

Questions for the Record
House Ways and Means Committee
Understanding the Tax Gap and Taxpayer Noncompliance
May 9, 2019

Submitted by Rep. Darin LaHood

Questions for The Honorable J. Russell George:

1. Your recent report on tip-related compliance says that more tips go unreported than are reported. Specifically, out of the \$44 billion in estimated tip income for 2006, \$23 billion (52%) went unreported. It's clear from the TIGTA Report that there is much room for improvement in closing the tax gap as it relates to tips.
 - a. The TIGTA report states that more tip income goes unreported each year than gets reported. You recommend that IRS more effectively prioritize its resources to higher risk work. Do you have any recommendations besides prioritizing workload that would enhance voluntary compliance in this area?

TIGTA Answer: In addition to the recommendation to more effectively prioritize resources in the tip compliance area, TIGTA made eight other recommendations in the report all of which would have the impact of increasing voluntary compliance, with the most significant being:

- *Instead of prioritizing the review of rates in tip agreements to determine whether the agreed upon rates between the IRS and the employer are appropriate (which do not result in any tax assessments), prioritize conducting examinations. Studies have shown that auditing taxpayers has both a direct impact on compliance and an indirect impact on tax compliance of over 11 times the direct effect.*
 - *Rather than spending resources reassessing the terms of tip agreements, renew the agreements for employers who appear compliant and extend the terms of those agreements from three to five years.*
 - *Actively revoke tip agreements of employers who are not in compliance with those agreements.*
- b. Since the IRS's enforcement reach in this area is limited, to what extent should we consider innovative ideas and incentives to voluntarily encourage better tip reporting?

TIGTA Answer: Innovative approaches could focus more on educating taxpayers on tip compliance. Social media is an inexpensive way to reach millions of taxpayers. As a result of these Questions for the Record, we reviewed the IRS's social media platforms for information about tip compliance. The IRS has a significant social media presence with Facebook and Instagram accounts, as well as educational videos on YouTube on various topics; however, none of these outreach efforts address tip compliance. The IRS should leverage its social media

presence to include educational information about tip compliance. TIGTA will raise this issue with IRS leadership.

2. For example, can you confirm your report's finding that the use of tip agreements has achieved higher compliance than would be achieved under regular examinations? Doesn't this fact suggest the need to expand on this concept to more employers?

TIGTA Answer: Tip agreements allow the IRS to address tip compliance with more taxpayers (both employers and tip-earning employees) than does the IRS's labor-intensive audit process. While any business in the tip earning industry can enter into a Tip Reporting Alternative Commitment (TRAC) agreement with the IRS, the IRS should utilize outreach efforts to promote use of the TRAC. The IRS has 65,000 TRACs in place; however, it is estimated there are over one million restaurants in the United States.

- a. A key fear of small business salon owners with tipped employees is that the IRS will show up one day and assess them for underreported tips by their employees. Your report indicates the average assessment exceeds \$55,000 for small businesses. An assessment of this magnitude would put many small employers out of business. Most salons have 10 or fewer employees.
 - i. H.R. 1349 would build on the tip reporting model by providing a safe harbor to employers in the salon industry who opt in to a system that contains the essential elements of a tip agreement (education and reporting obligations) in exchange for an assurance that they won't become subject to a future employer-only audit. To what extent would this improve compliance?

TIGTA Answer: We believe that tip agreements for the salon industry would likely have the same positive impact on tax compliance and be as effective as in the food and beverage industry. There is currently a tip agreement for cosmetology, which would cover the services provided by a salon. A copy of the cosmetology TRAC is attached.

- ii. The TIGTA report indicates that of the 65,000 TRAC agreements in effect in 2017, the IRS completed only 53 reviews since 2013. The IRS has neither the resources to negotiate agreements nor examine them. Why not provide audit protection to salon owners who are willing to comply with the IRS-designed requirements of TRAC?

TIGTA Answer: As described above, the IRS currently has a cosmetology TRAC which covers salon owners; a copy of it is attached.

