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TAX COMPLIANCE

Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches

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Highlights

Highlights of GAO-06-1000T, a testimony to the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate

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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 to what extent the tax gap could be reduced through three approaches—simplifying or reforming the tax system, providing IRS with additional enforcement tools, and devoting additional resources to enforcement—as well as various factors that could guide decision-making when devising a strategy to reduce the tax gap. This statement is based on prior GAO work.

What GAO Recommends

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

www.gao.gov/cgi-bin/getrpt?GAO-06-1000T.

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

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 be most likely to 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 can make currently underreported income transparent to IRS. These tools have been shown to lead to high, sustained levels of taxpayer compliance. Using these tools can also help IRS better allocate its resources to the extent they help 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, there are many forms of underreporting, 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 enforcement resources for IRS requires taking into account many factors such as how well 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 decides to provide IRS more enforcement resources, the amount the tax gap could be reduced 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 have resources to contact.

Finally, using multiple approaches may be the most effective strategy to reduce the tax gap, as no one approach is likely to fully and cost effectively address noncompliance. Key factors to consider in devising a tax gap reduction strategy include periodically measuring noncompliance and its causes, setting reduction goals, leveraging technology, optimizing IRS's allocation of resources, and evaluating the results of any initiatives.

Mr. Chairman and Members of the Subcommittee:

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 further 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, specifically by (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. I will also discuss various factors that could guide decision making when devising a strategy to reduce the tax gap. My remarks are based on our previous work on a variety of issues, in

[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.

particular, recent testimonies and a report on reducing the tax gap.[4] These efforts were conducted in accordance with generally accepted government auditing standards.

Let me begin by highlighting four major points:

- 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 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 it contacts. 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

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[4] GAO, *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).

many types of income are already subject to such requirements, there are many forms of underreporting, 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 of the tax gap that 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.

- Each approach to reducing the tax gap—simplifying or reforming the tax code, providing IRS with more enforcement tools, or devoting additional resources to enforcement—has the potential to reduce the tax gap, although using multiple approaches may be the most effective strategy since no one approach is likely to fully and cost effectively address noncompliance. Some key factors to consider in designing a strategy to reduce the tax gap include periodically measuring noncompliance and its causes, setting tax gap reduction goals and measuring progress against the goals, leveraging technology to enhance IRS's efficiency, identifying and considering the costs and benefits of possible approaches, optimizing the allocation of IRS's resources, and evaluating the results of any initiatives to reduce the tax gap.

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 by attempting to simplify the tax process, such as by revising forms and publications to make them electronically accessible and more easily understood by diverse taxpayer communities. 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 $47 billion in 2005 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]

[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.

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 3 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[9] 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.[10] Further, the Joint Committee on Taxation suggested that such dissimilar definitions may increase the likelihood of taxpayer errors and increase taxpayer frustration.[11]

[9]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).

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

[11]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.[12] Although some of this noncompliance may be intentional, we[13] and the National Taxpayer Advocate[14] 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.[15] A change was not made until 2004.[16] 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.

Another form of simplification could be to eliminate or consolidate tax expenditures. Among the many causes of tax code complexity is the growing number of preferential provisions in the code, defined in statute[17] as tax expenditures, such as tax exemptions, exclusions, deductions, credits, and deferrals.[18] 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

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

[13]GAO-06-208T.

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

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

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

[17]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)).

[18]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).

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. However, 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.[19]

However, 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.[20] Any tax system could be subject to noncompliance, and their design and operation, including the types of tools made available to tax administrators affect the size of any corresponding tax gap. Further, the motivating forces behind tax reform likely include factors beyond tax 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.

[19]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.

