

- *Supplement NRP reporting compliance studies with smaller and more targeted compliance studies*. By focusing on specific areas of noncompliance, smaller studies can yield more information about the sources of noncompliance. Targeted studies can also provide insight into the effectiveness of different types of compliance strategies.

- *Examine the linkages between taxpayer services and compliance.* Research would provide a better understanding of the relationship between taxpayer burdens and compliance and the impact of taxpayer service on voluntary compliance, two areas where there has been limited work to date. Understanding the link between taxpayer service and voluntary compliance could help the IRS better target taxpayer services as well as develop programs that would both ease taxpayer burden and improve voluntary compliance.

- *Develop new tools to uncover patterns of noncompliance.* Research must be done to understand the changing patterns of noncompliance and to develop tools to discover and address it. Improved abilities to link data sets and to recognize similarities in abusive tax reduction strategies allow the IRS to target examination resources on the most egregious cases.

- *Improve the allocation of resources.* Research could help the IRS better match enforcement and service resources with the types of noncompliance, thereby maximizing the overall impact on compliance.

3. Continue Improvements in Information Technology

Tax administration in the 21st century requires improved IRS information technology (IT). The IRS is committed to continuing to make improvements in technology, including:

- Replacing antiquated core account management systems and technology. The Customer Account Data Engine (CADE) is the technological foundation that will enable the IRS to manage its tax accounts better and provide the data for a modernized IRS. Over time, the existing data base (the Individual Master File) and retrieval system (the Integrated Data Retrieval System) will be replaced with new technologies, new data bases, and new applications.

- Expanding and enhancing compliance activities through early detection, better case selection, and better case management.

- Delivering effective customer service, including E-File systems and web services, at reduced cost.

- Investing in infrastructure necessary to perform operations more efficiently, thus freeing up resources for enforcement and taxpayer service projects.

Upon release of the Administration's fiscal year 2008 budget request, the IRS will report on specific steps that will be taken to continue to improve its information technology.

4. Improve Compliance Activities

The IRS has an annual budget of roughly $10.5 billion for fiscal year 2006 to process roughly 140 million individual, partnership, and corporate income tax returns and 1.5

billion information returns, provide guidance to taxpayers and their preparers, enforce the tax law, and collect over $2 trillion of taxes. The IRS can address only a small part of the tax gap each year through its enforcement activities. In 2005 taxpayer contacts by the IRS included: 3.2 million notices sent to individual taxpayers who made mathematical or clerical errors on their 2004 tax returns, 3.5 million notices sent to taxpayers who underreported income on their tax returns or did not file returns, and 1.2 million examinations of individual income tax returns.

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. For example, to combat abusive tax avoidance transactions, the IRS is expanding its front-line enforcement activities by redirecting employees. As detailed in the following section, the IRS continues to take advantage of technological advances, such as the Internet, to improve taxpayer services. Not only do these technological advances ease taxpayer burden, but they free valuable IRS resources to be devoted to enforcement activities.

The IRS will continue to reengineer its examination and collection procedures to reduce time, increase yield, and expand coverage. As part of its regular examination program, the IRS is expanding the use of cost-efficient audit techniques first pioneered in the NRP. By increasing its use of reliable third-party data to verify information reported by taxpayers, the IRS can better target its audit resources. The IRS is expanding its efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as non-filers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

However, efficiency gains in existing programs alone will not significantly reduce the tax gap. Some of the new steps described elsewhere in this strategy, such as providing the IRS with access to more third-party data and simplifying the tax code, would also help make compliance activities more effective.

To reduce the tax gap further, new initiatives, such as the following, are needed:

- *Expand information reporting*. If legislation were enacted to strengthen reporting requirements, the IRS could use the new information to increase and better target its enforcement activities. Voluntary compliance would also improve, freeing IRS resources to focus on more questionable returns.

- *Improve document matching program*. Increasing the number of inquiries to taxpayers when there are discrepancies between amounts reported on tax returns and third-party information returns would improve compliance.

- *Refine detection programs.* Refining and expanding detection programs to target enforcement efforts on noncompliant taxpayers would ensure that IRS resources are used effectively.

- *Increase examinations in selected areas.* Some types of noncompliance (such as the large amount of noncompliance attributable to unreported business income) can only be detected and prevented through labor-intensive, expensive examinations. Reducing the tax gap will require more examinations in areas where they are most cost-effective in recovering amounts attributable to past noncompliance and deterring future noncompliance. As noted above, the IRS is continuing to reengineer the examination process, allowing for some increase in coverage.