- iii. For employers with TRAC agreements who underreport tip income, the IRS must first complete a compliance review and then go through a process to revoke the agreement. The TIGTA report states that IRS's policy for revocation makes it difficult to revoke. The H.R. 1349 safe harbor proposal should make it easier for IRS to administer - a salon employer who fails to satisfy the basic education and reporting

requirements would not be entitled to the safe harbor. To what extent would an opt-in approach for employers mitigate risks, reduce costs and improve compliance?

TIGTA Answer: We believe that TRAC agreements promote tax compliance and are a cost effective compliment to the IRS's examination strategy. As indicated in our report, however, we identified significant noncompliance among businesses with TRAC agreements. During our review, we analyzed 6,513 employer taxpayers with tip compliance agreements that filed a business tax return, and Form 941 for Tax Year (TY) 2016. Our analysis identified 1,971 (30 percent) of 6,513 employers with projected unreported tips of nearly \$1.66 billion. However, the IRS provided tip income audit protection to these potentially noncompliant businesses and employees. The data shows that 815 (41 percent) of the 1,971 employers were under TRAC tip agreements that account for \$1.2 billion (72 percent) of the total \$1.66 billion in projected unreported tips, indicating significant risk of TRAC noncompliance. In comparison, Tip Rate Determination Agreement (TRDA) and Gaming Industry Tip Compliance Agreement (GITCA) projected unreported dollars combined represents \$456 million (28 percent) of the \$1.66 billion. Therefore, there remains a significant role for the IRS examination function to ensure that businesses remain compliant with their tip agreement commitments.

- b. What are the benefits to employees of having their tip income accurately reported? Are assessed amounts collected from an employer in an audit for underreported tip income allocated to the employees for purposes of calculating future SSA benefits?

Answer: The numerous benefits of accurate tip reporting include ensuring that employees get credit for the accurate amount of income earned, which can impact the calculation Social Security benefits, Medicare benefits and workers' compensation benefits (if the employee is injured on the job). Accurate tip reporting also ensures that employees and employers are paying the correct amount of tax. Generally, the employment tax audits conducted by the IRS's National Tip Reporting Compliance Program (NTRCP) do not result in individual audits of each employee. However, if the employee is audited, either as a result of the employer being audited or as a result of being selected for an individual audit by the IRS, any additional assessment would ultimately be reported to the Social Security Administration.

- c. Is it true that, if tip-reporting can be improved by just 10 percent, more than \$23 billion would be collected over ten years? Would an incremental improvement in addressing tip reporting noncompliance yield significant revenue?

TIGTA Answer: When the IRS last measured the tip component of the Tax Gap for TY 2006, it estimated that unreported tips accounted for approximately 10 percent or \$23 billion of the overall underreporting component of the Tax Gap (\$235 billion for

TY 2006). The underreporting component of the Tax Gap for TYs 2008 – 2010 was \$385 billion, and if the tip income component percentage of the underreporting tax gap remains at 10%, the amount of the tip component of the underreporting component of the Tax Gap would be approximately \$39 billion. A 10 percent improvement in tip reporting compliance annually could result in additional tax revenues of \$39 billion over 10 years.

- i. To what extent do you agree that tip reporting remains a difficult challenge?

TIGTA Answer: Underreporting remains a significant challenge in all areas where the IRS lacks third party reporting. Where there is third party reporting and withholding, the IRS believes tax compliance is 99 percent. Where there is just third party reporting, tax compliance drops to 93%. Where there is neither, tax compliance drops to 37%. The IRS receives some tip earning data from employers; however, often times this reporting information is only as accurate as the information that the employer receives from the employee.

- ii. While full compliance may be unobtainable, can ideas - such as those contained in H.R. 1349 - help improve compliance?

Answer: We have reviewed the text of the referenced bill but have not studied the possible impact on compliance. Given the significant noncompliance of some taxpayers participating in TRAC agreements, preventing the IRS from initiating audits of certain taxpayers, as the bill appears to do, may not have a positive effect on tax compliance.

- iii. TIGTA has looked into tip-related tax noncompliance and produced a report on this topic. Based on your review, what would be needed to improve voluntary compliance by ten percent?

Answer: While we cannot quantify the magnitude of the impact, we believe that the IRS can improve tax compliance in the tip industry by increasing examinations, using data analytics to better select taxpayers for examination, and increasing outreach to expand the use of TRAC agreements to more tip-earning businesses.

