United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
9:30 a.m. EDT
Thursday
April 19, 1990

IRS Can Use Tax Gap Data to Improve Its Programs for Reducing Noncompliance

Statement of
Paul L. Posner, Associate Director
Tax Policy and Administration Issues

Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

O483C / 141156

GAO/T-GGD-90-32

IRS CAN USE TAX GAP DATA TO IMPROVE ITS PROGRAMS FOR REDUCING NONCOMPLIANCE

SUMMARY OF STATEMENT BY
PAUL L. POSNER
ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

The Internal Revenue Service's (IRS) most recent estimate of the gross tax gap--the difference between the amount of income tax that taxpayers owe and the amount they voluntarily pay for a year--depicts the tax gap as large and growing. IRS estimated the gross tax gap to be $84.9 billion for 1987 and projected that it will reach $113.7 billion by 1992. Reducing this gap is important given its potential impacts on public confidence in the voluntary tax system and on the budget deficit, but the questions are how and with what resources.

Knowing more about the specific nature of noncompliance and the impact of current IRS programs in resolving noncompliance could help IRS better target its resources to close the gap. Accordingly, the Subcommittee asked us to analyze four major components of the tax gap: (1) sole proprietors or self-employed individuals; (2) informal suppliers, such as street vendors, who operate on a cash basis; (3) small corporations with assets under $10 million; and (4) large corporations with assets of $10 million or more. These components comprised over half of the $84.9 billion tax gap in 1987.

Our study suggests that IRS could do more to evaluate and target its programs to these major areas of noncompliance. Current programs have limitations in addressing the tax gap, including a declining rate of audit coverage and the exclusion of payments made to corporations in the Information Returns Program. Although improvements in IRS' programs are important, a cost effective strategy to reduce the tax gap must go beyond IRS' resources by more fully engaging the resources of third parties, such as employers, tax practitioners and state governments, to help taxpayers achieve a higher level of compliance.

IRS needs to better track the effectiveness of its programs in reducing the tax gap in order to develop a comprehensive strategy. Although IRS is undertaking some new evaluation initiatives to assess compliance problems and revenues generated by its enforcement programs, IRS does not have sufficient data to either identify the issues most responsible for the most troublesome pockets of the tax gap or to track how well its programs reduce the tax gap. Linking the results of these programs with trends in major components of the tax gap would give the agency a new scorecard to evaluate its success and decide on the need for new initiatives and resources.

Mr. Chairman and Members of the Subcommittee:

We are pleased to testify on our work for you on the tax gap. As you know, IRS defines the gross tax gap as the difference between the amount of income tax that taxpayers owe and the amount they voluntarily pay for a calendar year. In 1988, IRS estimated the gross tax gap to be $84.9 billion for 1987 and projected that it would reach $113.7 billion by 1992. In this testimony, I will discuss more specifically the tax gap's size, our analysis of IRS' data on the tax gap, and IRS programs for reducing the tax gap, along with ideas for improving them.

Reducing the tax gap is an important challenge, given its potential negative effects on public confidence in the voluntary tax system and on the budget deficit. In its 1988 tax gap report, IRS noted that its enforcement programs annually bring in about $20 billion, which includes tax liabilities from past years. Clearly, more could be done to reduce the tax gap; but, the questions are how and with what resources.

Knowing the specific nature and causes of noncompliance could help IRS to better target its enforcement resources to reduce the gap. However, the tax gap estimate is aggregated by broad categories of taxpayers and does not provide sufficiently detailed information on who and what caused the noncompliance. As a result, IRS cannot evaluate how well its enforcement programs are reducing specific parts of the gap.

To gain insight into its nature and causes, you asked us to analyze major components of IRS' gross tax gap estimate for 1987.[1] Our work illustrates that IRS could further analyze the tax gap data to gain valuable insights on the types of noncompliant taxpayers and issues of noncompliance. Such insights could help IRS evaluate its ability to reduce pockets of the tax gap and identify other promising ways to use its enforcement resources.

THE TAX GAP IS LARGE AND GROWING

IRS' estimate depicts the gross tax gap as large and growing. In 1988, IRS reported that the tax gap was $84.9 billion for 1987 and projected that it will grow to $113.7 billion by 1992.

