

**COMMITTEE ON WAYS AND MEANS
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**“Understanding The Tax Gap And
Taxpayer Noncompliance”**



**Testimony of
The Honorable J. Russell George
Treasury Inspector General for Tax Administration**

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Washington, D.C.

TESTIMONY
OF
THE HONORABLE J. RUSSELL GEORGE
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before the
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Chairman Neal, Ranking Member Brady, and Members of the Committee, thank you for the opportunity to discuss the Tax Gap, as well as challenges confronting the Internal Revenue Service (IRS) as it attempts to address taxpayer compliance.

The Treasury Inspector General for Tax Administration (TIGTA) was created by Congress in 1998 with a statutory mandate of ensuring integrity in America’s tax system. It provides independent audit and investigative services to improve the economy, efficiency, and effectiveness of IRS operations. TIGTA’s oversight activities are designed to identify high-risk systemic inefficiencies in IRS operations and to investigate exploited weaknesses in tax administration. TIGTA plays the key role of ensuring that the approximately 80,000 IRS employees¹ who collected more than \$3.5 trillion in tax revenue, processed more than 253 million tax returns and other forms, and issued more than \$464 billion in tax refunds during Fiscal Year (FY) 2018,² have done so in an effective and efficient manner while minimizing the risk of waste, fraud, and abuse.

In my testimony, I will discuss the Tax Gap and the work that TIGTA has completed as well as ways the IRS can improve its ability to address noncompliance by taxpayers.

SIZE AND SOURCES OF THE TAX GAP

The difference between what taxpayers owe and what they pay timely is referred to as the Tax Gap. The gross Tax Gap is the amount that is owed by taxpayers before collections from IRS enforcement actions and other late taxpayer payments are taken

¹ Total IRS staffing as of April 13, 2019. Included in the total are approximately 15,740 seasonal and part-time employees.

² IRS, *Management’s Discussion & Analysis, Fiscal Year 2018*.

into account and is estimated to be \$458 billion annually.³ The net Tax Gap is the difference between the amount that is owed by taxpayers and what is paid after taking into consideration the amount that the IRS enforcement efforts bring in and is estimated to average \$406 billion per year for Tax Years 2008-2010. The different components of the Tax Gap reflect different types of noncompliance, such as underreporting of taxes and nonpayment of taxes, as well as the types of taxes, such as income taxes, employment taxes, and estate and gift taxes. The underreporting of income taxes comprises the largest component of the Tax Gap at \$387 billion annually,⁴ with amounts attributable to nonfiling and nonpayment of taxes at \$32 billion and \$39 billion respectively.

OPPORTUNITIES TO IMPROVE TAX COMPLIANCE

If the IRS can increase the rates of voluntary compliance, it can reduce the Tax Gap. There are a number of different factors that drive voluntary tax compliance. The IRS estimates that information reporting and withholding requirements are significant drivers of tax compliance. For instance, when there is information reporting and withholding at the source tax compliance is approximately 99 percent. When there is information reporting, tax compliance is approximately 93 percent. When there is neither withholding nor information reporting, the IRS believes tax compliance is as low as 37 percent.⁵ The IRS also believes that the use of certain tax enforcement tools are more effective than other enforcement tools in driving tax compliance. For example, the use of tax audits has a significant positive indirect effect on tax compliance of 11.7 times the direct effect of the proposed adjustment.⁶ In 2002, the IRS determined (using 1991 tax data) that, if the audit rate was one percentage point higher, it would have yielded an additional \$56 billion in tax revenues. In other words, there is a significant multiplier effect on tax compliance derived from conducting audits. However, the IRS's audit rate has been decreasing, with 1.11 percent of all returns audited in 2010, 1.03 percent in 2012, .96 percent in 2013, .86 percent in 2014, .7 percent in 2015, and .5 percent in 2016. An explanation for this decrease is noted in the following section of this testimony.

³ Hereafter in this testimony, the Tax Gap refers to the gross Tax Gap.

⁴ Improper payments for the Earned Income Tax Credit and other refundable credits are considered as a component of this amount.

⁵ Federal Tax Compliance Research: Tax Gap Estimates Tax Years 2008-2010.

⁶ *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, 95th Annual Conference on Taxation (Nov. 14-16, 2002).

Diminished Resources Have Impacted Tax Compliance

Given the importance of audits to tax compliance, both because of the extent to which underreporting is the most significant component of the Tax Gap and because of the significant positive multiplier compliance effect from audits, it is important that the IRS has the resources to maintain or increase its audit coverage. However, due to diminished resources, IRS Examination personnel have decreased 38 percent from 13,138 examiners in FY 2010 to 8,205 examiners in FY 2017. The number of audits has also decreased by 32 percent from 1.6 million in FY 2013 to 1.1 million in FY 2017. Proposed assessments have steadily declined over the last 10 years, from \$44 billion in FY 2007 to \$29 billion in FY 2017.

Nonpayment of taxes owed is a smaller portion of the Tax Gap, estimated to be \$39 billion annually. However, similar reductions in resources have impacted payment compliance. From FY 2010 to FY 2017, field revenue officers have decreased by 42 percent from 4,016 to 2,364 (*i.e.*, 1,652 fewer Collection personnel). On average, revenue officers typically collect close to \$2 million each annually. With 1,652 fewer revenue officers, the Treasury collects approximately \$3.3 billion less each year.

