United States Government Accountability Office

GAO

Testimony

Before the Committee on Budget, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EST
Wednesday, February 15, 2006

TAX GAP

Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions

Statement of David M. Walker
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Accountability * Integrity * Reliability

GAO-06-453T

February 15, 2006

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GAO Accountability · Integrity · Reliability

Highlights

Highlights of GAO-06-453T, a testimony before the Committee on the Budget, U.S. Senate

Why GAO Did This Study

The Internal Revenue Service's (IRS) most recent estimate of the difference between what taxpayers timely and accurately paid in taxes and what they owed was $345 billion. IRS estimates it will eventually recover some of this tax gap, resulting in an estimated net tax gap of $290 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 the Budget asked GAO to present information on the causes of and possible solutions to the tax gap. This testimony addresses the nature and extent of the tax gap and the significance of reducing the tax gap, including some steps that may assist with this challenging task. For context, this testimony also addressed 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-06-453T.

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

Our nation's fiscal policy is on an imprudent and unsustainable course. As long-term budget simulations by GAO show, over the long term we face a large and growing structural deficit due primarily to known demographic trends, rising health care costs, and lower federal revenues as a percentage of the economy. GAO's 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 future fiscal flexibility.

Underreporting of income by businesses and individuals accounted for most of the estimated $345 billion tax gap for 2001, with individual income tax underreporting alone accounting for $197 billion, or over half of the total gap. Corporate income tax and employment tax underreporting accounted for an additional $84 billion of the gap.

Reducing the tax gap would help improve fiscal sustainability. Given the tax gap's persistence and size, it will require considering not only options that have been previously proposed but also new administrative and legislative actions. Even modest progress would yield significant revenue; each 1 percent reduction would likely yield nearly $3 billion annually. Reducing the tax gap will be a challenging long-term task, and progress will require attacking the gap with multiple strategies over a sustained period. These strategies could include efforts to regularly obtain data on the extent of, and reasons for, noncompliance; simplify the tax code; provide quality service to taxpayers; enhance enforcement of tax laws by utilizing enforcement tools such as tax withholding, information reporting, and penalties; leverage technology; and optimize resource allocation.

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**	**Corporate income**	**Employment**	**Estate**	**Excise**	**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 due to rounding.

Chairman Gregg, Senator Conrad, 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. The Internal Revenue Service (IRS) most recently estimated a gross tax gap that reached $345 billion for tax year 2001. IRS estimated that it would recover around $55 billion through late payments and IRS enforcement actions, resulting in a net tax gap of around $290 billion.[1] The tax gap arises when taxpayers intentionally or unintentionally fail to comply with the tax laws. Their failure to pay taxes increases the burden of funding the nation's commitments for those taxpayers who voluntarily pay their taxes.

For context in considering the tax gap, I will first provide the committee with an overview of the federal government's fiscal condition and the challenges we will face in funding our nation's commitments. Next, I will discuss the size and components of the tax gap. Finally, I will discuss the significance of reducing the tax gap and various means to achieve that goal, including measuring the extent of, and reasons for, noncompliance; simplifying the tax code; improving taxpayer service; enhancing IRS enforcement through the use of tools such as withholding, information reporting, and penalties; leveraging technology; and optimizing resource allocation.

My remarks are based on our previous work on a variety of issues, in particular, recent testimonies and a report on reducing the tax gap.[2] These efforts were conducted in accordance with generally accepted government auditing standards.

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

[2]GAO, *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); *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); and *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).

Let me begin by highlighting three major points:

- GAO's long-term budget simulations show that over the long term we face large and growing structural deficits due primarily to known demographic trends, rising health care costs, and lower federal revenues as a percentage of the economy. 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. 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.

- Underreporting of income by businesses and individuals accounted for most of the estimated $345 billion tax gap for 2001, with individual income tax underreporting alone accounting for $197 billion, or over half of the total gap. Corporate income tax and employment tax underreporting accounted for an additional $84 billion.

