Strengthening Tax Administration: Tax administration will be strengthened through disclosure revisions and stronger penalties for nonfiling.

- *Expand IRS access to information in the National Directory of New Hires (NDNH) for tax administration purposes.* This proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for noncompliant taxpayers, and identification of levy sources.

- *Permit disclosure of prison tax scams.* This proposal would authorize the IRS to disclose certain limited return information about tax violations by inmates so prison officials could punish and deter such conduct through administrative sanctions. This is expected to generate $5 million over the next ten years.

- *Make repeated willful failure to file a tax return a felony.* This proposal would subject any person who willfully fails to file tax returns in any three years within any five year period, if the aggregated tax liability for such period is at least $50,000, to a new aggravated failure to file criminal penalty. This proposal is estimated to generate $12 million over the next ten years.

Strengthening Penalties: Enhanced penalties will help to deter noncompliance.

- *Expand preparer penalties.* Legislation was signed May 25, 2007, implementing a modified version of this proposal. It expands the scope of the existing preparer penalties to include non-income tax returns and related documents. The proposal also increases related penalty amounts. The change will generate an estimated $80 million over the next ten years.

- *Impose penalty on failure to comply with electronic filing requirement.* This proposal would establish a penalty for failure to comply with e-file requirements. The amount of the penalty would be $25,000 for a corporation or $5,000 for a tax-exempt organization.

- *Create an erroneous refund claim penalty.* Legislation was signed May 25, 2007, implementing a version of this proposal. It imposes a penalty of up to 20 percent of a disallowed portion of a claim for refund or credit for which there is no reasonable basis for the claimed tax treatment, or for which the taxpayer did not have reasonable cause. The change will generate an estimated $98 million over the next ten years.

The Treasury Department and the IRS will continue to explore additional possibilities for legislative proposals, as well as improved methods for using external data and data from information reports.

Published Guidance

Published guidance in the form of regulations, revenue rulings, revenue procedures, notices, and announcements is a critical element in the IRS' efforts to reduce tax avoidance, improve taxpayer compliance, and close the tax gap.

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Published guidance:

- Enhances compliance by providing detailed substantive and procedural rules;
- Helps compliant taxpayers better understand how to determine and pay their tax liability;
- Reduces disputes between the IRS and taxpayers regarding the proper interpretation of the tax law and the procedures necessary to comply with it; and
- Makes it more difficult for noncompliant taxpayers to avoid detection or incorrectly claim that their behavior is permitted under the tax law.

Some tax statutes specifically direct the Treasury Department and the IRS to issue regulations or other guidance. Certain statutory provisions have little or no effect until implemented by regulations or other administrative guidance, and some provide only general direction and broadly delegate authority to publish regulations. Published guidance interprets the tax law and articulates how it applies in different circumstances, thus helping taxpayers determine how to comply with their tax obligations.

The Treasury Department and the IRS continue to resolve many difficult issues and remove impediments to voluntary compliance through published guidance. The ever-increasing complexity of, continuing changes in, and temporary nature of the tax law also present significant challenges to addressing long-standing compliance problems through guidance. The published guidance program also aids in identification of issues that guidance cannot address and serves a significant role in developing suggestions for legislative solutions.

Each year, the Treasury Department and the IRS issue a Priority Guidance Plan (PGP) that sets forth the guidance projects targeted for completion over the course of the following 12 months. The PGP typically includes more than 250 separate guidance projects.

Examples of published guidance designed to improve compliance recently issued by the Treasury Department and the IRS include:

- Regulations clarifying the tax rules and information reporting requirements for widely held fixed investment trusts;
- Regulations implementing and explaining new tax shelter disclosure rules and penalties;
- Regulations and other guidance on reporting and inclusion in income of deferred compensation from nonqualified deferred compensation plans;
- Regulations and other guidance clarifying and explaining the new deduction for domestic production activities;
- Guidance explaining the rules governing charitable contributions of vehicles;

- Guidance on transfer pricing issues related to cross-border services and cost-sharing agreements;
- Proposed regulations addressing the tax treatment of private annuities;
- Guidance designating a loss importation strategy as a listed transaction;
- Guidance implementing a new excise tax on tax-exempt entities and their managers in connection with participation in certain potentially abusive transactions;
- Guidance improving information reporting for certain wagering activities;
- Proposed regulations addressing when expenditures for tangible property may be deducted or must be capitalized; and
- Rulings addressing the consequences, including potential penalties, of filing returns (or failing to file returns) based on frivolous tax positions.