The nonfiler component of the Tax Gap is estimated to be \$32 billion. In 2002, the IRS determined that of all the compliance programs, the nonfiler program is the most cost-effective. At the time, however, the IRS believed that it was following up on most of the nonfiler leads. In several recent audits, TIGTA has determined that the IRS's nonfiler program has been significantly diminished.⁷ From FY 2011 to FY 2014, the IRS collected \$11 billion from the Automated Substitute for Return Program (ASFR) (a component of the IRS's overall nonfiler strategy); however, during TIGTA's 2017 audit, it was determined the program had been suspended due to resource issues. In an audit of the IRS's overall nonfiler strategy, TIGTA learned that, due to resource issues, the IRS decided not to pursue high-income taxpayers who had submitted applications for extension of time to file tax returns for Tax Year (TY) 2012 but did not file a tax return, and that the IRS had not pursued any taxpayers in TY 2013 who had submitted applications for extension of time to file but had never filed tax returns. TIGTA recommended that the IRS resume the ASFR program, and the IRS agreed and is in the process of revising its nonfiler strategy.

⁷ TIGTA Ref. No. 2017-30-078, *A Significantly Reduced Automated Substitute for Return Program Negatively Affected Collection and Filing Compliance* (Sept. 2017); TIGTA Ref. No. 2016-30-085, *Improvements to the Nonfiler Program Could More Effectively Help the IRS Address Additional Nonfilers Owing Billions of Dollars in Taxes*, (Sept. 2016).

The Criminal Investigation (CI) division contributes to increased tax compliance by pursuing tax and tax related crimes. However, resource constraints have caused CI to reduce its investigations by 45 percent. The number of investigations started by CI diminished by 2,428 per year, down from 5,234 in FY 2013 to 2,886 in FY 2018. In FY 2018, CI had 720 fewer special agents than it had in FY 2012, a reduction of 26 percent.

The IRS's FY 2020 budget requests additional funding for compliance positions; however, the request does not fully address the attrition that has occurred over the last five years. For Examination personnel, the FY 2020 budget would add 943 Full Time Equivalent (FTE) for a total of 9,148 Examination personnel. This would return Examination function staffing to 2015 levels when there were 9,189 Examination personnel. The attrition of Examination personnel in FY 2015 (342) and FY 2016 (642) alone was 984. The IRS's proposed FY 2020 budget adds 173 FTEs for Field Collection revenue officers for a total of 2,537, which would not even make up for the attrition of 264 revenue officers from 2015. The 144 proposed special agents for CI in the FY 2020 budget only covers a single year's (FY 2018) attrition of 140 agents, but CI will still have a net loss of 576 agents from FY 2012.

Improving the Efficiency and Effectiveness of Tax Compliance Programs

While additional resources will assist the IRS in its efforts to improve tax compliance, TIGTA reviews have also identified important improvements that should be made to the IRS's compliance programs that will not necessitate additional resources.

Impact of the Gig Economy on Tax Compliance

TIGTA recently issued two reports on the gig economy's impact on tax compliance and the lack of an IRS strategy to address this challenge.⁸ The gig economy comprises online platform companies such as Uber, Lyft, Etsy, Handy, and TaskRabbit. In this business model, the online platforms act as facilitators that bring together people offering a good or service with others that need such goods or services. One major implication of this arrangement is that the platform company typically does not withhold money from the service provider's payments for tax purposes, *i.e.*, income tax withholding and employment tax withholding. This creates a more complicated tax

⁸ TIGTA, Ref. No.: 2019-30-0116, *Expansion of the Gig Economy Warrants Focus on Improving Self-Employment Tax Compliance* (Feb. 2019); and TIGTA, Ref. No. 2018-30-077, *Improvements to the SS-8 Program Are Needed to Help Workers and Improve Employment Tax Compliance* (Sept. 2018).

situation for individuals who, in many cases, may not understand the tax obligations of their activities, such as the possible obligation to pay self-employment tax.

In traditional employment arrangements, the employer provides a Form W-2, *Wage and Tax Statement*, at the end of the calendar year, reporting to both the taxpayer and the IRS the amount of money the taxpayer made and what taxes were withheld, such as Social Security, Medicare, and income taxes. Throughout the year, the employer takes these taxes out of the taxpayer's paycheck and sends the money to the IRS on the taxpayer's behalf. However, when taxpayers are working in the gig economy, the online platform companies are not considered their employers. Issues sometimes arise for tax purposes between businesses and workers as to whether or not a worker is correctly classified as an employee or an independent contractor; however, with the growth of the gig economy, there are many more people now engaging in this type of temporary, independent work.⁹ With more workers engaging in self-employment, it is important that the IRS provide accurate guidance and notices about taxpayers' self-employment tax obligations.