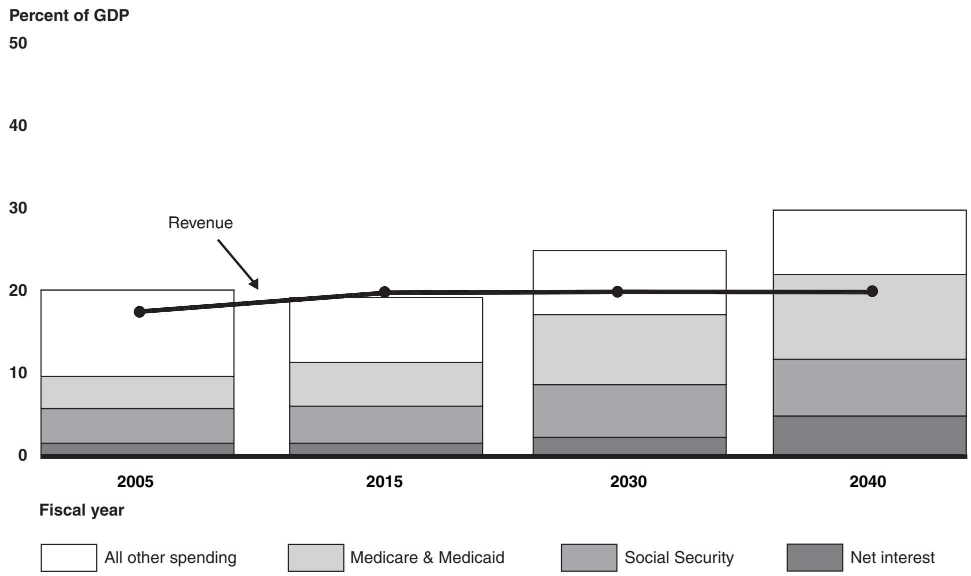
- Given the persistence and size of the tax gap, we need not only to consider options that have been previously proposed but also explore new administrative and legislative approaches to reducing the tax gap. Even modest progress would yield significant revenue; each 1 percent reduction would likely yield nearly $3 billion annually. Reducing the tax gap will be a challenging, long-term task and progress will require attacking the gap on multiple fronts and with multiple strategies over a sustained period. These strategies could include efforts to regularly obtain data on the extent of, and reasons for, noncompliance; simplify the tax code; provide quality services to taxpayers; enhance enforcement of the tax laws by utilizing enforcement tools such as tax withholding, information reporting, and penalties; leverage technology; and maximize resource allocation.

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

The federal government's financial condition and long-term fiscal outlook present enormous challenges to the nation's ability to respond to emerging forces reshaping American society, the United States' place in the world, and the future role of the federal government. Over the next few decades as the baby boom generation retires and health care costs continue to rise, federal spending on retirement and health programs—Social Security, Medicare, Medicaid, and other federal pension, health, and disability programs—will grow dramatically. Absent policy changes on the spending and/or revenue sides of the budget, a growing imbalance between expected federal spending and tax revenues will mean escalating and eventually unsustainable federal deficits and debt that will threaten our future economy, standard of living, and, ultimately, our national security. Ultimately, the nation will have to decide what level of federal benefits and spending it wants and how it will pay for these benefits.

GAO's long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society and the significance of the related challenges the government will be called upon to address. Indeed, the nation's long-term fiscal outlook is daunting under many different policy scenarios and assumptions. For instance, under a fiscally restrained scenario, if discretionary spending grew only with inflation over the next 10 years and all existing tax cuts expire when scheduled under current law, spending for Social Security and health care programs would grow to consume over 80 percent of federal revenue by 2040. (See fig. 1.) On the other hand, if discretionary spending grew at the same rate as the economy in the near term and if all tax cuts were extended, by 2040 federal revenues may just be adequate to pay only some Social Security benefits and interest on the growing federal debt. (See fig. 2.)

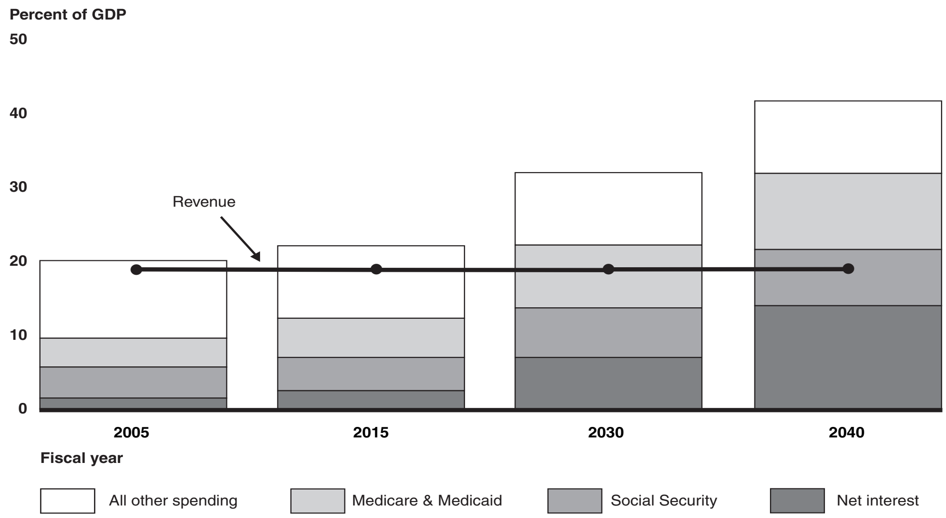
Figure 1: Composition of Spending as a Share of GDP Under Baseline Extended



Source: GAO's January 2006 analysis.

