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# TAX COMPLIANCE

# Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies

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# Highlights

Highlights of GAO-05-527T, a testimony to the Committee on Finance, U.S. Senate

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## TAX COMPLIANCE

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### Why GAO Did This Study

The Internal Revenue Service's (IRS) recent estimate of the difference between what taxpayers timely and accurately paid in taxes and what they owed ranged from $312 billion to $353 billion for tax year 2001. IRS estimates it will eventually recover some of this tax gap, resulting in a net tax gap from $257 billion to $298 billion. The tax gap arises when taxpayers fail to comply with the tax laws by underreporting tax liabilities on tax returns; underpaying taxes due from filed returns; or "nonfiling," which refers to the failure to file a required tax return altogether or in a timely manner.

The Chairman and Ranking Minority Member of the Senate Committee on Finance asked GAO to review a number of issues related to the tax gap. This testimony will address GAO's long-standing concerns regarding tax compliance; IRS's efforts to ensure compliance; and the significance of reducing the tax gap, including some steps that may assist with this challenging task. For context, this testimony will also address GAO's most recent simulations of the long-term fiscal outlook and the need for a fundamental reexamination of major spending and tax policies and priorities.

### What GAO Recommends

GAO is not making any new recommendations but discusses some past recommendations and highlights some new areas for possible attention.

www.gao.gov/cgi-bin/getrpt?GAO-05-527T.

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

### What GAO Found

Our nation's fiscal policy is on an unsustainable course. As long-term budget simulations by GAO, the Congressional Budget Office, and others show, over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. All simulations indicate that the long-term fiscal challenge is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Rather, a fundamental reexamination of major policies and priorities will be important to recapture our fiscal flexibility. Especially relevant to this committee will be deciding whether and how to change current tax policies and how to ensure that tax compliance is as high as practically possible. Tax law enforcement is one factor affecting compliance that has caused concern in the past, due in part to declines in IRS enforcement occupations, examinations, and other enforcement results. The recent turnaround in staffing and some enforcement results is good news, but IRS's recent compliance estimate indicates that compliance levels have not improved and may be worse than it originally estimated. Thus, sustained progress in improving compliance is needed.

Reducing the tax gap would help improve fiscal sustainability, but will be challenging given persistent noncompliance. This task will not likely be achieved through a single solution. Rather, the tax gap must be attacked on multiple fronts and with multiple strategies over a sustained period of time, including reducing tax code complexity, providing quality services to taxpayers, enhancing enforcement of tax laws, and evaluating the success of IRS's efforts to promote compliance. Also important is obtaining current information on the extent of, and reasons for, noncompliance. IRS's 2001 tax gap estimate is based in part on recently collected compliance data for individual income tax underreporting. However, IRS does not have firm plans to obtain compliance data for other areas of the tax gap or again collect data on individual income tax underreporting. Finally, IRS lacks quantitative, long-term goals for improving taxpayer compliance, which would be consistent with results-oriented management.

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

Dollars in billions

| Type of noncompliance | Type of tax: Individual income | Corporate income | Employment | Estate | Excise | Total |
|---|---|---|---|---|---|---|
| Underreporting | $150-$187 | $30 | $66-$71 | $4 | No estimate | **$250-$292** |
| Underpayment | 19 | 2 | 7 | 2 | 1 | **$32** |
| Nonfiling | 28 | No estimate | No estimate | 2 | No estimate | **$30** |
| **Total** | **$198-$234** | **$32** | **$73-$78** | **$8** | **$1** | **$312-$353** |

Source: IRS.

Note: Figures may not sum to totals due to rounding.

Chairman Grassley, Senator Baucus, and Members of the Committee:

I appreciate this opportunity to discuss the annual tax gap—the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law—and how reducing that gap can help the nation cope with its large and growing long-term fiscal challenges. Most recently, the Internal Revenue Service (IRS) estimated a gross tax gap from $312 billion to $353 billion for tax year 2001.[1] IRS estimated that it would eventually recover some of this amount through late payments and IRS enforcement actions, resulting in an estimated "net" tax gap for 2001 from $257 billion to $298 billion.[2] The tax gap arises when taxpayers fail to comply with the tax laws, either intentionally or unintentionally. As a result of their noncompliance, the burden of funding the nation's commitments, including funding growing budget deficits, falls more heavily on taxpayers who voluntarily pay their taxes. In addition, IRS expends substantial resources enforcing and explaining tax laws, with the goals of increasing compliance and reducing the tax gap.

For context in considering the tax gap, I will first provide the committee with the results of our most recent simulations of the long-term fiscal outlook. I will also discuss briefly the need for a fundamental reexamination of major spending and tax policies and priorities that will be important to recapturing our fiscal flexibility and updating our programs and priorities to respond to emerging social, economic, and security challenges. Next, I will discuss our long-standing concerns regarding tax compliance and IRS's efforts to ensure compliance. Finally, I will discuss the significance of reducing the tax gap and a number of issues related to this challenging task, including various means to potentially improve compliance, measuring the extent of the tax gap, IRS's understanding of the reasons why taxpayers are noncompliant, and IRS's plans and strategies for reducing the gap. My remarks are based on our previous reports on a variety of issues as well as work we are performing for this committee on the tax gap, which we will address in greater detail in a forthcoming report, and will be performed under generally accepted government auditing standards.

[1]IRS's most recent estimates of the tax gap are preliminary, and as such, IRS presents them as ranges.

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

Let me begin by highlighting several major points:

- The overall picture on the long-term fiscal outlook is not news to this committee. Simply put, our nation's fiscal policy is on an imprudent and unsustainable course. In addition, our long-term fiscal gap grew much larger in fiscal year 2004. Long-term budget simulations by GAO, the Congressional Budget Office (CBO), and others show that over the long term we face large and growing structural deficits due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by our children, grandchildren, and future generations.

- Regardless of the assumptions used, all simulations indicate that the long-term fiscal challenge is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Rather, a fundamental reexamination of major spending and tax policies and priorities will be important to recapturing our fiscal flexibility and updating our programs and priorities to respond to emerging social, economic, and security challenges. Ultimately, this reexamination will need to entail a national discussion about what Americans want from their government and how much they are willing to pay for those things. Especially relevant to this committee will be determining whether and how to change our current tax policies—including the type of tax base, the degree of progressivity in our tax system, or the extent of tax preferences in our system—and how to ensure that compliance with any tax system we may choose is as high as practically possible.