Implementation of these initiatives would have both direct and indirect benefits. Improving compliance activities would result in an increase in enforcement revenues as more noncompliant taxpayers are contacted and examined (the direct benefit). In addition, a more visible IRS enforcement presence would deter other taxpayers from evading their tax obligations, thus leading to an increase in voluntary compliance (the indirect benefit).

5. Enhance Taxpayer Service

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the Internet, taxpayer assistance centers, and volunteer income tax assistance (VITA) and tax counseling for the elderly (TCE) sites. Assisting taxpayers with their tax questions before they file their returns reduces burdensome notices and other correspondence from the IRS after returns are filed and reduces inadvertent noncompliance overall.

Since the enactment of the IRS Restructuring and Reform Act of 1998, the IRS has significantly improved customer service. For example: (1) in the 2006 filing season, over 56 percent of all individual taxpayers filed electronically (more than double the number who filed electronically in fiscal year 1999); (2) Low-Income Taxpayer Clinics have been established to provide free or nominal charge representation for low-income taxpayers in Federal tax disputes, and to provide tax education and outreach for taxpayers who speak English as a second language; (3) the number of hits on the IRS web site ("IRS.gov"), which enables taxpayers to more easily obtain forms, track refunds, and get answers to their questions, grew to over 135 million during 2006, up nearly 8 percent from 2005; (4) other services, including the provision of transcripts of tax returns and matching of taxpayer identification numbers for third-party payers, are now being provided on-line; and (5) a pilot Compliance Assurance Process (CAP) program, which allows large corporations to work with the IRS to determine tax return accuracy prior to filing, provides these corporations with greater accuracy on their tax returns and greater certainty about their tax liability at an earlier date.

In report language accompanying the fiscal year 2006 Appropriations bill for the Treasury Department, the Senate Committee on Appropriations requested that the IRS develop a five-year plan to improve taxpayer services. The Taxpayer Assistance Blueprint, the next phase of which will be delivered in January, will include a process for assessing taxpayer needs and preferences, develop a decision model to prioritize service initiatives and funding, recommend service improvement initiatives, create customer-centric performance and outcome measures, and outline a multi-year research plan. The

Taxpayer Assistance Blueprint will also provide an important tool to help establish benchmarks against which improvements in customer service can be measured.

6. Reform and Simplify the Tax Law

The current tax code is too complicated. The complexity of the tax code makes the tax law too difficult for taxpayers to understand and for the IRS to administer. Special rules and subtle distinctions in the tax law foster a sense of unfairness in our tax system, discouraging compliance and increasing the tax gap.

Taxpayers who want to comply with the tax code often make unintentional errors on their returns, as they struggle to understand complicated rules and forms. Complexity also provides opportunities for those who are willing to exploit the system. Furthermore, complexity makes it difficult for the IRS to detect noncompliance. Simplifying the tax code will reduce unintentional errors by well-meaning taxpayers and reduce opportunities for evasion. A simpler tax code will also be easier for the IRS to administer.

The complexity of the tax law also contributes to the tax gap because limited IRS resources are increasingly committed to administering a wide array of targeted tax provisions created to meet social policy goals. These targeted provisions, which themselves are growing increasingly complicated, divert IRS resources from basic compliance efforts.

The Administration's fiscal year 2007 budget contains six proposals that would simplify the tax treatment of savings and families. The Treasury Department will continue to develop additional legislative proposals to simplify the tax code in ways that will reduce the tax gap. In addition, the Treasury Department is studying the report of the President's Advisory Panel on Tax Reform and is considering options for reform. Simplification proposals aimed at reducing the tax gap would be part of a reform proposal.

Legislative initiatives will continue to be supplemented by administrative efforts to reduce taxpayer burdens. In recent years, the IRS has taken a number of steps to reduce taxpayer burden, including the establishment of the Office of Taxpayer Burden Reduction (TBR). Recent improvements in IRS forms, processes and procedures include simplifying the filing requirements for Form 944 (Employer's Annual Federal Tax Return), eliminating the need for filing Form 2688 (Application for Additional Extension of Time to File U.S. Individual Income Tax Return) by allowing the taxpayer to get an automatic six month extension to file, and the creation of the EITC Assistant, an on-line tool that helps taxpayers determine their eligibility for the earned income tax credit (EITC) and the estimated EITC amount. Additional projects to simplify tax forms and processes are currently under review by TBR.

7. Coordinate with Partners and Stakeholders

The Treasury Department and the IRS extensively coordinate with state and foreign governments, taxpayer representative groups and practitioners to increase compliance, gain efficiencies in tax administration, improve taxpayer services and minimize taxpayer burden. Increasing the level of such coordination activities will be an important part of a successful effort to reduce the tax gap.

