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TAX GAP

Sources of Noncompliance and Strategies to Reduce It

Statement of James R. White, Director
Strategic Issues

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GAO-12-651T

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Highlights

Highlights of GAO-12-651T, a testimony before the Subcommittee on Government Organization, Efficiency, and Financial Management, Committee on Oversight and Government Reform, House of Representatives

Why GAO Did This Study

In January 2012, IRS estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $450 billion for tax year 2006. IRS estimated that it would collect $65 billion through enforcement actions and late payments, leaving a net tax gap of $385 billion. From 2001 to 2006, IRS estimated that the gross tax gap increased by $105 billion. However, the percentage of taxes owed that were paid on time remained relatively constant at 83.1 percent in 2006, compared to 83.7 percent in 2001.

Given persistent levels of noncompliance and large and growing structural deficits, it will be important to understand the causes of tax noncompliance and develop new approaches to minimize it.

This testimony addresses two questions: (1) What types of taxpayers are responsible for the tax gap, and what is the nature of their noncompliance? (2) What are strategies for reducing the tax gap? The statement also discusses potential long-term strategies to prevent refund fraud related to identity theft. This statement is based largely on GAO's recent reports and recommendations on tax noncompliance and updates GAO's 2011 testimony on the tax gap.

What GAO Recommends

GAO has made numerous prior recommendations regarding actions to close the tax gap. Congress and IRS have acted on some, while others are reflected in the strategies presented in this testimony.

View GAO-12-651T. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

April 19, 2012

TAX GAP

Sources of Noncompliance and Strategies to Reduce It

What GAO Found

Noncompliance does not have a single source but occurs across different types of taxes and taxpayers. For example, individual income tax accounts for the largest portion of the tax gap, but corporate income tax and employment tax are also significant. Further, misreporting by individuals involves business income, non-business income, deductions, and credits. The extent of misreporting depends on the extent to which income tax is withheld or reported to the Internal Revenue Service (IRS) by third parties. For example, nearly 40 percent, or $179 billion, of the 2006 gross tax gap is due to misreporting of non-corporate business income and related self-employment taxes. Much of this misreporting can be attributed to sole proprietors underreporting receipts or over-reporting expenses. Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is reported to IRS by third parties.

Because noncompliance has multiple causes and spans different types of taxes and taxpayers, multiple approaches are needed to reduce the tax gap. The following strategies could help and will require actions by Congress or IRS.

Enhancing information reporting by third parties to IRS could reduce tax evasion and help taxpayers comply voluntarily. However, identifying additional reporting opportunities can be challenging because third parties may not have accurate information available in a timely manner. Also, adding reporting requirements creates burden for both third parties and IRS.

Ensuring high-quality services to taxpayers, such as by telephone and correspondence or online, can help taxpayers who wish to comply with tax laws but do not understand their obligations. However, tax law changes and funding priorities have recently affected IRS's ability to provide quality taxpayer services.

Devoting additional resources to enforcement would enable IRS to contact millions of potentially noncompliant taxpayers it identifies but cannot contact. To determine the appropriate level of enforcement resources, policymakers would need to consider how to balance taxpayer service and enforcement activities and how effectively and efficiently IRS currently uses its resources.

Expanding compliance checks before IRS issues refunds would involve matching information returns to tax returns during, rather than after, the tax filing season. This approach would require a major reworking of some fundamental IRS computer systems but could help address identity theft-related fraud and allow IRS to use enforcement resources on other compliance problems.

Leveraging external resources, such as paid tax return preparers and whistleblowers, can help improve tax compliance because paid preparers' actions have an enormous impact on IRS's ability to effectively administer tax laws, and whistleblowers provide IRS information on suspected noncompliance.

Modernizing information systems would allow IRS to post more comprehensive tax return information to its computer systems, which could facilitate the examination process and expedite taxpayer contacts for faster resolution.

Simplifying the tax code could help taxpayers understand and voluntarily comply with their tax obligations and limit opportunities for tax evasion.