Note: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2016 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2016, 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 2006 and All Expiring Tax Provisions are Extended



Source: GAO's January 2006 analysis.

Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.

Addressing the projected fiscal gaps shown here will require policymakers to examine the advisability, affordability, and sustainability of existing programs, policies, functions, and activities throughout the entire federal budget—spanning discretionary spending, mandatory spending, including entitlements, and tax policies and programs. Neither slowing the growth of discretionary spending nor allowing tax cuts to expire—nor both options combined—would by themselves eliminate our long-term fiscal imbalance. Additional economic growth is critical and will help to ease the burden, but the projected fiscal gap is so great that it is wholly unrealistic to expect that we will grow our way out of the problem. The President's 2007 budget released last week included some proposals to reduce the growth in Medicare spending. Whether or not these proposals are adopted, they should serve to raise public awareness of the importance of health care costs to both today's budget and tomorrow's. This could also serve to jump start discussion about appropriate ways to control a major driver of our long-term fiscal outlook—health care spending. Clearly, tough choices will be required. Changes in existing budget processes and financial, fiscal, and performance metrics will be necessary to facilitate these choices.

Early action to change existing programs and policies would yield the highest fiscal dividends and provide a longer period for prospective beneficiaries to make adjustments in their own planning. The longer we wait, the more painful and difficult the choices will become and the less transition time we will have. By waiting, an important window is lost during which today's relatively large workforce can increase saving and begin preparing for the necessary changes in fiscal policy, Social Security, and health care as well as other reforms that may be necessary parts of the solution to this coming fiscal crunch. However, the long-term challenge is fast becoming a short-term one as the retirement of the baby boomers' generation will begin as early as 2008 and since overall workforce growth has already begun to slow. While our long-term fiscal imbalance cannot be eliminated with a single strategy, reducing the tax gap is one approach that could help address the looming fiscal challenges facing the nation.

Underreporting Accounted for Most of the Tax Gap Estimate

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.[3] 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 most recently estimated that for tax year 2001, 83.7 percent of owed taxes were paid voluntarily and timely, which translated into an estimated gross tax gap of $345 billion. IRS

[3] 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.

developed these estimates using compliance data collected through the National Research Program (NRP).[4]

Using its recently collected compliance data, IRS has estimated that underreporting of income represented over 80 percent of the tax gap for 2001 (an estimated $285 billion out of a gross tax gap estimate of $345 billion), as indicated in table 1.

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**
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Total	**$244**	**$32**	**$59**	**$8**	**$1**	**$345**

Source: IRS.

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

Within the underreporting estimate, IRS attributed about $197 billion, or about 57 percent of the total tax gap, to individual income tax underreporting, including underreporting of business income, such as sole proprietor,[5] informal supplier,[6] and farm income (about $109 billion); nonbusiness income, such as wages, interest, and capital gains (about $56

[4]NRP replaced the Taxpayer Compliance Measurement Program, which last measured compliance for individuals for 1988 but then was canceled because of concerns about costs and burdens on taxpayers. GAO, *Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains*, GAO-02-769 (Washington, D.C.: June 27, 2002); and GAO, *Tax Administration: Status of IRS' Efforts to Develop Measures of Voluntary Compliance*, GAO-01-535 (Washington, D.C.: June 18, 2001) discuss the development of the NRP study.

[5] Sole proprietors are self-employed individuals who should file a Schedule C with their individual tax return to report profits and losses from their business. 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.

[6] 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 a Schedule C.

billion); overstated credits (about $17 billion); and overstated income adjustments, deductions, and exemptions (about $15 billion). Underreporting of corporate income tax contributed an estimated $30 billion, or about 10 percent, to the 2001 tax gap, which included both small corporations (those reporting assets of $10 million or less) and large corporations (those reporting assets of over $10 million).

Employment tax underreporting accounted for an estimated $54 billion, or about 16 percent, of the 2001 tax gap and included several taxes that must be paid by self-employed individuals and employers. Self-employed individuals are generally required to calculate and remit Social Security and Medicare taxes to the U.S. Treasury each quarter. Employers are required to withhold these taxes from their employees' wages, match these amounts, and remit withholdings to Treasury at least quarterly. Underreported self-employment[7] and employer-withheld employment taxes, respectively, contributed an estimated $39 billion and $14 billion to IRS's tax gap estimate. The employment tax underreporting estimate also includes underreporting of federal unemployment taxes (about $1 billion).