Issuing published guidance is an important tool for the IRS in closing the tax gap. Notwithstanding the inherent challenges, the Treasury Department and the IRS will continue to provide published guidance to improve compliance by addressing abusive tax avoidance transactions, providing clarifications and explanations of the tax laws, ensuring consistency of treatment of similarly situated taxpayers, and where possible, reducing burden on compliant taxpayers.

Some projects currently underway include development of guidance in these areas:

- Transfer pricing (Internal Revenue Code (IRC) section 482)
- Foreign tax credits (IRC section 901)
- Patent cross licensing
- International restructurings (IRC section 367)

Initiatives

- Work with Congress to enact remaining legislative proposals included in Administration's FY 2008 Budget:
  - Require information reporting on payments to corporations;
  - Require basis reporting on security sales;
  - Expand broker information reporting;

- o Require information reporting on merchant payment card reimbursements;
- o Require a certified Taxpayer Identification Number from contractors;
- o Require increased information reporting for certain government payments for property and services;
- o Increase information return penalties;
- o Require e-filing by certain large organizations;
- o Implement standards clarifying when employee leasing companies can be held liable for their clients' federal employment taxes;
- o Expand IRS access to information in the NDNH for tax administration purposes;
- o Permit disclosure of prison tax scams;
- o Make repeated willful failure to file a tax return a felony; and
- o Impose penalty on failure to comply with electronic filing requirement.

- Develop new legislative proposals for consideration in the Administration's FY 2009 Budget. Approaches under consideration include:
  - o Improvements in coordination with State governments, including coordination concerning licensing activities; and
  - o Further expansions of information reporting requirements, including reporting of financial activity that currently may not be subject to information reporting.
- Develop regulations and other published guidance clarifying ambiguous areas of the law, targeting specific areas of noncompliance, and preventing abusive behavior.

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Component 2

Make a Multi-Year Commitment to Research

Research is critical in helping the IRS understand behavior, develop strategies, and measure progress.

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, allocate resources more effectively, and reduce the tax gap. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, because this reduces the burden of unnecessary taxpayer contacts and because it enables the IRS to collect more with a given level of resources. Research is also critical in helping the IRS establish benchmarks against which to measure progress in improving compliance.

The NRP demonstrates the importance of comprehensive compliance data. In addition, accurate NRP data provides a critical benchmark for determining the sources of noncompliance and for measuring changes in compliance over time. Data from the NRP reporting compliance study have allowed the IRS to:

- Target examinations and other compliance activities better, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers; and
- Improve operational audits by using innovations pioneered during the 2001 NRP to reduce taxpayer burden.

Continued compliance research is a vital component of a sound tax gap strategy. An NRP reporting compliance study of 5,000 S corporation tax returns filed in 2003 and 2004 is currently in process. Since 1985, S corporation return filings have increased dramatically. In that year, there were 722,444 Forms 1120S filed. In 2004, that number had grown by nearly five times to over 3.6 million, while other corporate returns declined by approximately 500,000 for the same period.

By 1997, S corporations had become the most common corporate entity. In 2004, tax returns filed by S corporations accounted for over 63 percent of all corporate returns filed. The last time the IRS conducted an S corporation study was 1984. As a result, the IRS does not have reliable reporting compliance data for these entities. The current S corporation study represents the first time that the IRS has conducted a reporting compliance study across tax years, and it will require that the data be knitted together to provide a comprehensive picture. The study will continue through 2007.

