

Inter-American Center of Tax Administrations – CIAT

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“TAX MORALE AS DETERMINING FACTOR IN IMPROVING THE EFFECTIVENESS OF THE TAX ADMINISTRATION”

Subtopic 2.1:

“TAXPAYER ATTITUDES VIS-À-VIS THE TAX ADMINISTRATION: DIFFERENTIATE AND CLASSIFY TAXPAYER BEHAVIORS”

**Internal Revenue Service
USA**

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Summary

The area above the entrance to the IRS Headquarters in Washington DC carries the words of former U.S. Supreme Court Justice Oliver Wendell Holmes, Jr., “Taxes are what we pay for civilized society.” Throughout the centuries, people have written about the need for taxes and how problems come when there is a perception that the administration of the taxes is not fair. Voluntary compliance is the cornerstone of U.S. tax administration and the great majority of Americans pay their taxes willingly and on time. The Mission Statement of the IRS speaks directly to this great majority: “Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.”

To maintain integrity and fairness in the tax system, the IRS must ensure that all taxpayers are afforded the opportunity to comply with their tax obligations. As we believe most people want to file and pay their taxes accurately and on time, the IRS focuses on assisting them in that task. However, the United States Internal Revenue Code is neither perfect nor simple and even those who seek to comply need our help. With respect to those taxpayers trying to comply, the IRS educates and creates systems that will both ease the path to compliance and utilize all available information to catch errors. In dealing with the noncompliant and to maintain equity in the tax system, the IRS also focuses on enforcement. With respect to both the compliant and noncompliant, we are organized in our work by types of taxpayers. This includes not only specialized treatments intended for individuals versus business entities; it also takes account of how we deal with various levels of wealth.

As we look at categories of taxpayers and types of noncompliance we find two essential rules that guide much of our planning and approach. First, if payments to a taxpayer are reported to us by a trusted third party, that payment is very likely to show up on the taxpayer’s return as income. Second, the more we deputize third parties into withholding the tax from the payments they report and remitting this amount to us, the better off we are in ensuring the tax gets paid. As a result of these rules, the IRS takes the position that while some taxpayers seek to comply and some do not, both types of taxpayers will respond in a positive manner to increased income reporting and better utilization of such reporting by the IRS. This paper outlines our work to pursue additional reporting of third-party data and in deputizing third parties to partner with us in our tax compliance mission. Of course, the IRS must balance the burden on the taxpayer and on those who must report as we consider or implement additional withholding and reporting.

Studies conducted by the IRS over the years do support the two rules outlined above and show that the more “visible” the income or the deduction amounts are to the taxpayer and to the IRS, the better the compliance. The discussion section of this paper includes summaries of some of these studies. Based on this evidence, the United States Congress has increased third-party reporting and the IRS is beginning the implementation of this series of new information reporting requirements.

In addition, the IRS is also taking steps to increase its work to leverage both third parties and third-party data, with initiatives such as our return preparer and whistleblower programs. The IRS is also increasing its technical capabilities to match data from various sources in order to better monitor compliance by taxpayers. This paper describes many of the IRS's current efforts.

Introduction: Scope/Content

The discussion section of this paper has three parts: What the Data Shows about the Environment; Legislative/Administrative Actions Taken; and IRS Approaches to Utilizing Third parties and Third-party Data.

• **What the Data Shows about the Environment**

This section summarizes studies done by the IRS which show that the greater the “visibility”, i.e., the extent of third-party information reporting, the greater the level of compliance.

• **Legislative/Administrative Actions Taken**

This describes recent legislation and IRS initiatives requiring new forms of third-party information reporting that are in various stages of implementation. This includes:

- Government Payments to Contractors;
- Merchant/Payment Card Reporting;
- Basis Reporting for Securities Dealers;
- Information Reporting for Payments to Individuals and Corporations;
- Information Reporting Related to Rental Real Estate;
- Foreign Account Tax Compliance Tax Act (FATCA); and
- Uncertain Tax Position Reporting.

• **IRS Approaches to Utilizing Third Parties and Third-party Data**

This describes a number of IRS initiatives aimed at how we classify taxpayers, and how we leverage the work of third parties and utilize third-party information. These include:

- Tax Return Preparer Initiative;
- Whistleblower Program; and
- Automated Underreporter Program.