However, in a report evaluating the gig economy's impact on self-employment tax compliance, TIGTA reported that cases with billions of dollars in potential tax discrepancies involving taxpayers who earn income in the gig economy are not being worked by the IRS. Many cases were not selected to be worked by the IRS due to the large volume of discrepancies that were identified and resource constraints. In addition, a lack of an overall gig economy compliance strategy led IRS employees to remove thousands of cases from inventory without justification or with justifications that were inaccurate. Further, Treasury Regulations do not require certain gig economy businesses to issue Form 1099-K, *Payment Card and Third Party Network Transactions*, unless workers earn at least \$20,000 and engage in at least 200 transactions annually. Consequently, many taxpayers who earn income in the gig economy do not receive a Form 1099-K; therefore, their income is not reported to the IRS. When income information is not reported to the IRS, taxpayers are more likely to be noncompliant. The IRS agreed with our recommendation to work with the Treasury Office of Tax Policy to pursue a legislative change to close the information gap with respect to gig economy businesses.

⁹ In a recent study, it was estimated that 8 percent of Americans reported in 2016 that they earned money on some sort of digital platform by taking on a job or task, while nearly 18 percent of Americans earned money by selling something online.

In a second report, TIGTA evaluated the IRS SS-8¹⁰ Program's performance in determining employee or independent contractor status. Congress has previously recognized the importance of the SS-8 Program's impact on the Tax Gap and the protection of workers.¹¹ TIGTA found that the SS-8 Program did not have any guidance for its employees to handle workers in the gig economy and found that the lack of guidance had seriously delayed decisions on those cases. TIGTA also learned that the delays in resolving the gig economy cases were because the gig economy companies were also under employment tax audits by the Employment Tax Examination function. However, the IRS granted the gig economy companies Section 530 relief, which prevents the IRS from addressing past and future worker misclassification noncompliance by businesses if certain criteria are met.¹² Due to the potential unfairness of workers being misclassified and the impact to the Tax Gap of employers being granted past and future audit protection for misclassifying workers, the IRS agreed with our recommendation to work with the Treasury Office of Tax Policy to pursue a legislative change to Section 530.

International Tax Compliance Challenges

Generally, the Tax Gap numbers do not include international tax noncompliance. The Tax Gap is estimated using statistics from the IRS's National Research Program (NRP) data that does not include international noncompliance. Non-IRS estimates of the international tax gap vary widely (from \$40 billion to \$123 billion annually).¹³ The IRS has not measured the international tax gap using other methodologies and does not have an estimate for the number; however, the IRS is committed to addressing international tax noncompliance through many different approaches.¹⁴

¹⁰ Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.

¹¹ S. Rep. 112-79 (2011) ("[t]he Committee believes that the IRS SS-8 program is critical to ensuring that workers are classified correctly, identifying leads for employment tax exams and criminal investigations, and combating the underreporting of employment taxes that contributes significantly to the tax gap").

¹² In order for a business to qualify for Section 530 relief, it must have: 1) consistently treated the workers (and similarly situated workers) as non-employees; 2) complied with information reporting requirements with respect to the remuneration paid to workers for the tax years at issue; and 3) had a reasonable basis for treating the workers as non-employees. Section 530 does not make or validate workers as independent contractors but it allows the business to continue treating them as non-employees for Federal employment tax purposes. Section 530 of Public Law 96-600, 92 Stat. 2885 (1978) as amended by Public Law 96-167, 93 Stat. 1278 (1979); Public Law 96-541, 95 Stat. 3204 (1980); Public Law 97-248, 96 Stat. 552 (1982); and Public Law 104-188, 110 Stat. 1766 (1996).

¹³ TIGTA, Ref. No. 2009-IE-R001, *A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap* (Jan. 2009).

¹⁴ Comments of Douglas Shulman, IRS Commissioner, 21st Annual George Washington University International Tax Conference, IR-2008-37 News Release, December 8, 2008:

TIGTA has reported on a number of those approaches including the Foreign Account Tax Compliance Act (FATCA).¹⁵ Enacted into law in 2010 to address the international tax gap, FATCA was intended to be an important development in U.S. efforts to improve tax noncompliance involving foreign financial assets. Individual taxpayers are required to report specified foreign held assets annually on Form 8938, *Statement of Specified Foreign Financial Assets*.¹⁶ Foreign Financial Intermediaries (FFIs) (for example, a foreign bank) are required to report the specified foreign assets of U.S. citizens. There are significant consequences to individuals who do not disclose their foreign assets, including a \$10,000 fine,¹⁷ and FFIs who do not comply are subject to a 30 percent withholding tax on certain U.S. sourced transactions.¹⁸

The Joint Committee on Taxation estimated that revenue from FATCA would be \$8.7 billion from FY 2010 to FY 2020. While the IRS has accomplished much in terms of building the infrastructure to support FATCA and has spent well in excess of \$380 million on systems and processes to receive and interpret information from FFIs, it has yet to begin holding taxpayers and FFIs accountable for noncompliance with FATCA more than eight years after the law was enacted. There have been numerous problems with the quality of data submitted by FFIs; however, the most significant problem for the enforcement of FATCA is that FFIs have not provided Taxpayer Identification Numbers (TINs)¹⁹ (primarily Social Security Numbers) with the information being submitted. Without TINs, the IRS cannot match the taxpayer information coming from the FFIs with the information submitted by taxpayers. The reason the IRS does not have the TINs is that it extended the timeframes for certain FFIs to comply with the FATCA requirement to obtain and provide TINs to the IRS.²⁰

...the international tax gap. So how big is it? \$10 billion? \$100 billion? It's hard to say as I haven't seen any solid research to arrive at conclusive numbers. But in some ways, whatever the size of the international tax gap, our commitment to this issue would be unchanged. That is because our international compliance efforts are much more about protecting the \$2.7 trillion base of revenue that we collect today rather than just the incremental enforcement revenue that we collect from these efforts. Nevertheless, we are committed to aggressively pursuing the international tax gap - whatever amount it may ultimately be.

