

**WRITTEN TESTIMONY OF  
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BEFORE THE  
HOUSE OVERSIGHT AND GOVERNMENT REFORM COMMITTEE  
ON THE GOVERNMENT ACCOUNTABILITY OFFICE'S HIGH-RISK LIST  
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Chairman Chaffetz, Ranking Member Cummings and Members of the Committee, thank you for the opportunity to appear before you today to discuss the Government Accountability Office's (GAO) High-Risk List as it pertains to IRS operations.

As we understand it, the GAO's High-Risk List currently contains one item that relates to the IRS, which is enforcement of tax laws. Before discussing tax enforcement, I would note that another IRS program, the agency's Business Systems Modernization program, was removed from the list in 2013, after having been on the list since 1995.

In its 2013 report, the GAO said that the Business Systems Modernization program was no longer a high-risk program because of the advances made by the IRS over many years in addressing weaknesses in information technology (IT) and financial management capabilities. In fact, in reports issued in 2007, 2009, and 2011, the GAO noted the progress that the IRS was making in this area, even though the program continued to be on the High-Risk List during those years.

As the GAO has often pointed out, all of the programs on the High-Risk List involve complicated, difficult issues that do not lend themselves to quick fixes, but require the use of multiple strategies over long periods of time. This is true not only for business systems modernization, but applies to tax law enforcement as well.

We take very seriously the issues raised by the GAO in regard to tax enforcement. The IRS has worked over time, and continues to make every effort, to improve compliance with the tax laws, just as it has done and continues to do with business systems modernization. Our ability to keep making progress in both areas is limited, however, by the substantial reductions in funding for our agency over the last several years, which I will discuss in more detail later in this testimony.

The GAO has identified enforcement of the tax laws as a high-risk area because of the size of the tax gap and the difficulty over time in narrowing that gap. The tax gap is defined as the difference between the amount of tax owed by

taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws.

The most recent IRS study of the tax gap was released in 2012 and it covered tax year 2006. The study showed that the nation's voluntary tax compliance rate was 83.1 percent in 2006, essentially unchanged from the prior review covering tax year 2001. The IRS is in the process of preparing a new study on the tax gap, covering the tax year 2010. We expect this report to be released in early 2016.

The tax gap can be viewed in two different ways. There is the gross tax gap, which is simply the amount of tax liability faced by taxpayers that is not paid on time. For 2006 it is estimated to be \$450 billion. The net tax gap of \$385 billion represents the amount of tax liability that is not only not paid on time but also is not collected subsequently, either voluntarily or as the result of enforcement activities. Thus, the net tax gap represents the amount of tax liability that is never paid.

When looked at by mode of compliance, the tax gap can be divided into three components: Nonfiling, or not filing required returns on time; underreporting, or not reporting one's full tax liability when the return is filed on time; and underpayment, or not paying by the due date the full amount of tax reported on a timely filed return. Underreporting constituted 84 percent of the tax gap for 2006, while underpayment constituted 10 percent, and nonfiling 6 percent.

The underpayment gap is the easiest component to measure, because it is calculated directly from IRS administrative records for the individual income tax, the corporate income tax, employment taxes, estate tax, and excise taxes. Taxpayers who have filed returns indicating taxes owed but who have not paid the full amounts on time are identified upon filing. The difference between taxes owed as reported on returns and the amounts paid on time is the underpayment gap.

The other two components of the tax gap – nonfiling and underreporting – present vastly greater estimation challenges because they measure activity that is either not revealed to the IRS at all (such as failure to file a return) or is reported in an understated or otherwise mischaracterized fashion.

The predominant method used to calculate the underreporting gap involves auditing a random sample of taxpayers. These audits are time consuming, but they constitute the ideal method for estimating the underreporting gap for the individual income tax. These audits are done under a program called the National Research Program (NRP) that has been in place since 2000. The audits are more in depth than the usual audits, in that they examine a uniform set of issues that are part of the study, instead of focusing on problems with a given tax return. The information gleaned from these audits helps examiners more effectively

select the types of cases to audit, and offers other detailed insights about noncompliant behavior. Those insights are used throughout the IRS to better target service and enforcement work.