Individual and business taxpayers who do not voluntarily report taxes owed contribute to the tax gap. In 1987, according to IRS, they reported 83 percent of their tax liabilities. Because this rate has been fairly constant since 1973, IRS largely attributed the tax gap's growth to inflation and economic expansion, both of which raise income. IRS explained that higher income usually means more taxes owed, which means more unpaid taxes and a larger gross tax gap, even assuming a constant level of compliance.

---

[1] Tax Administration: Profiles of Major Components of the Tax Gap (GAO/GGD-90-53BR, Apr.4, 1990).

Since 1979, IRS has estimated the gross tax gap three times. For the most part, IRS has based the estimates on the additional tax assessments that examiners recommended from their review of tax returns. The recommended assessments largely came from detailed examinations that IRS annually completes on some large corporations and that IRS periodically does on individuals and businesses under its Taxpayer Compliance Measurement Program (TCMP). TCMP measures compliance across random samples of various tax returns, such as those for individuals and small corporations. IRS views the amount of additional recommended tax as a measure of noncompliance when compared to the tax that was voluntarily paid.[2]

ANALYSIS OF THE TAX GAP'S MAJOR COMPONENTS YIELDS INSIGHTS ON THE NATURE OF NONCOMPLIANCE

In its gross tax gap estimate, IRS aggregated the amount of noncompliance for over 20 types of components. At your request, we analyzed four major components: (1) sole proprietors, or self-employed workers who report business income and deductions on a Schedule C of their tax return; (2) informal suppliers, or self-employed workers--such as street vendors or "moonlighters"--who operate on a cash basis; (3) small corporations, or those with

[2] IRS is now questioning whether recommended assessments that are lost through appeals and other ways should continue to be part of the gross tax gap.

assets under $10 million; and (4) large corporations, or those with assets of $10 million or more. These components accounted for over half of the $84.9 billion tax gap in 1987.

For each component, we sought detailed information on the types of taxpayers and noncompliance that caused the tax gap, IRS programs to pursue this noncompliance, and ways IRS could better pursue it. Because IRS' tax gap report did not contain this information, we used a wide variety of IRS sources to get the best and most recent data on noncompliance and enforcement. The accuracy of the data depends on IRS' underlying examinations, analyses, and research, which we did not attempt to evaluate. Our analysis of these data led to the following insights on the four components.

-- Sole proprietors accounted for $16.6 billion, or about 20 percent, of the 1987 gross tax gap. IRS' examinations showed that they underpaid 23 percent of their tax liabilities, reflecting both unreported income and overstated deductions. Of the eight types of sole proprietors, those who underpaid the most taxes were service providers, producers of goods, and sellers of goods at fixed locations.[3]

---

[3]IRS listed over 50 types of service providers (e.g., lawyers, accountants, doctors); almost 40 types of producers (e.g., construction, manufacturing, mining); and almost 50 types of fixed-location sellers (e.g., car dealers, grocers, jewelers).

-- Informal suppliers who did not report income accounted for $7.7 billion, or about 9 percent, of the tax gap. Because they operate in cash, their income is often neither documented nor subjected to third-party controls. Of 16 types of informal suppliers, those who accounted for the most noncompliance, according to a study done for IRS, were those who made home repairs, provided child care, or sold food at roadside stands.

-- Small corporations accounted for $5.2 billion, or about 6 percent, of the tax gap. Their noncompliance was about equally divided between unreported income and overstated deductions, such as for depreciation and repairs. Compliance ranged from 50 percent for those with $50,000 or less in assets to 90 percent for those with $5-10 million. Of nine types of small corporations, those in services and retail sales had the lowest compliance rates.

-- Large corporations accounted for $15.8 billion, or about 19 percent, of the tax gap. IRS attributed their noncompliance largely to improper accounting for reported income and deductions. For example, they misallocated income among foreign and domestic subsidiaries and misstated periods for depreciating or expensing assets. Of 27 types of industries, those with the most noncompliance were concentrated in petroleum or banking, based on IRS' 1988 examination results.

