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U.S. Government Accountability Office
Joint Committee on Taxation

Highlights of the Joint Forum on Tax Compliance:

Options for Improvement and Their Budgetary Potential

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Highlights

Highlights of GAO-08-703SP, a CBO, GAO and JCT forum

HIGHLIGHTS OF A JOINT FORUM ON TAX COMPLIANCE

Options for Improvement and Their Budgetary Potential

Why CBO, GAO and JCT Convened This Forum

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

The Congressional Budget Office (CBO), GAO, and the Joint Committee on Taxation (JCT) convened this forum on September 6, 2007, to discuss tax compliance and the options to close the tax gap. Participants were a select group of individuals drawn from the federal tax policy community and state revenue offices. This forum was designed for the participants to discuss these issues openly and without individual attribution in order to facilitate a rich and substantive discussion. Therefore, comments expressed do not necessarily represent the views of any one participant or the organizations that these participants represent, including CBO, GAO and JCT.

To view the full product, including the scope and methodology, click on GAO-08-703SP. For more information, contact CBO, Thomas Woodward at (202) 226-2687 or TomW@cbo.gov; GAO, Michael Brostek at (202)512-9110 or brostekm@gao.gov; JCT, Edward D. Kleinbard at (202) 225-3621 or Edward.Kleinbard@mail.house.gov.

What Participants Said

Forum participants discussed numerous areas relating to the tax gap and gave suggestions for what types of approaches and actions might be effective in bridging the tax gap. Specifically the forum focused on the extent of noncompliance and the accuracy of the tax gap estimates; the extent to which enforcement actions, taxpayers service and tax code simplification might increase the compliance rate; and the most important initiatives the Congress and IRS could take to help close the tax gap.

As might be expected in a forum of this nature, the discussions included a mix of ideas that had been previously raised and newer ideas for helping IRS close the tax gap. The following are highlights which stood out from these discussions:

- Although valuable, tax gap estimates have limitations and serious efforts to reduce the tax gap should not be delayed while waiting for more precise estimates
- The IRS enforcement strategy should focus on large entities regardless of the type – S-corporations, C-corporations, partnerships or large sole proprietorships.
- IRS workforce challenges may have affected the quality of IRS's audits.
- Improvements to compliance may come from partnering with the states to share more data.
- Little data exist to show that taxpayer services increase voluntary compliance with the tax laws.
- Many Americans are not directly affected by tax code complexity because they are insulated from such complexity, at least somewhat, by either paid preparers or through the use of tax preparation software.

Participants also discussed the most important initiatives to undertake to reduce the tax gap. Some participants suggested increasing information reporting by enacting a proposal in the 2008 and 2009 President's budget that requires information reporting on merchant payment card reimbursements. Other participants recognized pilot compliance programs at the state level that have been effective in reducing noncompliance. For example, one state sent letters to taxpayers who were suspected in engaging in unlawful activities and offered the taxpayers a way to avoid penalties by filing amended returns and paying the taxes due. In most cases, taxpayers filed amended returns thus reducing the state's caseload. Furthermore the state was able to increase its revenue collected by $1.4 billion. Finally, participants also noted that providing incentives to improve compliance and extending or eliminating the statute of limitations on enforcement actions would help IRS improve compliance.

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Introduction

On September 6, 2007, the Congressional Budget Office (CBO), the U.S. Government Accountability Office (GAO), and the Joint Committee on Taxation (JCT) convened the Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential. This report summarizes the forum discussion as well as subsequent comments received from the participants based on a draft of this report.

The forum was intended to expand the dialogue on increasing voluntary tax compliance and reducing the tax gap. In particular, the forum sought to identify possible approaches and strategies that could enhance understanding of the tax gap and options available to the Congress and the Internal Revenue Service (IRS) for reducing it. The forum focused on (1) the extent of noncompliance and the accuracy of tax gap estimates; (2) the extent to which enforcement actions, taxpayer service, and tax code simplification might increase the compliance rate; and (3) the most important initiatives the Congress and IRS could take to help close the tax gap.

We thank all of the participants for the generous contribution of their time and the constructive exchange of views and ideas during the Forum. The participants were a select group of individuals drawn from the federal tax policy and administration community and state revenue offices. They discussed numerous tax gap issues and suggested approaches and actions that might be effective in reducing the tax gap. This forum was designed for the participants to discuss these issues openly and without attribution in order to facilitate a rich and substantive discussion. Therefore, the report does not necessarily represent the views of any one participant or the organizations they represent, including CBO, GAO, and JCT. Appendix I provides a list of the participants. Appendix II provides the Tax Gap Map for 2001 and the 2001 individual income tax underreporting gap estimates and net misreporting percentage. This report also includes a bibliography that lists products issued on the tax gap and tax compliance. This report is available at no charge on GAO's Web site at http://www.gao.gov.