- We have long been concerned about tax noncompliance and IRS's efforts to address it. Since 1990 we have had various aspects of tax noncompliance on our high-risk list, and this year we have affirmed our broad concern by consolidating two prior high-risk areas into one—Enforcement of Tax Laws. Tax law enforcement is a high-risk area in part because past declines in IRS's enforcement activities threatened to erode taxpayer compliance. Declines in key IRS enforcement occupations and examinations and other enforcement results reinforce the need to focus greater attention on tax compliance.[3] The turnaround that has begun in staffing and some enforcement results is good news. However, IRS's preliminary new compliance estimate indicates that compliance has not improved and may be worse than IRS originally estimated. Therefore, sustained progress in improving compliance is needed.

- Reducing the current tax gap would contribute to our fiscal sustainability while simultaneously improving fairness for those citizens who fully and timely meet their tax obligations. Although closing the entire tax gap is not practical, even modest reductions will have very significant financial benefits—each 1 percent reduction in the tax gap that we could achieve would likely generate more than $2.5 billion in revenue annually to help reduce defecits and/or fund our most pressing national priorities. Reducing the tax gap will be a challenging task given persistent levels of noncompliance and will not likely be achieved through a single solution. Rather, the tax gap must be attacked on multiple fronts and with multiple strategies over a sustained period of time. These strategies could include efforts to simplify the tax code, provide quality services to taxpayers, and utilize enforcement tools such as tax withholding and information reporting.

- Regularly measuring the extent and nature of noncompliance is critical to effective efforts to reduce the tax gap given changes in the economy and tax law. A significant portion of IRS's preliminary tax gap estimate for 2001 is based on recently collected compliance data on individual income tax reporting, which accounts for nearly 50 percent of the tax gap. However, for some areas of the tax gap, the estimate relies on outdated data and methodologies, including data from the 1970s and 1980s used to estimate corporate income tax underreporting and some employment tax underreporting. IRS does not have firm plans for obtaining more contemporary information on compliance for these areas of the tax gap or again measuring individual income reporting compliance. Further, IRS has missed opportunities to develop a better understanding of why taxpayers were noncompliant, which can guide IRS in determining what tools and techniques to use to address noncompliance. Finally, IRS's strategies for improving compliance do not have the clear focus on quantitative long-term goals and results

[3]GAO, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and the Interim Results of the 2005 Filing Season*, GAO-05-416T (Washington, D.C.: Apr. 7, 2005).

measurement that are associated with high-performing organizations and that are incorporated into statutory management framework Congress has adopted.

## 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 timely and accurately paid 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 timely.[4] Estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers.

IRS develops its tax gap estimates by measuring the rate of taxpayer compliance—the degree to which taxpayers fully and timely complied with their tax obligations. That rate is then used, along with other data and assumptions, to estimate the dollar amount of taxes not timely and accurately paid. For instance, IRS recently estimated that for tax year 2001, from 83.4 percent to 85 percent of owed taxes were paid voluntarily and timely, which translated into an estimate gross tax gap from $312 billion to $353 billion in taxes not paid that should have been. IRS also estimates the amount of the unpaid taxes that it will recover through enforcement and other actions and subtracts that to estimate the net annual tax gap. For tax year 2001, IRS estimated that it would eventually recover about $55 billion for a net tax gap from $257 billion to $298 billion.

IRS has estimated the tax gap on multiple occasions, beginning in 1979. IRS's earlier tax gap estimates relied on the Taxpayer Compliance Measurement Program (TCMP), through which IRS periodically performed line-by-line examinations of randomly selected tax returns. TCMP started with tax year 1963 and examined individual returns most frequently—generally every 3 years—through tax year 1988. IRS contacted all taxpayers selected for TCMP studies. IRS did not implement any TCMP

[4] 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 timely.

studies after 1988 because of concerns about costs and burdens on taxpayers.[5]

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 while minimizing taxpayer burden.[6] Under NRP, a program that we have encouraged, IRS recently completed its initial review of about 46,000 randomly selected individual tax returns from tax year 2001. Unlike with TCMP studies, IRS did not need to contact taxpayers for every tax return selected under NRP; handled some taxpayer contacts through correspondence, as opposed to face-to-face examinations; and during face-to-face examinations, generally only asked taxpayers to explain information that it was otherwise unable to verify through IRS and third-party databases.

IRS has a strategic planning process through which it supports decisions about strategic goals, program development, and resource allocation. Under the Government Performance and Results Act of 1993 (GPRA),[7] agencies are to develop strategic plans as the foundation for results-oriented management. GPRA requires that agency strategic plans identify long-term goals, outline strategies to achieve the goals, and describe how program evaluations were used to establish or revise the goals. GPRA requires federal agencies to establish measures to determine the results of their activities.

## Long-term Fiscal Challenge Provides Impetus to Reexamine Tax Policies and Compliance

The nation is facing a range of important new forces that are already working to reshape American society, our place in the world, and the role of the federal government. Our capacity to address these and other emerging needs and challenges will be predicated on when and how we deal with our fiscal challenges—the long-term fiscal pressures we face are daunting and unprecedented in the nation's history. As this committee is well aware, the size and trend of our projected longer-term deficits means that the nation cannot ignore the resulting fiscal pressures—it is not a

[5]GAO, *Tax Administration: Status of IRS' Efforts to Develop Measures of Voluntary Compliance*, GAO-01-535 (Washington, D.C.: June 18, 2001).

[6]GAO, *Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains*, GAO-02-769 (Washington, D.C.: June 27, 2002).