Chairman Platts, Ranking Member Towns, and Members of the Subcommittee:

I am pleased to be here to discuss the tax gap and related fraud, such as identity theft based refund fraud, and how to reduce it. In January 2012, the Internal Revenue Service (IRS) estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $450 billion in tax year 2006. IRS estimated that it would eventually recover about $65 billion of this amount through late payments and enforcement actions, leaving a net tax gap of $385 billion.[1] The tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with United States tax laws has changed little over the past three decades. In past testimonies, we have said that there are no easy fixes to this problem, and given persistent levels of noncompliance, reducing the tax gap will not likely be achieved through a single solution. Rather, the tax gap must be attacked on multiple fronts and with multiple strategies over a sustained period of time. Whether mistakes are intentional or unintentional, misreporting is unfair to compliant taxpayers and undermines the equity of the tax system. Moreover, in the face of large and growing structural deficits, it will be especially important to understand the causes of tax noncompliance today and continue to develop new approaches to minimize it.

My testimony today will answer two questions: (1) What types of taxpayers are responsible for the tax gap, and what is the nature of their noncompliance? (2) What are strategies for reducing the tax gap? As requested, we will also provide information on potential long-term strategies to prevent refund fraud related to identity theft. My testimony is based largely on our recent reports on tax noncompliance and updates our 2011 testimonies on the tax gap and identity theft.[2] Additional information on our scope and methodology is available in our published products.

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

[2]GAO, *Tax Gap: Complexity and Taxpayer Compliance*, GAO-11-747T (Washington, D.C.: June 28, 2011), and *Taxes and Identity Theft: Status of IRS Initiatives to Help Victimized Taxpayers*, GAO-11-721T (Washington, D.C.: June 2, 2011).

This testimony and the reports and testimonies upon which it is based were conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

For this hearing, we updated prior reported information about the estimated amounts for various components of the 2006 tax gap, the data and methodology used to estimate the 2006 tax gap, and actions IRS has taken to address our recommendations to improve taxpayer compliance. We confirmed the new information with IRS officials.

The Tax Gap Is Spread across Various Types of Taxpayers and Taxes

Characteristics of the Tax Gap

The gross tax gap has grown in dollar terms since IRS's previous estimate for tax year 2001, increasing from $345 billion to $450 billion for tax year 2006.[3] However, given the growth of the economy and total federal tax liability over that period, the percentage of taxes owed that taxpayers paid voluntarily and on time, known as the voluntary compliance rate, has remained relatively constant—83.7 percent in 2001 and 83.1 percent in 2006.[4]

[3]These amounts have not been adjusted for inflation.

[4]This 30 percent increase in the size of the gross tax gap from 2001 to 2006 is similar to the increase in the size of the United States economy (gross domestic product) over the time period. Likewise, total tax liabilities increased nearly 26 percent, from about $2.1 trillion to about $2.7 trillion, from tax years 2001 to 2006. (Dollar amounts for total tax liabilities do not match percentage increase because of rounding.) IRS also estimated that corporate income tax underreporting increased by $37 billion during this time. However, this growth may not indicate increased corporate noncompliance. According to IRS, the 2001 estimate of this portion of the tax gap was estimated based on old empirical data and was likely understated. In addition, from 2001 to 2006, corporation income tax liabilities more than doubled, while individual income tax liabilities grew by 15 percent.

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, which refers to the failure to file a required tax return altogether or on time.[5] The estimate also covers the five types of taxes that IRS administers—individual income, corporate income, employment, estate, and excise taxes.

The tax gap includes unintentional errors as well as intentional evasion, such as intentionally underreporting income, intentionally over-reporting expenses, and engaging in abusive tax shelters or frivolous tax schemes. It does not include legal tax avoidance activities (legally lowering tax liability), taxes due from illegally derived income, or various forms of fraud. For example, in general, refund fraud related to identity theft would not be included in the tax gap estimate because it does not involve evading a tax liability. Nevertheless, as discussed later in the testimony, actions taken to improve overall compliance and reduce the tax gap could also potentially address identity theft related fraud.