¹⁵ Pub. L. No. 111-147, Subtitle A, 124 Stat 97 (2010) (codified in scattered sections of 26 U.S.C.).

¹⁶ Specified foreign assets include financial accounts, stocks or other financial instruments. Single individuals living in the U.S. must report assets valued above \$50,000 and if married filing jointly above \$100,000, and if living outside the U.S. single individuals report foreign assets if total exceeds \$200,000 or if married filing jointly above \$400,000. 26 C.F.R. § 1.6038D-2(a).

¹⁷ I.R.C. § 6038D(d).

¹⁸ I.R.C. § 1471.

¹⁹ A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the TIN is an Employer Identification Number, a Social Security Number, or an Individual TIN.

²⁰ For example, see IRS Notice 2017-46, which provides that Model 1 FFIs will not be deemed in noncompliance through 2019 for not providing TINs as required by FATCA. The stated reason given for the extension is that some reporting Model 1 FFIs need additional time to implement practices and

Focusing Tip Compliance Resources to Audit Employer Noncompliance

Tip income constitutes approximately 10 percent of the underreporting component of the Tax Gap.²¹ The IRS maintains a National Tip Compliance Program (NTCP), with the intent of reducing the extent to which unreported tips contribute to the Tax Gap. However, the revenue agents dedicated to the NTCP spend most of their time (61 percent) reviewing terms of tip agreements for the gaming industry. These tip agreement reviews are not audits and do not result in proposed adjustments. Revenue agents spend only 31 percent of their time conducting audits of employer tip compliance. However, there is significant tax noncompliance in the tip earning industry, and TIGTA was able to identify employers with significant projected unreported tips. TIGTA identified approximately 2,000 tip industry employers that have tip agreements with the IRS and appear to be in violation of those agreements with almost \$1.65 billion in unreported tip income.²² TIGTA also identified 16,000 tip industry employers, with over \$6.3 billion in unreported tip income, that do not have tip agreements with the IRS. The IRS agreed with TIGTA's recommendation to focus more of its revenue agent resources in the NTCP on conducting audits, as opposed to revising terms of tip agreements for the gaming industry.

Making Use of Currency Transaction Reports to Address Nonfiling and Underreporting

Tax compliance is lowest where there is no information reporting. Transactions in the cash economy are at a high risk of not being reported because generally there is no third-party reporting to the IRS of such transactions. In 2007, when the underreporting component of the Tax Gap was estimated to be \$285 billion, the cash economy was estimated to comprise \$100 billion of the Tax Gap.²³ Currency Transactions Reports (CTRs) constitute an important exception to the lack of third-party reporting in the cash economy, since currency deposits or withdrawals in excess of \$10,000 must be reported to the IRS. In 2010, TIGTA learned that the IRS made no

procedures to obtain and report required U.S. TINs for preexisting accounts that are U.S. reportable accounts.

²¹ When tip income was last measured as a component of the Tax Gap for 2006, the underreporting Tax Gap was estimated to be \$235 billion with the tip income portion being \$23 billion. The underreporting portion for years 2008-2010 is \$387 billion.

²² TIGTA Ref. No.: 2018-30-081, *Billions in Tip Related Noncompliance Are Not Fully Addressed and Tip Agreements are Generally Not Enforced* (Sept. 2018).

²³ National Taxpayer Advocate, *2007 Annual Report to Congress* (2007). At the time of the National Taxpayer Advocate's report, the underreporting component of the Tax Gap was \$285 billion for TY 2001, whereas the most current estimate of the underreporting component of the Tax Gap is \$387 billion for TYs 2008 through 2010.

systemic use of CTRs to identify nonfilers or underreporters of income, and the IRS agreed to explore using CTRs in case selection. In 2018, TIGTA again audited the IRS's use of CTRs and found the IRS still makes no systemic use of CTR information. It once again agreed to make systemic use of CTR filings.²⁴ CTR information could yield important information on both nonfiling and underreporting noncompliance if the IRS were to effectively utilize this important data source.

Virtual Currency²⁵

Virtual currencies continue to present a significant risk to tax administration, particularly since one of the attractions to their use is the anonymity of transactions. In IRS Notice 2014-21, the IRS issued guidance in a frequently asked questions format applicable to virtual currencies, which for tax purposes treats them as property. In 2016, TIGTA issued a report recommending that the IRS: develop a compliance strategy with respect to virtual currencies; provide additional guidance to assist taxpayers with their tax compliance; and revise third-party information reporting documents to identify virtual currency related transactions.²⁶ Although the IRS has not issued additional guidance on virtual currencies, the IRS has taken steps towards ramping up compliance efforts, including seeking information with respect to virtual currency account holders with significant virtual currency assets. However, the IRS has not taken action on TIGTA's recommendation to update relevant information returns to allow for the designation of virtual currency transactions.