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Tax Compliance: Highlights of Forum Discussion

On September 6, 2007, the Congressional Budget Office (CBO), the U.S. Government Accountability Office (GAO), and the Joint Committee on Taxation (JCT) hosted a forum to discuss tax compliance and options to close the tax gap. The participants discussed the accuracy of the Internal Revenue Service's (IRS) current tax gap estimates, the effect of enforcement, taxpayer service, and tax code simplification on compliance, and the most important initiatives for closing the tax gap.

Background

The tax gap is an estimate of the difference between the taxes—including individual income, corporate income, employment, estate, and excise taxes—that should have been paid voluntarily and on time and what was actually paid for a specific year. IRS estimated the tax gap on multiple occasions between 1979 and 1988, relying on its Taxpayer Compliance Measurement Program (TCMP). IRS did not implement any TCMP studies after 1988 because of concerns about costs and burdens on taxpayers.

Recognizing the need for more current compliance data, IRS implemented a new compliance study called the National Research Program (NRP) to produce such data for individual taxpayers for tax year 2001 while minimizing taxpayer burden. The 2001 estimate revealed that taxpayers paid about 84 percent of the taxes that should have been paid on time under the law, resulting in an estimated gross tax gap of $345 billion. IRS estimated that it would eventually recover around $55 billion of the 2001 tax gap through late payments and IRS enforcement actions, leaving a net tax gap of $290 billion.[1]

The tax gap 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, or the failure to file a required tax return altogether or on time.[2] IRS's tax gap estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers. As shown in table 1, underreporting of tax liabilities accounted for most of the tax gap estimate for tax year 2001. IRS recognizes that the tax gap estimate is uncertain, in part, because some areas of the estimate rely on old data, IRS

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

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

has no estimates for other areas of the tax gap, and it is inherently difficult to measure some types of noncompliance. The limitations of the estimates were discussed by the participants; more detailed information is available in the following section.

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

Dollars in billions

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

Source: IRS.

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

IRS used data from NRP to estimate individual income tax underreporting and the portion of employment tax underreporting attributed to self-employed individuals. The underpayment segment of the tax gap is not an estimate, but rather represents the actual tax amounts that taxpayers reported on time but did not pay on time.

Because of taxpayer noncompliance, the burden of funding the nation's commitments falls more heavily on taxpayers who willingly and accurately pay their taxes. Based on IRS's estimate, each 1 percent reduction in the net tax gap would yield nearly $3 billion annually. The tax gap has been a persistent problem in spite of efforts to reduce it, as the estimated rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades.[3] Globalization and the ever-increasing tax code complexity add to IRS's tax administration challenges.

[3]IRS's tax gap estimation methodology changed over time, so estimates from different years are not entirely comparable.

Tax Gap Estimates Are Useful but Have Limitations and Are Likely Understated

Although valuable, tax gap estimates have limitations and serious efforts to reduce the tax gap should not be delayed while waiting for more precise estimates.

The participants generally agreed that although the tax gap estimates are valuable, they have limitations and are likely understated. The participants recognized that the current estimates provide IRS with useful information for evaluating options to reduce the tax gap. Some participants said the gap remains unacceptably large and serious efforts to reduce the tax gap should not be delayed while waiting for more precise estimates.

The participants cited several reasons why the current estimates are limited or understated, but other reasons may exist. Tax gap estimates do not include all areas of the economy, such as illegal activity. Illegal activity is not part of the tax gap for two main reasons. Philosophically, it is excluded because some believe the government should be trying to stop illegal activity not tax it, and therefore it should not be considered part of taxable activities. Furthermore, it is not practical for IRS to try to measure illegal activity. The underground economy is different from illegal activity in that income from the underground economy may not be reported to IRS but was gained in legal transactions—this is otherwise known as the cash economy.

The age of the data underlying some components of the tax gap estimate is a weakness. The participants noted that the tax gap estimates for corporations and partnerships are especially weak because compliance behavior may have changed markedly since the 1980s—the last time IRS collected data on corporations or partnerships. The participants also noted that changes in the global economy have affected the business environment over the past few decades, specifically with regard to business categorization and the very large amounts of money exchanged among related business entities. For example, since 1985, S-corporation[4] return filings have increased dramatically. In that year, over 700,000 Forms 1120S (U.S. Income Tax Return for an S-Corporation) were filed. In 2004, that number had grown by nearly five times to over 3.6 million, while other corporate returns declined by approximately 500,000 for the same period. According to a participant, S-corporations generate huge sums of money but have not been getting a proportionate amount of audit attention. IRS has recognized the need to update these data and is completing a study of S-corporations. IRS plans to have the study results available by the end of 2008.