Without new reporting compliance studies, the IRS must rely on studies conducted over 20 years ago to estimate compliance for areas other than individual income tax or S corporations. Moreover, with each passing year, the data from the 2001 study on individual income tax compliance becomes more outdated. Without up-to-date studies in all areas, the IRS is hampered in its ability to respond rapidly to trends and emerging vulnerabilities in the tax system. A multi-year commitment to research ensures that the IRS can efficiently target resources and effectively respond to new sources of noncompliance as they emerge.

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The Administration's FY 2008 Budget request for the IRS funds for three significant research initiatives. These include:

- *Increasing compliance studies.* The IRS will conduct reporting compliance studies for additional segments of taxpayers for which the IRS now relies on very old data (e.g., corporation income tax, employment tax, and partnerships), or for which the IRS has never conducted any compliance studies at all (e.g., excise tax).

- *Updating existing data from the 2001 NRP study.* The IRS will conduct an annual study of compliance among Form 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance data each year and, by combining samples over several years, will provide a regular update to the larger sample size needed to keep the IRS' targeting systems and compliance estimates up to date.

- *Researching the effect of service on taxpayer compliance.* This project will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

  1. Meeting taxpayer needs by providing the right channel of communication;
  2. Better understanding taxpayer burden;
  3. Understanding taxpayer needs through the errors they make; and
  4. Researching the impact of service on overall levels of voluntary compliance.

Initiatives

- Undertake additional compliance studies, including S corporations and individuals.
- Update tax gap estimates using new and existing data.
- Research the effect of service on taxpayer compliance.
- Research the relationship between complexity, burden, and compliance.

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Component 3

Continue Improvements in Information Technology

A combination of new systems and enhancements to existing systems is critical to a productive use of resources.

Information technology (IT) modernization is critical to ensuring the most productive use of both taxpayer service and compliance resources. It provides the necessary infrastructure that allows the most efficient utilization of resources, which in turn allows the IRS to target key components of the tax gap better. Because IT modernization is a cornerstone to efficient and effective tax administration, the IRS is committed to strong oversight and accountability of IT projects.

The IRS information technology vision includes systems that:

- Allow for better identification of the cases to be worked;
- Route those cases to the most appropriate workstream; and
- Employ cost effective technology analytics to best manage cases once they reach the correct workstream.

The IRS' current investment in technology infrastructure includes a combination of new systems and enhancements to existing systems, with emphasis on improving both effectiveness and efficiency. Included in this infrastructure are tools to increase taxpayer compliance through early detection, improved case selection, more efficient case delivery, and better case management:

- Case Selection. The NRP provides significant data for improving case selection criteria. NRP data facilitates selection of the most productive returns to examine. This not only reduces the tax gap, but also allows the IRS to update tax gap estimates. The case selection process is further enhanced through automated classification processes. The IRS also uses current audit information from "issue management" systems to provide for immediate identification of emerging issues. For Collection programs, the IRS will use improved decision analytics to select cases and route them to the most appropriate workstream.
- Case Delivery. Delivery systems also are being modified to move audit work into the system more effectively and efficiently. Both return classification and delivery will move toward digital rather than paper-based returns, eliminating the time consuming and expensive process of ordering returns and sending examiners out to IRS campus locations for classification details. Additionally, the IRS will replace manual processes with electronic case building and instant access to multi-year tax return information.
- Case Management. Automated systems are being deployed to allow more batched processing of high volume types of examinations. Technology enhancements will allow

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employees to work cases in an online environment, where returns and case-related data can be downloaded, and actions can be tracked electronically. The IRS will continue to link multiple internal and external databases to enhance overall effectiveness, allowing better identification, management, and performance monitoring for compliance workload. The IRS also has several projects that will enhance criminal enforcement, with spillover effects to civil cases.

The Administration's FY 2008 Budget request includes an additional $81 million in funding to improve the IRS' information technology infrastructure, which is vital to improving IRS' enforcement and services capabilities. The investments proposed in the Budget will allow the IRS to:

- *Upgrade critical IT infrastructure.* This will provide funding to upgrade the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in FY 2008 include procuring and replacing desktop computers, automated call distributor hardware, and Wide Area Network/Local Area Network routers and switches.

- *Enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security.* This will allow the CSIRC to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur.