As we have stated, tax compliance increases when the IRS receives third-party documentation regarding taxable transactions. Enhanced third-party information for virtual currencies will increase tax compliance. In part, virtual currencies have value due to virtual currency exchanges that buy, sell and exchange virtual currencies for customers. Some virtual currency exchanges also settle virtual currency transactions for other businesses. In doing so, some virtual currency exchanges are acting as Third Party Settlement Organizations,²⁷ and pursuant to I.R.C. § 6050W, these exchanges may be required to provide taxpayers Form 1099-K when they engage in transactions in excess of \$20,000 per year and at least 200 transactions per year. TIGTA has

²⁴ TIGTA, Ref. No.: 2018-30-076, *The IRS Still Does Not Make Effective Use of Currency Transaction Reports* (Sept. 2018).

²⁵ Also known as cryptocurrency.

²⁶ TIGTA, Ref. No.: 2016-30-083, *As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance* (Sept. 2016).

²⁷ A Third Party Settlement Organization settles a payment obligation for the payer for the benefit of the payee. Some virtual currency exchanges act as an intermediary to accept virtual currency on the part of the provider of goods or services and convert the virtual currency to regular currency.

recommended that the IRS leverage its Bank Secrecy Act (BSA) Program to audit virtual currency exchanges as part of its overall virtual currency strategy, and the IRS agreed. TIGTA is currently reviewing the IRS's BSA Program's virtual exchange audits to determine whether the IRS is using the audits to effectively encourage both Title 31 (Bank Secrecy Act) and Title 26 (Internal Revenue Code) compliance.

Auditing Tax Returns With the Highest Risk of Noncompliance

High-income taxpayers have the most opportunity to engage in tax avoidance planning. In the past, the IRS has recognized that, because of this reality, it needed a strategy and a special emphasis on auditing high-income taxpayers. TIGTA reported on the IRS's High Income – High Wealth Strategy, with a focus on the Large Business & International's (LB&I) Global High Wealth Division (GHW).²⁸ The High Income – High Wealth Strategy was a combined effort of LB&I and the Small Business/Self-Employed Division. Since that audit, LB&I reorganized and, as a result, the GHW function is no longer a standalone practice area. Instead, it has been deemphasized organizationally and folded under a directorate entitled "Pass Through Entities."

TIGTA found that the IRS defines "high income" as beginning at \$200,000. The origins of this relatively low threshold are unclear but have significant negative consequences to productivity and tax compliance. Many taxpayers in such income ranges may be employees whose Form W-2 income information is received by the IRS, and consequently, they tend to be more tax compliant. There are also many more taxpayers in this range than in the higher income ranges. As part of the high-income strategy, the IRS committed to auditing a higher percentage of taxpayers among different high-income ranges. The consequence of setting the relatively low threshold for which taxpayers are considered high income is that the IRS ends up conducting a relatively high percentage of audits on low risk returns. In Calendar Year (CY) 2013, the IRS audited 62,159 returns in the lowest range of the high income category (\$200,000 to \$399,999), yielding approximately \$400 million in proposed audit adjustments at an average recommended audit adjustment of \$605 per hour of revenue agents' time. There were approximately 4.1 million tax returns in that category.

On the other hand, the IRS conducted only 6,309 audits on taxpayers with incomes above \$5 million; however, those 6,309 audits yielded approximately \$880 million of proposed adjustments at an average of \$4,545 per hour of revenue agent's time. There were approximately 52,000 tax returns in that category. We

²⁸ TIGTA, Ref. No.: 20115-30-078, *Improvements are Needed in Resource Allocation and Management Controls for Audits of High Income Taxpayers* (Sept. 2015).

recommended that the IRS revisit the income threshold for what income amounts qualify as high-income and the IRS agreed; however, subsequently, the IRS cited resource constraints as a basis for not increasing the high-income threshold. We will be reviewing how increasing the high-income threshold, which would allow the IRS to conduct more productive audits on higher risk tax returns, could possibly be resource cost-prohibitive for the IRS. We also recommended that the IRS reallocate resources to audit more tax returns in the higher income ranges. The IRS disagreed, emphasizing the importance of audit coverage across all income ranges, as opposed to emphasizing higher compliance risk.

TIGTA is conducting additional audits currently as to whether the IRS has a high-income strategy for nonfilers and for those who owe the IRS unpaid taxes and who can pay but do not. Intentional failure to pay taxes and file tax returns is criminal behavior that represents brazen tax noncompliance and the IRS should make these taxpayers an enforcement priority.

Lack of Processes and Procedures to Identify and Address Significant Withholding Tax Non-compliance Results in Billions of Dollars of Losses to the Government

TIGTA has issued a number of reports that assess the IRS's efforts to ensure compliance with withholding tax reporting and payment provisions. These reviews have found that the IRS lacks processes and procedures to address significant employer and payer non-compliance with reporting and remitting taxes withheld.