3. The TIGTA report concludes that there is a higher risk of tax noncompliance for employers in tipping industries that do not have a tip agreement. However, the TIGTA report also acknowledges that the IRS has limited revenue agent resources to manage tip agreements and the number of personnel is not commensurate with the size of the program.

- a. The TIGTA report recommends that the IRS prioritize unreported tips with a high dollar value. Why does the TIGTA report solely focus on enforcement?

TIGTA Answer: We believe that education and outreach are also an important component of improving tax compliance. As we describe in the report, tip

agreements have an educational component requiring training on the part of the employer and employees. The NTRCP also spends significant resources in outreach, though it focuses much of those resources on the gaming industry.

Our report focused on enforcement because the priorities of the NTRCP were heavily skewed towards non-enforcement activities. As we reported, tip agreement rate reviews over the five fiscal years accounted for 64 percent (875 of 1,371) of total Field Examination case closures (these reviews do not result in assessments), while compliance reviews accounted for only four percent (53 of 1,371) and tip examinations accounted for 19 percent (262 of 1,371) of total Field Examination closures.

In responding to these questions, we viewed the IRS's social media platforms for information about tip compliance, but we could not identify significant outreach about tip compliance. We plan to address this issue with IRS representatives in future discussions.

- b. Tip agreements require employers to meet certain obligations in exchange for IRS assurance that no tip audits will be initiated. Despite the number of agreements in effect, TIGTA concludes that the IRS seldom reviews employers for compliance. The beauty industry is largely comprised of tens of thousands of small businesses with fewer than ten employees. To what extent would it benefit everyone to allow these employers to satisfy the obligations set out in these IRS agreements in exchange for the same audit assurances?

Answer: We believe that tip agreements promote tax compliance and are a cost effective compliment to the IRS's examination strategy.

4. IRS research indicates that substantial information reporting results in 93% likelihood of accurate reporting of such income. However, if there is no information reporting (and no withholding), the likelihood of income being accurately reported drops dramatically to 37 percent. To what extent is it more likely that a landlord (who is in the business of renting space) will be more likely to file information reports regarding such rental payments than the multiple freelance individuals operating separate small businesses in the landlord's establishment?

TIGTA Answer: We agree with the statement regarding the importance of information reporting in improving tax compliance. We also agree with the premise that self-employed individuals may be less likely to comply with information reporting requirements than would a larger established business.

5. One area of concern in the salon industry is when trained employees, who are subject to withholding, move to work as freelance stylists in non-employer salon establishments where they are required to file estimated tax returns on their small business income as well as information reports regarding rental payments made to their landlords. Do you have any suggestions as to how reporting could be simplified and improved with respect to these freelance stylists?

TIGTA Answer: We do not have specific information about IRS plans to further simplify the tax obligations of small businesses. However, the IRS can further assist small businesses by providing more outreach and education. With respect to both estimated taxes and information reporting, they can be completed online currently. See <https://www.irs.gov/businesses/small-businesses-self-employed/estimated-taxes>; <https://www.irs.gov/e-file-providers/filing-information-returns-electronically-fire>.

Questions for The Honorable J. Russell George, James R. McTigue, and Benjamin Herndon:

1. The most recent IRS study of the tax gap found the average annual tax gap for 2008-2010 is roughly \$458 billion. Does the IRS, TIGTA or GAO have any data to confirm that the 45B credit has been successful in helping restaurant employers to encourage accurate tip reporting among their employees? Any data to show it hasn't helped?

TIGTA Answer: Under Section 45B, employers that have paid FICA taxes on employee tips receive a tax credit to the extent the payments exceed the minimum wage (subject to certain limitations), regardless of whether the tips were reported by the employee. This tax credit was intended in part to give restaurants an incentive to encourage accurate tip reporting and remove some of the incentive for employers to subtly encourage their employees to underreport tip income. TIGTA is unaware of data on how the credit has impacted tip reporting.

2. The TIGTA report confirms that compliance has increased since implementation of tip agreements and that compliance is higher than would be achieved under regular examinations. How would voluntary use of TRAC agreements assist the IRS in compliance efforts?

