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TAXPAYER COMPLIANCE

Analyzing the Nature of the Income Tax Gap

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Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap

Messrs. Chairmen and Members of the Commission:

We are pleased to be invited by you to discuss the income tax gap—the difference between income taxes owed and those voluntarily paid. The Internal Revenue Service (IRS) has estimated that taxpayers do not voluntarily pay more than $100 billion annually of taxes due on income from legal sources.[1] While such "tax gap" estimate is necessarily imprecise, it indicates significant noncompliance and the challenge that IRS faces in finding ways to reduce the tax gap.

When some taxpayers do not pay all the taxes they owe, that part of the burden of funding approved government programs shifts to taxpayers who fully comply. Thus, maintaining high levels of compliance and reducing the tax gap are important for equity reasons. However, it would be unrealistic to assume that our tax system, or any tax system, can achieve 100-percent compliance and thus eliminate the tax gap.

My statement covers four points which are based on our previous reports and ongoing work. These points are:

- First, IRS' data suggest that U.S. taxpayers voluntarily pay about 83 percent of the income taxes they owe and ultimately pay about 87 percent after IRS enforcement programs. This compliance level, in combination with economic growth, translates into billions of "tax gap" dollars.
- Second, IRS' estimates show that voluntary compliance in reporting income varies across groups of individuals. Among those filing income tax returns, wage earners report 99 percent of their wages; self-employed individuals who operate formally report 68 percent of their business income; and "informal suppliers," self-employed individuals who operate informally on a cash basis, report just 19 percent of such income on their tax returns.
- Third, IRS data show that compliance is highest under tax withholding, a little lower without withholding but with information reporting to IRS, and much lower when neither system is in place. In addition to the relative visibility of the income to tax administrators, other factors also influence the level of compliance. For example, complex tax laws can lead to more noncompliance.
- Fourth, IRS faces many challenges in reducing the income tax gap. For example, some of the "tax gap" may not be collectible at an acceptable cost. Such collection might require either more intrusive record keeping or

[1]Income tax gap estimates released in 1988 and 1996 have excluded unpaid income taxes owed from illegal activities such as drug dealing and prostitution. IRS' tax gap estimates in 1979 and 1983 included such an estimate. Since then, IRS researchers have decided that the data and methodology for reliably making this estimate are lacking.

reporting than the public is willing to accept or more resources than IRS can commit. Thus, it is important that IRS know as much as possible about current compliance with the tax laws and use that knowledge to focus its resources in a cost-effective way.

Successfully reducing the tax gap may depend on several systematic factors in addition to overcoming the challenges faced by tax administrators. Before discussing these points, I would like to discuss the "tax gap" estimates and how they are derived.

Tax Gap Estimates

Tax gap estimates, for the most part, have traditionally begun with IRS' Taxpayer Compliance Measurement Program (TCMP). Under this program, IRS auditors did line-by-line audits of randomly selected tax returns to identify under- and overreporting for a line item. IRS used these results to estimate compliance for the taxpayers included in the TCMP. TCMP has been used since 1963 to measure compliance on income tax returns filed by individuals about every third tax year. The last TCMP for such individual filers covered tax year 1988. IRS also has done a few TCMPs for individual nonfilers and for small corporations (those reporting less than $10 million in assets). Other data from IRS enforcement programs and special studies have been used to supplement TCMP results or to estimate the tax gap for large corporations and informal suppliers.

IRS' most recent estimate (1996) projects tax gap numbers for individuals in tax years 1985, 1988, and 1992. Previous IRS estimates provided projections for other tax years as well as for corporations.[2] IRS estimated that the income tax gap for individuals reached as high as $95 billion for tax year 1992. IRS data show the tax gap has grown over time even though the compliance rate has remained roughly the same because the economy has grown and changes in the tax laws have had the unintended effect of increasing opportunities for noncompliance. After making adjustments for tax law changes and shifts in types of income, IRS estimated that overall individuals have been paying about 83 percent of the total income taxes owed.