The IRS's lack of enforcement in this area leaves substantial amounts of tax uncollected, which contributes to the Tax Gap. TIGTA reviews have identified billions of dollars in losses to the Government. For example, in September 2016, we reported that due to the lack of enforcement, taxpayers are avoiding the payment of billions of dollars in backup withholding.²⁹ Our review identified nearly \$9 billion in backup withholding tax that was not withheld, as required, by payers submitting Tax Year 2013 information returns with missing³⁰ or incorrect³¹ TINs. Payers are required to backup withhold 28 percent on payments associated with missing or incorrect TINs.³² Our analysis of the TY 2013 information returns identified:

²⁹ TIGTA, Ref. No. 2016-40-078, *Due to the Lack of Enforcement, Taxpayers Are Avoiding Billions of Dollars in Backup Withholding* (Sept. 2016).

³⁰ The IRS defines a missing TIN as one that is not provided, has more or less than nine numbers, or has an alpha character as one of the nine positions.

³¹ The IRS defines a TIN as incorrect if it is in the proper format but the name/TIN combination does not match or cannot be found on the IRS's or Social Security Administration records.

³² The Tax Cuts and Jobs Act of 2017 reduced the rate to 24 percent.

- 13,647 payers that submitted 27,576 information returns with the same missing payee TIN for two years in a row (TYs 2012 and 2013). These returns reported payments of about \$14.3 billion. As such, payers were required to immediately withhold nearly \$4 billion from these payees, yet just more than \$1 million was withheld.
- 62,714 payers that submitted 203,751 information returns for which the payee's TIN was incorrect in four consecutive years. These returns reported payments totaling nearly \$17 billion. As such, payers were required to withhold nearly \$5 billion from these payees, yet only \$1 million was withheld.

IRS management indicated that a strategy to address backup withholding compliance appeared to have been put in place in CY 1983 after legislation was enacted.³³ Management speculated that the subsequent restructuring of the IRS in CY 1998, and other reorganizations that have followed, have resulted in unintended gaps in the enforcement of backup withholding. As a result, the IRS is not enforcing payer backup withholding requirements, which is essential to ensuring that the Government is able to collect taxes on all appropriate income, particularly income that is not usually subject to withholding.

We recommended that the IRS establish a Service-wide information returns backup withholding enforcement strategy. The IRS agreed with our recommendation, and in 2016 convened a team to review the backup withholding process from beginning to end. The team prepared a comprehensive document that provided a Service-wide view of the information returns environment, including its evolution, current state, risks and risk mitigation efforts, and opportunities. However, specific processes and procedures have yet to be put in place to address this deficiency. We plan on conducting a follow-up review during FY 2020.

In July 2017, we reported that case selection processes resulted in billions of dollars in potential employer underreported tax not being addressed.³⁴ Our analysis of 137,272 IRS-identified TY 2013 discrepancy cases found that the IRS worked only 23,184 (17 percent). The remaining 114,088 (83 percent) discrepancy cases that were not worked had a potential underreported tax difference of more than \$7 billion. Discrepancy cases involve employers who, based on the IRS's comparison of what they reported to the Social Security Administration (SSA) on Forms W-2, *Wage and Tax*

³³ Congress enacted the Tax Equity and Fiscal Responsibilities Act of 1982 and the Interest and Dividend Tax Compliance Act of 1983, which require payers to backup withhold tax from certain reportable payments. The purpose of backup withholding is to make sure that the Government is able to collect taxes on all appropriate income, particularly income that is not usually subject to withholding.

³⁴ TIGTA, Ref. No. 2017-40-038, *Case Selection Processes Result in Billions of Dollars in Potential Employer Underreported Tax Not Being Addressed* (July 2017).

Statement, and Forms W-3, *Transmittal of Wage and Tax Statements* to what they reported on their filed employment tax returns, showed that they withheld tax from employees but did not fully report those withholdings to the Federal Government as required.

We identified that the discrepancy case selection processes do not ensure that priority is given to working discrepancy cases with the highest potential tax assessment. TIGTA analyzed the 114,088 discrepancy cases that were not worked to identify those 23,184 with the highest potential underreported tax amounts by case type. It turned out that these had total potential underreported tax of more than \$6.8 billion. The 23,184 discrepancy cases IRS worked resulted in total tax assessments of \$61 million.

The continual reduction in resources allocated to working discrepancy cases directly contributes to the IRS's inability to reduce the billions of dollars it reports each year as being lost as a result of the Tax Gap. Our review of resources allocated to address these discrepancy cases identified a 61 percent reduction in FTEs (from 57 to 22) from FYs 2013 to 2015. Yet for each of the unworked discrepancy cases, the IRS has information reporting documents from the SSA (Forms W-2 and Forms W-3), as well as information the employer reported on its employment tax return. As such, resources expended to address the discrepancy cases result in good tax administration with either the employer being assessed the amount of underreported tax, filing missing employment tax returns, or filing corrected Forms W-2 and Forms W-3 or employment tax returns.

We recommended that the IRS revise its case selection criteria to include cases with the highest potential tax assessment. The IRS agreed. In the next month, we plan to start a follow-up review to ensure the IRS is selecting the most productive cases to work.