A critical step toward reducing the tax gap is to understand the sources and nature of taxpayer noncompliance. As shown in table 1, noncompliance does not come from a single source but rather occurs across different types of taxes and taxpayers. For example, individual income tax accounted for most of the tax gap estimate for tax year 2006. However, corporate income tax and employment tax also contributed a significant portion.

[5]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.

Table 1: IRS's Tax Year 2006 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	$235	$67	$72	$2	No estimate	$376
Underpayment	36	4	4	2	0.1	46
Nonfiling	25	No estimate	No estimate	3	No estimate	28
Total	**$296**	**$71**	**$76**	**$7**	**$0.1**	**$450**

Source: IRS.

As shown in table 2, individual income tax underreporting includes both nonbusiness income tax and business income tax underreporting. Business income for individuals includes income from a variety of business types, including sole proprietors,[6] partnerships, and S corporations,[7] many of which are small businesses. Nearly 40 percent, or $179 billion, of the 2006 gross tax gap can be attributed to these types of business taxpayers who underreport their business income tax, and by extension their self-employment tax, on their individual income tax returns.[8] Further, the misreporting of business income tax can take on a variety of forms. For example, misreporting of non-corporate business income tax can be largely attributed to sole proprietors who understated receipts or overstated expenses.[9] A key reason for this misreporting is

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

[7]S corporations provide limited liability protection to shareholders and "pass through" gains and losses to shareholders' individual tax returns without generally paying taxes at the entity level. Limited liability protection means that a shareholder's financial liability for a company is limited to the amount of their investment in the company. Owners of S corporations are referred to as shareholders.

[8]Self-employed individuals are generally required to calculate and remit Social Security and Medicare taxes to the U.S. Treasury each quarter. 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.

[9]GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007).

well known. Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is subject to information reporting to IRS by third parties.

