



Highlights of [GAO-09-569](#), a report to the Committee on Finance, U.S. Senate

## Why GAO Did This Study

The California Department of Industrial Relations, Division of Labor Standards Enforcement (DLSE), requires applicants for California business licenses in three industries—farm labor contracting, garment manufacturing, and car washing and polishing—to be in compliance with federal employment tax obligations to qualify.

Based on questions about whether the Internal Revenue Service (IRS) is fully using data from state and local governments to reduce the tax gap, GAO was asked to analyze (1) the extent to which requiring a demonstration of federal tax compliance to qualify for a state business license has the potential to improve federal tax compliance and (2) what opportunities exist for increasing arrangements that require federal tax compliance to qualify for state business licensing. To address these objectives, GAO analyzed IRS administrative and tax data. GAO identified California as a case study. GAO interviewed IRS and state officials and contacted revenue officials in the 50 states and the District of Columbia.

## What GAO Recommends

GAO recommends that the Commissioner of Internal Revenue determine whether the return on investment (ROI) of arrangements in which states require compliance with federal taxes is sufficiently high to merit their expansion and, if so, work to expand such arrangements. IRS agreed with GAO's recommendations.

View [GAO-09-569](#) or [key components](#). For more information, contact Michael Brostek at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov).

## TAX COMPLIANCE

### Opportunities Exist to Improve Tax Compliance of Applicants for State Business Licenses

#### What GAO Found

The California requirement that three types of businesses be in compliance with federal employment taxes to obtain a state business license shows promise as a valuable tool for improving federal tax compliance. According to data from IRS, of 7,194 businesses that applied for a California business license one or more times from calendar years 2006 through 2008 about 24 percent had to file employment tax returns or pay overdue taxes to come into compliance with federal employment taxes. California businesses filed 441 employment tax returns and IRS collected nearly \$7.4 million in current dollars in employment taxes in calendar year 2006 and in 8 months of calendar year 2007. GAO estimated that IRS incurred about \$331,348 to operate the data-sharing arrangement for this period. Using this cost estimate, the ROI for this arrangement is 22:1. IRS has not tracked the cost data needed to compare the ROI of the IRS-DLSE enforcement activity with other current enforcement activities. However, IRS's highest estimated ROI among five new direct revenue-producing enforcement initiatives proposed in its fiscal year 2009 budget was 11.4:1. Tax compliance among businesses after they applied for state business licenses showed continued improvement. GAO identified 2,017 businesses that applied for business licenses in calendar year 2006 only and found that 315 of these businesses had unpaid assessments as of September 18, 2006. By August 18, 2008, 165 of these businesses had resolved or lowered their unpaid assessment debt by \$1,925,162. All but 1 of the 350 businesses that had unpaid assessments when they applied for business licenses in calendar year 2006 were small businesses. GAO's analysis, although showing a promising ROI, did not take into account certain factors, such as whether other tax collection activities were in process for the businesses that applied for licenses.

Many opportunities exist to require federal tax compliance to qualify for state business licenses. GAO contacted revenue officials in every state and the District of Columbia to ask whether their states require tax compliance for business licenses. For the 48 respondents, 20 revenue officials said that their states require compliance with state taxes to obtain a state business license, and that these requirements exist for one or more industries. Twenty said that their states do not have such a requirement; 8 said that their states have no business license requirement at the state level. According to IRS, arrangements exist with 13 states that require compliance with one or more federal taxes to qualify for a state business license. Varying licensing requirements from state to state and lack of uniformity among states in categorizing a license as a "business license" make pinpointing the exact number of opportunities difficult. States that currently require compliance with state taxes for selected business license applicants may represent more of an immediate opportunity for establishing arrangements that require federal tax compliance to qualify for a state business license since they already see tax compliance as important for the businesses. Some challenges, such as a lack of current legal authority in some states to link businesses to tax compliance, would need to be addressed if requiring federal tax compliance for state business licenses is to be expanded.