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# TAX COMPLIANCE

# Multiple Approaches Are Needed to Reduce the Tax Gap

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January 23, 2007

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## Why GAO Did This Study

The tax gap—the difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law—has been a long-standing problem in spite of many efforts to reduce it. Most recently, the Internal Revenue Service (IRS) estimated a gross tax gap for tax year 2001 of $345 billion and estimated it would recover $55 billion of this gap, resulting in a net tax gap of $290 billion. When some taxpayers fail to comply, the burden of funding the nation's commitments falls more heavily on compliant taxpayers. Reducing the tax gap would help improve the nation's fiscal stability. For example, each 1 percent reduction in the net tax gap would likely yield $3 billion annually.

GAO was asked to discuss the tax gap and various approaches to reduce it. This testimony discusses the need for taking multiple approaches and to what extent the tax gap could be reduced through three overall approaches—simplifying or reforming the tax system, providing IRS with additional enforcement tools, and devoting additional resources to enforcement. This statement is based on prior GAO work.

## What GAO Recommends

GAO is not making any new recommendations but highlights areas for possible attention.

www.gao.gov/cgi-bin/getrpt?GAO-07-391T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

## What GAO Found

Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since, for example, it has multiple causes and spans different types of taxes and taxpayers. Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major approaches, but providing quality services to taxpayers also is a necessary foundation for voluntary compliance. Such steps as periodically measuring noncompliance and its causes, setting tax gap reduction goals, evaluating the results of any initiatives to reduce the tax gap, optimizing the allocation of IRS's resources, and leveraging technology to enhance IRS's efficiency would also contribute to tax gap reduction.

Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by billions of dollars. IRS has estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Thus, considerable potential exists. However, these provisions serve purposes Congress has judged to be important and eliminating or consolidating them could be complicated. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few tax preferences) and taxable transactions are transparent to tax administrators. These characteristics are difficult to achieve, and any tax system could be subject to noncompliance.

Withholding and information reporting are particularly powerful tools to reduce the tax gap. They could help reduce the tax gap by billions of dollars, especially if they make underreported income transparent to IRS. These tools have led to high, sustained levels of taxpayer compliance and improved IRS resource allocation by helping IRS identify and prioritize its contacts with noncompliant taxpayers. As GAO previously suggested, reporting the cost, or basis, of securities sales is one option to improve taxpayers' compliance. However, designing additional withholding and information reporting requirements may be challenging given that many types of income are already subject to reporting, underreporting exists in many forms, and withholding and reporting requirements impose costs on third parties.

Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of IRS enforcement resources requires taking into account such factors as how well IRS uses its resources, the proper balance between taxpayer service and enforcement activities, and competing federal funding priorities. If Congress provides IRS more enforcement resources, the amount of tax gap reduction would depend on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Increasing IRS's funding would enable it to contact millions of potentially noncompliant taxpayers it identifies but does not contact.

Chairman Conrad, Senator Gregg, Members of the Committee:

I appreciate this opportunity to discuss the tax gap—the difference between what taxpayers pay in taxes voluntarily and on time and what they should pay under the law—and what is achievable in reducing the gap. Most recently, the Internal Revenue Service (IRS) estimated that for tax year 2001, taxpayers paid about 84 percent of the taxes that should have been paid on time under the law, resulting in an estimated gross tax gap of $345 billion. IRS estimated that it would eventually recover around $55 billion of the 2001 tax gap through late payments and IRS enforcement actions, leaving a net tax gap of $290 billion.[1] Because of taxpayer noncompliance, the burden of funding the nation's commitments falls more heavily on taxpayers who willingly and accurately pay their taxes. Reducing the tax gap would help improve the nation's fiscal stability. For example, based on IRS's estimate, each 1 percent reduction in the net tax gap would likely yield nearly $3 billion annually. However, the tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. Likewise, factors such as globalization and the ever-increasing complexity of the tax code challenge IRS's ability to administer the tax code.

My remarks focus on what is achievable in reducing the tax gap through a variety of approaches. First I will discuss the need for multiple approaches towards reducing the tax gap. Then I will discuss three specific tax gap reduction approaches: (1) simplifying or reforming the tax system; (2) providing IRS additional enforcement authority and tools, such as information reporting[2] and tax withholding,[3] through changes to the tax laws; and (3) devoting additional resources to enforcement under the existing tax laws. My remarks are based on our previous work on a variety of issues, in particular, recent testimonies and a report on reducing the tax

[1]Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

[2]Information reporting involves the filing of information returns with IRS and taxpayers that contain information on certain transactions, such as wage and salary information employers report to employees and IRS through Form W-2.

[3]An example of tax withholding is when employers withhold taxes on the wages that employees earn and remit them to IRS.

gap.[4] These efforts were conducted in accordance with generally accepted government auditing standards.

Let me begin by highlighting four major points:

- Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since, for example, it has multiple causes and spans different types of taxes and taxpayers. Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major approaches discussed below, but providing quality services to taxpayers also is a necessary foundation for voluntary compliance. Quality services can help taxpayers who wish to comply but do not understand their obligations, whereas enforcement actions may be needed for those who intentionally evade their tax obligations. Such steps as periodically measuring noncompliance and its causes, setting tax gap reduction goals, considering the costs and benefits of initiatives to reduce the gap, evaluating the results of such initiatives undertaken, optimizing the allocation of IRS's resources, and leveraging technology to enhance IRS's efficiency would also contribute to tax gap reduction.

- Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by many billions of dollars. For example, IRS estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Reducing the number of such credits and deductions therefore has some direct potential to reduce the tax gap. However, these credits and deductions serve purposes Congress has judged to be important, and eliminating them likely would be complicated. Fundamental tax reform, such as shifting to a consumption tax system, would most likely result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few or no tax preferences) and taxable transactions are transparent to tax administrators. These characteristics are difficult to

[4]GAO, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T (Washington, D.C.: July 26, 2006); *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions*, GAO-06-453T (Washington, D.C.: Feb. 15, 2006); *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance*, GAO-06-208T (Washington, D.C.: Oct. 26, 2005); *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005); and *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T (Washington, D.C.: Apr. 14, 2005).

achieve in any system, and any tax system could be subject to noncompliance.

- Providing IRS with more enforcement tools, particularly withholding and information reporting, also has the potential to reduce the tax gap by billions of dollars, especially if those tools help IRS deal with the largest contributor to the tax gap—underreported income. Tax withholding and information reporting have been shown to lead to high, sustained levels of taxpayer compliance because the income taxpayers earn is transparent to them and IRS. Also, using these tools can help IRS better allocate its resources by improving its ability to identify and prioritize noncompliant taxpayers to be contacted. For example, we found that having third parties report to taxpayers and IRS the cost, or basis, of stocks and mutual funds that taxpayers sell could help taxpayers improve their voluntary compliance and help IRS allocate its enforcement efforts concerning these transactions. However, designing withholding or information reporting requirements to address underreporting may be challenging given that many types of income are already subject to such requirements, underreporting exists in many forms, and any requirements could impose costs and burdens on the third parties that withhold or report.

- Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement resources, the amount the tax gap could be reduced depends in part on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Providing IRS with additional funding would enable it to contact millions of potentially noncompliant taxpayers it identifies but currently cannot contact given resource constraints.

## Background

The tax gap is an estimate of the difference between the taxes—including individual income, corporate income, employment, estate, and excise taxes—that should have been paid voluntarily and on time and what was actually paid for a specific year. The estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or on time.[5] IRS's tax gap estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers. As shown in table 1, underreporting of tax liabilities accounted for most of the tax gap estimate for tax year 2001.

**Table 1: IRS's Tax Year 2001 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax**

Dollars in billions

| | Type of tax | | | | | |
|---|---|---|---|---|---|---|
| **Type of noncompliance** | **Individual income tax** | **Corporate income tax** | **Employment tax** | **Estate tax** | **Excise tax** | **Total** |
| Underreporting | $197 | $30 | $54 | $4 | No estimate | **$285** |
| Underpayment | 23 | 2 | 5 | 2 | $1 | **$34** |
| Nonfiling | 25 | No estimate | No estimate | 2 | No estimate | **$27** |
| **Total** | **$244** | **$32** | **$59** | **$8** | **$1** | **$345** |

Source: IRS.

Note: Figures may not sum to totals because of rounding.

IRS has estimated the tax gap on multiple occasions, beginning in 1979, relying on its Taxpayer Compliance Measurement Program (TCMP). IRS did not implement any TCMP studies after 1988 because of concerns about costs and burdens on taxpayers. Recognizing the need for current compliance data, in 2002 IRS implemented a new compliance study called the National Research Program (NRP) to produce such data for tax year 2001 while minimizing taxpayer burden.

IRS has concerns with the certainty of the tax gap estimate for tax year 2001 in part because some areas of the estimate rely on old data, IRS has no estimates for other areas of the tax gap, and it is inherently difficult to measure some types of noncompliance. IRS used data from NRP to estimate individual income tax underreporting and the portion of employment tax underreporting attributed to self-employed individuals. The underpayment segment of the tax gap is not an estimate, but rather represents the tax amounts that taxpayers reported on time but did not pay on time. Other areas of the estimate, such as corporate income tax and employer-withheld employment tax underreporting, rely on decades-old data. Also, IRS has no estimates for corporate income, employment, and

[5] Taxpayers who receive filing extensions, pay their full tax liability by payment due dates, and file returns prior to extension deadlines are considered to have filed on time.

excise tax nonfiling or for excise tax underreporting.[6] In addition, it is inherently difficult for IRS to observe and measure some types of underreporting or nonfiling, such as tracking cash payments that businesses make to their employees, as businesses and employees may not report these payments to IRS in order to avoid paying employment and income taxes, respectively.[7]

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. IRS seeks to improve voluntary compliance through efforts such as education and outreach programs and tax form simplification. IRS uses its enforcement authority to ensure that taxpayers are reporting and paying the proper amounts of taxes through efforts such as examining tax returns and matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns it receives from third parties. IRS reports that it collected over $48 billion in fiscal year 2006 from noncompliant taxpayers it identified through its various enforcement programs.