We are also preparing a final report issuance later this month detailing our assessment of the IRS's efforts to ensure compliance with non-payroll tax withholding reporting and payment provisions. This review identified that billions of dollars in non-payroll tax withholding discrepancies are not being addressed.³⁵ Specifically, we identified 11,201 payers that did not report taxes withheld or reported less taxes withheld on Form 945, *Annual Return of Withheld Federal Income Tax*, than the withholding amounts reported to the IRS on Form 1099, *Certain Gambling Winnings*, or Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*. The potential non-reporting or underreporting by these payers totals more than

³⁵ TIGTA Audit No., 201740022, *Withholding Reported on Form 945*.

\$1.9 billion. The \$1.9 billion discrepancy represents the amount payers reported as being withheld but not paid to the Federal Government. This includes:

- 7,265 payers who reported withheld taxes totaling almost \$923 million to the IRS on Forms 1099 or W-2G but did not file a TY 2016 Form 945 as required. Our review of the associated payer's tax accounts identified that these payers also did not remit the reported tax withheld, as there were no payments or offsets credited to their associated tax accounts.
- 3,163 payers who reported more than \$760 million less in tax withheld on Forms 945 than what they reported on associated Forms 1099 or W-2G. For these 3,163 payers, the amount of withheld tax recorded on the associated tax accounts for the payers to remit is \$760 million less than the amount these payers reported on the associated Forms 1099 or W-2G.
- 773 payers who reported on Form 1096 withholding amounts totaling more than \$243 million. These payers did not file Form 1099, Form W-2G, or Form 945 with the IRS. These payers also did not remit any payments to the IRS.

In March 2019, the IRS announced plans to introduce a new program that will analyze information reporting inconsistencies and mismatches and will seek out employers or payers who filed a Form 1099 or other payment reporting document, but may not have sent the related Form 945, *Annual Return of Withheld Federal Income Tax*, indicating income tax was withheld. We will evaluate the effectiveness of this new program as part of our planned follow-up review of the IRS's backup withholding program.

Finally, we are continuing our assessment of withholding reporting and payment compliance relating to foreign persons. As such, we are conducting a follow-up review of the IRS's processes and procedures to ensure that amounts reported as withheld on Forms 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, are reported on Forms 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and are remitted to the IRS.³⁶ Prior audits have identified that processes have not been established to ensure that billions of dollars of taxes withheld from foreign persons are accurately reported and/or remitted. We are also conducting a review to assess the IRS's efforts to verify the accuracy of withholding credits reported on Forms 1040NR, *U.S. Nonresident Alien Income Tax Return* and Forms 1120-F, *U.S. Income Tax Return of a Foreign Corporation*.³⁷

³⁶ TIGTA Audit No. 201840022, *Follow-Up Review of Large Business and International Document Matching*, report scheduled for August 2019.

³⁷ TIGTA Audit No. 201840038, *Verification of Withholding Reported on Forms 1040-NR and 1120-F*, report scheduled for July 2019.

To provide information on the overall potential loss to the Government resulting from reported Federal tax withheld and not remitted, as required, by either employers or payers, we are developing a summary report. This report will summarize our body of audit work assessing the IRS's efforts to address employer and payer non-compliance with Federal tax withholding reporting and payment requirements.³⁸

Processes Do Not Ensure That Corporations Accurately Claim Carryforward General Business Credits

In February 2015, we reported that TIGTA had identified 3,285 e-filed Forms 1120, *U.S. Corporation Income Tax Return*, filed in Processing Year 2013 on which corporations claimed potentially erroneous General Business carryforward credits³⁹ totaling more than \$2.7 billion.⁴⁰ A potentially erroneous credit claim is one in which the corporation claims a carryforward amount on their current tax return that exceeds the amount shown as available to carry forward from the previous year's tax return. When corporate filers are unable to claim their entire General Business Credit amount in the current tax year, the taxpayer can carry forward the unused credit amount until the full amount of the credit is offset against income tax or up to 20 years. As such, companies that erroneously claim carryforward credits can reduce or eliminate their future tax liabilities.

We are currently conducting a follow-up review to evaluate the IRS's efforts to develop processes and procedures to detect and prevent questionable carryforward claims.⁴¹ This review will include an evaluation of all individual and business carryforward credits and deductions to quantify the total amount of potentially erroneous claims.

Development of Tax Forms and Implementation of Processing Controls Are Key to Identifying Erroneous Claims During Tax Return Processing

In March 2019, we reported that timing in the issuance of guidance did not provide sufficient time to develop a separate Qualified Business Income Deduction⁴² tax

³⁸ TIGTA Audit No., 201940023, *Assessment of the IRS's Efforts to Enforce Withholding Reporting and Payment Requirements*, report scheduled for October 2019.

³⁹ The General Business Credit (made up of several separate business-related credits) is offered as an incentive for a business to engage in certain kinds of activities considered beneficial to the economy or public at large, such as improving disability access for customers or providing childcare for employees' children.

⁴⁰ TIGTA, Ref. No. 2015-40-012, *Processes Do Not Ensure That Corporations Accurately Claim Carryforward General Business Credits* (Feb. 2015).

