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Statement to the Press of Senator Bob Dole
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The Underground Economy And Other Compliance Problems

Senator Grassley and I will introduce next week the Taxpayer Compliance Improvement Act of 1982. This measure will be the first comprehensive reform of our voluntary compliance system since 1954. By avoiding a broad extension of mandatory withholding, it also represents a fundamental redirection of our tax administration system and philosophy of tax collection.

Our bill will dramatically limit or reverse the growth of the so-called compliance gap -- the \$76 billion difference between the federal income taxes owed and the amount actually collected. By substantially reducing noncompliance with our federal income tax laws this bill will not only restore our citizens' sense of fairness in those laws but collect substantial revenues.

The revenue yield from the measure has been tentatively -- and I believe, conservatively -- estimated at \$3 billion in FY 1983, \$8.1 billion in FY 1984 and \$9.3 billion in FY 1985. We believe that tax equity and fiscal responsibility are both served by enactment of this measure.

THE EXPANDING COMPLIANCE GAP

Chart 1 shows the enormous growth in the income tax compliance gap -- the difference between what the Federal Government was owed and what it collected. That gap grew from \$21 billion in 1973 to \$76 billion in 1981. If unchecked, the compliance gap would increase to \$102 billion by 1985. Moreover, that growth reflects increasing percentages of unpaid tax.

The Three Principal Components

The compliance gap has three principal components: individuals' unreported and underreported legal income, unreported and underreported corporate income, and illegal income. Chart 3 shows the current (1981) composition of the \$74 billion that is lost. That chart makes clear that approximately 84% of the compliance gap, according to the IRS' most recent figures, is attributable to underreporting of individuals' legal income. Only 11% is due to underreporting of illegal income and only 5% is attributable to the corporate sector. The bulk of the noncompliance is thus by individuals, according to the IRS, and with respect to legal source income.

Chart 4 breaks down the sources of underreported legal income for individuals. This total amount is \$64 billion in 1981. The bar graph of chart 5 shows the varying levels of compliance with respect to certain important types of income. Compliance is highest for wages -- in excess of 99% according to the IRS. Farm income has the second highest compliance rate (92%). Capital gains has an estimated compliance rate of only 56%. Entirely off the chart are tips and illegal source income with average compliance rates of less than 20%.

These charts thus give a bird's eye view of the problem. They also point the way to some of our solutions.

THE NATURE OF THE SOLUTIONS

The measures we propose today fall into four principal categories. First are measures which improve the operation of our information reporting system. Second, the bill provides a new system of penalties when taxpayers refuse to comply with the information reporting system or the general tax laws. Third are proposals to increase the level of IRS resources to enable the IRS to do the job we expect of it. Fourth, a progressive voluntary withholding system is applied to pensions.

I would like to note at the outset that these proposals generally do not substitute a mandatory withholding system for a working information reporting system and do not do so in particular with respect to interest and dividend payments. I believe such proposals may be premature until we have seriously tried to improve our information reporting system.

I. IMPROVED INFORMATION REPORTING

The information reporting system now suffers from three principal flaws.

New Information

First, important and necessary information is not made available to the IRS and to taxpayers filing returns. Information reporting on interest and dividends, for example, not only appraises the IRS of the income a taxpayer receives but also reminds the taxpayer during the crucial tax filing season of these amounts. Four principal areas would be dealt with by this bill. First, information reporting would be extended to all interest bearing instruments - including federal obligations and bearer bonds. Second, low-cost information reporting on capital gains in commodities and securities transactions would be required from the highly computerized securities and commodities brokerage industry. Third, state income tax refunds would be reported to taxpayers -- reducing the \$330 million revenue loss associated with such payments. Fourth, tips paid over by large employers based upon credit card invoices would be subject to information reporting.

More Accurate Information

The key to the IRS information reporting system is the matching of third party reports -- like Form 1099's on interest and dividends -- with the returns filed by taxpayers. This system is important because it allows the IRS to monitor taxpayer compliance without imposing unnecessary burdens on taxpayers' time and money through involved office audits. Such matching virtually requires that the taxpayer's own return and the information return contain accurate social security numbers. Yet in 1979, the last year for which the information is available, 7.8% of all Form 1099's (a total of 5,568,416 returns) had no social security numbers at all. Over thirteen million information reports on interest had no social security numbers (5.9%). Approximately 10% more of each category of returns had incorrect social security numbers. Tracking down the correct social security number is either very expensive or, in many instances, simply impossible. A combination of new penalties and withholding for taxpayers who do not comply will substantially reduce this serious problem.

Using the Information Received

The third problem that the IRS faces is an inability to handle the information it receives. This problem, too, has several components. One dimension of the problem is resources. Budget cutbacks at the IRS have reduced its ability to process the information it receives. Although the Administration's proposal to increase compliance funding for the IRS is important, none of that money will be allocated to data processing. We urge the Administration to include in its 1984 and 1985 budgets higher funding to process the information this bill would make available. Even without such additional funding, however, the

new and more accurate information will boost compliance significantly. Equally important are the regulatory reform changes made by this bill. Under our bill, the IRS would be required to issue promptly regulations interpreting new statutory provisions, thus better enabling taxpayers to comply voluntarily with the Federal tax laws.