Taxpayers who do not file their tax returns on time or at all and otherwise do not pay their tax liabilities accounted for the remainder of the 2001 tax gap—around $61 billion. For example, nonfiling and underpayment noncompliance by individual taxpayers alone contributed an estimated $48 billion to this portion of the tax gap.

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. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes. For large corporate income tax underreporting, IRS based its estimate on the amount of tax recommended from operational examinations rather than the tax ultimately assessed as part of the total tax liability.[8] According to IRS officials, IRS relies on the amount of tax recommended because it is difficult to determine the true

[7]As employment taxes and income taxes for self-employed taxpayers are largely assessed on the same income, self-employed individuals who underreport their income consequently underreport the employment tax due on that income.

[8]IRS continually examines tax returns from about 1,100 of the nation's largest corporations, all of which have assets of more than $250 million. For fiscal year 2002, IRS examined around 7 percent of all large corporations.

tax liability of large corporations due to complex and ambiguous tax laws that create opportunities for differing interpretations and that complicate the determination. These officials further stated that because these examinations are not randomly selected and are not focused on identifying all tax noncompliance, the estimate produced from the examination data is not representative of the tax gap for all large corporations. They also explained that due to these complexities and the costs and burdens of collecting complete and accurate data, IRS has not systematically measured large corporation tax compliance through statistically valid studies, even though the officials acknowledged that such studies would be useful in estimating the related tax gap.[9]

IRS has no 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. 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.[10]

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. Recently, IRS has taken a number of steps that may improve its ability to reduce the tax gap. Favorable trends in staffing of IRS enforcement personnel; examinations performed through correspondence, as opposed to more complex face-to-face examinations; and the use of some enforcement sanctions such as liens and levies are encouraging. Also, IRS has 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 has successfully prosecuted a number of taxpayers who have committed criminal violations of the tax laws.

[9]GAO, *Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement*, GAO/GGD-94-70 (Washington, D.C.: Sept. 1, 1994); *Tax Administration: Factors Affecting Results from Audits of Large Corporations*, GAO/GGD-97-62 (Washington, D.C.: Apr. 17, 1997); and *Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128 (Washington, D.C.: June 23, 1998).

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

Reducing the Tax Gap Will Require Expanding Existing Approaches and Considering New Legislative Actions

Given its persistence and size, we need not only to consider expanding current approaches but also explore new legislation to help IRS in reducing the tax gap.[11] Although IRS has made a number of changes in its methodologies for measuring the tax gap over the past three decades, which makes comparisons difficult, regardless of methodology the voluntary compliance rate that underpins the gap has tended to range from around 81 percent to around 84 percent. Thus, although the dollar amounts of the tax gap have changed, IRS has consistently reported a persistent, relatively stable portion of the taxes that should have been timely and accurately paid were not paid.

As we have reported in the past,[12] closing the entire tax gap may not be feasible nor desirable, as it could entail more intrusive recordkeeping or reporting than the public is willing to accept or more resources than IRS is able to commit. However, given its size, even small or moderate reductions in the net tax gap could yield substantial returns, which could improve the government's fiscal position. For example, based on IRS's most recent estimate, each 1 percent reduction in the net tax gap would likely yield nearly $3 billion annually. Thus, a 10 percent to 20 percent reduction of the net tax gap would translate into from roughly $30 billion to $60 billion in additional revenue annually.[13]

[11] We have suggested similar steps for the entire tax system as well as all major spending programs in order to confront the nation's fiscal challenge through a fundamental review, reexamination, and reprioritization of government's capacity to align itself with the needs and demands of the 21st century. See GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

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

[13] 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.

However, reducing the tax gap will be challenging[14] and it must be attacked on multiple fronts and with multiple strategies, some of which follow.

Regularly Measure Compliance and Set Compliance Goals

A critical step toward reducing the tax gap is to understand the sources and nature of taxpayer noncompliance. Regularly measuring compliance, including the reasons why taxpayers are not compliant, can offer many benefits, including helping IRS identify new or growing types of noncompliance, identify changes in tax laws and regulations that may improve compliance, understand the effectiveness of its programs to promote and enforce compliance, more effectively target examinations of tax returns, and determine its resource needs and allocations. Likewise, regularly measuring compliance can provide IRS with information against which to set goals for improving compliance and measure progress in achieving such goals.