In spite of IRS's efforts to improve taxpayer compliance, the rate at which taxpayers pay their taxes voluntarily and on time has tended to range from around 81 percent to around 84 percent over the past three decades. Any significant reduction of the tax gap would likely depend on an improvement in the level of taxpayer compliance.[8]

## Multiple Approaches Are Needed to Reduce the Tax Gap

No single approach is likely to fully and cost-effectively address noncompliance and therefore multiple approaches are likely to be needed. The tax gap has multiple causes; spans five types of taxes; and is spread over several types of taxpayers including individuals, corporations, and partnerships. Thus, for example, while simplifying laws should help when noncompliance is due to taxpayers' confusion, enforcement may be

[6] For these types of noncompliance, IRS maintains that the data are either difficult to collect, imprecise, or unavailable.

[7] For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO-05-753.

[8] In some instances, the amount of the tax gap can change without a corresponding change in the level of compliance. For example, a reduction in marginal tax rates could result in a smaller tax gap even if the level of compliance remains unchanged because the amount of taxes that should be paid has been reduced. The tax gap would also tend to increase over time, even if the rate of taxpayer compliance remained unchanged, because of inflation.

needed for taxpayers who understand their obligations but decline to fulfill them. Similarly, while devoting more resources to enforcement should increase taxes assessed and collected, too great an enforcement presence likely would not be tolerated.

Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major tax gap reduction approaches discussed in more detail below, but providing quality services to taxpayers plays an important role in improving compliance and reducing the tax gap. IRS taxpayer services include education and outreach programs, simplifying the tax process, and revising forms and publications to make them electronically accessible and more easily understood by diverse taxpayer communities. For example, if tax forms and instructions are unclear, taxpayers may be confused and make unintentional errors. Quality taxpayer services would also be a key consideration in implementing any of the approaches for tax gap reduction. For example, expanding enforcement efforts would increase interactions with taxpayers, requiring processes to efficiently communicate with taxpayers. Also, changing tax laws and regulations would require educating taxpayers of the new requirements in a clear, timely, and accessible manner. In 2006, we reported that IRS improved its two most commonly used services—telephone and Web site assistance—for the 2006 filing season.[9] Increased funding financed some of the improvements, but a significant portion has been financed internally by efficiencies gained from increased electronic filing of tax returns and other operational improvements.

Although quality service helps taxpayers comply, showing a direct relationship between quality service and compliance levels is very challenging. As required by Congress, IRS is in the midst of a study that is to result in a 5-year plan for taxpayer service activities, which is to include long-term quantitative goals and to balance service and enforcement. Part of the study focuses on the effect of taxpayer service on compliance. A Phase I report was issued in April 2006 and a Phase II report is due in early 2007, which is to include, among other things, a multiyear plan for taxpayer service activities and improvement initiatives.

[9]GAO, *Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request*, GAO-06-499T (Washington, D.C.: Apr. 27, 2006).

However, in deciding on the appropriate mix of approaches to use in reducing the tax gap, many factors or issues could affect strategic decisions. Among the broad factors to consider are the likely effectiveness of any approach, fairness, enforceability, and sustainability. Beyond these, our work points to the importance of the following:

- **Measuring compliance levels periodically and setting long-term goals.** A data-based plan is one key to closing the tax gap. To the extent that IRS can develop better compliance data, it can develop more effective approaches for reducing the gap. Regularly measuring the magnitude of, and the reasons for, noncompliance provides insights on how to reduce the gap through potential changes to tax laws and IRS programs. In July 2005, we recommended that IRS periodically measure tax compliance, identify reasons for noncompliance, and establish voluntary compliance goals.[10] IRS agreed with the recommendations and established a voluntary tax compliance goal of 85 percent by 2009. Furthermore, we have identified alternative ways to measure compliance, including conducting examinations of small samples of tax returns over multiple years, instead of conducting examinations for a larger sample of returns for one tax year, to allow IRS to track compliance trends annually.

- **Considering the costs and burdens.** Any action to reduce the tax gap will create costs and burdens for IRS; taxpayers; and third parties, such as those who file information returns. For example, withholding and information reporting requirements impose some costs and burdens on those who track and report information. These costs and burdens need to be reasonable in relation to the improvements expected to arise from new compliance strategies.

- **Evaluating the results.** Evaluating the actions taken by IRS to reduce the tax gap would help maximize IRS's effectiveness. Evaluations can be challenging because it is difficult to isolate the effects of IRS's actions from other influences on taxpayers' compliance. Our work has discussed how to address these challenges, for example by using research to link actions with the outputs and desired effects.

- **Optimizing resource allocation.** Developing reliable measures of the return on investment for strategies to reduce the tax gap would help inform IRS resource allocation decisions. IRS has rough measures of return on investment based on the additional taxes it assesses. Developing

[10] GAO-05-753.

such measures is difficult because of incomplete data on the costs of enforcement and collected revenues. Beyond direct revenues, IRS's enforcement actions have indirect revenue effects, which are difficult to measure. However, indirect effects could far exceed direct revenue effects and would be important to consider in connection with continued development of return on investment measures. In general though, the impacts of tax gap reduction by improving voluntary tax compliance can be quite large. For example, if the estimated 83.7 percent voluntary compliance rate that produced a gross tax gap of $345 billion in tax year 2001 had been 85 percent, this tax gap would have been about $287 billion less; if it had been 90 percent, the gap would have been about $132 133 billion less.