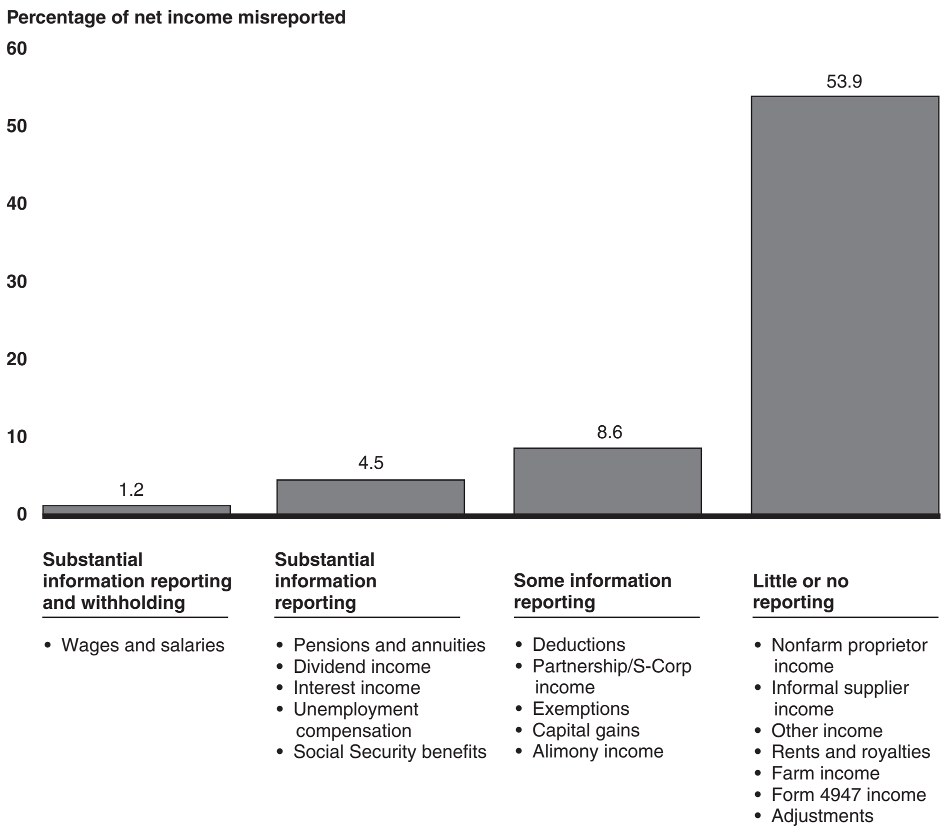
[20]For example, in a 2004 report, the National Audit Office in the United Kingdom reported on the 15.7 percent gap for the value added tax, which was introduced three decades earlier.

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 some or all of the taxes owed from a taxpayer's income and remit them to IRS. Information reporting tends to lead to high 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, because through withholding and information reporting IRS can better identify noncompliant taxpayers and prioritize contacting them by the potential for additional revenue, these tools can enable 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, there are varied forms of underreporting, 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 remains 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 report 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.[21]

[21]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).

Further, around half of the taxpayers who misreported did so because 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.[22] IRS's Taxpayer Advocate Service recently recommended allowing independent contractors to enter into voluntary withholding agreements.[23]

- **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,[24] payments made by

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

[23]Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2005 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2005).

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

others to corporations are generally not covered by information returns. The Taxpayer Advocate Service has recommended requiring information reporting on payments made to corporations,[25] and the administration's fiscal year 2007 budget has proposed requiring additional information reporting on certain good and service payments by federal, state, and local governments.[26]

In addition to improving taxpayer compliance, information reporting can help 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 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. As a result of all these benefits, basis reporting would allow IRS to better allocate its resources that focus on securities misreporting across its enforcement programs.

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, there are challenges involved with

[25]Internal Revenue Service, Taxpayer Advocate Service, 2005.

[26]Executive Office of the President, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2007*.

establishing new withholding or information reporting requirements for certain other types of income where there is extensive underreporting of income. Challenges exist because taxable income may be difficult to determine because of complex tax laws, complex transactions, or the lack of a practical and reliable third-party source to provide the information. For example, with regard to reporting securities basis information, we reported that it would be difficult for brokers to report information for some types of transactions because of complex tax laws and that representatives from the securities industry told us that a set of rules would need to be developed to establish clearly what types of transactions would be subject to any reporting requirement.

Likewise, a persistent and large part of the tax gap relates to nonfarm sole proprietor and informal supplier income.[27] As shown in figure 1, this income is not subject to information reporting, and these taxpayers misreported about half of the income they earned for tax year 2001. Although establishing withholding or information reporting requirements for these forms of income would likely improve taxpayers' compliance, practical and effective information reporting mechanisms are difficult to identify. For example, 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. Consequently, innovative approaches likely will be needed if tools like withholding and information returns are to be extended to cover more sources of the tax gap.

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

[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.

information will impose costs on the brokers that 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. Considering these costs and burdens should be part of any evaluation of additional withholding or information reporting requirements.

Although I have focused on information reporting and tax withholding, I want to mention one other enforcement tool that can potentially deter noncompliance, which is the use of penalties for filing inaccurate or late tax and information returns. Congress has placed a number of civil penalty provisions in the tax code. However, as with civil penalties related to other federal agencies, inflation may have weakened the deterrent effect of IRS penalties. For example, the Treasury Inspector General for Tax Administration has noted that the $50 per partner per month penalty for a late-filed partnership tax return, established by Congress in 1978, would equate to $17.22 in 2004 dollars. In its fiscal year 2007 budget, the administration has proposed expanding penalty provisions applicable to paid tax return preparers to include non-income tax returns and related documents. In addition, Congress recently increased certain penalties related to tax shelters and other tax evasion techniques.[28] Given Congress's recent judgment that some tax penalties were too low and concerns that inflation may have weakened the effectiveness of the civil penalty provisions in the tax code, additional increases may need to be considered to ensure that all penalties are of sufficient magnitude to deter tax noncompliance.

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 in that 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,

[28] American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

and the indirect increase in taxpayers' voluntary compliance that would likely result from expanded IRS enforcement.