In our July 2005 report on reducing the tax gap, we made recommendations to IRS to develop plans to periodically measure tax compliance; take steps to improve its data on the reasons why taxpayers do not comply; and establish long-term, quantitative goals for voluntary compliance levels with an initial focus on individual income tax underreporting and total tax underpayment. Taken together, these steps can help IRS build a foundation to understand how its taxpayer service and enforcement efforts affect compliance and make progress on reducing the tax gap. The Commissioner of Internal Revenue agreed with our recommendations, highlighted challenges associated with them, and commented on various steps IRS would take to implement each recommendation. We are encouraged that according to IRS's Fiscal Year 2007 Congressional Budget Justification, IRS has recently established a voluntary compliance goal, with a target of 85 percent voluntary compliance by 2009, and plans to periodically measure progress against this goal.

[14]Recognizing these challenges, 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 last year we have affirmed our broad concern by consolidating two prior high-risk areas into one—Enforcement of Tax Laws. See GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005).

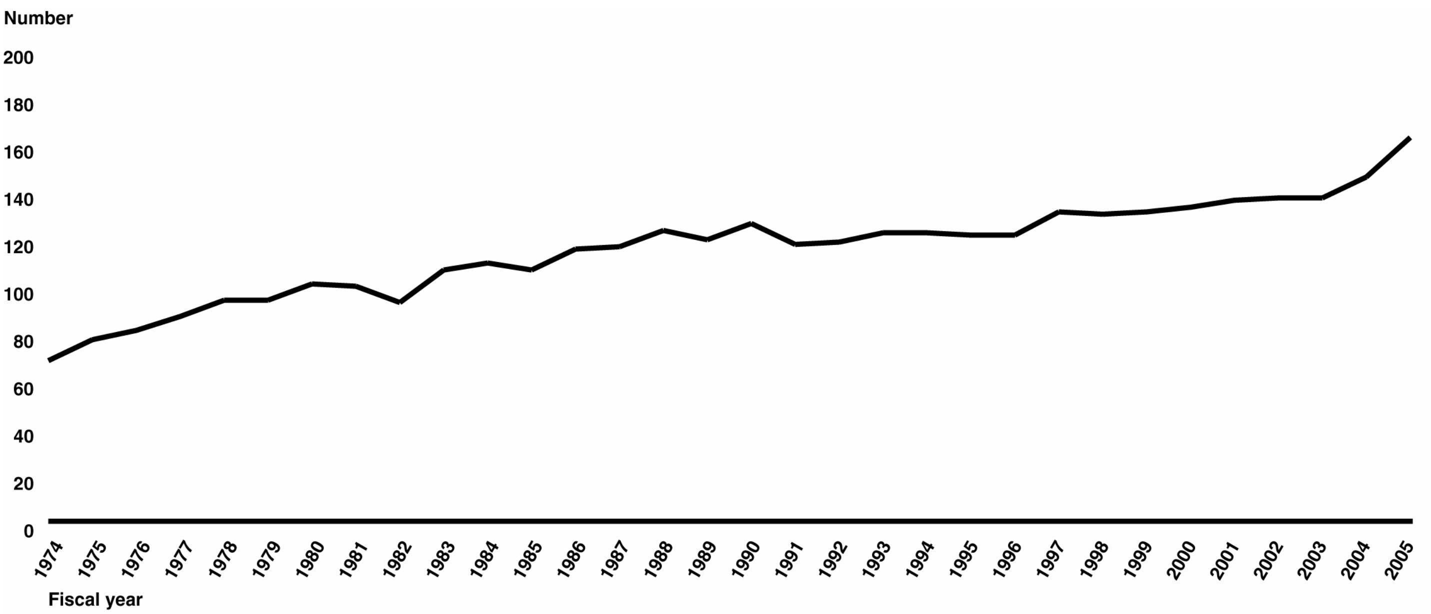
Simplify the Tax Code

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 businesses to understand and voluntarily comply with their tax obligations. Among the many causes of tax code complexity is the growing number of preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferral of tax liability, and preferential tax rates.[15] Tax expenditures—as they are known by statute[16]—can be a tool to further some federal goals and objectives, such as financing higher education or funding research and development. However, their aggregate number contributes to the complexity that taxpayers face in doing their taxes and planning their financial decisions. As figure 3 shows, the number of tax expenditures reported by the Department of the Treasury has more than doubled since 1974. Figure 4 shows the Revenue Loss Estimates for the Five Largest Tax Expenditures Reported for Fiscal Year 2005.

[15]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).