- **Leveraging technology.** Better use of technology could help IRS be more efficient in reducing the tax gap. IRS is modernizing its technology, which has paid off in terms of telephone service, resource allocation, electronic filing, and data analysis capability. However, this ongoing modernization will need strong management and prudent investments to maximize potential efficiencies.

Congress has been encouraging IRS to develop an overall tax gap reduction plan or strategy that could include a mix of approaches like simplifying code provisions, increased enforcement, and reconsidering the level of resources devoted to enforcement. Some progress has been made towards laying out the broad elements of a plan or strategy for reducing the tax gap. On September 26, 2006, the U.S. Department of the Treasury (Treasury), Office of Tax Policy released "A Comprehensive Strategy for Reducing the Tax Gap." However, the document generally does not identify specific approaches that Treasury and IRS will undertake to reduce the tax gap, the related time frames for such steps, or explanations of how much the tax gap would be reduced. The document said that such additional details the would be part of the fiscal year 2008 IRS budget request that will be deliberated during early 2007 because of the resource implications associated with tax gap reduction.

## Reducing the Tax Gap through Tax Simplification or Tax System Reform Depends on Their Design and May Have Effects Beyond Tax Compliance

Tax law simplification and reform both have the potential to reduce the tax gap by billions of dollars. The extent to which the tax gap would be reduced depends on which parts of the tax system would be simplified and in what manner as well as how any reform of the tax system is designed and implemented. Neither approach, however, will eliminate the gap. Further, changes in the tax laws and system to improve tax compliance could have unintended effects on other tax system objectives, such as those involving economic behavior or equity.

Simplification has the potential to reduce the tax gap for at least three broad reasons. First, it could help taxpayers to comply voluntarily with more certainty, reducing inadvertent errors by those who want to comply but are confused because of complexity. Second, it may limit opportunities for tax evasion, reducing intentional noncompliance by taxpayers who can misuse the complex code provisions to hide their noncompliance or to achieve ends through tax shelters. Third, tax code complexity may erode taxpayers' willingness to comply voluntarily if they cannot understand its provisions or they see others taking advantage of complexity to intentionally underreport their taxes.

Simplification could take multiple forms. One form would be to retain existing laws but make them simpler. For example, in our July 2005 report[11] on postsecondary tax preferences, we noted that the definition of a qualifying postsecondary education expense differed somewhat among some tax code provisions, for instance with some including the cost to purchase books and others not. Making definitions consistent across code provisions may reduce taxpayer errors. Although we cannot say the errors were due to these differences in definitions, in a limited study of paid preparer services to taxpayers, we found some preparers claiming unallowable expenses for books.[12] Further, the Joint Committee on Taxation suggested that such dissimilar definitions may increase the likelihood of taxpayer errors and increase taxpayer frustration.[13]

[11]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[12]GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (Washington, D.C.: Apr. 4, 2006).

[13]U.S. Congress, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System*, vol. II, 125-6 (April 2001).

Another tax code provision in which complexity may have contributed to the individual tax gap involves the earned income tax credit, for which IRS estimated a tax loss of up to about $10 billion for tax year 1999.[14] Although some of this noncompliance may be intentional, we[15] and the National Taxpayer Advocate[16] have previously reported that confusion over the complex rules governing eligibility for claiming the credit could cause taxpayers to fail to comply inadvertently.

Although retaining but simplifying tax code provisions may help reduce the tax gap, doing so may not be easy, may conflict with other policy decisions, and may have unintended consequences. The simplification of the definition of a qualifying child across various code sections is an example. We suggested in the early 1990s that standardizing the definition of a qualifying child could reduce taxpayer errors and reduce their burden.[17] A change was not made until 2004.[18] However, some have suggested that the change has created some unintended consequences, such as increasing some taxpayers' ability to reduce their taxes in ways Congress may not have intended.[19]

Another form of simplification could be to broaden the tax base while reducing tax rates, which could minimize incentives for not complying. This base- broadening could include a review of whether existing tax expenditures are achieving intended results at a reasonable cost in lost revenue and added burden and eliminating or consolidating those that are not. Among the many causes of tax code complexity is the growing number of preferential provisions in the code, defined in statute[20] as tax

[14]IRS measured the extent of noncompliance with the earned income tax credit in a study separate from NRP.

[15]GAO-06-208T.

[16]Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004).

[17]See GAO, *Tax Administration: Erroneous Dependent and Filing Status Claims*, GAO/GGD-93-60, (Washington, D.C: Mar.19, 1993).

[18]Pub. L. No. 108-311 (2004).

[19]See Nina E. Olson, "Uniform Qualifying Child Definition: Uniformity for Most Taxpayers," *Tax Notes*, (April 10, 2006), 225-228; and John Buckley, "Uniform Definition of a Child: Large Unintended Consequences," *Tax Notes*, (March 20, 2006), 1345-1349.

