

Fundamental Tax Reform

Consumption Tax Plans

- (1) -- National Retail Sales tax.
- (2) -- VAT
- (3) -- The Flat Tax
- (4) -- The USA Tax

(1) In 2003, Fed. personal and corp. taxes raised \$934.1 billion.

C = "consumption spending on all final goods and services"
= \$7760.9 billion

Lowest possible rate for a national retail sales tax:

$$= 100(934.1/7760.9)$$
$$= 12\%$$

If deduct "services" from C , denominator = \$3150.8

$$\Rightarrow 29.6\%$$

Very high.

→ Big incentive for sellers and buyers to deal "under the table."

Existing institutions for enforcing this are weak (better ones might develop).

$$(4) Y - S = C$$

People compute income and savings,
difference is consumption.

Doesn't offer a lot of obvious
simplification (still must define
& compute income), but it can
be made progressive. Just
have high tax rates on higher
levels of consumption.

Very thoroughly worked out and
thought through, including transition
issues.

(2) We know this works,
widely used.

Some simplification, only businesses
file returns.

Would hit elderly hard, but maybe
exemptions for them could be
built into system. Government has
earnings/tax data on them!

Nice self-enforcing feature.

Sellers liable for whole tax on
sales, but get credit for tax
paid by their suppliers.

(3) Progressivity from the front
end exemption.

\$25,500, then 19% rate

(Same as business)

Individual return trivial.

Business return probably not
simplified.

This simple scheme will always
give a windfall at the very
high income end.

P. 104, course reader,

Treasury Dept. Simulations.

	% change after tax income
Fourth Quintile (60-80%)	-2.4%
Next 10% (80-90%)	-2.7%
Next 5% (90-95%)	-1.8%
Next 4% (95-99%)	1.2%
Top 1%	11.7%

Could sell this to the groups taking a loss
in after tax income today if growth
is faster, leading to future after tax
gains.



- Tax "shelters" legal and illegal
- Compliance and enforcement

Examples of legal shelters.

-- Tax deductions for certain business investment.

Can come out ahead if you can deduct big chunk of principal.

I invest \$100,000 in oil drilling venture, loses \$10,000.

Gets a deduction of 60% of the \$100,000 principal = \$60,000

50% tax bracket, saves \$30,000 in taxes. Deducts \$60,000 against his ordinary income.

Could also deduct the \$10,000 loss a year later. Gets another \$5,000 saved in taxes.

$\$100,000 \rightarrow \$70,000 + \$30,000 + \$5,000 = \$125,000$. Actually ahead.

Also, *life insurance trusts: avoid estate taxes
*exchange funds: avoid capital gains taxes

See, "Gimme Shelter."

All legal. Only useful to people in very good economic circumstances.

Tax avoidance by highly taxed.

Lower income folk may resent it, see

These folks as avoiding "their share" of tax, but tax code is still very progressive.

That said, eternal vigilance is
the cost of revenue!

-- Tax resisters

-- Illegal shelters.

Constant enforcement.

Tax resisters: Wesley Snipes

Illegal shelters: business transactions
must have a reasonable expectation
of generating a pre-tax
profit.

"Intent"

Son of Boss: looks like fraud.

Did these folks just lose all
perspective?

Wesley Snipes arrested in Orlando

POSTED: 11:44 a.m. EST, December 8, 2006

ORLANDO, Florida (AP) -- Wesley Snipes surrendered to authorities Friday on tax fraud charges, two months after he was indicted, said federal officials and a publicist for his new film.

Snipes flew on a private jet from Namibia, where he is filming "Gallow Walker," to an Orlando airport to turn himself in, said Ian Thompson, a spokesman for Sheer Films, which is producing the movie. U.S. Attorney's spokesman Steve Cole in Tampa confirmed the arrest.

After a morning appearance in federal court in Ocala, Snipes planned to return to Africa to finish the movie, Thompson said from his London office.

Snipes was charged in October with fraudulently claiming refunds totaling nearly \$12 million in 1996 and 1997 on income taxes already paid. The star of the "Blade" trilogy and other films was also charged with failure to file returns from 1999 through 2004.