[4]Generally, S-corporations are not subject to federal income tax other than tax on certain capital gains and passive income. Instead, an S-corporation's shareholders are taxed on their portion of the corporation's taxable income, regardless of whether they receive a cash distribution.

The participants also emphasized that tax gap estimates for individuals are based on examiners' reviews of a sample of tax returns, so errors may be introduced when calculating the tax gap. Tax returns selected for an in-person audit are assigned to an examiner who is trained to look for underreporting of income. Since the examiner is human, errors are inevitably introduced. Because IRS knew that not all examiners would be equally able to detect all underreporting noncompliance, it multiplied the detected amounts of underreporting to reflect what the "best examiners" likely would have found. This was intended to yield a more accurate total estimate for underreported individual income tax. However, some participants noted that the multipliers IRS used have their own likely inaccuracy, thus the tax gap estimates are best interpreted as broad indications of the amount of noncompliance with fairly large confidence intervals around those estimates. Also, some participants noted that although agents are trained throughout their careers to detect noncompliance, they may not be equally attentive to errors in the taxpayers' favor. However, others thought taxpayers' self-interest in minimizing the tax they pay somewhat offsets this possible measurement bias.

Tax Gap Reductions Are More Likely to Come from Strengthening Enforcement Than Improving Taxpayer Service or Simplifying the Tax Code

The forum participants also discussed actions that the Congress or IRS could take to improve taxpayer compliance via enhanced enforcement activities, increased taxpayer services, and tax code simplification. The participants also discussed long-term plans for identifying areas where progress can be made in reducing the tax gap.

Enforcement May Yield the Greatest Impact but Is Not Going to Close the Tax Gap

The participants generally agreed that heightened enforcement of tax laws is the best way to bring about improvements in the tax gap but noted that increasing audits is not the only way to address the tax gap. The participants generally agreed that the following enforcement strategies may help IRS increase the amount of tax collected.

- **Increase the number of audits performed per year.** The participants agreed that a gradual increase in auditing over time will lower the tax gap and that audits have a direct effect on reducing the level of noncompliance. However, a participant stated that "even by doubling the number of audits, the IRS will not be able to audit itself out of the tax gap." The participant noted that compliance efforts have a ripple effect on future compliance, both for the individual taxpayer who was the subject of the enforcement as well as others who become aware of his or her experience. One participant thought that this ripple effect may have a larger impact on compliance than the actual audits. Furthermore, the participant said that the rate of return on audit expenditures is from 3:1 to 5:1. Similarly, an IRS official previously testified that based on over 10 years of data, IRS receives a 4:1 return on investment, not counting indirect compliance effects on taxpayers.

The IRS enforcement strategy should focus on large entities regardless of the type—S-corporations, C-corporations, partnerships or large sole proprietorships—as these entities can control large amounts of money. Noncompliance among these entities can be found in individual and corporate segments of the tax gap.

- **Focus audits where noncompliance is the greatest.** Some participants thought that IRS needs to conduct more audits where the risk of noncompliance is the greatest. Using the discriminate function (DIF)[5] scores, which are derived from tax gap data, IRS should be able to focus the selection process for audits on higher-return-on-investment cases. The participants also suggested focusing more audit resources on the business income tax area regardless of the type—S-corporations, C-corporations, partnerships or sole proprietorships. As mentioned above, they noted that very large amounts of money are controlled by some businesses and flow among some of the large businesses and related entities. To effectively audit these large organizations, some participants thought that IRS needs new methods. For example, one participant suggested that to address the corporate income tax gap more efficiently, IRS could supplement companies' tax return data with publicly available financial statements. Another participant suggested that IRS study the individual taxpayers' relationships with their businesses, for example, matching revenue from an individual return with revenue reported on an S-corporation return. According to the participant, both individuals and business entities have developed into complex webs of relationships with other entities and use these relationships to minimize their taxes both legally and illegally. To truly understand the accuracy of an individual or entity's tax return requires analyzing these interrelationships.

[5]Some returns are selected for examination on the basis of computer scoring. Computer programs give each return numeric "scores." The DIF score rates the potential for change, based on IRS experience with similar returns.

IRS workforce challenges may affect the quality of IRS's audits.