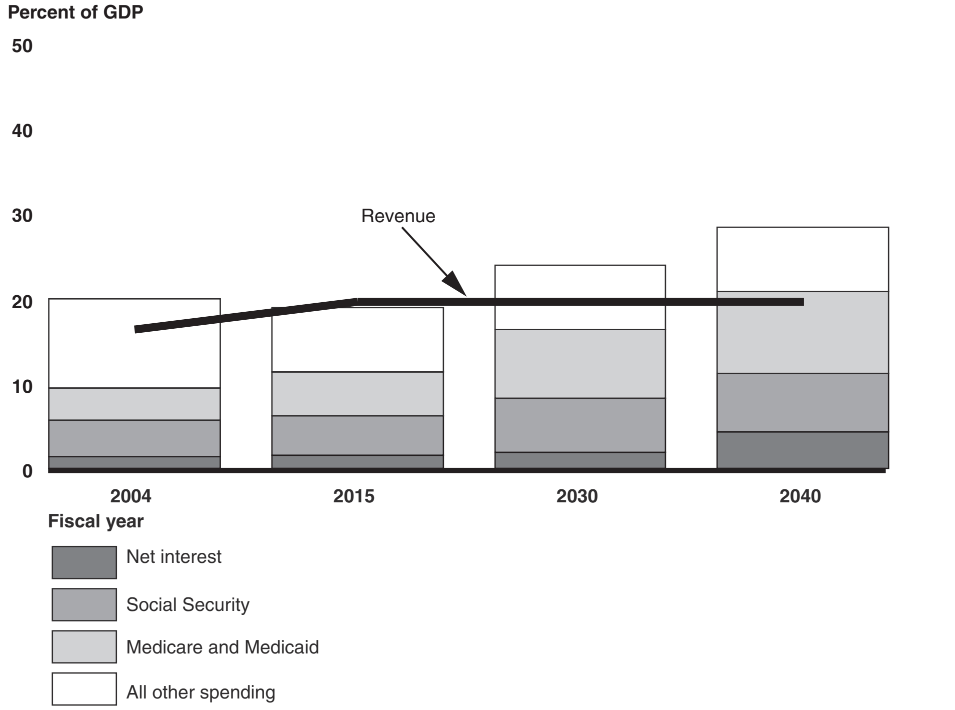
[7]Pub. L. No. 103-62 (1993).

matter of whether the nation deals with the fiscal gap, but when and how. Unless we take effective and timely action, our near-term and longer-term deficits present the prospect of chronic and seemingly perpetual budget shortfalls and constraints becoming a fact of life for years to come. Not only would continuing deficits eat away at the capacity of everything the government does, but they will erode our ability to address the wide range of emerging needs and demands competing for a share of a shrinking budget pie.

Our long-term simulations illustrate the magnitude of the fiscal challenges we will face in the future. Figures 1 and 2 present these simulations under two different sets of assumptions. In the first, we begin with CBO's January 2005 baseline—constructed according to the statutory requirements for that baseline.[8] Consistent with these requirements, discretionary spending is assumed to grow with inflation for the first 10 years and tax cuts scheduled to expire are assumed to expire. After 2015, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of gross domestic product (GDP) at the 2015 level. In the second figure, two assumptions are changed: (1) discretionary spending is assumed to grow with the economy after 2005 rather than merely with inflation and (2) all temporary tax cuts are extended. For both simulations, Social Security and Medicare spending is based on the 2005 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted.

[8]Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015* (Washington, D.C.: January 2005).

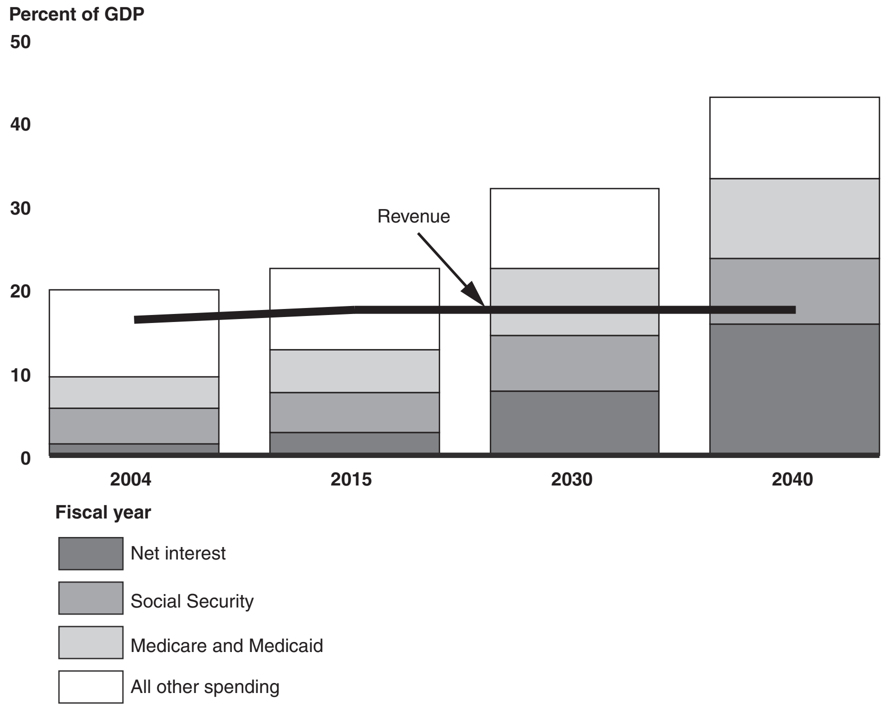
**Figure 1: Composition of Spending as a Share of GDP under Baseline Extended**




Source: GAO's March 2005 analysis.

Note: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the Alternative Minimum Tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Figure 2:  Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended



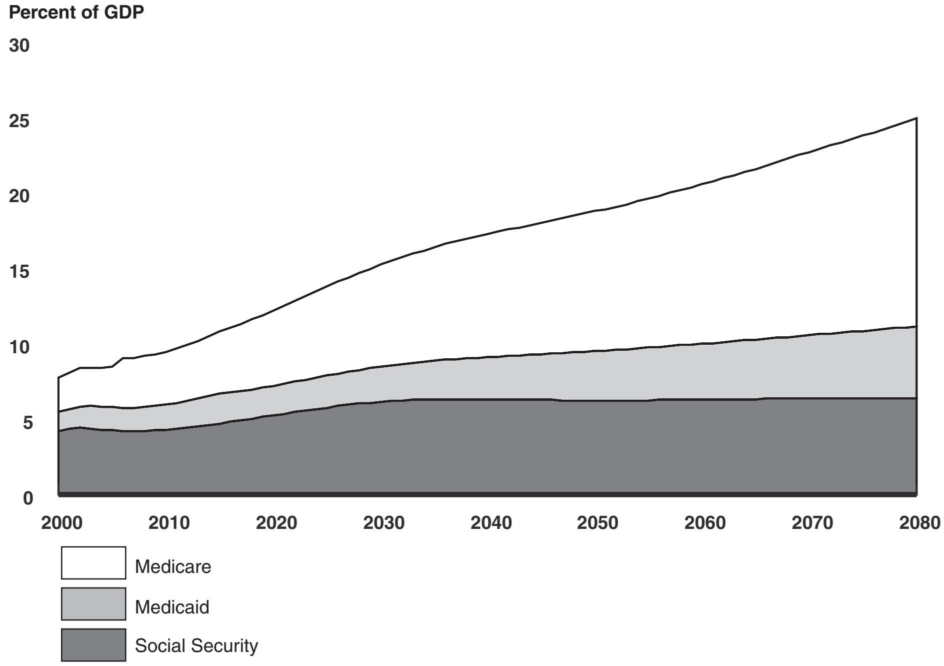

Source:  GAO's March 2005 analysis.