Discussion

1. What the Data Shows about the Environment—the Efficiency and Effectiveness of Third-Party Data

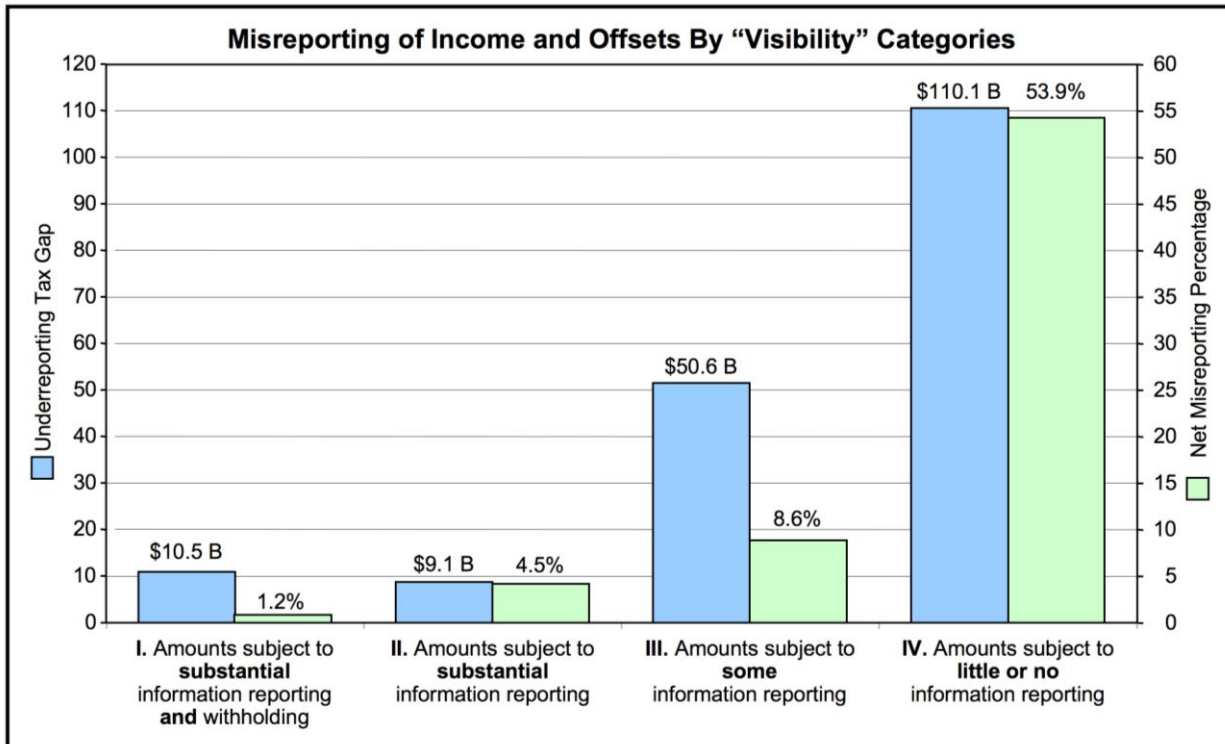
Historically, the IRS based estimates of federal tax compliance on special studies, including the Taxpayer Compliance Measurement Program (TCMP), covering income and self-employment taxes for particular groups of taxpayers and consisting of line-by-line audits of random samples of returns. These studies provided the IRS with information on compliance trends and allowed the IRS to update its audit selection formulas regularly. This method of data gathering, however, was extremely burdensome on the taxpayers whose returns were selected. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988. The IRS conducted several much narrower compliance studies between 1988 and 2001, but these studies did not provide a comprehensive perspective on the overall tax gap.

The National Research Program (NRP), which the IRS has used to estimate the most recent compliance level updates, arose out of a desire to find a less intrusive means of measuring tax compliance. The IRS used a focused statistical selection process that resulted in the selection of approximately 46,000 individual income tax returns for Tax Year (TY) 2001 — somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time. Like the compliance studies of the past, the NRP was designed to allow the IRS to meet certain objectives: to estimate the overall extent of reporting compliance among individual income tax filers and to update the audit-selection formulas. Data for analysis included amounts reported by taxpayers on their tax returns and the corrected amounts determined by examiners.