- **Improve the quality of audits.** One participant observed that the quality of audits varies significantly. This may be attributed to changes in IRS's workforce. According to one IRS executive, a significant number of employees have less than 3 years of experience and historically examiners needed 3 years of experience in order to work on the more complicated corporate returns. According to a participant, improving examiner training may help to improve the quality of audits. Furthermore, ensuring that examiners are given audits with complexity commensurate with their training will help to ensure more consistent, high-quality audits.

Improvements to compliance may come from partnering with the states to share more data.

- **Increase data sharing and partnering with the states.** Exchanging information between the states and IRS could be an effective tool for reducing the tax gap. According to one participant, the data sharing between California and IRS allows California's Franchise Tax Board to collect an additional $300 million to $500 million in taxes per year. A state official noted that state-level audit information could be better shared by the states and IRS. For example, Minnesota's Department of Revenue has a program that allows the department to notify the state licensing authority to stop license issuance or renewal or to revoke a license at any time if, among other things, the business or person owes at least $500 in tax, penalty, interest, or debt to another agency. IRS could make use of information about these actions by the state because they may indicate a problem with the taxpayer's federal tax return. One impediment to efficient data sharing between the states and IRS is the pledges made to taxpayers that their electronic returns would not be used any differently than returns filed on paper. A fairness issue is raised if information about electronic filers, which is easily transferred, is shared between states and IRS but paper filers' information is not.

While agreeing that enhanced enforcement is important, the participants also cited several reasons why enforcement should not be the only method of addressing the tax gap. For example, the participants noted that low-dollar noncompliance can be expensive to address. Although a small portion of taxpayers owe large amounts because of noncompliance, much of the tax gap is made up of small amounts of noncompliance by large numbers of taxpayers.[6] When this latter type of noncompliance can only be addressed on a case-by-case basis it becomes very expensive for IRS to pursue. As one participant observed, IRS knows that about half of all

[6]For example, GAO reported (GAO-07-1014) that small proportions of sole proprietors, but still a significant number, have relatively large amounts of unpaid taxes.

returns have some mistake on the return, some in the taxpayers' favor and some in the government's favor. Errors tend to be distributed such that there are many small errors, but the errors that yield the largest dollar amounts often are fewer in number (falling in one "tail" of the distribution). Furthermore, another participant questioned whether the complexity of the tax code raises the noncompliance rate by providing "gray space"—where whether an action or transaction is noncompliant is open to interpretation—and making it more difficult to audit tax returns.

The participants also noted that IRS faces challenges in the corporate income tax area. They said that aggressive use of tax shelters and the complex nature of the corporate tax returns in general make it difficult for IRS to identify noncompliance, and that when IRS identifies noncompliance these factors create fertile ground for litigation over IRS's interpretation of the tax law. The participants also noted that it is hard to know what is economically recoverable from corporate taxes. The cost of pursuing litigation with corporations can be high and not all of the cases are won in part because of the complexity and differing interpretations of the law.

Better Taxpayer Services May Increase Compliance, but It Is Hard to Quantify the Effect

Little data exist to show that taxpayer services increase voluntary compliance with the tax laws.

The participants provided a range of opinions regarding the effectiveness of trying to improve taxpayer service as a means to improve compliance. Although the participants said they were unaware of any quantifiable estimates that measure the effect of taxpayer service on compliance, a number of participants noted it is still important to provide taxpayers the best possible tools to help them comply with the tax code.

Better taxpayer services may have different effects on different groups of taxpayers. According to one participant, two classes of people do not pay their taxes. One is made up of those taxpayers who intentionally evade paying taxes. According to participants, education and improved service are much less likely to improve tax compliance for this population because these taxpayers are trying to circumvent tax laws. The second group includes those taxpayers who do not understand the tax code but are trying to comply. The participants thought that improved taxpayer services may help this population comply with tax laws. For example, one component of this group includes the immigrant population, which may face cultural and language barriers. California publishes tax forms in five foreign languages to help these immigrant populations comply with tax laws. California is also conducting outreach to many immigrant populations who typically distrust the government and whose businesses deal mostly with cash. Minnesota has outreach units that work with banks and other community service organizations that work with immigrant populations, among others, in an effort to educate these groups about tax compliance. These taxpayer services and outreach efforts allow the taxpayers to better understand the tax laws and thereby comply with them. One participant noted that education and improved taxpayer services may decrease the amount some taxpayers pay if they had been previously overpaying their taxes.