Research by IRS and others offers some reasons for noncompliance in the four components. First, noncompliance often occurs due to uncertainty about tax laws and a desire to increase profits. For example, noncompliance by sole proprietors and small corporations often resulted from confusion over their tax liabilities or from efforts to increase their profits by reducing tax liabilities. For large corporations, complex tax laws contributed to noncompliance, such as determining what expenses can be deducted under the research credit. Second, studies show that noncompliance is more prevalent and difficult to pursue when taxes are not withheld and information returns are not submitted. IRS' studies show that taxpayers report almost all wages and salaries, which are withheld, and interest and dividends, which are subject to information reporting. But, they report only 13 percent of informal supplier income, which is unlikely to be withheld or subject to information reporting.

ENHANCING IRS' APPROACH TO REDUCING THE TAX GAP

IRS generally does not design its major enforcement programs to specifically pursue components of the tax gap. With some limited exceptions, these programs address noncompliance in a general way by focusing on the types of tax returns rather than the type of noncompliance. As a result, these programs cannot be easily aligned with the tax gap components. Although IRS generally believes its programs are effective, the programs have limitations in reducing the tax gap.

For example, due to various reasons, IRS' rate for examining returns has steadily dropped to about 1 percent for individuals and under 2 percent for all corporations. However, because IRS has recently focused its examinations on cases with higher potential for generating tax revenue, IRS reports that its revenue yield has increased. For those returns that are examined, IRS officials have expressed concerns about whether examiners identify all noncompliance and recommend assessments that can withstand appeal. In 1989, IRS' Research Division estimated that individuals appeal about 63 percent of the amount of recommended assessments while large corporations appeal about 81 percent. It also estimated that IRS loses about 70 percent of the amount of recommended assessments that individuals and corporations appeal. Further, IRS estimates that income tax examinations only uncover about one-third of the unreported income due to inadequate documentation on what taxpayers earned.

IRS' document-matching program helps to disclose unreported income; it generated over $1.8 billion in recommended taxes and penalties in 1988. However, IRS cannot match all information returns to tax returns when information returns have erroneous information about who received the income. Nor does IRS have the resources to investigate all indications of unreported income that emerge from the matching. Further, IRS has not expanded the program to include payments to all types of businesses, such as corporations.

IRS recognizes these limits and has some initiatives to improve enforcement. For example, IRS has a special examination program to probe for unreported income by sole proprietors. IRS also has created a cross-index file to enable it to match information returns that had inadequate information on the identity of a sole proprietor.

The limitations in IRS' current approach and the size of the tax gap have prompted outside observers as well as IRS officials to offer ideas to improve IRS' enforcement. In 1989, for example, we recommended using information returns to identify employers who misclassify employees as independent contractors. Misclassification lowers federal revenues because taxes are not withheld and independent contractors usually are less compliant.[4] We also recommended that IRS develop a business document matching program to, among other things, identify corporations which have not reported income or filed tax returns.[5] IRS is studying the feasibility of implementing both recommendations. To capture taxes owed by informal suppliers, an IRS Assistant Commissioner

[4]Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 1989).

[5]The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, Mar. 17, 1987).

suggested that state and local authorities verify that vendors and others seeking business licenses filed their federal tax returns.

While we have not evaluated all of the IRS initiatives and the proposals made, we believe that they warrant consideration and demonstrate the value of looking beyond IRS for both ideas and resources. However, given a limited budget, IRS needs to decide which ones would most cost-effectively reduce the tax gap. Further, we know from our past work that simply increasing enforcement resources will not lower the tax gap very quickly. In 1988, we reported that an attempt to hire more examiners did not produce revenues within the timeframes that Congress envisioned. IRS could not quickly hire the allotted number of examiners and then easily train and absorb them to do examinations without lowering the productivity of experienced revenue agents.[6] In essence, our work showed that not only does IRS need better information on resources and examination results, but that increasing IRS resources cannot be the sole response to quickly reverse a growing tax gap.

Instead, we believe a multi-faceted approach is needed to attack the many dimensions of noncompliance. Through this approach, IRS would build on its partnership with third parties to enhance its

---

[6]Tax Administration: Difficulties in Accurately Estimating Tax Examination Yield, GAO/GGD-88-119, August 1988.

overall enforcement effort. Employers can help by withholding income taxes and depositing the taxes in a timely manner. They also can help by properly classifying workers as employees instead of as independent contractors. Business and government entities can help by submitting information returns to report required payments, which enables IRS to match them with tax returns to identify unreported income. Correctly reporting such payments reduces the cost of these matches. Representatives of taxpayers and tax practitioners can help by encouraging and assisting taxpayers to comply when they file their tax returns.