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

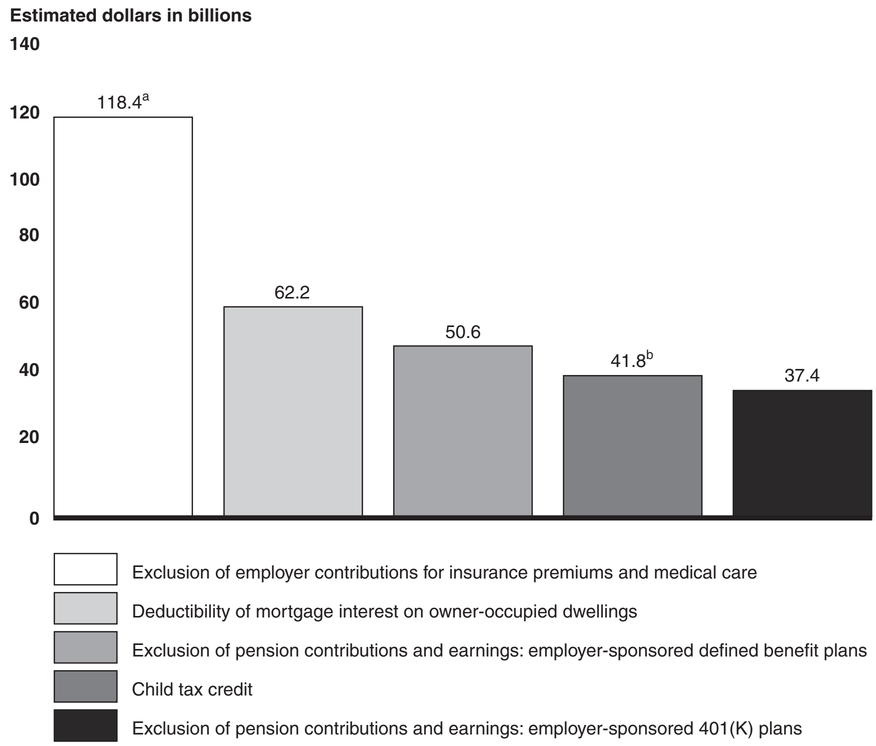
Figure 3: Number of Tax Expenditures Reported by Treasury, 1974-2005



Source: GAO analysis of OMB budget reports on tax expenditures, Fiscal Years 1976-2007.

Note: The number of tax expenditures reflects all provisions reported by Treasury, including those enacted but effective for future fiscal years. For example, Treasury's last list included tax expenditures enacted in 2005 that will be effective in fiscal years 2006 and later. The trend also reflects changes in Treasury's income tax baseline that defines a tax expenditure.

Figure 4: Revenue Loss Estimates for the Five Largest Tax Expenditures Reported for Fiscal Year 2005



Source: Office of Management and Budget (OMB), *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007.*

Note: "Tax expenditures" refers to the special tax provisions that are contained in the federal income taxes on individuals and corporations. OMB does not include forgone revenue from other federal taxes such as Social Security and Medicare payroll taxes.

[a]If the payroll tax exclusion were also counted here, the total tax expenditure for employer contributions for health insurance premiums would be about 50 percent higher or $177.6 billion.

[b]This is the revenue loss and does not include associated outlays of $14.6 billion.

The multiple tax preferences for education assistance illustrate the consequences of the proliferation of tax expenditures. In our July 2005 report[17] on postsecondary tax preferences, we found that hundreds of thousands of taxpayers do not appear to make optimal decisions when

[17]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).

selecting education-related tax preferences. One explanation of these taxpayers' choices may be the complexity of postsecondary tax preferences, which experts have commonly identified as difficult for tax filers to use. Also, many argue that complexity creates opportunities for tax evasion, through vehicles such as tax shelters. Simplification may reduce opportunities for taxpayers to avoid taxes through the creation of complex and abusive tax shelters.

Another area of the tax system that may deserve additional exploration, although not directly related to the tax gap, is whether the federal income-based tax system is sustainable and administrable in a global economy and how we should tax the income of U.S. multinational corporations that is earned outside of the United States.[18] Every year, U.S.-based multinational corporations transfer hundreds of billions of dollars of goods and services between their affiliates in the United States and their foreign subsidiaries.[19] Such transactions may be a part of normal business operations for corporations with foreign subsidiaries. However, it is generally recognized that given the variation in corporate tax rates across countries, an incentive exists for corporations with foreign subsidiaries to reduce their overall tax burden by maximizing the income they report in countries with low income tax rates, and minimizing the income they report in or repatriate to countries with high income tax rates. Various studies have suggested that U.S.-based multinational corporations appear to engage in transactions such as these that shift income from their affiliates in high-tax countries to subsidiaries in low-tax countries to take advantage of the differences in tax rates in foreign countries.[20]

The growth in multinational corporate transactions and structures has also introduced increasing complexity in administering the tax code. The loss of highly skilled technical employees at IRS who can examine compliance

[18]Although not necessarily a solution to the tax gap, given the challenges facing our income-based tax system, some have suggested moving more towards a consumption-based tax system. Our recent report on understanding the tax reform debate discusses a number of topics that tax experts have identified as those that should be considered when evaluating tax policy. See GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

[19]GAO, *International Taxation: Information on Federal Contractors with Foreign Subsidiaries*, GAO-04-293 (Washington, D.C.: Feb. 2, 2004).