Increased taxpayer services may not help increase compliance when paid tax preparers are involved. As a participant noted, paid tax preparers are "a mixed bag;" some help taxpayers avoid noncompliance, for example, by using their expertise to help ensure that complex laws are understood, but others add to noncompliance by either introducing their own mistakes or guiding taxpayers to underreport their tax liability. For example, a limited GAO investigation in 2006 found that for the 19 tax preparers GAO visited, all 19 made some mistake, with tax consequences that were sometimes significant.[7] During this investigation, several paid preparers gave the GAO undercover investigators incorrect information, such as that reporting cash income was the taxpayer's decision because IRS would not know of it unless the taxpayer reported it. Another preparer told the investigator that she did not have to report such income unless it was over $3,200. Other preparers overclaimed the Earned Income Tax Credit (EITC) by reporting an ineligible child, despite being told by the GAO investigator that the child did not live with her. Therefore, IRS cannot fully rely on paid tax preparers to increase compliance with the laws.

One participant noted that if additional requirements are established for tax preparers, the tax preparer community might take compliance issues more seriously and therefore increase compliance. One participant noted that practitioners should face consequences for not complying with the laws, even when the practitioners are erroneously applying the tax law. However, another participant asked, can the IRS encourage such "surrogate" tax administration? If IRS makes tax practitioners guilty of perjury if they falsify a tax return, would this increase compliance or lead to unanticipated undesirable reactions? Noncompliance on a prepared return may be the result of the taxpayer misinforming or lying to the preparer. In a circumstance like this, is it fair to ask the preparer to be an

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

agent of IRS and look for noncompliance, or penalize the preparer if he or she doesn't realize the taxpayer is trying to be noncompliant?

Many Americans Are Not Directly Affected by Tax Code Complexity

Since over 80 percent of Americans have help preparing their individual tax returns, either from paid preparers or through the use of tax preparation software, taxpayers are insulated, at least somewhat, from tax code complexity.

A participant noted that between paid tax return preparers and the use of software to self-prepare returns, over 80 percent of individual taxpayers have help in preparing their tax returns and therefore are insulated, at least somewhat, from tax code complexity. Software companies often act as surrogate tax administrators in that they keep abreast of tax law changes and tend to submit tax returns that have fewer math errors.

The participants said that another group whose compliance may not be affected much by simplifying the tax code is small business taxpayers. Small businesses contribute a large proportion of the tax gap because of underreporting of income. Since the requirement to report all income is fairly straightforward, tax code simplification may not do much to help decrease underreporting in this area. Further, a participant noted that all tax systems have noncompliance. For example, a retail sales tax could be simpler than the current income tax system, but states nevertheless must maintain robust programs to address compliance problems.

On the other hand, the participants recognized that some taxpayers may benefit from tax code simplification. For instance, low-income taxpayers face an array of complicated issues on their tax returns, such as claiming the EITC. Anecdotal evidence suggests that simplifying the tax laws can lead to an increase in compliance. For example, taxpayers may unintentionally claim the wrong amount of EITC because they do not understand the complex rules governing eligibility for claiming the credit. Both Congress and the administration have long been concerned with the complexity of the EITC qualifications, including the definition of a qualifying child. The administration's proposed fiscal year 2008 budget suggested legislative language to simplify eligibility requirements for the credit as well as to further clarify the uniform definition of a qualifying child. Making definitions consistent across code provisions may reduce taxpayer errors because dissimilar definitions may increase the likelihood of taxpayer errors and increase taxpayer frustration.

One participant also noted that because the tax code is used as a vehicle for so many policy initiatives and programs other than collecting revenue, simplifying the tax code may not be as easy as it sounds. For example, the purpose of the EITC is not to collect revenue but is to offset the burden of Social Security taxes and provide a work incentive for low-income taxpayers. Similar non-revenue-generating policy purposes exist for tax preferences in the tax code. The trade-off between tax administration and tax policy considerations is something the Congress must consider, and in some cases the tax system may be the preferred way to accomplish social policies even though the tax code is made more complex.

A Long-term Plan Should Guide Efforts at IRS to Develop a Strategic Approach to Addressing the Tax Gap

The participants noted that for many years IRS has implemented short range plans to address the tax gap, but many also agreed that IRS needs a long-term strategy for addressing the tax gap. They said that the strategy should focus audits on taxpayers who are noncompliant and, to the extent possible, on those who can pay the tax assessments. The plan will have to be implemented over a number of years, possibly as long as a decade, and will have to be properly funded. One participant noted that if IRS wants to approach the tax gap intelligently, officials should develop a 10-year plan focusing on four areas:

(1) Investing in technology (making better use of information resources, such as data matching or data mining).