Figure 1 below, based on data from the NRP report on TY 2001 for individuals, shows the highest level of non-compliance in those areas where there is the least amount of “visibility”, i.e., the level of information reporting associated with the income. All types of individual business income are underreported, including farms, non-farm proprietorships, rents, royalties, and partnerships. Farm and non-farm sole proprietorships are the largest source of underreported income.

Figure 1. Underreporting of Income by “Visibility” Categories

Tax Year 2001 Individual Income Tax Underreporting Gap



Based on estimates derived from the TY2001 National Research Program reporting compliance study.

This relatively high rate of underreporting of income among sole proprietors is largely due to the general absence of information reporting by third parties on their earnings. Prior research studies show that reporting compliance depends directly on the "visibility" of the relevant transactions, i.e., the degree to which a type of income is subject to information reporting determines the degree to which it is "visible" to the IRS. Quite simply, the more information reporting and withholding, the better the compliance.

Furthermore, Figure 1 shows that, even with substantial information reporting, compliance is improved with the addition of withholding of tax at the source. The misreporting percentage drops from 4.5 percent to 1.2 percent. Withholding serves the purpose of pre-paying one's tax obligation as the income is earned; that lessens the possibility that the taxpayer will not have the money to pay the tax at the time of filing, which fosters better compliance.

2. Legislative and Administrative Actions Taken

Organizational Structure of IRS

As we discuss how the IRS differentiates and classifies taxpayers, the IRS approach begins by focusing on specific taxpayer groups. As a result, a little more than 10 years ago, the IRS

implemented a major reorganization that called for the creation of Business Operating Divisions (BOD's) focused on specific groups of taxpayers. Over the years there were some shifts of responsibility for specific taxpayer groups from one BOD to another for a variety of reasons. Today, the IRS has the following structure:

- Wage and Investment (W&I) – Individuals with income from wages and investments;
- Small Business/Self-Employed (SBSE) – Businesses with assets of less than \$10 million including farms, trusts, estates and rental properties operating under a variety of organizational structures;
- Large Business and International LB&I) – Businesses with assets of \$10 million or more, international taxpayers and the high wealth individuals; and
- Tax Exempt and Government Entities (TEGE) – Charitable and other tax exempt organizations; pension plans; state and local governments and Native American tribal governments.

Each BOD tailors its enforcement and outreach to meet the needs of the specific taxpayers it serves. Thus, each BOD approaches outreach and education slightly differently. LB&I's taxpayers, for example, work with the IRS through accounting or law firms or their own internal legal and accounting staffs and, as a result, do not need the kind of one-on-one service generally required for individual taxpayers. There are similar differences in the approach to enforcement.

The IRS has also taken steps to tailor its approach not only on the business form of the taxpayer, but on other demographics as well. For example, the IRS has developed a method of examining the very wealthy by forming the Global Wealth Industry Group. Tax agencies around the world, including those in Japan, Germany, the UK, Canada and Australia, have also formed high wealth groups.

The IRS launched its Global High Wealth Industry Group to centralize and focus IRS compliance expertise involving high wealth individuals and their related entities. High wealth individuals are quite different from a typical taxpayer with wages, dividends, interest and maybe a small business. Their tax picture is more complicated and nuanced. For a variety of reasons – including valid business reasons – many high wealth individuals make use of sophisticated financial, business, and investment arrangements with complicated legal structures and tax consequences. The IRS will initially focus the group's efforts on individuals with tens of millions of dollars of assets or income. By taking a unified look at the entire complex web of business entities controlled by a high wealth individual, the IRS believes it will be able to better assess the overall tax compliance of such arrangements. Rather than continuing to approach each tax return in such enterprises as that of a single and separate entity, the goal is to better understand the entire economic picture of the enterprise.

Information Reporting Efforts

The IRS is pursuing a wide range of initiatives, most based on legislation, around leveraging the efforts of third parties and third-party data in order to improve voluntary compliance with United States tax laws. Starting in 2005, Congress enacted a number of provisions to enhance tax-filing accuracy through increased third-party information reporting. The various provisions require new information reporting to the IRS for both individual and business taxpayers. This should not only improve the overall compliance rate, but will provide the IRS improved information that will make enforcement actions more effective and efficient.