[20]The Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3, 88 Stat. 299 (July 12, 1974) (codified at 2 U.S.C. § 622(3)).

expenditures, such as tax exemptions, exclusions, deductions, credits, and deferrals.[21] The number of these tax expenditures has more than doubled from 1974 through 2005. Tax expenditures can contribute to the tax gap if taxpayers claim them improperly. For example, IRS's recent tax gap estimate includes a $32 billion loss in individual income taxes for tax year 2001 because of noncompliance with these provisions. Simplifying these provisions of the tax code would not likely yield $32 billion in revenue because even simplified provisions likely would have some associated noncompliance. Nevertheless, the estimate suggests that simplification could have important tax gap consequences, particularly if simplification also accounted for any noncompliance that arises because of complexity on the income side of the tax gap for individuals.[22]

Despite the potential benefits that simplification may yield, these credits and deductions serve purposes that Congress has judged to be important to advance federal goals. Eliminating them or consolidating them likely would be complicated, and would likely create winners and losers. Elimination also could conflict with other objectives such as encouraging certain economic activity or improving equity.

Similar trade-offs exist with possible fundamental tax reforms that would move away from an income tax system to some other system, such as a consumption tax, national sales tax, or value added tax. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few tax preferences or complex tax code provisions and if taxable transactions are transparent. However, these characteristics are difficult to achieve in any system and experience suggests that simply adopting a fundamentally different tax system may not by itself eliminate any tax gap.[23] Any tax system could be subject to noncompliance, and its design and operation, including the types of tools made available to tax administrators, will affect the size of any corresponding tax gap. Further, the motivating forces behind tax reform likely include factors beyond tax

[21] GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

[22] The tax gap for underreported individual income taxes exceeded $150 billion for tax year 2001. However, IRS does not have data on how much of this noncompliance arose because of complexity.

[23] For example, in a 2004 report, the National Audit Office in the United Kingdom reported on the 15.7 percent gap for the value added tax, which was introduced three decades earlier.

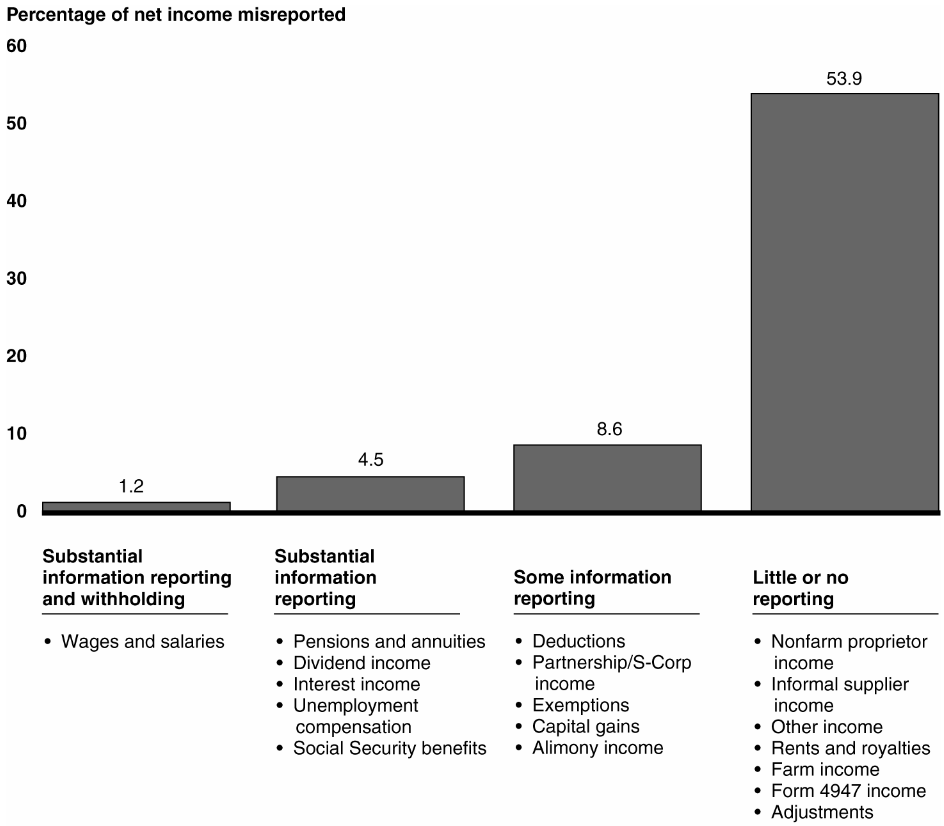
compliance, such as economic effectiveness, equity, and burden, which could in some cases carry greater weight in designing an alternative tax system than ensuring the highest levels of compliance.