According to the indictment, Snipes had his taxes prepared by accountants with a history of filing false returns to reap payments for their clients. The firm, American Rights Litigators, would receive 20 percent of refunds from clients, according to the indictment.

The 44-year-old actor has said he is a scapegoat and was unfairly targeted by prosecutors. If convicted, he faces up to 16 years in prison.

Label

(See instructions on page 16.) Use the IRS label. Otherwise, please print or type.

Label Here

For the year Jan. 1–Dec. 31, 2006, or other tax year beginning , 2006, ending , 20 OMB No. 1545-0074 Your first name and initial Last name Your social security number If a joint return, spouse's first name and initial Last name Spouse's social security number Home address (number and street). If you have a P.O. box, see page 16. Apt. no. City, town or post office, state, and ZIP code. If you have a foreign address, see page 16. You must enter your SSN(s) above. Checking a box below will not change your tax or refund.

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16) You Spouse

Filing Status

Check only one box.

- 1 Single 2 Married filing jointly (even if only one had income) 3 Married filing separately. Enter spouse's SSN above and full name here. 4 Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. 5 Qualifying widow(er) with dependent child (see page 17)

Exemptions

If more than four dependents, see page 19.

6a Yourself. If someone can claim you as a dependent, do not check box 6a 6b Spouse 6c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) if qualifying child for child tax credit (see page 19) 6d Total number of exemptions claimed

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 8a Taxable interest. Attach Schedule B if required 8a 8b Tax-exempt interest. Do not include on line 8a 8b 9a Ordinary dividends. Attach Schedule B if required 9a 9b Qualified dividends (see page 23) 9b 10 Taxable refunds, credits, or offsets of state and local income taxes (see page 24) 10 11 Alimony received 11 12 Business income or (loss). Attach Schedule C or C-EZ 12 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here 13 14 Other gains or (losses). Attach Form 4797 14 15a IRA distributions 15a 15b Taxable amount (see page 25) 15b 16a Pensions and annuities 16a 16b Taxable amount (see page 26) 16b 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17 18 Farm income or (loss). Attach Schedule F 18 19 Unemployment compensation 19 20a Social security benefits 20a 20b Taxable amount (see page 27) 20b 21 Other income. List type and amount (see page 29) 21 22 Add the amounts in the far right column for lines 7 through 21. This is your total income 22

Adjusted Gross Income

23 Archer MSA deduction. Attach Form 8853 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 One-half of self-employment tax. Attach Schedule SE 27 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction (see page 29) 29 30 Penalty on early withdrawal of savings 30 31a Alimony paid b Recipient's SSN 31a 32 IRA deduction (see page 31) 32 33 Student loan interest deduction (see page 33) 33 34 Jury duty pay you gave to your employer 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 31a and 32 through 35 36 37 Subtract line 36 from line 22. This is your adjusted gross income 37



HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2000-41, page 248.

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 2000.

T.D. 8896, page 249.

REG-103735-00; REG-110311-98; REG-103736-00, page 258.

Proposed and temporary regulations modify the disclosure, registration, and list maintenance requirements relating to tax shelters under sections 6011, 6111, and 6112 of the Code.

T.D. 8897, page 234.

Final regulations under section 263A of the Code provide guidance relating to the application of the uniform capitalization rules to property produced in the trade or business of farming. Notices 87-76, 88-24, and 88-86 (section V) obsolete.

Notice 2000-44, page 255.

Tax avoidance using artificially high basis. Taxpayers and their representatives are alerted that the purported losses arising from certain types of transactions are not properly allowable for federal income tax purposes. Also, the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in promoting or reporting these transactions.

Notice 2000-45, page 256.

Capitalization; business expenses; farmers. This notice provides guidance to taxpayers engaged in the trade

or business of farming in determining whether a plant has a preproductive period in excess of 2 years for purposes of section 263A(d) of the Code.

Rev. Proc. 2000-33, page 257.