Table 2: Underreporting Portion of IRS's Tax Year 2006 Gross Tax Gap Estimates

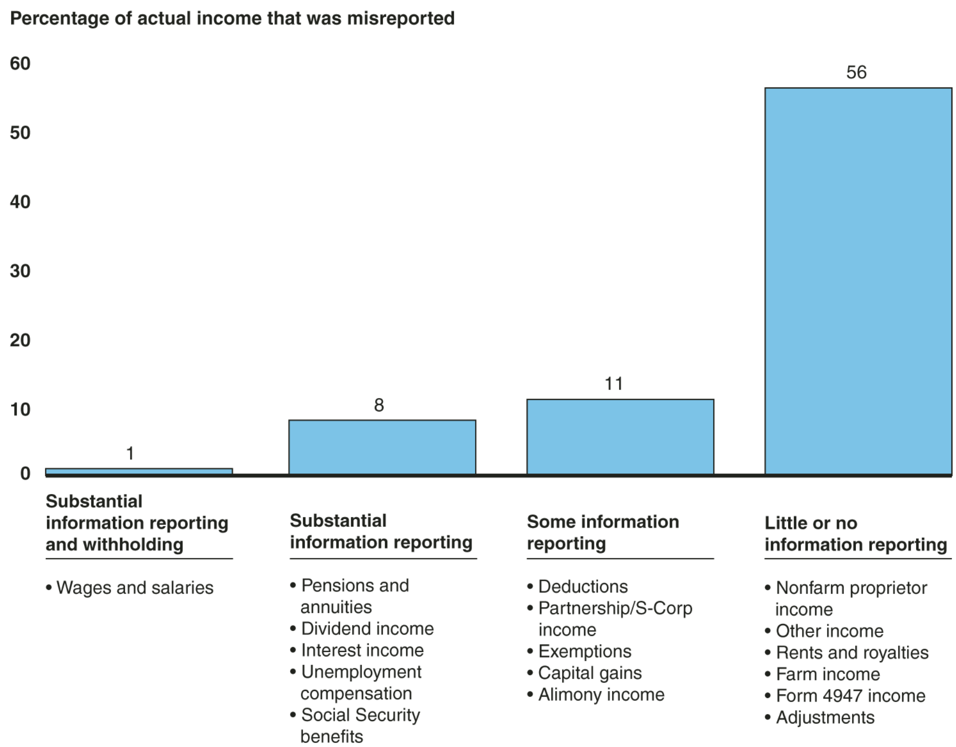
Dollars in billions

Tax gap component	Estimated underreporting amount
Individual income tax	**$235**
Nonbusiness income	68
Business income	122
Adjustments, deductions, and exemptions	17
Credits	28
Corporate income tax	**$67**
Small corporations	19
Large corporations	48
Employment tax	**$72**
Self-employment tax	57
FICA and unemployment tax	15
Estate tax	**$2**
Total underreporting	**$376**

Source: IRS.

As shown in figure 1, the extent to which individual taxpayers accurately report their income is related to the extent to which the income is reported to them and IRS by third parties or taxes on the income are withheld. For example, for types of income for which there is little or no information reporting, such as business income, individual taxpayers tend to misreport over half of their income. In contrast, employers report most wages, salaries, and tip compensation to employees and IRS through Form W-2. Also, 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. Findings from IRS's study of individual tax compliance indicate that nearly 99 percent of these types of income are accurately reported on individual tax returns.

Figure 1: Effect of Information Reporting on Taxpayer Compliance, Tax Year 2006



Source: IRS.

Taxpayers misreport income and expenses for a variety of reasons. Some misreporting is intentional; some is unintentional. Often it is impossible to tell from a tax return whether errors are intentional or unintentional or even who made the error. For example, paid tax return preparers could make errors or taxpayers could fail to share relevant information with their preparers. Our past reports shed some light on the extent of unintentional errors. In our report on securities cost basis reporting,[10] we found that among individual taxpayers who misreported securities sales, roughly one-third over-reported income (i.e., they

[10]Generally, a taxpayer's gain or loss from a securities sale is simply the difference between the gross proceeds from the sale and the original purchase price, or original cost basis. However, before taxpayers can determine any gains or losses from securities sales, they must determine if and how the original cost basis of the securities must be adjusted to reflect certain events, such as stock splits, nontaxable dividends, or nondividend distributions.

overstated gains or understated losses).[11] For sole proprietors, we reported that 9 percent over-reported their net income, while 61 percent underreported their net income in 2001.[12] It seems likely that such instances of over-reporting could be due to unintentional errors.

Measuring the Tax Gap

We have long encouraged regular tax gap measurement because these estimates are important to gauge progress in addressing the tax gap and, perhaps more importantly, because analyzing the data used to estimate it can help identify ways to improve tax compliance. One source of such data is the National Research Program (NRP), which uses audits of a stratified, random sample of tax returns to produce statistically valid estimates of noncompliance for the entire population of tax return filers. IRS uses the NRP sample results to better target its enforcement examinations of noncompliant taxpayers. Better targeting examinations to taxpayers who are noncompliant reduces burden on compliant taxpayers.

Updated compliance data can also help identify changes in tax laws and regulations that may improve compliance. For example, we analyzed NRP data on individual taxpayer compliance and reported that, among other things, Congress could consider requiring brokers to report to both taxpayers and IRS the adjusted basis of securities that taxpayers sell.[13] Congress enacted this provision,[14] which the Joint Committee on Taxation estimated would raise $6.7 billion in revenue through 2018.

As we have reported in the past, closing the entire gap may not be feasible since it could entail more intrusive recordkeeping or reporting than the public is willing to accept or more resources than IRS is able to commit.[15] However, given the size of the tax gap, even modest reductions

[11]GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

[12] GAO-07-1014.

[13]GAO-06-603.

[14]Energy Improvement and Extension Act of 2008, Pub. L. No 110-343, § 403, 122 Stat. 3768, 3854 (Oct. 3, 2008).

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

would yield very significant financial benefits. We have made numerous recommendations over time that could address the tax gap, as follows.

Various Strategies Are Required to Reduce the Tax Gap

Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since the noncompliance has multiple causes and spans different types of taxes and taxpayers. While the tax gap will remain a challenge into the future, the following strategies could help. These strategies would require actions by Congress or IRS.