[20]A survey of studies that examine income shifting by multinational corporations appears in Department of the Treasury, Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* (Washington, D.C.: December 2000), 197-213.

issues arising from globalization, such as transfer pricing, underscores the challenge that IRS faces in ensuring it has sufficient staff with adequate skills to address these complex issues.

Enhance Services to Taxpayers

Providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap. One method of improving compliance through service is to educate taxpayers about confusing or commonly misunderstood tax requirements.[21] 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.[22]

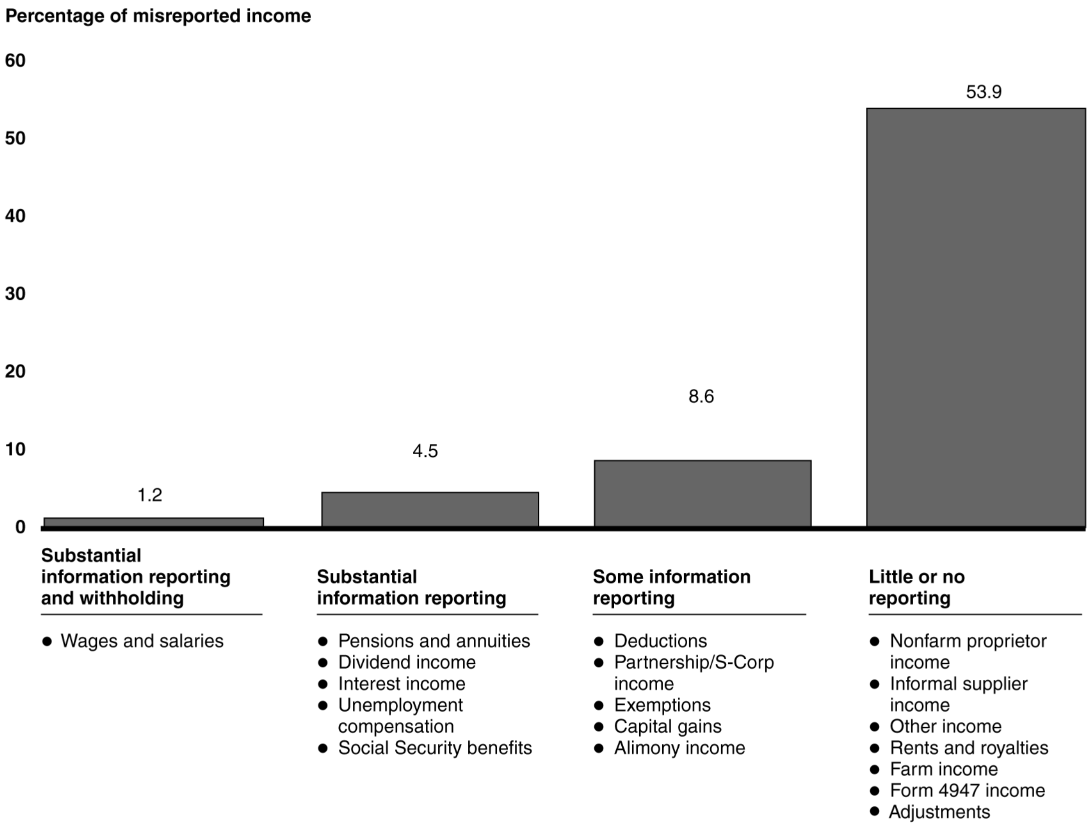
Enhance Enforcement Tools Available to IRS

In terms of enforcement, IRS will need to use multiple strategies and techniques to identify and deter noncompliance. As figure 5 shows, one pair of tools have been shown to lower levels of noncompliance—withholding tax from payments to taxpayers and having 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. Findings from NRP indicate that around 98.8 percent of these types of income are accurately reported on individual returns.