Acquisition of corporate debt. This procedure provides guidance on whether an acquisition of corporate debt by a beneficiary of the decedent creditor's estate or by a beneficiary of a revocable trust that became irrevocable upon the creditor's death is a direct acquisition within the meaning of section 1.108-2(b) of the regulations.

EMPLOYEE PLANS

Announcement 2000-77, page 260.

This announcement provides guidance on the types of plan amendments that may be needed to obtain a favorable determination letter for volume submitter plan applications.

ADMINISTRATIVE

T.D. 8896, page 249.

REG-103735-00; REG-110311-98; REG-103736-00, page 258.

Proposed and temporary regulations modify the disclosure, registration, and list maintenance requirements relating to tax shelters under sections 6011, 6111, and 6112 of the Code.

Announcement 2000-76, page 260.

The Service expects to post planned changes to the 2001 Forms W-2 and W-3 on the IRS web site by mid-October 2000. Earlier drafts are being modified in response to public comments.

Finding Lists begin on page ii.

Announcement of Disbarments and Suspensions begins on page 262.

Index for August begins on page iv.



Part III. Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Artificially High Basis

Notice 2000-44

In Notice 99-59, 1999-52 I.R.B. 761, the Internal Revenue Service and the Treasury Department described certain transactions that were being marketed to taxpayers for the purpose of generating artificial tax losses. This notice concerns other similar transactions that purport to generate tax losses for taxpayers.

As stated in Notice 99-59, a loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. See *ACM Partnership v. Commissioner*, 157 F.3d 231, 252 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) (“Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of ‘bona fide’ losses that are deductible under the Internal Revenue Code and regulations.”); *Scully v. United States*, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a “genuine economic loss”); *Shoenberg v. Commissioner*, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be “actual and real”); § 1.165-1(b) of the Income Tax Regulations (“Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.”).

Notice 99-59 describes an arrangement that purported to give rise to deductible losses on disposition of stock by applying the rules relating to distributions of encumbered property to shareholders in order to create artificially high basis in the stock. The Service and the Treasury have become aware of similar arrangements that have been designed to produce noneconomic tax losses on the disposition of partnership interests. These arrangements purport to give taxpayers artificially high basis in partnership interests and thereby give rise to deductible losses on disposition of those partnership interests.

One variation involves a taxpayer’s borrowing at a premium and a partnership’s subsequent assumption of that indebtedness. As an example of this variation, a taxpayer may receive \$3,000X in

cash from a lender under a loan agreement that provides for an inflated stated rate of interest and a stated principal amount of only \$2,000X. The taxpayer contributes the \$3,000X to a partnership, and the partnership assumes the indebtedness. The partnership thereafter engages in investment activities. At a later time, the taxpayer sells the partnership interest.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that only the stated principal amount of the indebtedness, \$2,000X in this example, is considered a liability assumed by the partnership that is treated as a distribution of money to the taxpayer that reduces the basis of the taxpayer’s partnership interest under § 752 of the Internal Revenue Code. Therefore, disregarding any additional amounts the taxpayer may contribute to the partnership, transaction costs, and any income realized or expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the excess of the cash contributed over the stated principal amount of the indebtedness, even though the taxpayer’s net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. In this example, the taxpayer purports to have a basis in the partnership interest of \$1,000X (the excess of the cash contributed (\$3,000X) over the stated principal amount of the indebtedness (\$2,000X)). On disposition of the partnership interest, the taxpayer claims a tax loss with respect to that basis amount, even though the taxpayer has incurred no corresponding economic loss.

In another variation, a taxpayer purchases and writes options and purports to create substantial positive basis in a partnership interest by transferring those option positions to a partnership. For example, a taxpayer might purchase call options for a cost of \$1,000X and simultaneously write offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than \$1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that the basis in the taxpayer’s partnership interest is increased by the cost of the purchased call options but is not reduced under § 752 as a result of the partnership’s assumption of the taxpayer’s obligation with respect to the written call options. Therefore, disregarding additional amounts contributed to the partnership, transaction costs, and any income realized and expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options (\$1,000X in this example), even though the taxpayer’s net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. On the disposition of the partnership interest, the taxpayer claims a tax loss (\$1,000X in this example), even though the taxpayer has incurred no corresponding economic loss.