Enhancing Information Reporting by Third Parties to IRS

Information reporting is a powerful tool that reduces tax evasion and helps taxpayers comply voluntarily. Several major new information requirements have recently taken effect, based at least in part on our work and recommendations.

- Brokers are required to report their clients' basis for securities sales, starting in 2012.[16]
- Banks and other third parties are required to report businesses' credit card and similar receipts, starting in 2011.[17]
- Under the Foreign Account Tax Compliance Act, starting in 2014, U.S. financial institutions and other entities are required to withhold a portion of certain payments made to foreign financial institutions that have not entered into an agreement with IRS to report details on U.S. account holders to IRS.[18]

As these three sets of information reporting requirements have only recently taken effect, it is too soon to tell the actual impact they are having on taxpayer compliance.

We have identified other options for information reporting.

[16]GAO-06-603.

[17]GAO, *Tax Administration: Costs and Uses of Third-Party Information Returns*, GAO-08-266 (Washington, D.C.: Nov. 20, 2007).

[18]GAO, *Reporting Foreign Accounts to IRS: Extent of Duplication Not Currently Known, but Requirements Can Be Clarified*, GAO-12-403 (Washington, D.C.: Feb 28, 2012).

- **Service payments to corporations.** Currently, businesses must report to IRS payments for services they make to unincorporated persons or businesses, but payments to corporations generally do not have to be reported.[19]
- **Service payments made by landlords.** Taxpayers who rent out real estate are required to report to IRS expense payments for certain services, such as payments for property repairs, only if their rental activity is considered a trade or business. However, the law does not clearly spell out how to determine when rental real estate activity is considered a trade or business.[20]

Broader requirements for these two forms of information reporting, covering goods in addition to services, were enacted into law in 2010 but were later repealed. We believe the more narrow extensions of information reporting to include services, but not goods, remain important options for improving compliance.

Additionally, we have identified existing information reporting requirements that could be enhanced.

- **Higher education expenses.** Eligible educational institutions are currently required to report information on qualified tuition and related expenses for higher education so that taxpayers can determine the amount of educational tax benefits they can claim.[21] IRS revising the information reporting form could improve the usefulness of reported information.[22]
- **Mortgaged properties.** Requiring third parties, such as mortgage lenders, to report mortgaged property addresses in addition to

[19]GAO, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238 (Washington, D.C.: Jan. 28, 2009).

[20]GAO, *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

[21]26 U.S.C. § 6050S.

[22]GAO, *2009 Tax Filing Season: IRS Met Many 2009 Goals, but Telephone Access Remained Low, and Taxpayer Service and Enforcement Could Be Improved*, GAO-10-225 (Washington, D.C.: Dec. 10, 2009).

information they are already required to report on mortgaged properties would help IRS identify potential noncompliance.[23]

Identifying additional third-party reporting opportunities is challenging. Considerations include whether any third parties have accurate information available in a timely manner, the burden of reporting on the third parties, and whether IRS can enforce the reporting requirement. To illustrate, in a 2009 report, we found that a major reason why little information reporting on sole proprietor expenses exists is because of the difficulty identifying third parties.[24] For example, there is no third party that could verify the business use of cars or trucks by sole proprietors.

Ensuring High-Quality Services to Taxpayers

Ensuring high-quality taxpayer services, such as by telephone and correspondence or online, can help taxpayers who wish to comply with tax laws but do not understand their obligations. However, in recent years and continuing this year, IRS's service performance has seen declines. Tax law changes and other funding priorities have affected IRS's ability to provide quality taxpayer services. For example, we recently reported that call volume has increased nearly 35 percent from the same time period last year, which IRS attributed, in part, to taxpayer questions about tax law changes.[25] Concurrently, taxpayers' ability to get through to IRS telephone assistors has declined.[26] Through late February of this year, 65 percent of callers seeking to talk to an IRS telephone assistor got through, compared to 70 percent for 2011. To improve service, we have recommended that IRS determine the costs and benefits of creating additional automated telephone applications and finalize a more

[23]GAO, *Home Mortgage Interest Deduction: Despite Challenges Presented by Complex Tax Rules, IRS Could Enhance Enforcement and Guidance*, GAO-09-769 (Washington, D.C.: July 29, 2009); *Tax Administration: Expanded Information Reporting Could Help IRS Address Compliance Challenges with Forgiven Mortgage Debt*, GAO-10-997 (Washington, D.C.: Aug 31, 2010); and GAO-08-956.