- *International Exchange of Information*. Through tax treaties and tax information exchange agreements, the United States is able to obtain from foreign tax authorities information needed to enforce U.S. tax laws. In addition, the United States participates in information sharing regarding broader, non-taxpayer-specific information. For example, through the Joint International Tax Shelter Information Centre (JITSIC), the IRS and tax authorities in other participating countries will continue to share information regarding abusive tax avoidance transactions.

- *Federal-State Partnerships*. The IRS continues to work with state governments to develop strategies to address trends in noncompliance. For example, combined Federal-state employment tax reporting allows extensive coordination between the IRS and state governments with respect to employer noncompliance with employment tax obligations. In addition, the Treasury Department's Financial Management Service and the IRS will launch a pilot program with two states in January 2007 to enable taxpayers to pay all their Federal and certain state taxes online by means of the Treasury's Electronic Federal Tax Payment System (EFTPS). This initiative will provide one stop for taxpayers to make their Federal and state tax payments. Additional actions to address the tax gap in the next 18 months will include:

    - Exploring the use of state data-mining capabilities, designed to utilize proprietary state data, to refine further and prioritize IRS audit leads;
    - Testing the use of state Department of Revenue audit reports as an efficient basis for IRS audit assessments;
    - Testing the use of State Workforce Agency employment tax audit reports as an efficient basis for similar IRS audit assessments;
    - Expanding coordination with other Federal agencies with the goal of leveraging their resources and securing data pertinent to IRS compliance programs;
    - Identifying state and Federal resources and programs that can be used to communicate tax gap messages; and
    - Identifying non-traditional methods utilizing state and Federal resources to communicate the societal impact of the tax gap.

- *Practitioner Liaison and Education*. The Treasury Department and the IRS conduct liaison and education activities with practitioners in order to learn about developments in tax return preparation and to ensure that advisors provide appropriate tax advice. The IRS maintains active relationships with several national practitioner groups, small business representatives, and industry organizations to provide information related to the most current IRS positions and guidance. The creation of the Office of Professional Responsibility has helped restore credibility to enforcement of professional standards. Over the next 12 months, the IRS will enhance outreach efforts with these practitioner and industry stakeholders to engage in a discussion of key components of the tax gap including:

    - Proper reporting of gross receipts;
    - Correct computation of business deductions such as cost of goods sold, depreciation, travel and entertainment expenses, and motor vehicle expenses; and
    - Third party information reporting.

- *Taxpayer Representatives*. The Treasury Department and the IRS often communicate with taxpayer representative groups to learn about taxpayer concerns, including issues regarding taxpayer rights in administering the tax code. For example, comments received from organizations representing low-income taxpayers significantly improved new EITC procedures that are currently being tested by the IRS. Recent meetings with representatives of small businesses have focused on the importance of balancing the IRS's need for action in areas of noncompliance with taxpayer concerns about increased burdens. Ongoing interaction with these groups is an integral part of this tax gap strategy.

Conclusion

The Administration is committed to reducing the tax gap. In doing so, the Administration recognizes that the most effective way to reduce the tax gap is to increase compliance rates through a combination of initiatives (including targeted legislative and administrative changes, taxpayer service, and enforcement efforts) that are sensitive to taxpayer rights and minimize taxpayer burden. Simplification of the tax law is also critically important to this effort. This document provides a broad strategy for reducing the tax gap. The Administration is committed to working with Congress to further refine and implement it.

Tax Gap Strategy Timeline for Fiscal Year 2007

2006	
September	• Initial tax gap strategy
October	• Stakeholder meetings to review initial tax gap strategy
November	• Development of Administration legislative proposals for inclusion in fiscal year 2008 budget request • Development of Administration's budget request for the IRS for fiscal year 2008
December	• Proposal for next NRP Reporting Compliance Study
2007	
January	• Taxpayer Advocate's Annual Report to Congress • Update of 2006-2007 Treasury Department/IRS Priority Guidance Plan • Launch of Federal/State Electronic Federal Tax Payment System (EFTPS). • Deliver Taxpayer Assistance Blueprint Phase II Report to Congress
February	• Administration's fiscal year 2008 budget request, including anticipated legislative proposals for compliance initiatives, tax code simplification and IRS funding
March/April	• Detailed outline of IRS tax gap strategy reflecting provisions in Administration's fiscal year 2008 budget request o Outline steps to reduce opportunities for evasion o Outline IRS research initiatives o Outline IRS information technology initiatives o Outline IRS compliance initiatives o Outline IRS taxpayer service initiatives o Outline steps to reform and simplify the tax law
May	• Stakeholder meetings to discuss Administration's fiscal year 2008 budget request
June	• Treasury Department review of practitioner compliance initiatives
July	• 2007-2008 Treasury Department/IRS Priority Guidance Plan.