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

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

Figure 5: Individual Income Tax Underreporting Categorized by Amount Subject to Withholding and Information Reporting, 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:[23]

- **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

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

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.[24] IRS's Taxpayer Advocate Service recently recommended allowing independent contractors to enter into voluntary withholding agreements.[25]

- **Requiring information return reporting on payments made to corporations**. Unlike payments made to sole proprietors, payments made to corporations for services are generally not required to be reported on information returns. IRS and GAO have contended that the lack of such a requirement leads to lower levels of compliance for small corporations. Although Congress has required federal agencies to provide information returns on payments made to contractors since 1997,[26] payments made by others to corporations are generally not covered by information returns. The Taxpayer Advocate Service has recommended requiring information reporting on payments made to corporations,[27] and the Administration, in its fiscal year 2007 budget, has proposed requiring additional information reporting on certain goods and service payments by federal, state, and local governments.[28]

- **Requiring 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. The Taxpayer Advocate Service has

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

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

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

[27]*National Taxpayer Advocate 2005 Annual Report to Congress.*

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

recommended requiring financial institutions to track cost basis information and report it to IRS and taxpayers.[29]

Although withholding and information reporting 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. Opportunities to expand information reporting and tax withholding could be especially relevant toward improving compliance in areas that are particularly complex or challenging to administer, such as with net income and losses passed through from “flow-through” entities such as S corporations and partnerships to their shareholders and partners.[30]

Another enforcement tool that can potentially deter noncompliance 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.[31] 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.

Leverage Technology

Leveraging technology to improve IRS’s capacity to receive, process, and utilize taxpayer returns could help IRS better determine how to allocate its

[29] *National Taxpayer Advocate 2005 Annual Report to Congress.*

[30] 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.

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

resources to reduce the tax gap and would seem to be a prudent investment. IRS has invested heavily in modernizing its technology and those investments have paid off. Telephone service has improved and taxpayers are much more likely to get through to IRS and obtain assistance from IRS than before IRS upgraded its technology. Further, electronic filing has grown substantially. Tax information submitted to IRS electronically enables faster, more accurate processing and quicker interactions between IRS and taxpayers. Electronically filed returns are processed as they are received, therefore giving IRS access to more timely and accurate tax information, which can be used for better data analysis capability and quicker focus on issues that need resolution. IRS estimates it saves $2.15 on every individual tax return that is processed electronically. According to IRS data, electronic filing has allowed IRS to use more than a 1,000 fewer staff years to process paper returns, resources that can then be dedicated to other service or enforcement work.[32]

However, IRS's Business Systems Modernization project, through which the agency is modernizing its outdated technology, is far from complete. IRS needs to continue to strengthen management of this effort and make prudent technology investments to maximize the efficiencies that can be gained in IRS operations and services to taxpayers.

Optimize Resource Allocation

Sound resource allocation is another tool for addressing the tax gap. The more effectively IRS can allocate its resources, the more progress should result. The new NRP data, for example, are to be used to better identify which tax returns to examine so that fewer compliant taxpayers are burdened by unnecessary audits and IRS can increase the amount of noncompliance that is addressed through its enforcement activities. As part of its attempt to make the best use of its enforcement resources, given budget constraints, IRS has developed rough measures of return on investment in terms of tax revenue that is directly assessed from uncovering noncompliance. Developing such measures is difficult because of incomplete information on all the costs and all the tax revenue ultimately collected from specific enforcement efforts, as well as on the indirect tax revenues generated when current enforcement actions prompt voluntary compliance improvements in the future. Continuing to develop

[32]Some state and federal tax experts have recognized that mandatory electronic filing for certain categories of tax practitioners is one remaining option with the potential to significantly increase electronic filing. However, mandatory electronic filing would likely impose some costs and burdens on tax practitioners.

the return on investment measures could help officials make more informed decisions about allocating resources, particularly during periods of budget constraints. Even with better data, however, officials will need to make judgments that take into account intangibles, such as how to achieve an equitable enforcement presence across the various taxpayer groups.

Concluding Observations

Our nation's fiscal imbalance and challenges have created an imprudent and unsustainable path that needs to be addressed. While our long-term fiscal imbalance is too large to be corrected by one strategy, reducing the tax gap can help address the looming fiscal challenges. Collecting the billions of dollars that already should be paid, for example, would help ease the many difficult decisions that need to be made about our spending programs as well as the rest of the tax system. However, the tax gap itself has been large and pervasive over the years and therefore, reducing the gap will not only require expansions of current efforts, but also new and innovative solutions. While IRS takes the lead in continuing to find ways to significantly reduce the tax gap, support from Congress will be essential since legislation will likely be needed to implement many of the tax gap reduction ideas offered today. We look forward to continuing to work with Congress and IRS on these issues.

Chairman Gregg, Senator Conrad and members of the committee, this concludes my testimony. I would be happy to answer any questions you may have at this time.

Contact and Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. 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 Tom Short, Assistant Director; Jeff Arkin; Elizabeth Fan; and Cheryl Peterson.

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