[24]GAO, *Tax Gap: Limiting Sole Proprietor Loss Deductions Could Improve Compliance but Would Also Limit Some Legitimate Losses*, GAO-09-815 (Washington, D.C.: Sept. 10, 2009).

[25]GAO, *2011 Filing Season: Processing Gains, but Assistance Could Be Enhanced by More Self-Service Tools*, GAO-12-176 (Washington, D.C.: Dec. 15, 2011).

[26]GAO, *Internal Revenue Service: Interim Results of 2012 Tax Filing Season and Summary of the Fiscal Year 2013 Budget Request*, GAO-12-566 (Washington, D.C.: Mar. 20, 2012).

comprehensive plan for online services, including an assessment of granting taxpayers the ability to update their account information online.

Devoting Additional Resources to Enforcement

Devoting additional resources to enforcement would enable IRS to contact millions of potentially noncompliant taxpayers that it currently identifies but cannot contact given resource constraints. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. For example, in a 2009 report, we found that despite investing nearly a quarter of all revenue agent time in 2008, IRS was able to examine (audit) about 1 percent of estimated noncompliant sole proprietors. Not only are these exams burdensome for businesses, they are also costly for IRS and yield less revenue than examinations of other categories of taxpayers, in part because most sole proprietorships are small in terms of receipts.[27]

Expanding Compliance Checks Before IRS Issues Refunds

IRS could reduce the tax gap by expanding compliance checks before issuing refunds to taxpayers. The Commissioner of Internal Revenue has talked about a long-term vision to increase compliance activities before refunds are sent to taxpayers. In one example, IRS is exploring a requirement that third parties send information returns to IRS and taxpayers at the same time as opposed to the current requirement that some information returns go to taxpayers before going to IRS. The intent is to allow IRS to match those information returns to tax returns during tax return filing season rather than after the filing season is complete.[28] As will be discussed later, this approach could also help IRS address identity theft-related fraud and could also allow IRS to use its enforcement resources on other significant compliance problems. However, the Commissioner made clear that his vision for more prerefund compliance checks will take considerable time to implement, will require a major reworking of some fundamental IRS computer systems, and could impose some additional burden on third parties.

[27] GAO-09-815.

[28] GAO, *Taxpayer Account Strategy: IRS Should Finish Defining Benefits and Improve Cost Estimates*, GAO-11-168 (Washington, D.C.: Mar. 24, 2011).

Leveraging External Resources Such as Paid Tax Return Preparers and Whistleblowers

Another way IRS may be able to reduce the tax gap is by leveraging external resources.

- Paid tax return preparers prepare approximately 60 percent of all tax returns filed, and IRS has acknowledged that paid preparers' actions have an enormous impact on its ability to administer tax laws effectively. Based in part on our work and recommendations, IRS recently developed new requirements for paid preparers, such as competency testing, which it has concluded will increase tax compliance.[29] IRS's goals for the program include leveraging relationships with paid preparers and improving the accuracy of the tax returns they prepare.
- Tax whistleblowers can help improve tax compliance by providing information to IRS on others' suspected tax noncompliance. We have made several recommendations for IRS to improve its whistleblower program through enhanced data collection and whistleblower claim processing timeliness.[30] According to IRS, it is in the process of implementing these recommendations.