The purported losses resulting from the transactions described above do not represent bona fide losses reflecting actual economic consequences as required for purposes of § 165. The purported losses from these transactions (and from any similar arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests) are not allowable as deductions for federal income tax purposes. The purported tax benefits from these transactions may also be subject to disallowance under other provisions of the Code and regulations. In particular, the transactions may be subject to challenge under § 752, or under § 1.701-2 or other anti-abuse rules. In addition, in the case of individuals, these transactions may be subject to challenge under § 165(c)(2). See *Fox v. Commissioner*, 82 T.C. 1001 (1984). Furthermore, tax losses from similar transactions designed to produce noneconomic tax losses by artificially overstating basis in corporate stock or other property are not allowable as deductions for federal income tax purposes.

Appropriate penalties may be imposed on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related

penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as or substantially similar to the transactions described in this Notice 2000-44 are identified as “listed transactions” for the purposes of § 1.6011-4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the Temporary Procedure and Administration Regulations. See also § 301.6112-1T, A-4. It should be noted that, independent of their classification as “listed transactions” for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), the transactions described in this Notice 2000-44 may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111-2T and 301.6112-1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111-1T and 301.6112-1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a) and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

In addition, the Service and the Treasury have learned that certain persons who have promoted participation in transactions described in this notice have encouraged individual taxpayers to participate in such transactions in a manner designed to avoid the reporting of large capital gains from unrelated transactions on their individual income tax returns (Form 1040). Certain promoters have recommended that taxpayers participate in these transactions through grantor trusts and use the same grantor trusts as vehicles to realize the capital gains. Further, although each separate capital gain and loss attributable to a portion of a trust that is treated as owned by a grantor under the grantor trust provisions of the Code (§ 671 and following) is properly reported as a separate item on the grantor’s individual income tax return (see § 1.671-2(c) and the Instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts), the Service and the Treasury understand that these promoters have advised that the capital gains and losses from these transactions may be netted, so that only a small net capital gain or loss is re-

ported on the taxpayer’s individual income tax return. In addition to other penalties, any person who willfully conceals the amount of capital gains and losses in this manner, or who willfully counsels or advises such concealment, may be guilty of a criminal offense under §§ 7201, 7203, 7206, or 7212(a) or other provisions of federal law.

The principal authors of this notice are David A. Shulman of the Office of Associate Chief Counsel (Passthroughs and Special Industries) and Victoria S. Balacek of the Office of Associate Chief Counsel (Financial Instruments and Products). For further information regarding this notice, contact Mr. Shulman at (202) 622-3080 or Ms. Balacek at (202) 622-3930 (not toll free calls).

List of Plants, Grown in Commercial Quantities in the United States, Having a Preproductive Period in Excess of Two Years Based on the Nationwide Weighted Average Preproductive Period for Such Plant

Notice 2000-45

PURPOSE

This notice provides guidance to taxpayers engaged in the trade or business of farming in determining whether a plant has a preproductive period in excess of 2 years for purposes of § 263A(d) of the Internal Revenue Code. This guidance is derived from the nationwide weighted average preproductive period for various plants grown in commercial quantities in the United States.

BACKGROUND

Section 263A requires generally that the direct costs and an allocable share of indirect costs of real or tangible personal property produced by a taxpayer be capitalized. Under § 263A, taxpayers generally are required to capitalize the costs of producing property in a farming business (including animals and plants without regard to the length of their preproductive period).

Sections 263A(d) and (e) set forth special rules for property produced in the

trade or business of farming. Under § 263A(d)(1) and § 1.263A-4(a)(2) of the Income Tax Regulations, taxpayers neither required by § 447 to use an accrual method nor prohibited by § 448(a)(3) from using the cash method (“qualified taxpayers”) are not required to capitalize the costs of producing plants that have a preproductive period of 2 years or less or animals. In addition, under § 263A(d)(3) and § 1.263A-4(d), a qualified taxpayer may elect to have § 263A not apply to the cost of producing plants in a farming business. Thus, unless an election is made to have § 263A not apply in accordance with § 263A(d)(3), qualified taxpayers generally are required to capitalize the costs of producing plants that have a preproductive period in excess of 2 years.

