National Association of Enrolled Agents

Written Comments of Roger Harris, EA
On behalf of
The National Association of Enrolled Agents

IRS Oversight Board Public Forum
March 7, 2007

1120 Connecticut Ave., NW, Suite 460
Washington, DC 20036-3953

p 202.822.NAEA (6232) f 202.822.6270
e info@naeahq.org www.naea.org

Testimony of Roger Harris, EA
Government Relations Committee Chair,
National Association of Enrolled Agents[i]
before the Internal Revenue Service Oversight Board
March 7, 2007

Thank you, Mr. Chairman and members of the IRS Oversight Board for inviting the National Association of Enrolled Agents (NAEA) to testify before you today on the tax gap. My name is Roger Harris and I am representing NAEA, the premier organization representing the interests of the 46,000 enrolled agents (EAs) across the country. Enrolled agents are the *only* tax practitioners the IRS directly tests and regulates, and NAEA is committed to increasing industry professionalism, improving the integrity of the nation's tax administration system, and protecting taxpayers' rights to representation. Further, we believe that NAEA is well positioned to offer an informed perspective about the sources of – and potential options for closing – the tax gap.

Let's start by briefly sketching the tax gap facts as we know them and then proceed to possible solutions. The briefest of definitions is that the gross tax gap, now estimated at $345 billion annually, is the difference between taxes owed and taxes paid in a timely fashion. More specifically, IRS' gross tax gap estimate is derived from three components, namely:

1) filing compliance—are all required tax returns filed?

2) payment compliance—is the full self-assessed tax included with the originally filed return?

3) reporting compliance— did the taxpayer accurately report income and expenses?

The agency's most recent tax gap estimate is presented in Appendix I. The chart reveals that approximately 80% of the tax gap is the result of misreporting taxable income (whether by understating income, overstating expenses, or claiming erroneous deductions and/or credits).

Two items with respect to reporting compliance are noteworthy:

1) the more information reporting (and withholding at the source) occurs, the greater a taxpayer's reporting compliance. A direct correlation exists between information reporting—which invariably leads to document matching at IRS—and reporting compliance (see Appendix II).

2) the largest portion of misreporting is the result of understating earnings (see Appendix III).

While economists and statisticians may parse IRS data and arrive at any number of conclusions, common sense seems to indicate that any serious strategy to narrow the tax gap will of necessity include measures aimed at shoring up reporting compliance.

Many factors contribute to reporting non-compliance, which means that focusing on the right issues may prove a significant challenge. Clearly, a great portion of underreported income is believed to come from sources for which there is no information reporting, ranging from capital gains income from securities sales and auction sale proceeds to rents and royalties income. The cash economy is also an area with the potential for high rates of underreporting. Further, the complexity of the tax code can make it difficult for even the most well-intentioned self-preparers to understand their tax liabilities.

The onset of the tax gap as an increasingly high-profile issue has prompted a lively discussion about what steps can be taken to recover more of this forgone revenue. The Joint Committee on Taxation and the Department of Treasury have each put forth specific proposals to that end.[1] I would like to mention three such proposals, all of which were put forth by the Joint Committee, and one of which was included in President Bush's FY 2008 budget request. Two of these changes would eliminate potential opportunities for understating earnings, which, as mentioned above, constitutes the lion's share of misreporting. NAEA believes these are examples of modest, common sense steps to increase compliance through information reporting:

- **Publicly-Traded Securities Basis Reporting** would likely result in more accurate reporting of capital gains income and/or loss. For a variety of reasons, many of our clients struggle when asked to provide cost basis for securities they sold. In most cases, brokerage firms are well-placed to provide this information. At the same time, we acknowledge there are probably administrative challenges to transferring some of the responsibility of basis calculation from the taxpayer to the broker, both for the broker and for the taxpayer. To that end, we believe the taxpayer has the right to an explanation of how a basis was calculated, as well as the right to appeal the calculation, so long as the taxpayer presents a lawful method of alternate calculation.