Modernizing Information Systems

Modernization of IRS's information systems could improve taxpayer compliance. IRS is engaged in a multiyear effort to replace the systems it uses to process individual tax returns and receive electronically filed tax returns.[31] IRS had identified various compliance benefits to replacing the system it uses to process individual tax returns, including increasing taxpayer and paid preparer voluntary compliance and examination case selection.[32] Among other benefits, replacing its electronic filing system will allow IRS to accept taxpayers' prior-year returns and portable document format (PDF) files attached to their tax returns. According to IRS officials,

[29]GAO, *Tax Preparer Regulation: IRS Needs a Documented Framework to Achieve Goal of Improving Taxpayer Compliance*, GAO-11-336 (Washington, D.C.: Mar. 31, 2011); *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation*, GAO-08-781 (Washington, D.C.: Aug. 15, 2008); and *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, GAO-08-567 (Washington, D.C.: Mar. 13, 2008).

[30]GAO, *Tax Whistleblowers: Incomplete Data Hinders IRS's Ability to Manage Claim Processing Time and Enhance External Communication*, GAO-11-683 (Washington, D.C.: Aug. 10, 2011).

[31]GAO-12-176.

[32]GAO-11-168.

posting more comprehensive information from individual income tax returns to its computer systems could facilitate the examination process, expedite taxpayer contacts for faster resolution, and potentially better define specific tax gap issues.[33]

Simplifying the Tax Code or Fundamental Tax Reform

Tax code complexity can lead to noncompliance. Efforts to simplify or reform the tax code may help reduce the tax gap by making it easier for individuals and businesses to understand and voluntarily comply with their tax obligations. For example, eliminating or combining tax expenditures, such as exemptions, deductions, and credits, could help taxpayers reduce unintentional errors and limit opportunities for tax evasion.

Policymakers may find it useful to compare any proposed changes to the tax code based on a set of widely accepted criteria for assessing alternative tax proposals. These criteria include the equity, or fairness, of the tax system; the economic efficiency, or neutrality, of the system; and the simplicity, transparency, and administrability of the system. These criteria can sometimes conflict, and the weight one places on each criterion will vary among individuals. Our publication, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, may be useful in guiding policymakers as they consider tax reform proposals.[34]

Our recent reports show how changing tax laws to include more consistent definitions across tax provisions could help taxpayers more easily understand and comply with their obligations.

- For example, higher education expenses that qualify for some of the savings and credit provisions in the tax code differ by provision. These dissimilar definitions require that taxpayers keep track of expenses

[33]GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated*, GAO-08-38 (Washington, D.C.: Nov. 15, 2007).

[34]GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

separately, applying some expenses to some tax preferences but not others.[35]

- Likewise, more clarity would help taxpayers determine how to treat certain financial derivative products for tax purposes. Unique characteristics of financial derivatives make them particularly difficult for the tax code and IRS to address. Deferring gains or accelerating losses, changing ordinary income into capital gains or vice versa for losses, and altering the source of gains to avoid withholding taxes are examples of inconsistent tax rules for financial derivatives resulting in equivalent economic outcomes being taxed differently.[36]

Challenges to Addressing Identity Theft

Identity theft creates problems for both taxpayers and IRS. In refund fraud cases, an identity thief uses a legitimate taxpayer's identity to fraudulently file a tax return and claim a refund during the filing season. In these cases, the identity thief typically uses a stolen Social Security Number (SSN) to file a forged tax return and obtain a refund early in the filing season. The legitimate owner of the SSN may not be aware that this has occurred until he or she files a tax return later in the filing season and IRS discovers that two returns have been filed using the same SSN. In this instance, the legitimate taxpayer's refund will likely be frozen until IRS can determine the legitimate owner of the SSN.[37]

In our June 2011 testimony before this subcommittee, we reported that IRS faced various challenges in resolving, detecting, and preventing identity theft. These challenges included limitations in coordinating with other agencies and taxpayers because of privacy and other laws, inability

[35]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on 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).

[36]GAO, *Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse*, GAO-11-750 (Washington, D.C.: Sept. 20, 2011).