Section 263A(e)(3)(B) and § 1.263A-4(b)(2)(i)(B) provide that, for purposes of determining whether a plant has a preproductive period in excess of 2 years, the preproductive period of plants grown in commercial quantities in the United States must be based on the nationwide weighted average preproductive period for such plants. The legislative history of § 263A explains that Congress expected the Treasury Department to periodically publish a list of the preproductive periods of various plants based on the nationwide weighted averages for such plants. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 628 (1985), 1986-3 (Vol. 2) C.B. 628. A proposed list was included in the preamble of the proposed § 1.263A-4 regulations (62 FR 44542). The Internal Revenue Service and Treasury Department received and considered comment letters relating to this proposed list.

Based upon information provided by the United States Department of Agriculture, the Service Treasury Department have determined that plants producing the following crops or yields have a nationwide weighted average preproductive period in excess of 2 years:

almonds, apples, apricots, avocados, blackberries, blueberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, papayas, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, raspberries, tangelos, tangerines, tangerines, and walnuts.

Table 18 -- Criminal Investigation Program, by Status or Disposition, Fiscal Year 2005

Status or disposition	Total	Legal source tax crimes [1]	Illegal source financial crimes [2]	Narcotics-related financial crimes [3]
	(1)	(2)	(3)	(4)
Investigations initiated [4]	4,269	1,693	1,632	944
Investigations discontinued	1,245	594	426	225
Referrals for prosecution	2,859	951	1,141	767
Information and indictments [5]	2,406	731	993	682
Convictions	2,151	655	894	602
Sentenced	2,095	615	900	580
Incarcerated [6]	1,738	495	716	527
Percentage of those sentenced who were incarcerated [6]	83.0	80.5	79.6	90.9

[1] Legal Source tax investigations involve legal industries and legal occupations and, more specifically, legally earned income associated with the violation of Title 26 (tax violations) and Title 18 (tax-related violations) of the U.S. Code. The Legal Source Tax Crimes Program also includes those cases that threaten the tax system, such as Questionable Refund Program (QRP) cases, unscrupulous return preparers, and frivolous filers/nonfilers who challenge the legality of the filing requirements. Excise tax and employment tax cases are also important elements of the Legal Source Tax Crimes Program.

[2] Illegal source financial crimes involve proceeds derived from illegal sources other than narcotics. These encompass all tax and tax-related violations, as well as money-laundering and currency violations under the following statutes: Title 26 (tax violations); Title 18 (tax-related and money-laundering violations); and Title 31 (currency violations) of the U.S. Code. The utilization of forfeiture statutes to deprive individuals and organizations of illegally obtained assets is also linked to the investigation of criminal charges within this program.

[3] Under the Narcotics Related Financial Crimes Program, IRS Criminal Investigation seeks to identify, investigate, and assist in the prosecution of the most significant narcotics-related tax and money-laundering offenders. IRS derives this authority from the statutes for which it has jurisdiction: Title 26 (tax violations); Title 18 (tax-related and money-laundering violations); and Title 31 (currency violations) of the U.S. Code. IRS Criminal Investigation devotes resources to high-level multiagency narcotics investigations warranting Organized Crime Drug Enforcement Task Force (OCDETF) designation in accordance with OCDETF Program reimbursable funding.

[4] Since actions on a specific investigation may cross fiscal years, the data shown in cases initiated may not always represent the same universe of cases shown in other actions within the same fiscal year.