- *Enhance the IRS' network infrastructure security.* This will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

The FY 2008 Budget request also includes a total of $282 million to continue the development and deployment of the IRS' Business Systems Modernization (BSM) program in line with the recommendations identified in the IRS' Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

- *Continue development of CADE and AMS.* The development of CADE and AMS systems is the heart of IRS' IT modernization. These two systems, working together, will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. The objective is for the IRS to operate similarly to a bank, where account transactions occurring during the business day are posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers to have access to all current information regarding that taxpayer, including electronic access to tax return data and electronic copies of correspondence. Armed with such comprehensive and up-to-date information, IRS representatives will be in a much better position to help taxpayers resolve their issues, which benefits both the IRS and taxpayers while promoting voluntary compliance.

The development of CADE and AMS also includes a comprehensive re-working of the notice system to streamline the process and enhance its efficiency. In July 2008, CADE is scheduled to post and settle tax returns with a balance due condition and amended tax returns, Form 1040X. The daily settlement of these accounts through CADE and the linkage with AMS will enable the balance due notices to be sent on a daily basis and delivered to the taxpayer as much as eight days faster than current time lines.

- *Continue development of MeF.* MeF is the future of electronic filing. It provides a standard data format for all electronically filed tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns, resulting in a quicker filing acknowledgement to the taxpayer or their representative. In FY 2007, the IRS is beginning the development and implementation of the Form 1040 on the MeF platform. The MeF system will enable the IRS to better analyze tax compliance issues and address noncompliance among taxpayers by removing the impediments caused by lack of data availability and completeness, access, and data accuracy. MeF will allow the re-engineering of much of the current manual and time consuming compliance processes including the following:
    - Completeness of Data. The MeF system provides 100 percent of the data contained within the returns, their schedules and attachments, third-party documents, and amended returns in an electronic form. All documentation will be available completely and electronically, which is equivalent to a paper copy of the entire return file, but in a more usable and transportable form. The current e-filing system only provides returns and does not have the ability to provide supplemental documentation, including attachments, electronically. Paper submissions provide only limited transcriptions of return data or an image of the return. All other documentation is recalled and analyzed using time consuming manual processes.
    - Data Availability and Access. Currently, IRS electronic systems capture an average of 20 percent of the data contained within tax and information returns. To gather additional information for compliance needs, the IRS must conduct manual transcriptions, which are costly and time consuming. For each form, the amount of information retained or transcribed varies by form type, complexity, and size. For those returns submitted through MeF, 100 percent of the data will be available to the IRS in electronic format, including associated schedules and attachments, regardless of the form type and without additional expense.
    - Data Accuracy. The IRS currently expends time and resources ensuring the data received from tax and information filers and transcriptions are accurate and reliable. The MeF system and its processes increase data accuracy by reducing the incidence of errors and by minimizing the need for manual transcriptions. This is made possible by validating the information prior to submission. The use of business rules also ensures that the returns are free of computation errors.

- Cost Effective Data Capture & Storage. The manual processing of return data, attachments, and schedules is time consuming and costly. E-filing is the most effective means of capturing, storing, and recalling data. Savings include a reduction in submission processing and storage costs. Additional savings will be achieved from reduced cost for retrieving and re-filing returns for examinations and transcription for identification of compliance trends or research.

- *Fed/State Electronic Federal Tax Payment System.* The IRS and the Treasury Department's Financial Management Service are developing a pilot in conjunction with South Carolina and Illinois. The pilot will enable Illinois taxpayers (South Carolina will participate in a later phase) to pay all their federal and certain state taxes online via the Treasury's Electronic Federal Tax Payment System (EFTPS). This initiative will provide one stop for taxpayers to make their federal and state tax payments.

- *Compliance Monitoring Process.* Compliance monitoring is premised on the notion that the IRS should make use of every available tool and public data source in trying to bring corporations into compliance. The Large and Mid-Size Business (LMSB) division has designed a Compliance Monitoring Process (CMP). LMSB developed and will be implementing an enhanced compliance initiative dependent on information technology that leverages the increases in transparency mandated by Sarbanes-Oxley and other laws. This program also leverages the increased transparency of public companies' financial statements that will result from implementation of Financial Accounting Standards Board Interpretation No. 48 (FIN 48).