- **Real Estate Tax Reporting** would lead to more accurate deducted amounts. Many taxpayers do not differentiate between taxes and assessments when calculating their deduction. Further, this proposal would provide more oversight of such deductions by the IRS. We caution, however, that a taxpayer's home sale at any

---

[1] http://finance.senate.gov/press/Gpress/2005/prg101906.pdf; http://www.ustreas.gov/offices/tax-policy/library/bluebk07.pdf

point in the calendar year may cause both inaccurate reporting and difficulty for IRS document matching programs.

- **Auction Sales Proceeds Reporting** would increase compliance among a fast-growing group of taxpayers (or, more accurately, people who should be taxpayers). A 2005 study[2] found that 724,000 eBay sellers rely on eBay sales as their primary or secondary source of income – an increase of 68 percent over two years. Another 1.5 million individuals supplement their income with eBay sales. In 2005, eBay users sold $44.3 billion of merchandise, none of which was directly reported to the IRS on behalf of the individual sellers. (N.B. We use eBay for illustrative purposes only, as the firm provides a high profile example of the extent to which online auction commerce has increased in recent years.)

In addition to the proposals above, we firmly believe one other reform option would help to close the tax gap—the regulation of unenrolled return preparers. Our members are repeatedly faced with fallout from the work of incompetent or corrupt paid preparers. The following real-life accounts told by enrolled agents are illustrative:

- "My most shocking experiences [with respect to corrupt tax preparers] deal with fabricated businesses established in order to reduce taxable income. In one instance, a taxpayer went to a local storefront tax service (not national) open only during the tax season. A fabricated Schedule C was filed and the [paid preparer] received his fee based on the refund. In yet another instance, the paid preparer padded Schedule A charitable contributions and miscellaneous business expenses <u>in addition to</u> fabricating a Schedule C."

- "I have a new client referral with two corporations plus personal returns on my desk right now. The personal return includes multiple rental properties, five children (his, hers, and theirs). The couple has been married five years and my new client switched accountants because she thinks her former [unlicensed] preparer is over his head. When I asked her to bring in the last three years of returns, **all** were prepared as Head of Household for each of them (husband and wife) at different addresses for 2003 and 2004 and at the same address for 2005. The former preparer appears to have "swapped" children over the three years to gain maximum refund. Not surprisingly, some refunds include an earned income credit for which the taxpayer was not eligible. My referral will owe close to $10,000 **without** interest and penalties. Upon learning she'd have to amend 3 years of returns and hearing an estimate of what she owed, she had a change of heart and decided to return to her original preparer.

[2] ACNielsen International Research (July 2005).

So is the former preparer corrupt? Inept? How many more families has he done this for? I am sure the preparer is not on anybody's radar screen. I also know that while I did the right thing, my new client 'walked.' I know that he gave her sunshine and daisies and I gave her the cold, hard facts. In the absence of an audit, sunshine and daisies are hard to compete against…"

- "I represented a [law enforcement] officer who had overstated employee expenses (*e.g.*, deducting personal grooming) and overstated Sched. C (*e.g.*, part-time work where the car was 100% deducted with no log book). To top it off, when I advise taxpayers of the requirement for an auto log book, **I** look like the bad guy…"

A 2006 GAO study (*Paid Tax Return Preparers: In a Limited Study Chain Preparers Make Serious Errors*) estimates that **more than half of individual income tax returns filed are prepared by a paid tax preparer**.[3] In the same study, GAO found several instances of incompetent preparation by chain preparers, often resulting in large refund overclaims.[4]

National Taxpayer Advocate Nina Olson believes that "untrained and unscrupulous preparers present a serious problem" and that "[taxpayers] are harmed by the absence of a comprehensive federal program to regulate unenrolled return preparers." Thus, she "has advocated the establishment of minimum levels of competency for return preparation by developing a federal system to register, test, and certify unenrolled return preparers."[5]

Congress could act to improve competence and ethical standards in the tax preparation industry by enacting a bill identical to S. 832, the Taxpayer Protection and Assistance Act, which was introduced in the 109th Congress. Enrolled agents believe that if enacted and fully implemented, this program could be one of the most significant legislative contributions for improving upfront compliance to come along in many years.