[37]Identity theft may also involve employment fraud. This occurs when an identity thief uses someone else's name and SSN to obtain a job. In this instance, IRS would receive a Form W-2 or a Form 1099 reporting income on the taxpayer's account, which the rightful owner of the SSN had not earned and does not report as income to IRS. As a result, the taxpayer may be subject to enforcement action when, during the filing process, IRS matches what the employer and the taxpayer report and it appears that he or she earned more income than was reported on his or her tax return.

to detect suspicious cases until after fraud has occurred, and the lack of resources and authority to investigate and prosecute identity thieves.[38]

Addressing these challenges will require significant, long-term changes in IRS's operations and systems. As previously discussed, the Commissioner's long-term vision to increase up-front compliance activities could help. For example, matching employer information with tax returns before refunds are issued could prevent identity thieves from using phony W-2s to claim fraudulent refunds. However, significant changes would be needed before this matching could occur. Third-party information returns would need to be filed with IRS earlier in the filing season.[39] IRS would also need to improve its automated processing systems; IRS's current Customer Account Data Engine (CADE 2) effort is one key step.[40]

Chairman Platts, Ranking Member Towns, and Members of the Subcommittee, this completes my prepared statement. I would be pleased to respond to any questions that you may have at this time.

GAO Contacts and Staff Acknowledgements

If you or your staff have any questions about this testimony, please contact me at (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony are listed in appendix II.

[38]GAO, *Tax Administration: IRS Has Implemented Initiatives to Prevent, Detect, and Resolve Identity Theft-Related Problems, but Needs to Assess Their Effectiveness*, GAO-09-882 (Washington, D.C.: Sept. 8, 2009), and GAO-11-721T.

[39]Many information returns, such as forms W-2 filed by employers, are not due to the government until the end of February.

[40]GAO-11-18.

Appendix I: 2006 Tax Gap Estimate Data and Methodology

The Internal Revenue Service's (IRS) tax gap estimates are based on a variety of data sources and methodologies. For example, IRS studied individual taxpayer compliance through the National Research Program (NRP) and used the resulting compliance data to estimate the tax gap for individual income tax underreporting and the portion of employment tax underreporting attributed to self-employment taxes for tax year 2006.

The 2006 Individual NRP involved auditing a random selection of about 13,000 to 14,000 individual tax returns and is much smaller than the tax year 2001 Individual NRP of approximately 45,000 returns. Starting with the 2006 Individual NRP compliance study, IRS is using a rolling sample, which will combine samples across three years. According to IRS, this change will reduce cost and provide more up to date compliance data. The sample design for the 2006 Individual NRP included 11 primary strata, which were based on the examination classes used in audit workload selection. Also, the 2006 Individual NRP was designed to oversample returns with business income reported on Schedule C, E, or F or Form 2106.

The individual underreporting gap for tax year 2006 was based on findings from the 2006 Individual NRP and from an econometric analysis of tax year 2001 NRP data. This econometric analysis, called Detection-Controlled Estimation (DCE), attempts to account for income that taxpayers do not report on their tax returns and that NRP auditors could not detect. Because insufficient NRP data has been accumulated for tax year 2006 and later years for full DCE analysis, an improved DCE was undertaken using tax year 2001 NRP data and adjusted using other information to estimate undetected income for tax year 2006 NRP returns.

We have not verified the accuracy of IRS's estimate of the tax gap. According to IRS, a significant portion of IRS's 2006 tax gap estimate is based on recent compliance data and improved estimation methods. However, the tax gap estimate continues to be incomplete and partly based on older data. For example, the underreporting estimates for both FICA and unemployment taxes are projections based on applying the estimated compliance rates for 1984 to currently reported taxes.

To estimate the 2006 individual nonfiling gap, IRS used tax year 2005 third-party information returns, rather than the Census Exact Match study, as it did for the tax year 2001 estimate. The underpayment component 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.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the contact named above, Jeff Arkin, Assistant Director; Elizabeth Fan, Analyst-in-Charge; David Lewis; Karen O'Conor; and Sonya Vartivarian made key contributions to this report. Gregory Borecki, Shannon Finnegan, Tom Gilbert, Lois Hanshaw, Ed Nannenhorn, Jeff Niblack, Jeff Schmerling, and Joanna Stamatiades also provided valuable assistance.

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