Note: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

As both these simulations illustrate, absent policy changes on the spending or revenue side of the budget, the growth in spending on federal retirement and health entitlements will encumber an escalating share of the government's resources.  Indeed, when we assume that recent tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 federal revenues may be adequate to pay little more than interest on the federal debt.  Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance.  Although revenues will be part of the debate about our fiscal future, assuming no further borrowing, making no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require at least a doubling of taxes, and that seems highly implausible.  Such significant tax increases would also likely have an adverse effect on economic growth and disposable income available to Americans.  Accordingly, substantive reform of Social Security and our major health programs remains critical to recapturing our future fiscal flexibility.

Although considerable uncertainty surrounds long-term budget projections, we know two things for certain: the population is aging and the baby boom generation is approaching retirement age.  The aging population and rising health care spending will have significant implications not only for the budget but also the economy as a whole. Figure 3 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid.  Under the 2005 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 15.2 percent of GDP in 2030 from today's 8.5 percent.  It is clear that taken together Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 3: Social Security, Medicare, and Medicaid Spending as a Percent of GDP




Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Notes: Social Security and Medicare projections based on the intermediate assumptions of the 2005 Trustees' Reports. Medicaid projections based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

Early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to build economic resources and reform future claims entails risks. First, we lose an important window during which today's relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. We also lose the opportunity to reduce the burden of interest in the federal budget, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift. Unfortunately, the long-range challenge has become more difficult, and the window of opportunity to address the entitlement challenge is narrowing.

## A Fundamental Review, Reexamination, and Reprioritization Is Needed

Confronting the nation's fiscal challenge will require nothing less than a fundamental review, reexamination, and reprioritization of all major spending and tax policies and programs that may take a generation or more to resolve. Traditional incremental approaches to budgeting will need to give way to more fundamental and periodic reexaminations of the base of government. Many, if not most, current federal programs and policies were designed decades ago to respond to trends and challenges that existed at the time of their creation. If government is to respond effectively to 21st century trends, it cannot accept what it does, how it does it, who does it, and how it gets financed as "given." Not only do outmoded commitments, operations, choices of tools, management structures, and tax programs and policies constitute a burden on future generations, but they also erode the government's capacity to align itself with the needs and demands of the 21st century.

Reexamining the base of government will be a challenging task, and we at GAO believe we have an obligation to assist and support Congress in this endeavor. To that end, we recently issued a report[9] that provides examples of the kinds of difficult choices the nation faces with regard to discretionary spending; mandatory spending, including entitlements; as well as tax policies and compliance activities. Regarding tax policy, a debate is under way about the future of our tax system that is partly about whether the goals for the nation's tax system can be best achieved using the current structure or a fundamentally reformed tax structure. The debate is also motivated by increasing globalization, the growing complexity of our tax system, and the growing use of tax preferences whose aggregate revenue loss has exceeded all discretionary spending in 5 of the past 10 years.

Although outside the scope of this hearing, today's pressing tax challenges raise important questions. For example:

- Given our current tax system, what tax rate structure is more likely to raise sufficient revenue to fund government and satisfy the public's perception of fairness?

[9]GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: Feb. 2005).

- Which tax preferences need to be reconsidered because they fail to achieve the objectives intended by the Congress, their costs outweigh their benefits, they duplicate other programs, or other more cost effective means exist for achieving their objectives?

- Should the basis of the existing system be changed from an income to a consumption base? Would such a change help respond to challenges posed by demographic, economic, and technological changes? How would such a change affect savings and work incentives? How would reforms address such issues as the impact on state and local tax systems and the distribution of burden across the nation's taxpayers?

Regarding compliance with our tax laws, the success of our tax system hinges greatly on the public's perception of its fairness and understandability. Compliance is influenced not only by the effectiveness of IRS's enforcement efforts but also by Americans' attitudes about the tax system and their government. A recent survey indicated that about 12 percent of respondents say it is acceptable to cheat on their taxes. Furthermore, the complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so and for IRS to explain and enforce tax laws. Complexity also creates a fertile ground for those intentionally seeking to evade taxes and often trips others into unintentional noncompliance. The lack of transparency also fuels disrespect for the tax system and the government. Thus, a crucial challenge for reexamination will be to determine how we can best strengthen enforcement of existing laws to give taxpayers confidence that their friends, neighbors, and business competitors are paying their fair share.

## Enforcement of Tax Laws Is on GAO's High-Risk List

We have long been concerned about tax noncompliance and IRS efforts to address it. Collection of unpaid taxes was included in our first high-risk series report in 1990, with a focus on the backlog of uncollected debts owed by taxpayers. In 1995, we added Filing Fraud as a separate high-risk area, narrowing the focus of that high-risk area in 2001 to Earned Income Credit Noncompliance because of the particularly high incidence of fraud and other forms of noncompliance in that program. We expanded our concern about the Collection of Unpaid Taxes in our 2001 high-risk report to include not only unpaid taxes (including tax evasion and unintentional noncompliance) known to IRS, but also the broader enforcement issue of unpaid taxes that IRS has not detected. In our high-risk update that we issued in January,[10] we consolidated these areas into a single high-risk area—Enforcement of the Tax Laws—because we believe the focus of concern on the enforcement of tax laws is not confined to any one segment of the taxpaying population or any single tax provision.