In conclusion, NAEA suggests that policymakers set significant and reasonable goals to reduce the tax gap. We owe it to honest taxpayers—whose tax bills are thousands of dollars larger than they should be[6]—to make meaningful strides. While no one wants to live in a world in which the tax gap is zero, the current tax gap is unacceptable and undermines support in our system of voluntary self-assessment. A number of possible solutions—some regulatory, some legislative; some enforcement-based and some assistance based—present themselves. As

---

[3] Government Accountability Office, *Testimony Before the Committee on Finance, U.S. Senate: Paid Tax Return Preparers* (April 2006), p. 4.

[4] *Ibid*, p. 5.

[5] National Taxpayer Advocate, *2006 Annual Report to Congress* (January 2007), p. 197.

[6] *Ibid*, p. 6 – The National Taxpayer Advocate estimates that compliant taxpayers are essentially charged a $2,200 surtax to subsidize noncompliance.

always, this organization and its members stand ready to work with the Internal Revenue Service and the IRS Oversight Board in weighing the merits of various proposals and standing at the front lines of accurate and ethical tax administration.

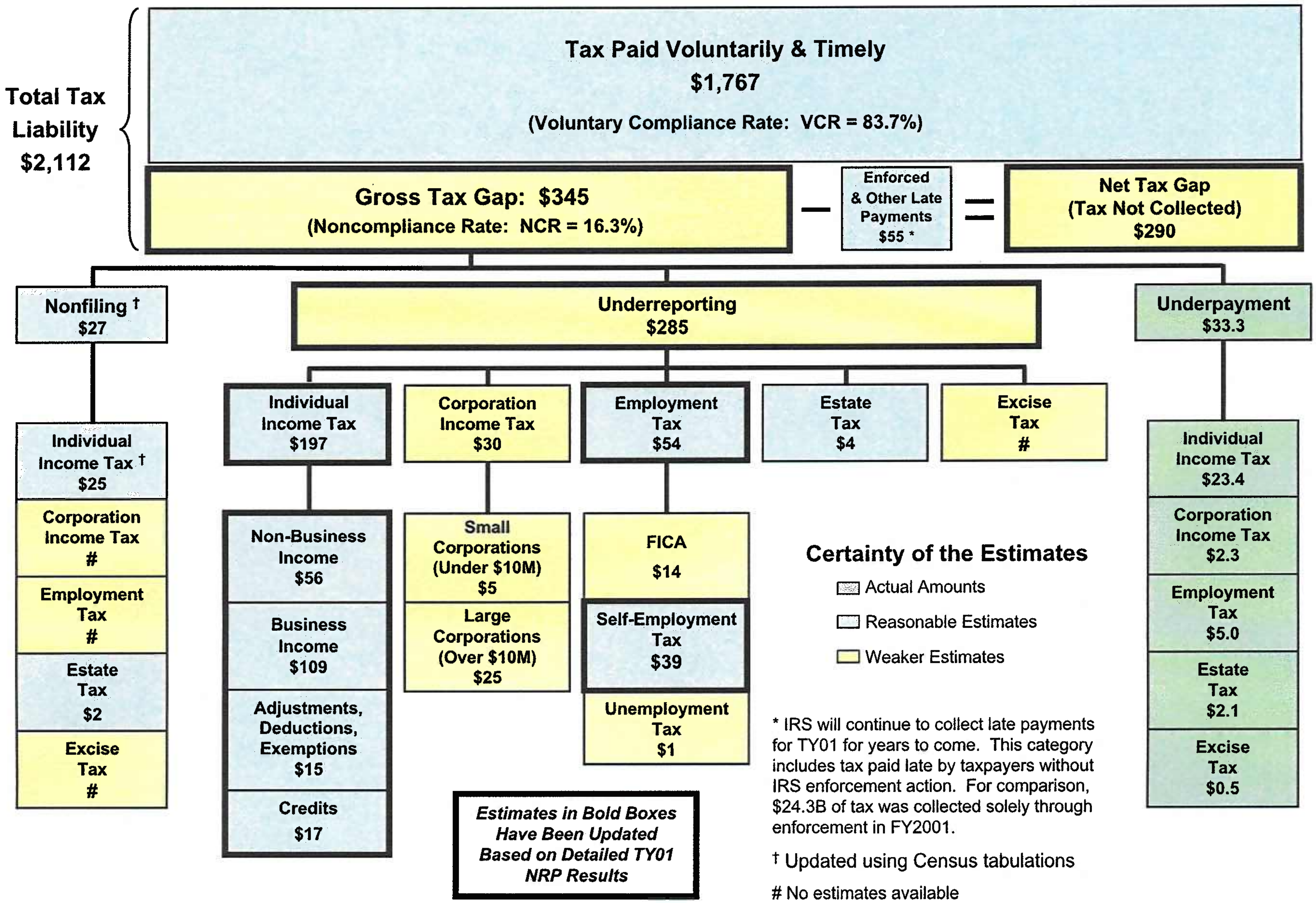
---

[i] The **National Association of Enrolled Agents (NAEA)** is the professional society representing enrolled agents (EAs), which number some 46,000 nationwide. Its 11,000+ members are licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service (IRS), including examination, collection and appeals functions.

While the enrolled agent license was created in 1884 and has a long and storied past, today's EAs are the only tax professionals tested by IRS on their knowledge of tax law and regulations. They provide tax preparation, representation, tax planning and other financial services to millions of individual and business taxpayers. EAs adhere to a code of ethics and professional conduct and are required by IRS to take Continuing Professional Education. Like attorneys and Certified Public Accountants, enrolled agents are governed by Treasury Circular 230 in their practice before the IRS.

Since its founding in 1972, NAEA has been the enrolled agents' primary advocate before Congress and the IRS. NAEA has affiliates and chapters in 42 states. For additional information about NAEA, please go to our website at www.naea.org.