One of the key findings from our ongoing research on the tax gap has been that tax compliance is far higher when reported amounts are subject to information reporting and, more so, when subject to withholding as well. For 2006, the net misreporting percentage (NMP) – taking the net amount that was misreported (which includes both under- and overreporting items) and expressing it as a ratio of the absolute value of the correct amount that should have been reported – was 1 percent for amounts subject to substantial information reporting and withholding, and 8 percent for amounts subject to substantial information reporting without withholding. But the NMP jumped to 56 percent for amounts subject to small amounts of or no information reporting or withholding.

In terms of what makes up the tax gap, the underreporting of business income by individual taxpayers – income of sole proprietors, farmers and those earning rental, royalty, partnership, and S Corporation income – is the largest contributor, accounting for \$122 billion of the total \$450 billion in 2006. We believe that the lack of reliable and comprehensive reporting and withholding for business income received by individuals is the main reason for these findings.

These statistics provide further confirmation that “visibility” of income sources and financial transactions is the main factor in high compliance rates, and information reporting is one of the few means of sizably increasing the compliance rate. Business income reported on 1040s is a much lower-visibility income source because it is not subject to the same information reporting and withholding requirements that exist for salary and wage income.

It is important to understand that while the tax gap is a helpful guide to the scale of tax compliance in the economy, it overstates the amount of tax debt owed that is feasible to recover through IRS enforcement alone.

Major attempts to narrow the tax gap must take into account taxpayer burden and taxpayer rights. While it might be theoretically possible to achieve 100 percent tax compliance, getting to that point would require an extremely high volume of examinations and substantial income reporting and withholding requirements, all of which would certainly be considered unduly burdensome on individuals and businesses, and would also put a major strain on IRS resources, as well as on the taxpayer. Put another way, it would not be advisable to audit our way out of the tax gap.

It is also important to point out that failures to comply with tax law often involve unintentional mistakes that are the result of not fully understanding what has come to be an extremely complex tax code. For that reason, efforts to increase tax compliance must also include programs to educate taxpayers in their tax

obligations, along with efforts to improve taxpayer service, to make it easier for individuals and businesses to fulfill filing requirements.

Despite the many challenges, the IRS has been and continues to be committed to finding ways of improving tax compliance, particularly voluntary compliance, which is the cornerstone of our tax system. From a revenue standpoint, the importance of voluntary compliance cannot be overstated: Each additional percentage point of voluntary compliance established brings in about \$30 billion in tax receipts. Therefore, any loss of public confidence in the proficiency and fairness of the IRS, which reduces voluntary compliance, would come at a high cost, and the effects of a reduction in voluntary compliance would take a long time to reverse.

Achieving greater voluntary compliance in order to narrow the tax gap involves a comprehensive, integrated multi-year strategy. Along with increased enforcement activities which enhance confidence and fairness in the tax system, components of this strategy also include: expanding compliance research; improving information technology; reforming and simplifying the tax law; coordinating with states, foreign governments, and other partners and stakeholders to share compliance strategies; and, as noted above, enhancing taxpayer service.

The agency's program for implementing legislation on merchant card reporting is a good example of our recent efforts to narrow the \$122-billion portion of the tax gap that represents underreporting of business income by individuals. This program involves requiring electronic payment processors to send us information on Form 1099-K.

Congress enacted the reporting requirement because lawmakers understood that cash and credit card transactions were the source of much of the income underreporting by small businesses. Bad actors who wanted to gain an unfair advantage over those who follow the law could do so simply by not reporting all of their transactions. Therefore, in addition to helping improve tax compliance, the Form 1099-K reporting regime also helps level the playing field for small businesses.

The challenge for the IRS is determining how to properly use the data gleaned from the Form 1099-K, because reported income is generally a mix of credit card and cash receipts. But the Form 1099-K does allow us to compare similar businesses, spot anomalies, and follow up with businesses to determine why those anomalies exist. In fact, we are already beginning to notice an impact from this new reporting regime.

The IRS has worked to utilize the information received from the Form 1099-K while minimizing the burden on small businesses by seeking input from the business community on this program and by giving taxpayers extra opportunities to respond, fix errors, or explain their situation. In fact, most taxpayers contacted

by the agency have responded to our notices, and have taken the opportunity to explain unusual circumstances or correct errors, often without an audit. It is important to note that about 60 percent of taxpayers we contacted about potential underreporting of 2011 income increased the amount of income reported in 2012.

Another good example of our recent work to increase tax compliance involves the international tax area in general, and offshore tax avoidance in particular. The IRS has made great strides over the last several years both in finding tax evaders hiding assets overseas and bringing them to justice and in encouraging people to voluntarily disclose their foreign accounts and pay the taxes they owe.