As I previously mentioned, IRS is able to secure tens of billions of dollars in tax revenue from noncompliant taxpayers it identifies through its various enforcement programs. However, given resource constraints, IRS is unable to contact millions of additional taxpayers for whom it has evidence on 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.[29] 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. However, 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.[30]

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. IRS prioritizes the cases of potentially noncompliant taxpayers it reviews through its enforcement programs based on factors, such as the likelihood that a taxpayer is noncompliant, the potential amount of additional taxes that could be assessed, and collection potential. As such, it is likely that IRS would begin to experience diminishing returns as it began to review additional, lower priority cases of potentially noncompliant taxpayers. Given the diminishing returns IRS would likely experience as it moves to working less and less productive cases, the amount of expected reduction

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

[30]There are many aspects to the overall tax gap. 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.

in the tax gap for each additional dollar of funding would decline. Further, reductions in the tax gap that could be derived from additional enforcement funding may not be immediate. The reductions may occur gradually as IRS is able to hire and train enforcement personnel.

Recently, IRS obtained some additional funding targeted for enforcement activities that it estimated will result in additional revenue. In its fiscal year 2006 budget request, IRS requested millions of dollars to expand its tax return examination and tax collection activities with the goal of increasing individual taxpayer compliance and addressing concerns raised by GAO[31] and others regarding the erosion of IRS's enforcement presence and the continued growth in noncompliance. In estimating the revenue that it would obtain from the increased funding, IRS took several factors into account, 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 initial year after expanding enforcement activities, the additional revenue it expects to collect is less than half the amount it expects to collect annually 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 Congress may choose to provide also depends on how well IRS can manage the additional resources. As previously mentioned, IRS does

[31]GAO issued a number of products regarding the erosion of IRS's enforcement presence and a continued growth in noncompliance. See GAO, *Internal Revenue Service: Assessment of Fiscal Year 2005 Budget Request and 2004 Filing Season Performance*, GAO-04-560T (Washington, D.C: Mar. 30, 2004); *Internal Revenue Service: Assessment of Fiscal Year 2004 Budget Request and 2003 Filing Season Performance to Date*, GAO-03-641T (Washington, D.C: Apr. 8, 2003); *Internal Revenue Service: Assessment of Fiscal Year 2003 Budget Request and Interim Results of the 2002 Tax Filing Season*, GAO-02-580T (Washington, D.C: Apr. 9, 2003); *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2003); *Compliance and Collection: Challenges for IRS in Reversing Trends and Implementing New Initiatives*, GAO-03-732T (Washington, D.C.: May 7, 2003); *IRS Modernization: Continued Progress Necessary for Improving Service to Taxpayers and Ensuring Compliance*, GAO-03-796T (Washington, D.C.: May 20, 2003); *High Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005); and our products on the tax gap mentioned earlier in this statement, GAO-06-453T, GAO-06-208T, GAO-05-753, and GAO-05-527T.

not have compliance data for some segments of the tax gap and others are based on old data. Periodic measurements of compliance levels can indicate the extent to which compliance is improving or declining and provide a basis for reexamining existing programs and triggering corrective actions, if necessary. Also, regardless of the type of noncompliance, IRS has concerns with its information on whether taxpayers unintentionally or intentionally fail to comply with the tax laws. Knowing the reasons why taxpayers are noncompliant 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. For those portions of the tax gap that rely on old data and where IRS does not know the reason for taxpayers' noncompliance, IRS may be less able to target resources efficiently to achieve the greatest tax gap reduction at the least burden to taxpayers.

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. However, in addition to current returns on investment estimated being rough, IRS also lacks information on the incremental returns on investment for some enforcement programs. 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 differing enforcement efforts is subject to uncertainty.

Given the variation in estimated returns on investment for differing 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 IRS's decisions about how to allocate the increase. Although it might be tempting to allocate resources heavily toward those 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.

Importantly, expanded enforcement efforts could reduce the tax gap more than through direct tax revenue collection, 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]

Various Factors Should Be Considered in Devising Strategies to Reduce the Tax Gap

Although closing the entire tax gap is neither feasible nor desirable due to costs and intrusiveness, reducing the tax gap is worthwhile for many reasons, including fairness to those who are compliant and also because it is a means to improve our nation's fiscal position. Each of the three approaches I have discussed could make a contribution to reducing the tax gap, although using multiple approaches may be the most effective strategy since no one approach is likely to address noncompliance fully

[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).

and cost effectively. However, in deciding on one or more of the three broad approaches to use, 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.** 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.[34] IRS agreed with the recommendations and established a voluntary tax compliance goal of 85 percent by 2009. In terms of measuring tax compliance, we have also 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.

- **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.

- **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. As discussed earlier, for example, withholding and information reporting requirements impose some costs and burdens on those that track and report information. These costs and burdens need to be reasonable in relation to the improvements expected to arise from new compliance strategies.

- **Optimizing resource allocation.** As previously discussed, 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 such measures is difficult because of incomplete data on the costs of enforcement and collected revenues. Beyond direct

[34]GAO-05-753.

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.

- **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.

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 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 one 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 Subcommittee, 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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