## Providing IRS with Additional Enforcement Tools Potentially Could Improve Compliance Significantly, but Identifying and Designing Such Tools Can Be Challenging

Changing the tax laws to provide IRS with additional enforcement tools, such as expanded tax withholding and information reporting, could also reduce the tax gap by many billions of dollars, particularly with regard to underreporting—the largest segment of the tax gap. Tax withholding promotes compliance because employers or other parties subtract taxes owed from a taxpayer's income and remit them to IRS. Information reporting tends to lead to high levels of compliance because income taxpayers earn is transparent to them and IRS. In both cases, high levels of compliance tend to be maintained over time. Also, withholding and information reporting help IRS to better identify noncompliant taxpayers and prioritize contacting them, which enables IRS to better allocate its resources. However, designing new withholding or information reporting requirements to address underreporting can be challenging given that many types of income are already subject to at least some form of withholding or information reporting, underreporting exists in varied forms, and the requirements could impose costs and burdens on third parties.

Taxpayers tend to report income subject to tax withholding or information reporting with high levels of compliance, as shown in figure 1, because the income is transparent to the taxpayers as well as to IRS. Additionally, once withholding or information reporting requirements are in place for particular types of income, compliance tends to remain high over time. For example, for wages and salaries, which are subject to tax withholding and substantial information reporting, the percentage of income that taxpayers misreport has consistently been measured at around 1 percent over time.

**Figure 1: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Withholding and Information Reporting, Tax Year 2001**




Source: IRS.

In the past, we have identified a few specific areas where additional withholding or information reporting requirements could serve to improve compliance:

- **Require more data on information returns dealing with capital gains income from securities sales.** Recently, we reported that an estimated 36 percent of taxpayers misreported their capital gains or losses from the sale of securities, such as corporate stocks and mutual funds.[24] Further, around half of the taxpayers who misreported did so because

[24] GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

they failed to report the securities' cost, or basis, sometimes because they did not know the securities' basis or failed to take certain events into account that required them to adjust the basis of their securities. When taxpayers sell securities like stock and mutual funds through brokers, the brokers are required to report information on the sale, including the amount of gross proceeds the taxpayer received; however, brokers are not required to report basis information for the sale of these securities. We found that requiring brokers to report basis information for securities sales could improve taxpayers' compliance in reporting their securities gains and losses and help IRS identify noncompliant taxpayers. However, we were unable to estimate the extent to which a basis reporting requirement would reduce the capital gains tax gap because of limitations with the compliance data on capital gains and because neither IRS nor we know the portion of the capital gains tax gap attributed to securities sales.

- **Requiring tax withholding and more or better information return reporting on payments made to independent contractors.** Past IRS data have shown that independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. We have also identified other options for improving information reporting for independent contractors, including increasing penalties for failing to file required information returns, lowering the $600 threshold for requiring such returns, and requiring businesses to report separately on their tax returns the total amount of payments to independent contractors.[25]

- **Requiring information return reporting on payments made to corporations.** Unlike payments made to sole proprietors, payments made to corporations for services are generally not required to be reported on information returns. IRS and GAO have contended that the lack of such a requirement leads to lower levels of compliance for small corporations. Although Congress has required federal agencies to provide information returns on payments made to contractors since 1997,[26] payments made by others to corporations are generally not covered by information returns. Information reporting helps IRS to better allocate its resources to the extent that it helps IRS better identify noncompliant taxpayers and the potential for additional revenue that could be obtained by contacting these taxpayers. For example, IRS officials told us that receiving information on

[25] GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

[26] Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

basis for taxpayers' securities sales would allow IRS to determine more precisely taxpayers' income for securities sales through its document matching programs and would allow it to identify which taxpayers who misreported securities income have the greatest potential for additional tax assessments. Similarly, IRS could use basis information to improve both aspects of its examination program—examinations of tax returns through correspondence and examinations of tax returns face to face with the taxpayer. Currently, capital gains issues are too complex and time consuming for IRS to examine through correspondence. However, IRS officials told us that receiving cost basis information might enable IRS to examine noncompliant taxpayers through correspondence because it could productively select tax returns to examine. Also, having cost basis information could help IRS identify the best cases to examine face to face, making the examinations more productive while simultaneously reducing the burden imposed on compliant taxpayers who otherwise would be selected for examination.

Although withholding and information reporting lead to high levels of compliance, designing new requirements to address underreporting could be challenging given that many types of income, including wages and salaries, dividend and interest income, and income from pensions and Social Security are already subject to withholding or substantial information reporting. Also, challenges arise in establishing new withholding or information reporting requirements for certain other types of income that are extensively underreported. Such underreporting may be difficult to determine because of complex tax laws or transactions or the lack of a practical and reliable third-party source to provide information on the taxable income.

For example, while withholding or information reporting mechanisms on nonfarm sole proprietor and informal supplier income[27] would likely improve their compliance, comprehensive mechanisms that are practical and effective are difficult to identify. As shown in figure 1, this income is not subject to information reporting, and these taxpayers misreported

[27]Nonfarm proprietors are self-employed individuals other than farmers who should file Schedule C with their individual tax returns to report profits and losses from their businesses. Sole proprietors include those who provide services, such as doctors or accountants; produce goods, such as manufacturers; and sell goods at fixed locations, such as car dealers and grocers. Informal suppliers are sole proprietors who work alone or with few workers and, by definition, operate in an informal manner. Informal suppliers include those who make home repairs, provide child care, or sell goods at roadside stands. These taxpayers should report business profits or losses on Schedule C.

about half of the income they earned for tax year 2001. Informal suppliers by definition receive income in an informal manner through services they provide to a variety of individual citizens or small businesses. Whereas businesses may have the capacity to perform withholding and information reporting functions for their employees, it may be challenging to extend withholding or information reporting responsibilities to the individual citizens that receive services, who may not have the resources or knowledge to comply with such requirements.