A related problem is information returns filed on paper. The bill would give the IRS express authority to require persons filing large numbers of returns to file on magnetic tape and related formats. Such requirements would accelerate and increase the efficiency of processing such returns.

Finally, because of concerns that the IRS has all too often collected information without being able to process it, this bill would require the IRS to make a comprehensive examination of its information returns and their processing and report back to the Congress the results of that study by next spring.

II. PENALTIES AND INTEREST

The second principal type of remedy proposed by the bill would be a comprehensive revision of the penalty and interest system. In addition to imposing meaningful penalties on taxpayers who do not comply with the requirements of our information reporting system, the bill would make five major changes to that system.

Computation of Interest

Current law offers taxpayers unintended and unwarranted interest bonanzas. Recently, the opportunity to receive interest at 20% on net operating losses for up to a full year has received special attention. Taxpayers entitled to a refund can adopt a similar strategy and receive interest at up to 20% on their money for up to three years. The Federal Government ought not pay 20% interest in such instances, and these loopholes will be closed.

Compounding of Interest

Currently, only simple interest accrues on refunds and deficiencies. Despite the 1981 increase in the rate of interest, the failure to compound interest provides taxpayers with a strong incentive to delay settlement of controversies. Beginning in 1983, interest will be compounded semi-annually.

Interest Rates

A matter that has deeply concerned Senator Grassley is the failure to provide a realistic measure of the interest rate under the formula of the 1981 Act. This bill reflects those concerns. If enacted, it will insure that interest rates conform to economic reality. Beginning in 1983, interest rates will be adjusted semi-annually to the average prime rate over the prior six months.

Tax Shelter Penalty

A problem that has long concerned the IRS and the bar is the need to restrict the ability of well-advised taxpayers to take unsupportable positions on their returns while gambling that their tax return will not be audited. Even if audited, such taxpayers can generally rely on the advice of their advisor to defeat a penalty. Our bill would change the sophisticated calculations of such high-income, well-advised taxpayers. In the case of a very substantial understatement of tax arising out of items with respect to which the taxpayer took a position contrary to or inconsistent with a published position of the IRS that had not been fully disclosed on the tax return, a 10% penalty would be imposed. No showing of negligence or fraud would be required.

Corporate Officer Fraud Penalty

The bill would adopt a proposal made last year by the Tax Section of the New York State Bar Association and permit the civil fraud penalty to be assessed against a manager of a corporation who commits tax fraud on behalf of his corporate employer. Although current law allows the Government to send such an individual to prison, a civil fraud penalty may operate as a more efficient deterrent.

III. IRS FUNDING

The third element of this program will be increased funding for the IRS data processing and examination (audit) functions in FY 1984 and FY 1985 as the underlying information reporting requirements and new penalties begin to have substantial effect. Because we are joining with the Administration in urging higher funding for collection activities, as provided in the FY 1983 budget, revenues so generated are also included in the revenue estimate of this package.

IV. VOLUNTARY WITHHOLDING ON ANNUITIES

Currently, taxpayers receiving annuity distributions from pensions may elect voluntary withholding. The substantive tax law is complex, and many taxpayers mistakenly believe that all amounts received are nontaxable. Because no progressive withholding rate charts are available, taxpayers cannot compute the amount that ought to be withheld to avoid either over withholding or the need to make estimated tax payments. Not surprisingly, few taxpayers elect in. The compliance gap for pension distributions is already approximately \$3 billion, and projected to grow very sharply.

We believe that taxpayers ought not to be required to be subject to withholding on annuity distributions if they do not so choose. On the other hand, annuities are generally taxable, and, as for wages, taxpayers ought to be allowed to avoid making estimated tax payments. Thus, a progressive withholding table will be provided. Withholding will apply unless the taxpayer elects out.

Lump sum distributions are subject to special fixed tax rates. In the case of taxable lump sum distributions, it therefore appears entirely appropriate to apply a mandatory withholding system unless the taxpayer makes a qualified tax-free rollover of the proceeds.

INDEPENDENT CONTRACTORS

Earlier this Congress I introduced S. 8, a bill that provides a broad safe harbor for the definition of independent contractors. I continue to work toward a solution to the fundamental problems of equity and of compliance for independent contractors. We are close to agreeing on a bill and I hope to introduce a bill with safe harbors and information reporting -- and without withholding -- next week.

CONCLUSION

The bill represents a dramatic departure from prior strategies to deal with the rapidly growing compliance gap. Without imposing broad based withholding and without a massive increase in audit coverage, the bill will substantially increase compliance with the federal tax laws. The bill offers a balanced package, weighing taxpayers' interest in a limited paperwork burden and in privacy with the clear need to collect revenues. Our efforts to narrow the projected budget deficits and maintain confidence in the integrity and the equity of our federal tax laws should insure that these proposals receive careful attention.