The agency has conducted thousands of offshore-related audits that have produced tens of millions of dollars, and, where appropriate, has pursued criminal charges leading to billions of dollars in criminal fees and restitution. Taxpayers have also been given the opportunity to come forward and get right with the government. Since its establishment in 2009, the Offshore Voluntary Disclosure Program (OVDP) has resulted in more than 50,000 disclosures of underpaid or unpaid taxes and the collection of more than \$7 billion in back taxes, interest and penalties.

In 2010, Congress gave the IRS an important new tool to help us improve offshore tax compliance when it enacted the Foreign Account Tax Compliance Act (FATCA). This law requires foreign financial institutions (FFIs) to report information to the IRS about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. More than 150,000 FFIs have registered under FATCA, and in March of this year they will begin supplying the IRS with information about overseas accounts of U.S. taxpayers.

Programs such as Form 1099-K reporting and FATCA are important not only because they help the IRS collect the correct amount of tax, but because they encourage voluntary compliance. These efforts to improve compliance help assure the public that when they are paying their taxes, everyone else is paying their fair share as well. Small business owners, for example, should feel confident that when they properly report their cash receipts, other businesses are doing the same. Likewise, the average person who can't afford high-priced financial advice should feel confident that the very wealthy are not able to hide their money in foreign countries and avoid paying tax on those assets.

This sense of fairness is the underpinning of our system of voluntary compliance. Year after year, the IRS Oversight Board studies taxpayer behavior, and it has consistently found that the vast majority of people -- about three quarters of those surveyed -- believe paying taxes is their civic duty. An even higher percentage of those surveyed believe it is not acceptable to cheat on their taxes. To maintain this sense of responsibility and fairness, we must continue doing everything we can to improve overall tax compliance.

But as I noted earlier in this testimony, the IRS' budget situation represents a very serious challenge to our ability to continue making progress on this front. In order to keep up our efforts, the agency needs to have adequate funding, and I am deeply concerned about the impact of the reductions in our funding over the last several years.

Just over a month ago, the agency's Fiscal Year (FY) 2015 budget was set at about \$10.9 billion, which is \$346 million less than FY 2014. But this actually amounts to a total reduction of almost \$600 million from last year, when another \$250 million in mandated costs and inflation that we must absorb are counted.

Further, the reduction I just described is on top of another \$600 million cut the IRS had already taken as a result of government-wide sequestration in 2013. Congress ended up reversing most of those government-wide cuts, so that nearly every major federal agency was restored to the pre-sequester level, except for one: the IRS. The result is that the IRS is essentially two sequesters ahead of all other major government agencies.

The IRS is now at its lowest level of funding since FY 2008. If inflation is taken into account, however, the current funding level is comparable to that of 1998. Since then, the number of individual and business tax filers has increased by more than 30 million, or 23 percent.

In order to absorb the most recent reductions in our budget, the IRS has taken a number of difficult steps, including enforcement cuts of more than \$160 million for FY 2015, and we estimate the agency will lose about 1,800 enforcement personnel through attrition during this fiscal year. We anticipate the result of these cuts will be fewer audit and collection cases. Specifically, we expect there will be at least 46,000 fewer individual and business audit closures and more than 280,000 fewer Automated Collection System and Field Collection case closures.

We estimate that, as a result, the government will lose at least \$2 billion in revenue that otherwise would have been collected. In addition to the revenue loss to the government, the curtailment of enforcement programs is extremely troublesome because these programs help create a deterrent effect that is the key to preserving high levels of voluntary compliance.

The President's 2016 Budget provides \$12.3 billion in base discretionary resources, an increase of \$1.3 billion from FY 2015, to make strategic investments in the IRS to continue modernizing our systems, improve service to taxpayers, and reduce the deficit through more effective enforcement and administration of tax laws. The Budget also proposes a \$667 million cap adjustment to support program integrity efforts aimed at restoring enforcement of current tax laws to acceptable levels and to help reduce the tax gap. This multi-

year effort is expected to generate \$60 billion in additional revenue over the next ten years at a cost of \$19 billion, thereby reducing the deficit, if enacted, by an additional \$41 billion.

Chairman Chaffetz, Ranking Member Cummings, and Members of the Committee, thank you again for the opportunity to discuss the tax gap and IRS efforts to improve tax compliance. This concludes my statement, and I would be happy to take your questions.