Tax law enforcement is a high-risk area in part because past declines in IRS's enforcement activities threatened to erode taxpayer compliance. In recent years, the resources IRS has been able to dedicate to enforcing the tax laws have declined. For example, the number of revenue agents (those who examine complex returns), revenue officers (those who perform field collection work), and special agents (those who perform criminal investigations) decreased over 21 percent from 1998 through 2003. However, IRS achieved some staffing gains in 2004 and expects modest gains in 2005. IRS's proposal for fiscal year 2006, if funded and implemented as planned, would return enforcement staffing in these occupations to their highest levels since 1999.[11]

Concurrently, IRS's enforcement workload—measured by the number of taxpayer returns filed—has continually increased. For example, from 1997 through 2003, the number of individual income tax returns filed increased by about 8 percent. Over the same period, returns for high income individuals grew by about 81 percent.[12] Due to their income levels, IRS believes that these individuals present a particular compliance risk. In light of declines in enforcement staffing and the increasing number of returns filed, nearly every indicator of IRS's coverage of its enforcement workload has declined in recent years. Although in some cases workload coverage has begun to increase, overall IRS's coverage of known workload is considerably lower than it was just a few years ago. Figure 4 shows the trend in examination rates—the proportion of tax returns that IRS examines each year—for field, correspondence, and total examinations since 1995. Field examinations involve face-to-face examinations and correspondence examinations are typically less comprehensive and complex, involving communication through written notices. IRS experienced steep declines in examination rates from 1995 to 1999, but the

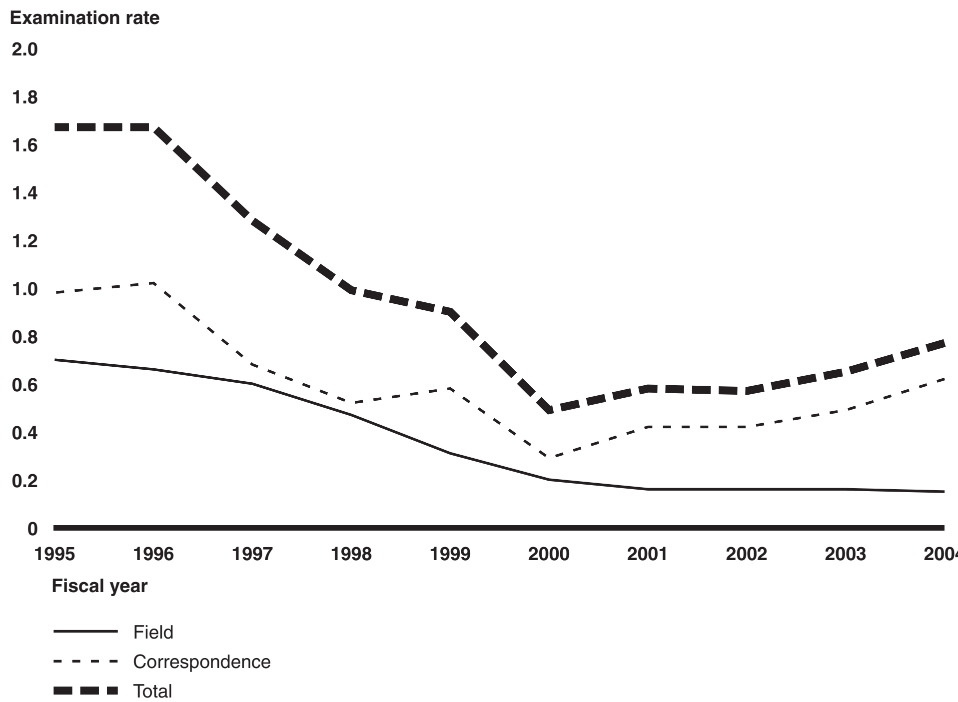
[10]GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005).

[11]GAO-05-416T.

[12]High income individual taxpayers are those reporting $100,000 or more of "total positive income," which is, in general, the sum of all positive amounts shown for the various sources of income reported on individual tax returns and thus excludes net losses.

examination rate has slowly increased since 2000. However, as the figure shows, the increase in total examination rates of individual filers has been driven mostly by correspondence examinations, while more complex field examinations continue to decline.

**Figure 4: Examination Rate for Individual Income Tax Returns, Fiscal Years 1995-2004**




Source: GAO analysis of IRS data.

On the collection front, IRS's use of enforcement sanctions, such as liens, levies, and seizures, dropped precipitously during the mid- and late 1990s. In fiscal year 2000, IRS's use of these three sanctions was at 38 percent, 7 percent, and 1 percent, respectively, of fiscal year 1996 levels. However, beginning in fiscal year 2001, IRS's use of liens and levies began to increase.[13] By fiscal year 2004, IRS's use of liens, levies, and seizures reached 71 percent, 65 percent, and 4 percent of 1996 levels, respectively.

Further, IRS's workload has grown ever more complex as the tax code has grown more complex. IRS is challenged to administer and explain each new provision, thus absorbing resources that otherwise might be used to enforce the tax laws. Concurrently, other areas of particularly serious noncompliance have gained the attention of IRS and Congress, such as abusive tax shelters and schemes employed by businesses and wealthy individuals that often involve complex transactions that may span national boundaries. Given the broad declines in IRS's enforcement workforce, IRS's decreased ability to follow up on suspected noncompliance, and the emergence of sophisticated evasion concerns, IRS is challenged in attempting to ensure that taxpayers fulfill their obligations.

IRS is working to further improve its enforcement efforts. In addition to recent favorable trends in enforcement staffing, correspondence examinations, and the use of some enforcement sanctions, IRS has recently made progress with respect to abusive tax shelters through a number of initiatives and recent settlement offers that have resulted in billions of dollars in collected taxes, interest, and penalties. In addition, IRS is developing a centralized cost accounting system, in part to obtain better cost and benefit information on compliance activities, and is modernizing the technology that underpins many core business processes. It has also redesigned some compliance and collections processes and plans additional redesigns as technology improves. Finally, the recently completed NRP study of individual taxpayers not only gives us a benchmark of the status of taxpayers' compliance but also gives IRS a better basis to target its enforcement efforts. However, IRS's preliminary compliance estimate based on NRP indicates that compliance has not improved and may be worse than IRS originally estimated. As such, sustained progress toward improving compliance is needed.

[13]We made a number of recommendations to improve and expand IRS's levy efforts. See GAO, *Tax Administration: IRS's Levy of Federal Payments Could Generate Millions of Dollars*, GAO/GGD-00-65 (Washington, D.C.: Apr. 7, 2000), and *Tax Administration: Millions of Dollars Could Be Collected if IRS Levied More Federal Payments*, GAO-01-711 (Washington, D.C.: July 20, 2001).