TAX GAP MAP for Tax Year 2001 *(in $ Billions)*

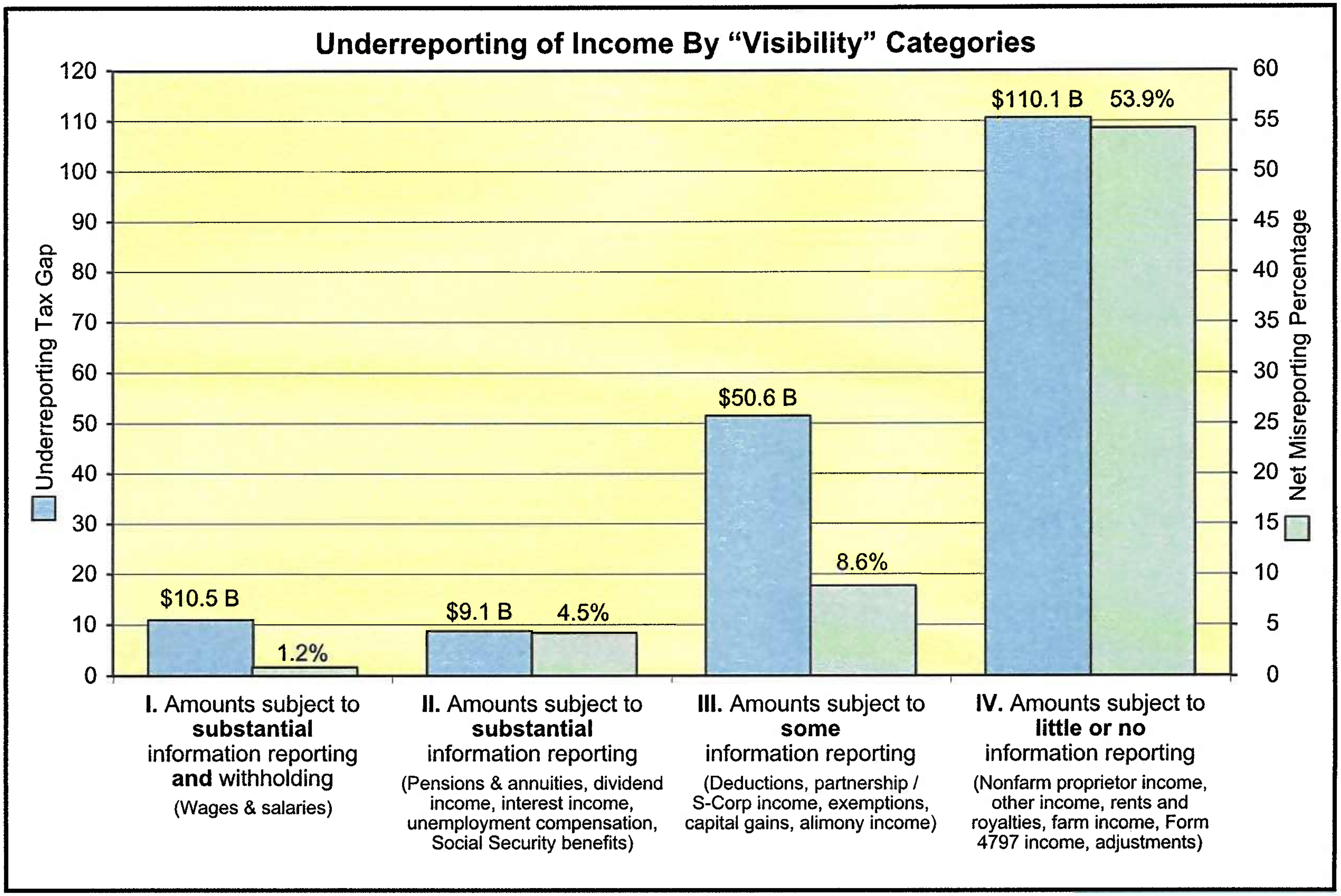


* IRS will continue to collect late payments for TY01 for years to come. This category includes tax paid late by taxpayers without IRS enforcement action. For comparison, $24.3B of tax was collected solely through enforcement in FY2001.

† Updated using Census tabulations

No estimates available

Tax Year 2001 Individual Income Tax Underreporting Gap



Based on updated estimates derived from the National Research Program underreporting compliance study.

Individual Income Tax Underreporting Gap Estimates, Tax Year 2001

Category	*Tax Gap ($B)*	*NMP †*
Items Subject to Substantial Information Reporting and Withholding	**10.5**	**1.2%**
Wages, salaries, tips	10.5	1.2%
Items Subject to Substantial Information Reporting	**9.1**	**4.5%**
Interest income	1.6	3.6%
Dividend income	1.1	3.7%
State income tax refunds	0.6	11.6%
Pensions & annuities	4.2	4.1%
Unemployment Compensation	*	11.1%
Social Security benefits	1.1	5.8%
Items Subject to Some Information Reporting	**50.6**	**8.6%**
Partnership, S-Corp, Estate & Trust, etc.	22.0	17.8%
Alimony income	*	7.2%
Capital gains	11.0	11.8%
Deductions	13.5	5.4%
Exemptions	4.2	5.4%
Items Subject to Little or No Information Reporting	**110.1**	**53.9%**
Form 4797 income	3.3	64.4%
Other income	22.6	63.5%
Nonfarm proprietor income	68.0	57.1%
Farm income	5.8	72.0%
Rents & royalties	13.4	51.3%
Total Statutory Adjustments	-3.0	-21.1%
Not Shown on Visibility Chart	**17.1**	**26.3%**
Credits	17.1	26.3%
Total	**197.4**	**18.0%**

† NMP = Net Misreporting Percentage, the net amount of income or offset misreported divided by the amount that should have been reported.

* Less than $0.5 billion.