Government Payments to Contractors

The IRC Section 3402(t)(1), created by the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005, generally requires governmental entities to deduct and withhold a 3% tax from payments made to any person providing property or services, subject to certain exceptions. The governmental entities must provide the payee and the IRS with an annual information return concerning the payments and amounts withheld. TIPRA originally provided that it applied to payments made after December 31, 2010, but the American Recovery and Reinvestment Act of 2009 delayed the new withholding requirement for one year to payments made after December 31, 2011.

The following governmental entities will be subject to the new reporting and withholding requirements: the U.S. government, including all federal agencies, the executive branch, the legislative branch and the judicial branch; all states including the District of Columbia (but not including Indian tribal governments); and all political subdivisions of a state government or every instrumentality of such subdivisions unless it makes annual payments for property or services of less than \$100 million.

Generally, withholding will be required at the time of payment on all payments totaling \$10,000 or more to all persons providing property or services to the government, including individuals, trusts, estates, partnerships, associations, and corporations.

Merchant/Payment Card Reporting

The Housing Assistance Tax Act of 2008 added Section 6050W to the Internal Revenue Code. This provision requires information reporting to the IRS on payment card transactions occurring after December 31, 2010. Under the provision, the bank or other organization with the contractual obligation to make payments to participating payees in settlement of a payment card transaction will issue to the payees a Form 1099-K, Merchant Card and Third-Party Payments. This statement will indicate the amount of gross proceeds paid to them for the transactions reduced by any fees, rebates, etc. A "payment card" generally means a credit card, debit card, transit card, governmentally-issued electronic benefit transaction (EBT) card, or any other card accepted as payment by a network of persons unrelated to the issuer of the card and to the other merchants who accept the card as payment. This new information reporting requirement is intended to help in ensuring that all income is reported.

This information will also help the IRS in determining if non-credit card income is reported by comparing credit card data to other information.

Basis Reporting for Security Dealers

The Energy Improvement and Extension Act of 2008 requires securities brokers to report a customer's adjusted basis in sold securities and classify gain or loss as long-term or short-term. It also allowed taxpayers to compute the basis of certain stock (acquired through a dividend reinvestment plan) by averaging. The regulations affect brokers and custodians that make sales or transfer securities on behalf of customers, issuers of securities, and taxpayers that purchase or sell securities. The reporting requirements are effective beginning in 2011.

Information Reporting for Payments to Individuals and Corporations

The Patient Protection and Affordable Care Act of 2010 added new reporting requirements as well. For many years, it has been required for businesses to report payments to individuals for certain property or services if the amount exceeded \$600 over the course of the tax year. After December 31, 2011, it also will be necessary for businesses to report to the IRS payments made to corporations for goods or services as part of their trade or business, if the amount exceeds \$600 over the course of the year. At the time this paper was submitted, the United States Congress was in the process of considering repeal of this new requirement in light of the burden it places on businesses.

Information Reporting for Payments made in Connection with Rental Real Estate

Section 2101 of the Small Business Jobs Act of 2010 modified information reporting in the case of rental income recipients to require that they be subject to the same information reporting requirements as other taxpayers engaged in a trade or business. This means that rental income recipients must file a Form 1099-MISC to the IRS and furnish a statement to a payee when they make payments of \$600 or more to the payee in any taxable year in connection with the rental activity. This reporting requirement applies to payments to non-corporate service providers made after December 31, 2010 (and will apply to payments for property, and payments to corporations, made after December 31, 2011).

Like the new information reporting requirement for payments made to individuals and corporations, Congress is also considering repeal of the new reporting requirements related to rental real estate.

Foreign Account Tax Compliance Act (FATCA)

On March 18, 2010, the Hiring Incentives to Restore Employment (HIRE) Act of 2010, Pub. L. 111-147 (H.R. 2847) included FATCA, which makes a number of changes to the tax law affecting tax compliance with respect to foreign accounts and cross-border transactions.