## Multiple Service and Enforcement Strategies, Periodic Compliance Measurement, and A Results-Oriented Compliance Approach May Help IRS Reduce the Tax Gap

Reducing the tax gap would be a step toward improving our fiscal sustainability while simultaneously enhancing fairness for those citizens who meet their tax obligations. That said, reducing the tax gap is a challenging task, and closing the entire tax gap is not practical. Reducing the tax gap will not likely be achieved through a single solution, but will likely involve multiple strategies that include reducing tax code complexity, providing quality services to taxpayers, and enhancing enforcement of the tax laws through the use of tools such as tax withholding and information reporting that increase the transparency of income and deductions to both IRS and taxpayers. Also, as IRS moves forward in continuing to address the tax gap, building and maintaining a base of information on the extent of, and reasons for, noncompliance as well as defining desired changes in the tax gap and measuring results of efforts to address it will be critical.

### Reducing the Tax Gap Could Have a Positive Fiscal Impact but Will Require Multiple Strategies

Given its size, even small or moderate reductions in the net tax gap could yield substantial returns. For example, based on IRS's most recent estimate, each 1 percent reduction in the net tax gap would likely yield more than $2.5 billion annually. Thus, a 10 percent to 20 percent reduction of the net tax gap would translate into from $25 billion to $50 billion or more in additional revenue annually.[14]

Although reducing the tax gap may be an attractive means to improve the nation's fiscal position, achieving this end will be a challenging task given persistent levels of noncompliance. IRS has made efforts to reduce the tax gap since the early 1980s; yet the tax gap is still large—although without these efforts it could be even larger. Also, IRS is challenged in reducing the tax gap because the tax gap is spread across the five different types of taxes that IRS administers, and a substantial portion of the tax gap is attributed to taxpayers who are not subject to withholding or information reporting requirements. Moreover, as we have reported in the past,[15] closing the entire tax gap may not be feasible nor desirable, as it could

[14]Any significant reduction of the tax gap would likely depend on an improvement in the level of taxpayer compliance. 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 simply because the amount of tax that should be paid has been reduced, even if the level of compliance remains unchanged.

[15]GAO, *Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap*, GAO/T-GGD-97-35 (Washington, D.C.: Jan. 9, 1997).

entail more intrusive recordkeeping or reporting than the public is willing to accept or more resources than IRS is able to commit.

Although much of the tax gap that IRS currently recovers is through enforcement actions, a sole focus on enforcement will not likely be sufficient to further reduce the net tax gap. Rather, the tax gap must be attacked on multiple fronts and with multiple strategies on a sustained basis. For example, efforts to simplify the tax code and otherwise alter current tax policies may help reduce the tax gap by making it easier for individuals and business to understand and voluntarily comply with their tax obligations. For instance, reducing the multiple tax preferences for retirement savings or education assistance might ease taxpayers' burden in understanding and complying with the rules associated with these options. Also, simplification may reduce opportunities for tax evasion through vehicles such as abusive tax shelters. However, for any given set of tax policies, IRS's efforts to reduce the tax gap and ensure appropriate levels of compliance will need to be based on a balanced approach of providing service to taxpayers and enforcing the tax laws.

Furthermore, providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap. As we have reported in the past,[16] one method of improving compliance through service is to educate taxpayers about confusing or commonly misunderstood tax requirements. For example, if the forms and instructions taxpayers use to prepare their taxes are not clear, taxpayers may be confused and make unintentional errors. One method to ensure that forms and instructions are sufficiently clear is to test them before use. However, we reported in 2003 that IRS had tested revisions to only five individual forms and instructions from July 1997 through June 2002, although hundreds of forms and instructions had been revised in 2001 alone.[17]

Finally, in terms of enforcement, IRS will need to use multiple strategies and techniques to find noncompliant taxpayers and bring them into compliance. However, a pair of tools has been shown to lead to high levels of compliance: withholding tax from payments to taxpayers and having

[16]GAO/T-GGD-97-35.

[17]GAO, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions*, GAO-03-486 (Washington, D.C.: Apr. 11, 2003).

third parties report information to IRS and the taxpayers on income paid to taxpayers. For example, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Similarly, most wages, salaries, and tip compensation are reported by employers to employees and IRS through Form W-2. Preliminary findings from NRP indicate that more than 98.5 percent of these types of income are accurately reported on individual returns.

In the past, we have identified a few potential areas where additional withholding or information reporting requirements could serve to improve compliance:[18]

- **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 separately report on their tax returns the total amount of payments to independent contractors.[19]

- **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,[20] payments made by others to corporations are generally not covered by information returns.

[18]GAO, *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123 (Washington, D.C.: May 11, 1994).

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

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

- **Require more data on information returns dealing with capital gain income.** Past IRS studies have indicated that much of the noncompliance associated with capital gains is a result of taxpayers overstating an asset's "basis," the amount of money originally paid for the asset. Currently, financial institutions are required to report the sales prices, but not the purchase prices, of stocks and bonds on information returns. Without information on purchase prices, IRS cannot use efficient and effective computer-matching programs to check for compliance and must use much more costly means to examine taxpayer returns in order to verify capital gain income.

Although withholding and information returns are highly effective in encouraging compliance, such additional requirements generally impose costs and burdens on the businesses that must implement them. However, continued reexamination of opportunities to expand information reporting and tax withholding could increase the transparency of the tax system. Such reexamination could be especially relevant toward improving compliance in areas that are particularly complex or challenging to administer, such as noncash charitable contributions or net income and losses passed through from "flow-through" entities such as S corporations and partnerships to their shareholders and partners.[21]

Finally, making progress on closing the tax gap requires that the tools and techniques being used to promote compliance are evaluated to ensure that they actually are effective. IRS evaluates some of its efforts to assess how well they work, perhaps most notably its current effort to test new procedures designed to reduce noncompliance with the Earned Income Tax Credit,[22] but misses other opportunities. For example, the lack of testing for forms and instructions mentioned earlier is one instance where improved evaluation would be worthwhile. We also reported in 2002 that the effectiveness of the Federal Tax Deposit Alert program—a program that since 1972 has been intended to reduce delinquencies in paying

[21]Partnerships and S corporations are businesses commonly referred to as flow-through entities, as they do not generally pay taxes on income. Instead, they distribute net income and losses to partners, shareholders, and beneficiaries, who are subsequently required to report net income or losses on their individual tax returns and pay any applicable taxes.

[22]GAO, *Earned Income Credit: Qualifying Child Certification Test Appears Justified, but Evaluation Plan Is Incomplete*, GAO-03-794 (Washington, D.C.: Sept. 30, 2003), and *Earned Income Tax Credit: Implementation of Three New Tests Proceeded Smoothly, But Tests and Evaluation Plans Were Not Fully Documented*, GAO-05-92 (Washington, D.C.: Dec. 30, 2004).

employment taxes—could not be evaluated because IRS had no system to track contacts IRS made with delinquent employers.[23] The availability of current compliance information should enhance IRS's ability to evaluate the success of its efforts to promote compliance.