Finally, implementing tax withholding and information reporting requirements generally imposes costs and burdens on the businesses that must implement them, and, in some cases, on taxpayers. For example, expanding information reporting on securities sales to include basis information will impose costs on the brokers who would track and report the information. Further, trying to close the entire tax gap with these enforcement tools could entail more intrusive recordkeeping or reporting than the public is willing to accept.

## Devoting Additional Resources to Enforcement Likely Could Reduce the Tax Gap, but to What Extent Is Difficult to Predict

Devoting more resources to enforcement has the potential to help reduce the tax gap by billions of dollars, as IRS would be able to expand its enforcement efforts to reach a greater number of potentially noncompliant taxpayers. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account many factors, such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement resources, the amount of the tax gap that could be reduced depends in part on the size of any increase in IRS's budget, how IRS would manage any additional resources, and the indirect increase in taxpayers' voluntary compliance that would likely result from expanded IRS enforcement.

Given resource constraints, IRS is unable to contact millions of additional taxpayers for whom it has evidence of potential noncompliance. With additional resources, IRS would be able to assess and collect additional taxes and further reduce the tax gap. In 2002, IRS estimated that a $2.2 billion funding increase would allow it to take enforcement actions against potentially noncompliant taxpayers it identifies but cannot contact and would yield an estimated $30 billion in revenue.[28] For example, IRS estimated that it contacted about 3 million of the over 13 million taxpayers it identified as potentially noncompliant through its matching of tax returns to information returns. IRS estimated that contacting the additional 10 million potentially noncompliant taxpayers it identified, at a cost of about $230 million, could yield nearly $7 billion in potentially collectible revenue. We did not evaluate the accuracy of the estimate, and as will be discussed below, many factors suggest that it is difficult to estimate reliably net revenue increases that might come from additional enforcement efforts.[29]

Although additional enforcement funding has the potential to reduce the tax gap, the extent to which it would help depends on several factors. First, and perhaps most obviously, the amount of tax gap reduction would depend in part on the size of any budget increase. Generally, larger budget increases should result in larger reductions in the tax gap. The degree to which revenues would increase from expanded enforcement depends on many variables, such as how quickly IRS can ramp up efforts, how well IRS selects the best cases to be worked, and how taxpayers react to enforcement efforts. Estimating those revenue increases would require assumptions about these and other variables. Because actual experience is likely to diverge from those assumptions, the actual revenue increases are likely to differ from the estimates. The lack of reliable key data compounds the difficulty of estimating the likely revenues. To the extent possible, obtaining better data on key variables would provide a better understanding of the likely results with any increased enforcement resources.

With additional resources for enforcement, IRS would be able to assess and collect additional taxes, but the related tax gap reductions may not be immediate. If IRS uses the resources to hire more enforcement staff, the reductions may occur gradually as IRS is able to hire and train the staff. Also, several years can elapse after IRS assesses taxes before it actually collects these taxes.

[28]Commissioner of Internal Revenue Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of IRS and the Tax System*, October 2002.

[29]The overall tax gap has many components. Thus, if the tax gap in a specific area is reduced either through congressional actions like simplifying provisions or through IRS actions, the size of the overall gap may not be reduced if other portions of the gap increase.

Similarly, the amounts of taxes actually collected can vary substantially from the related tax amounts assessed through enforcement actions by the type of tax or taxpayer involved. In a 1998 report, we found that 5 years after taxes were assessed against individual taxpayers with business income, 48 percent of the assessed taxes had been collected, whereas for the largest corporate taxpayers, 97 percent of assessed taxes had been collected.[30]

Over the last 2 years, IRS has requested and received additional funding targeted for enforcement activities that it estimated will result in additional revenue. In its fiscal year 2007 budget request, IRS requested an approximate 2 percent increase in funding from fiscal year 2006 to expand its enforcement efforts, including tax return examination and tax collection activities, with the goal of increasing individual taxpayer compliance and addressing concerns that we and others have raised[31] regarding the erosion of IRS's enforcement presence. In estimating the revenue that it would obtain from the increased funding, IRS accounted for several factors, including opportunity costs because of training, which draws experienced enforcement personnel away from the field; differences in average enforcement revenue obtained per full-time employee by enforcement activity; and differences in the types and complexity of cases worked by new hires and experienced hires. IRS forecasted that in the first year after expanding enforcement activities, the additional revenue to be collected is less than half the amount to be collected in later years. This example underscores the logic that if IRS is to receive a relatively large funding increase, it likely would be better to provide it in small but steady amounts.

The amount of tax gap reduction likely to be achieved from any budget increase also depends on how well IRS can use information about noncompliance to manage the additional resources. Because IRS does not have compliance data for some segments of the tax gap and others are based on old data, IRS cannot easily track the extent to which compliance

[30]GAO, *Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128 (Washington, D.C.: June 23, 1998).