The implementation of FATCA is one of the key projects the IRS is working on in the international area right now. The effective date is January 1, 2013.

FATCA will require participating foreign financial institutions to report on U.S. persons who hold accounts in foreign financial institutions or who own large interests in foreign entities that hold such accounts. If a foreign financial institution does not enter into an agreement to provide the IRS with such information on U.S. account holders, then FATCA imposes a withholding tax on U.S. source income and gross proceeds paid to the foreign financial institution.

The IRS has begun the substantial process of implementing FATCA. The IRS has sought and received well over 50 comment letters in response to Notice 2010-60 that it issued in August, and is in the process of carefully considering those comments as part of the regulatory rulemaking process. The IRS recognizes that it must partner with the private sector to effectively implement these rules and wants to devise a process that will meet the goals of the legislation, in an efficient manner that recognizes the operational considerations of the financial services industry and the sovereignty of U.S. trading partners.

Uncertain Tax Position (UTP) Reporting

One of the most important steps the IRS has taken in improving the information it receives is UTP reporting. Guided by the fundamental principle that transparency to the tax administrator is essential to achieving an effective and efficient self-assessment tax system, the IRS took a major step forward with Announcement 2010-75, Reporting of Uncertain Tax Positions. With this Announcement, the IRS sought to leverage the work done in financial auditing and to bridge the gap between financial and tax reporting. Accordingly, certain corporate taxpayers, whether U.S.-based or foreign-based, using U.S.-Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), now must report basic information about their uncertain tax positions when they file their tax returns.

At least at a conceptual level, taxpayers and the IRS have shared goals:

- Certainty regarding tax obligations sooner, rather than later;
- Consistent treatment across all taxpayers; and
- Efficient use of resources – both government and taxpayer – by focusing on issues and taxpayers with the greatest risk of non-compliance.

Over the past year the IRS has worked in consultation with taxpayers to fine tune the UTP reporting process. As a result, UTP reporting will be phased in over a five-year period. With

the phase-in approach (outline below), smaller companies will have additional time to comply with the new reporting requirement.

<u>Assets</u>	<u>Filings Begins With</u>
\$100 million of more	2010 tax years
\$50-99 million	2012 tax years
\$10-40 million	2014 tax years

An uncertain tax position shown in the financial statements of a company reflects a reserve established by the company. The reserve is essentially a hedge that offsets a tax benefit, where the tax benefit reflects a tax position taken on a tax and the hedge reflects the estimate that the benefit will not be sustained. The UTP form does not ask taxpayers to disclose the actual reserve. Instead it asks them to rank their UTPs from highest to lowest. Critical to the disclosure is the concise description that taxpayers must provide to sufficiently identify the issue and the relevant facts. The new form is intended to increase the ability of the IRS to select corporations for examination and also assist in the selection of issues once an examination is underway.

Finally, it is worth noting in this discussion that taxpayers have expressed concern that the reported UTP information would be automatically disclosed to foreign governments under treaties or tax information exchange agreements (TIEAs). The IRS has assured taxpayers that automatic disclosure will not occur.

3. IRS Approaches to Utilizing Third Parties and Third-party Data

In addition to the direct reporting discussed in the prior section, there are a number of IRS initiatives to utilize third parties and third-party information.

Tax Return Preparer Initiative

A key example of utilizing third parties to improve compliance is our Tax Return Preparer Initiative. The IRS instituted this initiative to require registration, testing and continuing education for all individuals paid to prepare federal tax returns. The initiative is expected to increase the quality of tax returns prepared by paid tax returns preparers. Thus far, over 650,000 paid tax return prepares have registered for this filing season. The IRS will also test preparers for basic competence and will impose continuing education requirements.

The IRS has also begun a series of additional efforts related to paid tax return preparers, including contacting selected tax return preparers to improve the accuracy and quality of filed tax returns and to heighten awareness of preparer responsibilities. The IRS also sent letters to approximately 10,000 return preparers nationwide to outline current responsibilities, consequences of filing incorrect returns; and highlights of new tax return preparer requirements.

This year, IRS revenue agents are also conducting approximately 2,500 compliance visits with return preparers across the country. The purpose of these visits is to confirm that tax return preparers are complying with current return preparer requirements for maintaining records, signing and furnishing an identifying number on returns they prepare, and to provide information on new return preparer requirements effective for the 2011 filing season.