## Regular Compliance Measurement Can Support Informed Decisions to Reduce the Tax Gap, but IRS Lacks Firm Plans for Such Measurement

Regularly measuring compliance can offer many benefits, including helping IRS identify new or major types of noncompliance, identify changes in tax laws and regulations that may improve compliance, more effectively target examinations of tax returns or other enforcement programs, understand the effectiveness of its programs to promote and enforce compliance, and determine its resource needs and allocations. For example, by analyzing 1979 and 1982 TCMP data, IRS identified significant noncompliance with the number of dependents claimed on tax returns and justified a legislative change to address the noncompliance. As a result, for tax year 1987 taxpayers claimed about 5 million fewer dependents on their returns than would have been expected without the change in law. In addition, tax compliance data are useful outside of IRS for tax policy analysis, revenue estimating, and research.

A significant portion of IRS's new tax gap estimate is based on recent compliance data. IRS used data from NRP to update individual income tax underreporting and the portion of individual employment tax underreporting from self-employed individuals.[24] Completion of NRP is a substantial achievement—as table 1 indicates, underreporting of individual income taxes represented about half of the tax gap for 2001 (the estimate ranges from $150 billion to $187 billion out of a gross tax gap estimate that ranges from $312 billion to $353 billion). Also, from $51 billion to $56 billion of the $66 billion to $71 billion in estimated underreported employment tax was due to self-employment tax underreporting. IRS used current, actual data from its Master Files to calculate the underpayment segment of the tax gap.

[23]GAO, *Tax Administration: IRS's Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 2002).

[24]Self-employed individuals are required to calculate and remit Social Security and Medicare taxes to the U.S. Treasury each quarter, while employers generally withhold these taxes from their employees' wages, match these amounts, and are required to remit these withholdings to Treasury at least quarterly.

**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 | $150-$187 | $30 | $66-$71 | $4 | No estimate | $250-$292 |
| Underpayment | 19 | 2 | 7 | 2 | 1 | $32 |
| Nonfiling | 28 | No estimate | No estimate | 2 | No estimate | $30 |
| **Total** | **$198-$234** | **$32** | **$73-$78** | **$8** | **$1** | **$312-$353** |

Source: IRS.

Note: Figures may not sum to totals due to rounding.

IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and IRS has no estimates for other areas of the tax gap. IRS does not have estimates for corporate income, employment, and excise tax nonfiling or for excise tax underreporting. For these types of noncompliance, IRS maintains that the data are either difficult to collect, imprecise, or unavailable. IRS has not recently collected compliance data for the remaining segments of the tax gap. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes.

IRS is taking several steps that could improve the tax gap estimate for tax year 2001. IRS plans to further analyze the preliminary results from NRP and expects to publish a revised estimate by the end of 2005. The revised estimate will incorporate new methodologies, including those for estimating overall individual income tax underreporting as well as for the portion attributable to self-employed individuals who operate businesses informally, and for estimating individual income tax nonfiling. In addition, IRS research officials have proposed a compliance measurement study that will allow IRS to update underreporting estimates involving flow-through entities. This study, which IRS intends to begin in fiscal year 2006, would take 2 to 3 years to complete. Because either individual taxpayers or corporations may be recipients of income (or losses) from flow-through entities, this study could affect IRS's estimates for the underreporting gap for individual and corporate income tax.

While these data and methodology updates could improve the tax gap estimates, IRS has no documented plans to periodically collect more or better compliance data over the long term. Other than the proposed study of flow-through entities, IRS does not have plans to collect compliance data for other segments of the tax gap. Also, IRS has indicated that given its current research priorities, it would not begin another NRP study of individual income tax returns before 2008, if at all, and would not complete such a study until at least 2010. When IRS initially proposed the NRP study, it had planned to study individual income tax underreporting on a 3-year cycle.

According to IRS officials, IRS has not committed to regularly collecting compliance data because of the associated costs and burdens. Taxpayers whose returns are examined through compliance studies such as NRP bear costs in terms of time and money. Also, IRS incurs costs, including direct costs and opportunity costs—revenue that IRS potentially forgoes by using its resources to examine randomly selected returns, which may include returns from compliant taxpayers, as opposed to traditional examinations that focus on taxpayer returns that likely contain noncompliance and may more consistently produce additional tax assessments.

Although the costs and burdens of compliance measurement are legitimate concerns, as we have reported in the past, we believe compliance studies to be good investments.[25] Without current compliance data, IRS is less able to determine key areas of noncompliance to address and actions to take to maximize the use of its limited resources. The lack of firm plans to continually obtain fresh compliance data is troubling because the frequency of data collection can have a large impact on the quality and utility of compliance data. As we have reported in the past, the longer the time between compliance measurement surveys, the less useful they become given changes in the economy and tax law.[26]

In designing the NRP study, IRS balanced the costs, burdens, and compliance risk of studying that area of the tax gap. Any plans for obtaining and maintaining reasonably current information on compliance levels for all portions of the tax gap would similarly need to take into

[25]GAO, *Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved*, GAO/GGD-93-52 (Washington, D.C.: Apr. 5, 1993).

[26]GAO/GGD-93-52.

account costs, burdens, and compliance risks in determining which areas of compliance to measure and the scope and frequency of such measurement.

## Knowing the Reasons for Noncompliance Could Help Guide Compliance Efforts, but IRS Has Concerns with Its Data on These Reasons

Data on whether taxpayers are unintentionally or intentionally noncompliant with specific tax provisions are critical to IRS for deciding 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. Recognizing such benefits, the National Taxpayer Advocate has urged IRS to consider performing additional research into causes of noncompliance.[27] We have also reported in the past[28] that rigorous research of the causes of noncompliance seems intuitive.

IRS collects data on the reasons for noncompliance for specific tax issues during its examinations of tax returns, including those reviewed for NRP. However, IRS has a number of concerns with the data:

- The database is incomplete as not all examiners have been sending information on the results, including reasons, of closed examinations to be entered into the database.
- IRS has not tested the adequacy of the controls for data entry or the reliability of the data being collected. IRS has found instances where examiners close examinations without assigning a reason for noncompliance or by assigning the same reason to all instances of noncompliance, regardless of the situation.
- IRS has not trained all examiners to deal with the subjectivity of determining reasons to ensure consistent understanding of the reason categories.