(2) Increasing staffing.

(3) Increasing information reporting.

(4) Addressing emerging issues caused by the global economy.

Other participants noted that IRS should think primarily about deterring aggressive tax avoidance, designing a credible enforcement strategy to accompany its information technology modernization efforts, and obtaining additional resources over a period of time to reduce the tax gap. Since much of the debate on the tax gap is focused on the amount of tax IRS can collect, IRS should apply the resources it already has more effectively by focusing on initiatives with higher return on investment. However, as a participant noted, basing enforcement activities solely on return on investment is risky because some enforcement actions may have low returns on investment, such as many criminal prosecutions, but nevertheless be necessary both for fairness and to encourage voluntary compliance.

Some participants were concerned that the Congress is too focused on the 1-year budget cycles. The participants said that IRS does not seem to get the resources it needs unless there is a major budget crisis and the Congress sees the need to heighten enforcement to collect more taxes. They also generally agreed that IRS will need an increased budget over a number of years to execute a meaningful long-term plan. They also noted, however, that even a substantial budget increase for several years would not eliminate the tax gap. The problem, they said, is that a multiyear plan seems to run contrary to the usual legislative process, which is based on 1-year budgets. Some participants thought that a consensus needs to be reached on creating a program that will last for multiple years and that there needs to be leadership from the White House, the U.S. Department of the Treasury, IRS, and CBO.

Proposals May Make Progress in Closing the Tax Gap, but Improvements Will Be Incremental

The participants discussed the most important initiatives to undertake to reduce the tax gap. The participants generally agreed that new initiatives are needed to help IRS close the tax gap and discussed a variety of proposals, which are summarized below. Many of these proposals would require enacting legislation.

- **Increase information reporting.** Information reporting tends to lead to high levels of compliance because the income taxpayers earn is transparent both to taxpayers and to IRS. Individuals subject to substantial information reporting and withholding are 99 percent compliant, whereas self-employed individuals who are subject to little or no information reporting and withholding are 46 percent compliant.[8] Specific suggestions for increasing information reporting were as follows:
  - Enact the proposals in the 2008 and 2009 President's budgets to require information reporting on merchant payment card reimbursements and brokers to report the basis of security sales. One participant noted that the merchant payment proposal may not result in a large increase in direct enforcement revenue, but may have a large impact on voluntary compliance. Nevertheless, one participant had concerns about this proposal, saying that (1) the industry needs time to implement it, (2) it could be a big burden, (3) IRS is not prepared to use the data, and (4) IRS will not be able to use the resulting data to do information matching but will only be able to profile merchants for audit selection. Another participant did not think the proposal would be as large a burden as some were

[8]According to IRS data, for wages and salaries, which are subject to substantial information reporting and tax withholding, the percentage of income that taxpayers misreport has consistently been measured at around 1 percent over time. Further, those taxpayers who are subject to little or no information reporting misreport their income 54 percent of the time.

claiming, and noted that this proposal would provide a new source of data for IRS to use.
  - Leverage more data to identify capital gains income. For example, Form 1099 is not currently required for the sale of buildings. This is an area where states and the federal government could work together since counties have access to information on the value of the real estate when properties change hands.

- **Increase compliance through waivers of penalties and other techniques.** An example of a compliance program at the state level was California sending letters to taxpayers who were suspected of engaging in unlawful activities and offering the taxpayers a way to avoid penalties by filing amended returns and paying the taxes due. In most cases, taxpayers filed amended returns and thus reduced the state's caseload. Furthermore, California received $1.4 billion in revenue from the amnesty program after originally estimating it would bring in $90 million. In another example, California piloted a program with the intent of encouraging self-compliance by first educating taxpayers and then giving them an opportunity to correct any filing errors rather than undergo the more traditional audit. The state mailed self-compliance letters to taxpayers who claimed the car and truck expense. The letters explained the expense deduction rules and provided worksheets to calculate the amount to claim. About 80 percent of those letter recipients filed amended returns.

- **Provide incentives to improve compliance.** Some participants noted that giving taxpayers an incentive to comply may be an underused strategy. For example, one participant noted a Customs and Border Protection (CBP) program that fast-tracks goods into the country. CBP is to review companies' self-policing procedures and how effective they are. According to the participant, if a company is diligent in its self-policing, it has an opportunity to fast-track its goods into the country. If CBP finds a company's not diligent in self-policing, the company loses the opportunity to fast-track its goods into the country. IRS uses similar techniques in some cases, but some participants thought more could be done. For example, the Compliance Assurance Process, an IRS pilot program, has been used by about two dozen large corporations. Under this program, IRS works with large businesses to identify and resolve issues prior to the filing of a tax return. The objective of the program is to reduce taxpayer burden and uncertainty while assuring IRS of the accuracy of tax returns prior to filing, thereby reducing or eliminating the need for postfiling examinations.