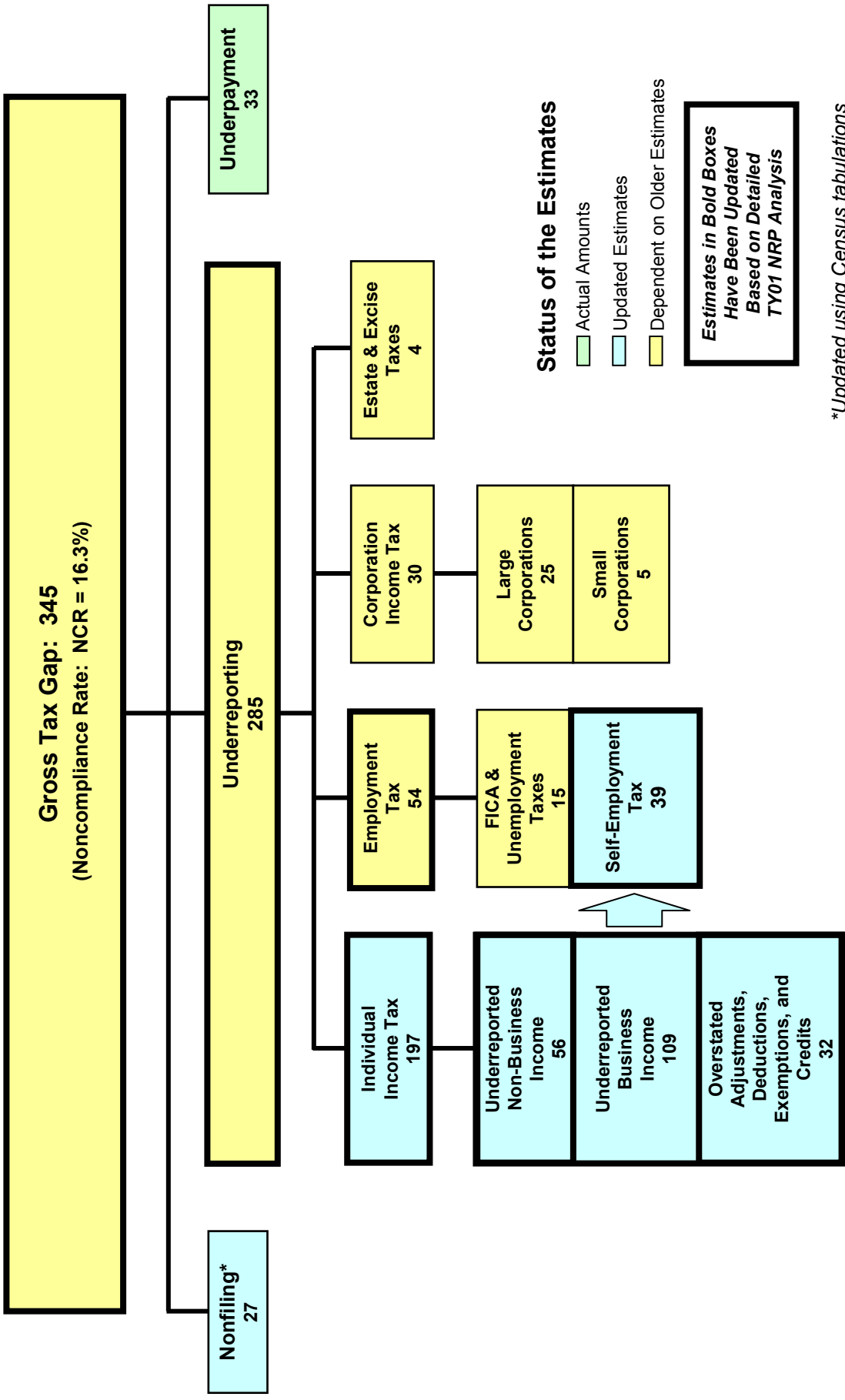
[5] Both "information" and "indictments" are accusations. "Information" means an accusation made by law enforcement without the intervention of a grand jury, whereas an "indictment" is an accusation made by a prosecutor and issued by a grand jury.

[6] Incarcerated may include prison time, home confinement, electronic monitoring, or a combination thereof.