[27] Testimony of Nina E. Olson, National Taxpayer Advocate, before the Senate Committee on Finance, July 21, 2004, and Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004).

[28] GAO, *Tax Research: IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109 (Washington, D.C.: June 5, 1996).

- The data are not representative of the population of noncompliant taxpayers because the examined tax returns were not selected randomly.

As IRS continues to collect data on the reasons for noncompliance in the future, it will be important to take these concerns into account. Additionally, as with its efforts to measure compliance, it will be important for IRS to consider the costs and burden of obtaining data on the reasons for noncompliance.

## Long-term, Quantitative Goals for Improving Taxpayers' Compliance Would Be Consistent with Results-Oriented Management

Focusing on outcome-oriented goals and establishing measures to assess the actual results, effects, or impact of a program or activity compared to its intended purpose can help agencies improve performance and stakeholders determine whether programs have produced desired results. As such, establishing long-term, quantitative compliance goals offers several benefits for IRS. Perhaps most important, compliance goals coupled with periodic measurements of compliance levels would provide IRS with a better basis for determining to what extent its various service and enforcement efforts contribute to compliance. Additionally, long-term, quantitative goals may help IRS consider new strategies to improve compliance, especially since these strategies could take several years to implement. For example, IRS's progress toward the goal of having 80 percent of all individual tax returns electronically filed by 2007[29] has required enhancement of its technology, development of software to support electronic filing, education of taxpayers and practitioners, and other steps that could not be completed in a short time frame. Focusing on intended results can also promote strategic and disciplined management decisions that are more likely to be effective because managers who use fact-based performance analysis are better able to target areas most in need of improvement and select appropriate interventions. Likewise, agency accountability can be enhanced when both agency management and external stakeholders such as Congress can readily measure an agency's progress toward meeting its goals. Finally, setting long-term, quantitative goals would be consistent with results-oriented management principles that are associated with high-performing organizations and incorporated into the statutory management framework Congress has adopted through GPRA.

[29]Congress established this electronic filing goal in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998).

IRS's strategies for improving compliance generally lack a clear focus on long-term, quantitative goals and results measurement. Although IRS has established broad qualitative goals and strategies for improving taxpayer service and enhancing enforcement of the tax laws, it has not specified by how much it hopes these strategies will improve compliance. IRS has also identified measures, such as compliance rates for tax reporting, filing, and payment as well as the percentage of Americans who think it is acceptable to cheat on their taxes,[30] which are intended to gauge the progress of its strategies toward its broad goals. However, IRS does not always collect recent data to update these measures and has not established quantitative goals against which to compare the measures. In response to a President's Management Agenda[31] initiative to better integrate budget and performance information, IRS officials said that they are considering various long-term goals for the agency. These goals are to be released by May 2005. The officials have not indicated how many goals will be related to improving taxpayer compliance or whether they will be quantitative and results-oriented.

Not unlike other agencies,[32] IRS faces challenges in implementing a results-oriented management approach, such as identifying and collecting the necessary data to make informed judgments about what goals to set and to subsequently measure its progress in reaching such goals. However, having completed the NRP review of income underreporting by individuals, IRS now has an improved foundation for setting a goal or goals for improving

[30]Other measures for enhancing enforcement are (1) the percentage of priority guidance list items published (percentage of tax issues IRS will address through regulations, notices, and other forms of guidance) and (2) average cycle time between receipt and completion of an audit case.

[31]The President's Management Agenda is intended to help the federal government become more results-oriented and encourage federal managers to ask whether their programs are working as intended and, if not, what can be done to achieve greater results.

[32]GAO, *The Government Performance and Results Act: 1997 Governmentwide Implementation Will Be Uneven*, GAO/GGD-97-109 (Washington, D.C.: June 2, 1997), and *Results-Oriented Government: GPRA Has Established a Solid Foundation for Achieving Greater Results*, GAO-04-38 (Washington, D.C.: Mar. 10, 2004).

taxpayers' compliance.[33] Nevertheless, measuring progress toward any goals that may be set could be challenging. For example, IRS researchers have found it difficult to determine the extent to which its enforcement actions deter noncompliance or its services improve compliance among taxpayers who want to comply. Measuring these effects is complicated in part because many factors outside of IRS's actions can affect compliance. However, as the National Taxpayer Advocate's 2004 annual report to Congress[34] pointed out, current and existing data on noncompliance may help IRS better understand and address this challenge. Furthermore, even if IRS is unable to show that its actions directly affected compliance rates, 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.

## Concluding Observations

The nation is currently on an imprudent and unsustainable fiscal path that threatens our future. If we act now to address the looming fiscal challenges facing the nation, the lives of our children and grandchildren will be measurably better than if we wait. Nevertheless, the decisions we must make will not be easy. They involve difficult choices about the role of government in our lives and our economy. Acting now will impose sacrifices, but today we have more options with less severe consequences than if we wait.

Reducing the tax gap is one option that would help. While our long term-fiscal imbalance is too large to be eliminated by one strategy, reducing the tax gap can ease the difficult decisions that are needed. But, regardless of the contribution that a reduced tax gap can make to easing our long-term challenges, we need to make concerted efforts to address the tax gap because it is fundamentally unfair and threatens Americans' trust in their

[33]The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998), specifically prohibits IRS from using its records of tax enforcement results to evaluate employees or to impose or suggest production quotas or goals with respect to such employees. That restriction does not, however, prevent IRS from using its records of tax enforcement results to examine whether its current enforcement efforts are effective in deterring noncompliance and to in turn establish long-term strategies and priorities for improvement.

[34]Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress*.

government. The tax gap is both a measure of the burden and frustration of taxpayers who want to comply but are tripped by tax code complexity and of willful tax cheating by a minority who want the benefits of government services without paying their fair share.

Chairman Grassley, Senator Baucus, and Members of the Committee, this concludes my testimony. At the request of the committee, in the near future, we will issue a report that addresses the tax gap in greater detail and, as appropriate, may make recommendations related to the topics covered in my statement. We look forward to continuing to support the committee's oversight of the tax gap and related issues. I would be happy to answer any questions you may have at this time.

## Contact and Acknowledgments

For further information on this testimony, please contact Michael Brostek on (202) 512-9110 or brostekm@gao.gov. Individuals making key contributions to this testimony include Jeff Arkin, Elizabeth Fan, Shannon Groff, George Guttman, Michael Rose, and Tom Short.

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