[2]IRS last updated in 1990 an estimate of the corporate income tax gap. That tax gap estimate was $33 billion for tax year 1992. It did not include the most recent TCMP for small corporations, which showed that their income tax compliance, dropped from 81 percent in 1980 to 61 percent in 1987. IRS Research Division did not know when it would have the time and resources to finish updating the corporate tax gap estimates.

IRS has been able to recover a portion of the tax gap through its enforcement programs, such as audits and document matching.[3] IRS estimates that its enforcement programs have, on average, recovered about 4 percent of all individual and corporate income taxes due in any particular tax year. Thus, IRS estimates that overall compliance reaches about 87 percent after IRS enforcement programs. However, because of the time consumed by these programs and by any subsequent appeals and litigation, the 87-percent compliance level cannot be reached until a number of years after the taxes were due.

Components of the Tax Gap

As shown in table I.1, IRS' estimate attributes about three-fourths of the gross income tax gap to individuals and one-fourth to corporations. For tax year 1992, the individual tax gap primarily arose from individuals not fully reporting their income on filed tax returns ($59 billion of the $95 billion estimate). The most recent estimate of the corporate tax gap projected it to be $33 billion for tax year 1992. Noncompliance in reporting income, deductions, and other offsets to income or tax comprised most of the total—$24 billion by large corporations and $7 billion by small corporations.

Within these overall tax gap estimates, compliance varied by type of individual taxpayers filing the tax returns (see table I.2), as follows:

- Wage earners whose wages are subject to tax withholding (the most systematic method for making income visible to IRS) are estimated to report 99 percent of their wages.
- Individuals are estimated to report 98 percent of their interest income and 92 percent of their dividend income, most of which is subject to tax-information reporting but not tax-withholding requirements.
- In contrast, IRS estimates that self-employed individuals who formally operate businesses other than farms report about 68 percent of their business income, which is neither subject to withholding nor necessarily covered by information reporting.
- Finally, self-employed informal suppliers, who are even less likely to have income reported to IRS on information returns, report an estimated 19 percent of their business income.

The tax gap for individual taxpayers who did not file tax returns for tax year 1992 was almost $14 billion. Other components of the individual tax

[3] IRS' 1996 estimate for individuals noted that IRS enforcement programs recovered about $15 billion of the $95 billion income tax gap for 1992, leaving a net gap of $80 billion.

gap included overreported deductions, credits and other offsets to income ($14 billion), and taxes not remitted along with the filed return ($8 billion).

Similarly, variations in compliance exist in the corporate sector. Small corporations tend to mirror the compliance patterns of self-employed individuals. Unreported business income is the biggest compliance problem, and sufficient documentation of income is often lacking. In large corporations, by contrast, the tax gap typically arises from different interpretations of an ambiguous and complex tax code. Upon audit, IRS auditors may interpret the tax provisions differently and, as a result, recommend adjustments to the corporation's tax liability.[4]

Systematic Factors That Influence Tax Compliance

Tax administrators around the globe have worked to promote compliance with whatever tax system is in place. On the basis of our previous work[5], we have identified some common principles that have influenced their success.

First: The simpler the rules, the better. This reflects the basic principle that the simpler the tax code, the more certain the results in applying it and the fewer the opportunities for disagreements over the "fine points" of tax law. However, we have reported that the existing U.S. system is neither simple nor certain. For example, some paragraphs in the Internal Revenue Code have generated as many as 250 pages of implementing regulations.

Second: Collecting from fewer sources is easier. Tax withholding allows the tax collector to focus on the relatively small number of employers rather than on all employees. For example, Congress followed this reasoning in changing the collection point for diesel fuel taxes to the smaller number of businesses earlier in the production chain. Subsequent to this and other changes in the taxation scheme for diesel fuel, collections have risen significantly.

Third: More visible tax information promotes higher compliance. Tax withholding and information reporting are two means of making income and some deductions visible to both the taxpayer and the tax administrator; this visibility leads to significantly higher compliance rates.