SOURCE: Criminal Investigation, Communications and Education Division SE:CI:CE

Tax Year 2001 FEDERAL TAX GAP

(in Billions of Dollars)



Status of the Estimates

- Actual Amounts
- Updated Estimates
- Dependent on Older Estimates

Estimates in Bold Boxes Have Been Updated Based on Detailed TY01 NRP Analysis

*Updated using Census tabulations

Individual Income Tax Underreporting Gap Estimates, Tax Year 2001

Type of Income or Offset	Tax Gap (\$B)	NMP †
Total Underreporting Gap	197	18%
Underreported Income	166	11%
Non-Business Income	56	4%
Wages, salaries, tips	10	1%
Interest income	2	4%
Dividend income	1	4%
State income tax refunds	1	12%
Alimony income	*	7%
Pensions & annuities	4	4%
Unemployment Compensation	*	11%
Social Security benefits	1	6%
Capital gains	11	12%
Form 4797 income	3	64%
Other income	23	64%
Business Income	109	43%
Nonfarm proprietor income	68	57%
Farm income	6	72%
Rents & royalties	13	51%
Partnership, S-Corp, Estate & Trust, etc.	22	18%
Overreported Offsets to Income	15	4%
Adjustments	-3	-21%
SE Tax deduction	-4	-51%
All other adjustments	1	6%
Deductions	14	5%
Exemptions	4	5%
Credits	17	26%
Net Math Errors (non-EITC)	*	

† NMP = Net Misreporting Percentage

* Less than \$0.5 billion.

IRS Updates Tax Gap Estimates

IR-2006-28, Feb. 14, 2006

Washington — Internal Revenue Service officials announced today that they have updated their estimates of the Tax Year 2001 tax gap based on the National Research Program (NRP).

The updated estimate of the overall gross tax gap for Tax Year 2001 – the difference between what taxpayers should have paid and what they actually paid on a timely basis – comes to \$345 billion. This figure falls at the high end of the range of \$312 billion to \$353 billion per year, an estimate released last March.

IRS enforcement activities, coupled with other late payments, recover about \$55 billion of the tax gap, leaving a net tax gap of \$290 billion for Tax Year 2001.

“The vast majority of Americans pay their taxes accurately and are shortchanged by those who don’t pay their fair share,” said IRS Commissioner Mark W. Everson. “The magnitude of the tax gap highlights the critical role of enforcement in keeping our system of tax administration healthy.”

The complexity of the tax law is also a significant factor in causing the tax gap, which can be seriously addressed only in the context of fundamental tax reform and simplification.

While no tax system can ever achieve 100 percent compliance, the IRS is committed to taking all reasonable steps to improve compliance through increased and better targeted enforcement and through increased taxpayer service and outreach efforts.

“Helping taxpayers better understand their obligations under the current tax law will facilitate compliance, but simplifying the tax code would have a big impact on reducing the tax gap” said Everson.

One important administrative step already taken to improve compliance has been the updating of the audit selection system with the NRP information. The newer statistics enable the IRS to audit more efficiently and improve the detection of underreported income and overstated deductions, credits, etc.

To gain an estimate of taxpayer compliance, the IRS launched the NRP, a three-year study of tax year 2001 returns of individuals. The study involved the review and examination of about 46,000 randomly selected returns.

These audits were completed by the fall of 2005. To gather statistically valid data, the return selection process for the NRP included an over-sampling of high income returns. This enabled IRS researchers to draw valid conclusions about important sub-categories of taxpayers.

As with prior estimates, the updated estimate of the tax gap shows that the largest component of this gap, more than 80 percent, comes from underreported taxes. Underreported income tax is the largest component of this (see attached Tax Gap Map for Tax Year 2001). Nonfiling and underpayment of tax comprise the rest of the tax gap.

The updated NRP estimates also include estimates of the Net Misreporting Percentage (NMP) for each major line item on individual income tax returns. The NMP is the net amount that was misreported on a given line item expressed as a percentage of the total amount that should have been reported on that line item (see attached table, Individual Income Tax Underreporting Estimates, Tax Year 2001).