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, and the business community, but also contribute to operational improvements and efficiencies within the IRS.

Initiatives

- Improve high income and non-EITC exam workload selection and method of delivery and assess the effectiveness of the exam treatment stream on selected nonfiler cases. (Also supports Component 4)
- Expand Automated Underreporter (AUR) Auto Notice Generation to include additional income types and all Form 1040 family returns. (Also supports Component 4)
- Develop system requirements for expanding the AUR Soft Notice Test, which involves asking taxpayers to voluntarily self-correct for future years. (Also supports Component 4)
- Evaluate the AUR matching process, and implement an improved case scoring and selection concept to select the most productive cases. (Also supports Component 4)
- Develop enhancements to the Compliance Data Warehouse to improve workload identification and prioritization algorithms, allowing better evaluation of alternative treatment streams and ensuring Collection cases receive the most efficient and effective treatments. (Also supports Component 4)

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- Update the Collection inventory management system to improve functionality navigation, performance, and efficiency. (Also supports Component 4)
- Automate lien delivery, recording, and release processes with state and local jurisdictions to improve the timeliness of lien filings and the payment of fees. (Also supports Component 4)
- Test the use of statistical modeling techniques within the Tax Exempt and Government Entities Division (TEGE) to detect high-risk compliance patterns in order to use data to expand and improve examination case selection. (Also supports Component 4)
- Develop and implement a set of compliance decision analytical tools that will support analysis of TEGE returns and other data to detect compliance trends and improve case and issue selection. (Also supports Component 4)
- Implement a new TEGE electronic examination system (TREES) that will consolidate agent tools to increase the accuracy and efficiency of the examination process.
- Build and implement MeF receipt of electronic transmissions for additional tax forms.

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Component 4

Improve Compliance Activities

Obtaining maximum coverage and yield from available resources is necessary for the greatest impact on compliance.

The IRS has made significant progress in reducing the tax gap through improvements in enforcement efforts. The following examples demonstrate this progress:

- Enforcement revenues have grown by nearly $15 billion since FY 2001, totaling $48.7 billion in FY 2006.
- Examinations of individual taxpayer returns increased by 77 percent between FY 2001 and FY 2006, when the IRS conducted nearly 1.3 million examinations. Similarly, the coverage rate rose from 0.58 percent to 0.98 percent during that period.
- The IRS has focused more resources on examinations of individuals with income over $1 million. The number of examinations in this category rose by almost 80,000 in FY 2006 as compared to FY 2004, the first year the IRS began tracking them separately. The coverage rate has similarly risen from 5.03 percent to 6.30 percent in that period.
- Audits of business returns increased by 29 percent between FY 2001 and FY 2006. The coverage rate over the same period rose from 0.55 percent to 0.60 percent.
- Audits of corporations with assets over $10 million grew from 8,718 in FY 2001 to 10,578 in FY 2006, and the coverage rate increased from 15.1 percent to 18.6 percent.
- Examinations of the very largest corporations, those with assets over $250 million, increased by nearly 30 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.
- For audits of taxpayers with assets greater than $10 million, the cycle time per audit has been reduced by 22.6 percent from 23 months in FY 2001 to 17.8 months in FY 2006. This allows IRS to use its resources more efficiently and increase the number of corporate audits conducted.
- The IRS has placed more emphasis on tax-exempt organizations by increasing the number of examinations by nearly 33 percent from 5,342 in FY 2001 to 7,079 in FY 2006.
- The IRS achieved a 91.4 percent conviction rate on criminal investigation cases from FY 2001 through December 31, 2006.
- The IRS established the position of Deputy Commissioner, International to improve oversight of and focus on global taxation issues.

These results reflect the direct impact of IRS enforcement initiatives. Though difficult to quantify, there is also a significant indirect effect of IRS enforcement, which some research suggests could be at least three times the direct effect of enforcement efforts. This indirect effect is seen when an

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