- **Extending or eliminating the statute of limitations on enforcement actions.** Some participants said IRS is confined by time limitations in assessing taxes owed by a taxpayer who filed a return and thereafter (1) in collecting of the tax, (2) penalizing of the taxpayer, and (3) subsequently prosecuting the taxpayer if necessary. Extending or eliminating these time limitations may allow IRS to recover some additional taxes that it would currently be barred from pursuing but this could also raise fairness issues.

Appendix I: Forum Participants

Facilitators

Peter Orszag	Director Congressional Budget Office
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Thomas Barthold	Acting Chief of Staff[a] Joint Committee on Taxation

Participants

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[a]Title as of date of forum, September 6, 2007.

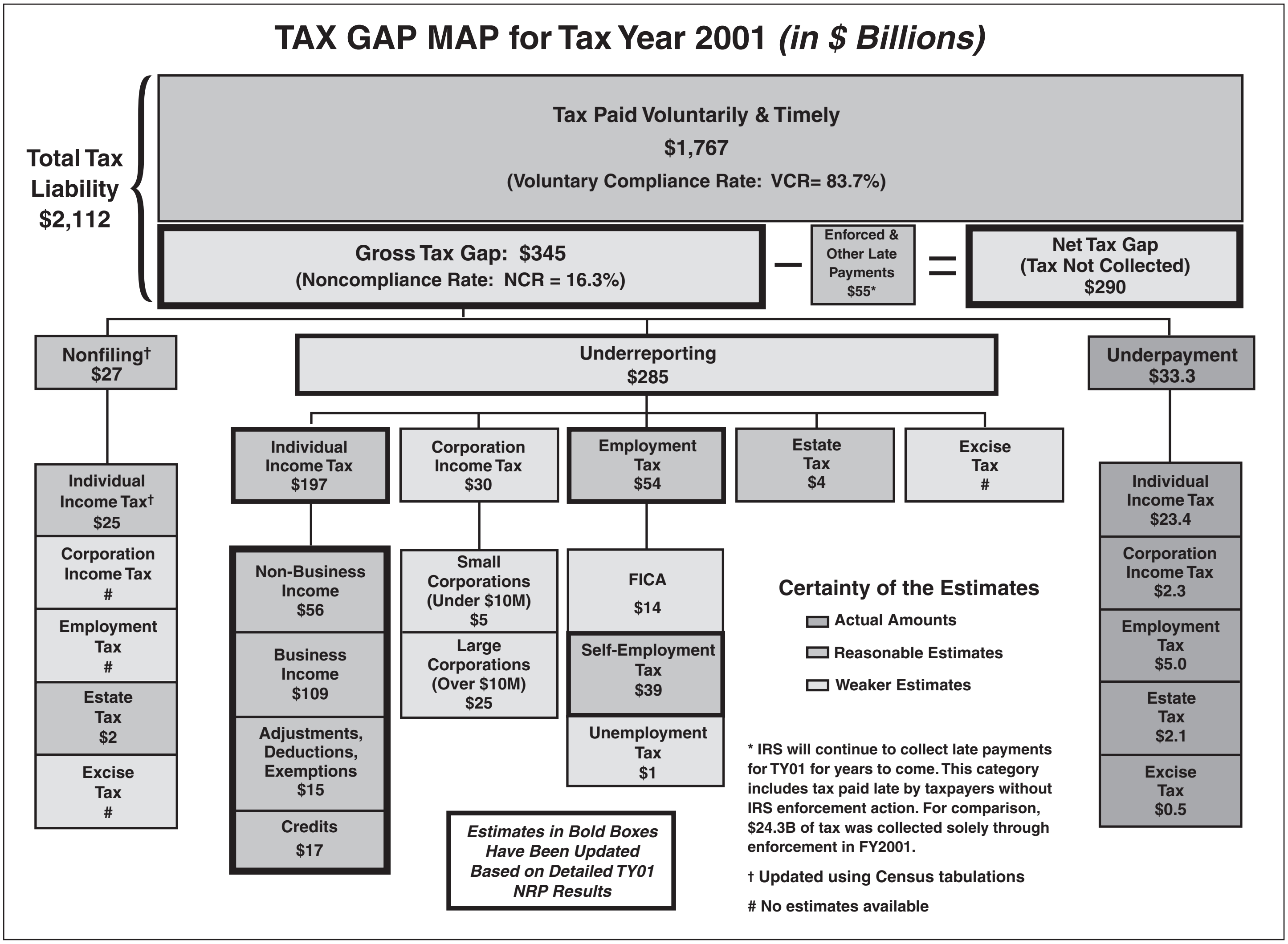
Appendix II: IRS's Tax Gap Map for 2001 and 2001 Individual Income Tax Underreporting Gap and Net Misreporting Percentage