TIGTA Answer: Tip agreements allow the IRS to address tip compliance with more taxpayers (both employers and tip-earning employees) than does the IRS's labor-intensive audit process. They contain educational requirements for employers and employees to better inform tip earners of their compliance responsibilities. While any business in the tip earning industry can enter into a TRAC with the IRS, the IRS should utilize outreach efforts to promote use of the TRAC.

3. A significant area of concern for salon owners is when their trained employees, who are subject to withholding, move to work as freelance stylists in non-employer salon establishments where they are required to report their business income themselves. Not only must they file estimated tax returns, but they must also file information reports regarding rental payments they make to landlords that are organized as unincorporated businesses.
 - a. We have heard from operators of chair rental establishments that they seldom, if ever, receive Forms 1099 from their chair renters. What does your data show regarding the level of compliance with information reporting requirements in the salon industry with respect to such rental payments?

TIGTA Answer: TIGTA does not have information with respect to this request.

- b. There has been a substantial shift in the salon industry from employer-based salons to non-employer establishments, such as chair rentals and salon suites. What steps could be taken to improve compliance when such individuals who are subject to withholding and information reporting move to situations where there is neither?

Answer: The IRS could improve its education and outreach to small businesses. The IRS has an extensive presence on social media sites and could do more to educate small businesses about fulfilling their tax obligations.

4. What are the benefits to the IRS of changing the responsibility for filing the Form 1099, related to rental income, from the self-employed individuals to the landlord businesses who are more accustomed to complying with existing IRS information reporting requirements?

TIGTA Answer: TIGTA has not evaluated the potential impact of such a change. Generally, third party reporting of payments has a higher degree of impact on compliance than requirements for self-reporting of receipt of payments.

- a. How could the IRS utilize such information?

TIGTA Answer: It is not known whether such a change would increase reporting compliance on these payments. To the extent that taxpayers comply with the requirements, it could help identify non-filers and underreporters of income.

- b. To what extent could the IRS connect the rental payment expense deducted by such small business (as a cost of doing business) against the income generated by the individual in such business?

TIGTA Answer: The IRS has very little insight into cash transactions so it cannot systemically evaluate income reported by small businesses if they transact mainly in cash. However, if a merchant accepts credit cards and has more than \$20,000 in sales each year and more than 200 transactions per year, the IRS will receive Form 1099-K from the credit card companies with respect to the credit card sales of the merchant for that year. The IRS can analyze the merchant's tax return to examine whether the income on the tax return is less than the sum of the income from Form 1099-Ks that pertain to the merchant. While the IRS has the technical capacity to select tax returns by evaluating 1099-K data, TIGTA has identified in past reports that the IRS has made limited use of this ability.

- c. Does information reporting of business expenses improve compliance by individuals?

TIGTA Answer: The IRS's research demonstrates that third party reporting increases the tax compliance of recipients of payments. The IRS is able to identify

underreporting by compiling the income from information returns and comparing the total to the total revenue reported by the taxpayer on the tax return. We are not aware of IRS research that specifically evaluates whether taxpayers are more or less likely to overstate deductions because of the existence of information reporting. The IRS's use of information returns focuses mainly on the underreporting of income as opposed to the overstatement of expense.

- d. If the IRS receives a Form 1099 indicating a rental payment has been made, can it be assumed that the IRS has the capacity to compare it to a corresponding individual income tax return?

Answer: Through the IRS's Automated Underreporter (AUR) program, the IRS is able to automatically compare Form 1099 amounts with a respect to a taxpayer to the taxpayer's tax return to assess the risks that the Form 1099 amounts were not reported. Discrepancies are systemically analyzed and only discrepancies meeting certain thresholds are pursued by AUR personnel.

- e. To what extent does the existence of an information report increase taxpayer compliance, notwithstanding the fact the IRS may never completely utilize the information in its enforcement activities?

TIGTA Answer: The IRS has never been able to work all, or even a significant percentage, of the millions of discrepancies between third party information reports and the tax returns of those taxpayers. The IRS has never had the resources to work all of these discrepancies. Nevertheless, compliance remains very high (93 percent) for transactions that are reported by third parties to the IRS.