Even with such help, we believe that IRS cannot solely rely on enforcement to capture all noncompliance. Taxpayer assistance and education play important roles in encouraging compliance. IRS must continue, with the help of third parties, to assist taxpayers. IRS has been offering more workshops for small businesses and testing innovative ways to help small businesses to comply. IRS also must continue to educate taxpayers--including compliant ones--about their compliance responsibilities and enlist their support in improving compliance.

The success of any changes in IRS' enforcement will rest on the support of taxpayers and third parties. We recognize that changes may generate concerns. A program's start-up costs may exceed benefits in the short-term. New administrative or paperwork burdens may be opposed by IRS and others. Taxpayers' support may diminish when better enforcement, such as expanded information reporting, increases paperwork burdens along with the prices of goods and services from businesses and informal suppliers. Even so, we believe that the concerns can be addressed to minimize any burdens and that a lower tax gap is worth some additional costs and risks.

IRS CAN ANALYZE ITS TAX GAP DATA TO BETTER TARGET ENFORCEMENT RESOURCES

The study we did for you suggests that IRS could further analyze its tax gap data to more specifically pinpoint the types of taxpayers and noncompliance giving rise to the tax gap. Knowing more about noncompliance could allow IRS to target enforcement resources on troublesome pockets of the tax gap that can be cost-effectively pursued.

We believe that such knowledge also could provide IRS with a better basis to evaluate the effectiveness of its enforcement programs, as well as proposals that offer promise for reducing the tax gap. Although IRS estimates the total revenues produced by its enforcement programs, it does not have sufficient data to track the issues most responsible for the tax gap and whether these programs reduce noncompliance among taxpayers. As a result, IRS cannot link the enforcement programs' results to the tax gap components for any specific tax year.

For example, with the exception of TCMP, IRS does not track the issues of noncompliance raised through its examinations. Without such tracking, it is difficult for IRS to evaluate whether its examinations successfully deal with the major issues causing the tax gap for such components as large corporations or sole proprietorships. The lack of a system to track issues, as well as the recommended assessments, from examinations through appeals and ultimately to collection also has complicated IRS' efforts to better understand problems with its current programs, such as why it loses an estimated 70 percent of appealed assessments.

IRS recognizes that it needs to know more about noncompliance and its enforcement results. For example, to detect noncompliance early, IRS now has teams of employees who are reviewing random samples of tax returns at all service centers. IRS' goal is to identify trends in noncompliance as returns are filed rather than wait 3 years or more for the results of examinations or special studies. IRS believes that this effort eventually will highlight issues that need immediate attention.

Regarding the need for more information about enforcement results, IRS published a report in 1989 on its study of various problems and ongoing improvements in estimating enforcement revenue. For example, IRS is using more recent data and is revising assumptions on how much recommended tax gets assessed and collected. The report also outlined future improvements such as (1) compiling actual revenue by type of tax and year of the tax liability and (2) developing a system to capture the flow of enforcement revenue across functions, such as the Examination and Collection Divisions.

Further, IRS is studying cases that are appealed and litigated to learn more about noncompliance and enforcement results. According to IRS, this study will identify why it loses recommended assessments, such as the types of noncompliance that cause the most problems, and provide information on enforcement results by computing the amount of taxes lost. In turn, this information could enhance IRS' evaluations of its programs and allocations of its resources in deciding how to reduce the gap.

\- - - - -

In conclusion, we believe that IRS' estimate of the gross tax gap can be a good starting point for better tailoring enforcement programs to reduce the gap. The tax gap's size and growth suggest that IRS needs to do more to evaluate and target its programs based on the major areas of noncompliance. More in-depth analyses of noncompliance by tax gap component could create a more systematic basis for targeting enforcement resources. Regularly evaluating enforcement programs' success in reducing the tax gap could show whether IRS should redirect resources to other programs or initiatives.

Overall, we support IRS' efforts to improve its enforcement programs and its information on noncompliance. We believe these initiatives have been needed for a long time, and we encourage IRS to complete them. Striving for improvement is crucial given a growing tax gap, a voluntary tax system, and a serious budget deficit.

That ends my prepared statement. I would be happy to answer any questions.