Though the net misreporting percentage varies by category of income, the rates reflect that compliance is highest where there is third-party reporting or withholding.

“Simply stated, compliance is highest where there is third-party reporting,” Everson said.

For example, one percent of all wage, salary, and tip income is misreported, contributing an estimated \$10 billion to the tax gap. In contrast, nonfarm sole proprietor income, which is reported on a Schedule C and is subject to little third-party reporting or withholding, has a net misreporting percentage of 57 percent, contributing about \$68 billion to the tax gap.

Since 2001, the year covered by the study, the IRS has taken a number of steps to bolster enforcement and reduce the tax gap. The IRS increased its enforcement revenues by nearly 40 percent from \$33.8 billion in 2001 to \$47.3 billion in 2005. Audits of high-income taxpayers — those earning \$100,000 or more — topped 221,000 in fiscal year 2005, the highest number in the past 10 years. Total audits of all taxpayers topped 1.2 million last year—a 20 percent jump from the prior year.

Proposals to Begin Addressing the Tax Gap

The President’s FY 2007 budget proposal contains five legislative changes aimed at narrowing the tax gap. These proposals include:

- Expanding third-party information reporting to include certain Government payments for property and services;
- Expanding third-party information reporting on debt and credit card

- reimbursements paid to certain merchants;
- Clarifying liability for employment taxes for employee leasing companies and their clients;
 - Expanding beyond income taxes the requirement that paid return preparers sign returns, and imposing a penalty when they fail to do so; and
 - Authorizing the IRS to issue levies to collect employment tax debts prior to collection due process proceedings.

Label

(See instructions on page 16.) Use the IRS label. Otherwise, please print or type.

Label Here

For the year Jan. 1–Dec. 31, 2006, or other tax year beginning , 2006, ending , 20 OMB No. 1545-0074 Your first name and initial Last name Your social security number If a joint return, spouse's first name and initial Last name Spouse's social security number Home address (number and street). If you have a P.O. box, see page 16. Apt. no. City, town or post office, state, and ZIP code. If you have a foreign address, see page 16. You must enter your SSN(s) above. Checking a box below will not change your tax or refund.

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16) You Spouse

Filing Status

Check only one box.

- 1 Single 2 Married filing jointly (even if only one had income) 3 Married filing separately. Enter spouse's SSN above and full name here. 4 Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. 5 Qualifying widow(er) with dependent child (see page 17)

Exemptions

If more than four dependents, see page 19.

6a Yourself. If someone can claim you as a dependent, do not check box 6a 6b Spouse 6c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) if qualifying child for child tax credit (see page 19) 6d Total number of exemptions claimed

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 8a Taxable interest. Attach Schedule B if required 8a 8b Tax-exempt interest. Do not include on line 8a 8b 9a Ordinary dividends. Attach Schedule B if required 9a 9b Qualified dividends (see page 23) 9b 10 Taxable refunds, credits, or offsets of state and local income taxes (see page 24) 10 11 Alimony received 11 12 Business income or (loss). Attach Schedule C or C-EZ 12 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here 13 14 Other gains or (losses). Attach Form 4797 14 15a IRA distributions 15a 15b Taxable amount (see page 25) 15b 16a Pensions and annuities 16a 16b Taxable amount (see page 26) 16b 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17 18 Farm income or (loss). Attach Schedule F 18 19 Unemployment compensation 19 20a Social security benefits 20a 20b Taxable amount (see page 27) 20b 21 Other income. List type and amount (see page 29) 21 22 Add the amounts in the far right column for lines 7 through 21. This is your total income 22

Adjusted Gross Income

23 Archer MSA deduction. Attach Form 8853 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 One-half of self-employment tax. Attach Schedule SE 27 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction (see page 29) 29 30 Penalty on early withdrawal of savings 30 31a Alimony paid b Recipient's SSN 31a 32 IRA deduction (see page 31) 32 33 Student loan interest deduction (see page 33) 33 34 Jury duty pay you gave to your employer 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 31a and 32 through 35 36 37 Subtract line 36 from line 22. This is your adjusted gross income 37