[31]GAO issued a number of products regarding the erosion of IRS's enforcement presence and a continued growth in noncompliance. For examples, see GAO, *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2003); *High Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005); and our tax gap products cited earlier in this statement, GAO-06-1000T, GAO-06-453T, GAO-06-208T, GAO-05-753, and GAO-05-527T.

is improving or declining. IRS also has concerns with its information on whether taxpayers unintentionally or intentionally fail to comply with the tax laws. Knowing the reasons for taxpayer noncompliance can help IRS decide whether its efforts to address specific areas of noncompliance should focus on nonenforcement activities, such as improved forms or publications, or enforcement activities to pursue intentional noncompliance. To the extent that compliance data are outdated and IRS does not know the reason for taxpayer noncompliance, IRS may be less able to target resources efficiently to achieve the greatest tax gap reduction at the least taxpayer burden.

IRS has taken important steps to better ensure efficient allocation and use. For example, the NRP study has provided better data on which taxpayers are most likely to be noncompliant. IRS is using the data to improve its audit selection processes in hopes of reducing the number of audits that result in no change, which should reduce unnecessary burden on compliant taxpayers and increase enforcement staff productivity (as measured by direct enforcement revenue).

As part of an effort to make the best use of its enforcement resources, IRS has developed rough measures of return on investment in terms of tax revenue that it assesses from uncovering noncompliance. Generally, IRS cites an average return on investment for enforcement of 4:1, that is, IRS estimates that it collects $4 in revenue for every $1 of funding. Where IRS has developed return on investment estimates for specific programs, it finds substantial variation depending on the type of enforcement action. For instance, the ratio of estimated tax revenue gains to additional spending for pursuing known individual tax debts through phone calls is 13:1, versus a ratio of 32:1 for matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns. In addition to returns on investment estimates being rough, IRS lacks information on the incremental returns on investment from pursuing the “next best case” for some enforcement programs. It is the marginal revenue gain from these cases that matters in estimating the direct revenue from expanded enforcement. Developing such measures is difficult because of incomplete information on all the costs and all the tax revenue ultimately collected from specific enforcement efforts. Because IRS’s current estimates of the revenue effects of additional funding are imprecise, the actual revenue that might be gained from expanding different enforcement efforts is subject to uncertainty.

Given the variation in estimated returns on investment for different types of IRS compliance efforts, the amount of tax gap reduction that may be achieved from an increase in IRS's resources would depend on how IRS allocates the increase. Although it might be tempting to allocate resources heavily toward areas with the highest estimated return, allocation decisions must take into account diverse and difficult issues. For instance, although one enforcement activity may have a high estimated return, that return may drop off quickly as IRS works its way through potential noncompliance cases. In addition, IRS dedicates examination resources across all types of taxpayers so that all taxpayers receive some signal that noncompliance is being addressed. Further, issues of fairness can arise if IRS focuses its efforts only on particular groups of taxpayers.

Beyond direct tax revenue collection, expanded enforcement efforts could reduce the tax gap even more, as widespread agreement exists that IRS enforcement programs have an indirect effect through increases in voluntary tax compliance.[32] The precise magnitude of the indirect effects of enforcement is not known with a high level of confidence given challenges in measuring compliance; developing reasonable assumptions about taxpayer behavior; and accounting for factors outside of IRS's actions that can affect taxpayer compliance, such as changes in tax law. However, several research studies have offered insights to help better understand the indirect effects of IRS enforcement on voluntary tax compliance and show that they could exceed the direct effect of revenue obtained.[33]

## Concluding Observations

When taxpayers do not pay all of their taxes, honest taxpayers carry a greater burden to fund government programs and the nation is less able to address its long-term fiscal challenges. Thus, reducing the tax gap is

[32]Two types of indirect effect are (1) the increase in voluntary compliance in the larger population resulting from examinations or other enforcement and nonenforcement actions on targeted taxpayers, and (2) the increase in voluntary compliance of the targeted taxpayer in subsequent years.

[33]Economists have estimated the indirect effect of an examination on voluntary compliance to range from 6 to 12 times the amount of proposed tax adjustments. See Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96) (Washington, D.C.: November 1996), 2, 35-36; Jeffrey A. Dubin, Michael J. Graetz, and Louis L. Wilde, "The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986," *43 National Tax Journal*, (1990), 395, 396, 405; and Jeffrey A. Dubin, "Criminal Investigation Enforcement Activities and Taxpayer Noncompliance" (paper written for the IRS Research Conference, June 2004), http://www.irs.gov/pub/irs-soi/04dubin.pdf (downloaded July 1, 2005).

important, even though closing the entire tax gap is neither feasible nor desirable because of costs and intrusiveness. All of the approaches I have discussed have the potential to reduce the tax gap alone or in combination, and no single approach is clearly and always superior to the others. As a result, IRS needs a strategy to attack the tax gap on multiple fronts with multiple approaches.

Mr. Chairman and Members of the Committee, this concludes my testimony. I would be happy to answer any question you may have at this time.

## Contact and Acknowledgments

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