Whistleblowers

The IRS and the United States Congress have also sought to utilize third parties by creating an initiative to bring in more third-party information from whistleblowers. The whistleblower program, which is legislatively mandated, presents a stream of improved information that will modify the way the IRS does business in the coming years. Since Congress changed the law in 2006 to mandate the amount of certain awards, there has been a sharp increase in the number of high dollar cases submitted and IRS has a wide variety of whistleblower claims in inventory. We have only recently proposed our first awards under the new rules.

Large corporate issues currently account for almost half of the open inventory of whistleblower cases. The issues raised in these cases cover a wide range, in areas ranging from transfer pricing, compensation, offshore activity, financial transactions and business restructurings.

The IRS has set up processes that coordinate the Whistleblower Office with the business operating divisions. In the future the whistleblower program will bring the IRS welcome data in a number of key strategic areas.

Automated Underreporter Process

The IRS firmly believes that the amount and quality of information we are getting is key to improving the compliance rate of Americans under the United States tax system. While Congress has required that more data be provided, the IRS has the challenge of building the IT systems to make that data available for compliance purposes. Additionally, the IRS must create the business processes to utilize the data for ongoing enforcement.

The Automated Underreporter (AUR) Program combines the IT solution with a business process. The annual AUR process begins with an inventory list of potential underreporter cases by matching taxpayer return data against the data received by third parties. This works to identify taxpayers who appear to have received income which they did not report. Matches occur at multiple times during the year. The matches result in approximately 18 million potential underreporter cases.

The main purpose of the Automated Underreporter Program is to resolve income discrepancies between the information that taxpayers report to the IRS on tax returns and the related information employers and financial institutions provide the IRS on information returns. Once discrepancy cases are identified, the IRS decides how many cases it will investigate.

Once selected, AUR cases go to one of six IRS campuses where tax examiners manually review each case. After analyzing the tax returns, tax examiners are sometimes able to immediately resolve the discrepancies. For the remaining AUR cases, tax examiners may request additional information from taxpayers.

Because IRS resources cannot investigate every instance of noncompliance, including AUR discrepancies, the IRS is increasingly utilizing alternative approaches to resolve compliance issues outside its traditional processes. AUR has begun to issue what the IRS calls a “soft notice” to certain taxpayers with apparent underreported income. The notice informs the taxpayer that there appears to be a discrepancy with the income types listed but does not provide them with any type of tax calculations. Instead, the notice instructs the taxpayer to file an amended return to correct their return if the information shown on the notice is correct.

Use of Other Data

In addition to AUR, and more generally, a key area of work for the IRS in the next couple of years will be to address what data it should acquire and how to use that data. There is no doubt that in coming years the IRS will have more and better data than it has today. This will be true all across the IRS.

The merchant/payment card and securities basis reporting data described above are key examples. Merchant/payment card reporting in particular will provide a window into the revenue flows of numerous business segments and should be most useful with smaller businesses. In fact, it will be the cornerstone of IRS attempts to address incorrect income reporting by small businesses.

Teams are working on the matching and analytic tools needed to successfully mine data for research, case selection and case audit purposes. These efforts will start with the new merchant/payment card data. Eventually, the IRS will apply these techniques to all areas.

Conclusion

The IRS is fortunate in that the vast majority of U.S. taxpayers are compliant. What is less clear is whether this is the result of a national attitude or the result of a very successful set of withholding and reporting rules. Regardless of the answer to this largely philosophical question, the IRS and the United States Congress have worked to increase the type and amount of reporting that is required from the populace. In the coming years, the use of data will only increase as the new streams of data described above, along with the new processes that will utilize third parties to promote compliance, are implemented.

As stated, the IRS has found that the more visible a taxpayer’s income, the greater the level of compliance. Third-party reporting assists the honest taxpayer in preparing a more accurate return and it lets the IRS more effectively focus on those returns that are not

accurately reporting income. These efforts contribute not only to the perception but also to the reality that the IRS is making every effort to fulfill its mission statement by "...applying the tax law with integrity and fairness to all."