Figure 1 is taken from the IRS report Reducing the Federal Tax Gap[1] and summarizes the key components of the tax gap and how they relate to one another. It has come to be known as the Tax Gap Map. As the map indicates, IRS estimates that for tax year 2001 approximately $55 billion of the gross tax gap will eventually be paid though enforcement or other late payments, leaving a net tax gap of about $290 billion. This projection of what will eventually be paid is based on fiscal year tabulations of past enforcement revenue and on prior studies of amounts that are paid late without enforcement efforts. This estimate of enforcement revenues and other late payments is necessarily subject to some uncertainty.

Further, the report noted that the Tax Gap Map distinguishes between "good" and "weak" estimates. For example, the corporation income tax estimates are acknowledged as weak because compliance behavior may have changed since the mid-1980s, which is the last time IRS collected data on corporate compliance. Moreover, the underreporting tax gap is estimated as the difference between true tax liability and reported amounts. Determining true tax liability for large multinational corporations can be difficult, given the complexity of the tax law, economic activities undertaken by these taxpayers, and the difficulty of making any kind of statically valid assumptions based on a limited population of taxpayers. Weaknesses in general arise from two causes: using old data and using data and methods that do not adequately reflect the full extent of noncompliance.

[1]Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (Washington, D.C.: Aug. 2, 2007).

Figure 1: The Tax Gap Map for Tax Year 2001



Source: Internal Revenue Service.

The individual income tax underreporting gap can be broken out by the various line items on a typical return—income sources, offsets to income, and offsets to tax. Table 2 provides updated estimates of both the tax gap arising from misreporting on each line item and the corresponding net misreporting percentage (NMP).[2] These estimates are based on thorough audits of a representative sample of returns, but they also account for underreporting that is not detected in those audits.

Table 2: Individual Income Tax Underreporting Gap Estimates and Net Misreporting Percentage, Tax Year 2001

Dollars in Billions

Type of Income or Offset	Tax Gap	Net Misreporting Percentage[a]
Total Underreporting Gap	**$197**	**18%**
Underreported Income	**$166**	**11**
Non-Business Income	**$56**	**4**
Wages, salaries, tips	10	1
Interest income	2	4
Dividend income	1	4
State income tax refunds	1	12
Alimony income	< 0.5 billion	7
Pensions and annuities	4	4
Unemployment compensation	< 0.5 billion	11
Social Security benefits	1	6
Capital gains	11	12
Form 4797 Sales of Business Property	3	64
Other income	23	64
Business Income	**$109**	**43**
Nonfarm proprietor income	68	57
Farm income	6	72
Rents and royalties	13	51
Partnerships, S-corporation, Estate, Trust, etc.	22	16
Overreported Offsets to Income	**$15**	**4**
Adjustments	-3	-21
Self-employed tax deduction[b]	-4	-51
All other adjustments	1	6

[2] The NMP is the net amount of income misreported divided by the sum of the absolute values of the amounts that should have been reported. The NMP measures provide insights into the extent of noncompliance for any given provision. However, caution should be applied when comparing NMPs across tax provisions. First, a provision may have a large NMP but contribute only slightly to the tax gap (e.g., the total true tax liability for a particular item is relatively small). Second, the NMP contains an adjustment for income amounts that were underreported but does not have a corresponding adjustment for offset amounts that were not claimed.

Dollars in Billions		
Type of Income or Offset	**Tax Gap**	**Net Misreporting Percentage[a]**
Deductions	14	5
Exemptions	4	5
Credits	**$17**	**26**
Net Math Errors (non-Earned Income Tax Credit)	**< $0.5 billion**	

Source: IRS.

[a]The amount of income or offset misreported divided by the amount that should have been reported. The National Research Program contains an adjustment for income amounts that were underreported, but does not have a corresponding adjustment for offset amounts that were not claimed.

[b]Taxpayers understate this adjustment because they understate their self-employment income and, thereby, their self-employment tax. Therefore, the gap associated with this item is negative.

Appendix III: Contacts

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