⁴¹ TIGTA Audit No., 201840023, *Follow-Up Review of General Business Credits Claimed on Individual and Business Tax Returns*.

⁴² The Tax Cuts and Jobs Act of 2017 includes Internal Revenue Code Section 199A which provides individuals with a new tax deduction for qualified business income. Section 199A provides a deduction of up to 20 percent for an individual's domestic qualified business income from their taxable income.

form.⁴³ A separate tax form would have allowed the IRS to capture data to assist in evaluating compliance with the deduction requirements. For example, the IRS could use information from a form to improve systemic identification of erroneous deduction amounts. The IRS estimates that almost 23.7 million taxpayers may be eligible to claim the deduction. In addition, the Joint Committee on Taxation estimates a reduction in tax from this provision of \$27.7 billion in FY 2018 and \$47.1 billion in FY 2019, and totaling \$414.5 billion over FYs 2018 through 2027.

When we raised our concerns to management, management responded that they wanted to ensure an appropriate balance between compliance risk and taxpayer burden. IRS management indicated that delaying the development of a tax form until Tax Year 2019 allowed the IRS to receive comments on the guidance, consider those comments before finalizing the guidance, and gain some experience with the first filing season. As an alternative, the IRS developed a worksheet to assist taxpayers with calculating the Qualified Business Income Deduction.

However, the IRS did develop two business rules⁴⁴ and one error resolution code⁴⁵ in response to the concerns we raised. In April 2019, we reported⁴⁶ that the IRS rejected 10,534 tax returns as of February 26, 2019, and sent 152,515 tax returns to error resolution as of February 27, 2019.

In conclusion, the IRS faces formidable challenges in completely and accurately estimating the Tax Gap and finding effective ways to increase voluntary compliance. We at TIGTA take seriously our mandate to provide independent oversight of the IRS in its administration of our Nation's tax system. Accordingly, we plan to provide continuing audit coverage of the IRS's efforts to address the Tax Gap.

Chairman Neal, Ranking Member Brady, and Members of the Committee, thank you for the opportunity to share my views.

⁴³ TIGTA, Ref. No. 2019-44-022, *Tax Cuts and Jobs Act: Implementation of the Qualified Business Income Deduction* (Mar. 2019).

⁴⁴ Business rules are used to validate information included on e-filed tax returns for acceptance into tax return processing. The IRS will reject e-filed tax returns from processing when the tax return does not meet a business rule.

⁴⁵ Error resolution codes are used to validate the accuracy of paper-filed and e-filed tax returns during processing. When a tax return is identified with an error condition, the IRS suspends the tax return from processing and sends the return to a tax examiner to correct the error.

⁴⁶ TIGTA, Ref. No. 2019-44-030, *Interim Results of the 2019 Filing Season* (Apr. 2019).



J. Russell George

Treasury Inspector General for Tax Administration

Following his nomination by President George W. Bush, the United States Senate confirmed J. Russell George in November 2004 as the Treasury Inspector General for Tax Administration. Prior to assuming this role, Mr. George served as the Inspector General of the Corporation for National and Community Service, having been nominated to that position by President Bush and confirmed by the Senate

in 2002.

A native of New York City, where he attended public schools, including Brooklyn Technical High School, Mr. George received his Bachelor of Arts degree from Howard University in Washington, D.C., and his Doctorate of Jurisprudence from Harvard University's School of Law in Cambridge, MA. After receiving his law degree, he returned to New York and served as a prosecutor in the Queens County District Attorney's Office.

Following his work as a prosecutor, Mr. George joined the Counsel's Office in the White House Office of Management and Budget, where he was Assistant General Counsel. In that capacity, he provided legal guidance on issues concerning presidential and Executive Branch authority. He was next invited to join the White House Staff as the Associate Director for Policy in the Office of National Service. It was there that he implemented the legislation establishing the Commission for National and Community Service, the precursor to the Corporation for National and Community Service. He then returned to New York and practiced law at Kramer, Levin, Naftalis, Nessen, Kamin & Frankel.

In 1995, Mr. George returned to Washington and joined the staff of the Committee on Government Reform and Oversight and served as the Staff Director and Chief Counsel of the Government Management, Information and Technology Subcommittee (later renamed the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations), chaired by Representative Stephen Horn. There he directed a staff that conducted over 200 hearings on legislative and oversight issues pertaining to Federal Government management practices, including procurement policies, the disposition of Government-controlled information, the performance of chief financial officers and inspectors general, and the Government's use of technology. He continued in that position until his appointment by President Bush in 2002.

Mr. George also served as a member of the Integrity Committee of the Council of Inspectors General for Integrity and Efficiency (CIGIE). CIGIE is an independent entity within the executive branch, statutorily established by the Inspector General Act of 1978, as amended, to address integrity, economy, and effectiveness issues that transcend individual Government agencies and to increase the professionalism and effectiveness of personnel by developing policies, standards, and approaches to aid in the establishment of a well-trained and highly skilled workforce in the offices of the Inspectors General. The CIGIE Integrity Committee serves as an independent review and investigative mechanism for allegations of wrongdoing brought against Inspectors General.