[4]IRS' primary basis for estimates of the large corporation tax gap arise from these recommended audit adjustments. When any taxpayer appeals the recommendation, the appeal process may result in the recommended tax liability being reduced in whole or in part.

[5]Reducing the Tax Gap: Results of a GAO-Sponsored Symposium (GAO/GGD-95-157, Jun. 2, 1995).

Good records and other types of paper trails also lead to better results when the tax administrator audits a return or takes some other enforcement action.

Fourth: Good information is critical to identifying compliance problems. This principle recognizes the importance of systematically estimating the extent of noncompliance and variations in taxpayer behavior. In this way, the tax administrator can identify areas warranting attention, tax returns to audit, and the results of any efforts to improve compliance.

Fifth: Focus compliance efforts where they will do the most good. Having information on the most significant compliance problems helps the tax administrator to tailor its enforcement efforts accordingly. At present, the largest component of the U.S. income tax gap arises from individuals not fully reporting their income, particularly income that is not subject to tax withholding. This knowledge has helped IRS to train its auditors to better detect unreported income.

Sixth: Deal with compliance problems quickly. IRS has found that the longer it takes to reach a taxpayer, whether through enforcement or assistance, the less success in correcting the compliance problem.

The Challenge for IRS

IRS' goal has been to improve the compliance level from 87 percent to 90 percent by 2001. The tax gap estimates have provided ways for determining whether compliance is improving. At the broadest level, the estimates provide an indicator of the seriousness of the compliance problems and any related inequities. To the extent that sufficient details are known, the estimates also provide insights on the types of tax issues or taxpayers associated with low and high compliance.

One method by which IRS hopes to improve compliance is by increasing its compliance presence. Over the last 30 years, the rates at which IRS has audited income tax returns have declined over 75 percent. While alternative mechanisms such as document matching reach many types of income that may not be reported, IRS has no substitute for auditing in the case of more complex tax issues. Another method of improving compliance is to educate the taxpayer about confusing or commonly misunderstood tax requirements. IRS has initiated efforts to develop better information that should help IRS to improve its compliance presence as well as to secure more opportunities for outreach and education with taxpayer groups.

To support such efforts, IRS has been reorganizing its compliance research function to push more research into field offices. IRS hopes that systematic research, combined with detailed knowledge about tax and enforcement issues, can provide a road map to large-scale compliance gains. With this end in mind, IRS has been scheduling various research projects and attempting to build new databases to allow its researchers access to current data related to the compliance of various taxpayer groups. Finally, IRS is considering different ways to measure how well our voluntary tax system is working.

The importance of these steps has increased with the demise of TCMP. In October 1995, concerns about costs and burdens on taxpayers prompted IRS to cancel a planned tax year 1994 TCMP for individuals, small corporations, and other types of small businesses.[6] IRS has not yet developed an alternative to the comprehensive, statistically valid estimates on tax compliance that TCMP provided. Lacking such a replacement to date, IRS hopes that its enhanced research activities will provide a partial substitute.

It is not yet clear whether IRS will be able, absent TCMP data, to continue to provide a comprehensive tax gap estimate with any statistical precision at the national level. Without such an estimate, IRS and Congress will not know how well our voluntary tax system works overall and the extent that all types of taxpayers are paying their fair share of taxes. Nor will IRS and Congress have a broad context by which to judge the seriousness of the compliance problems uncovered in field research of selected tax issues and taxpayer groups.

One factor IRS must balance against its desire to increase voluntary compliance is the additional costs and burdens that are incurred by both IRS and the taxpayer. Depending on the actions taken, improving the compliance rate could dramatically increase the costs to IRS and the burdens on taxpayers. Reaching for a near-perfect compliance rate very

[6]While TCMP audits would actually reduce the overall long-term burden on taxpayers to the extent that fewer compliant taxpayers would be selected for IRS audits in the future, the time and documentation requirements for taxpayers selected for a TCMP audit can be burdensome. For a discussion of the difficulties of measuring tax system burden, see our prior testimony entitled Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, Dec. 9, 1994).

likely would mean imposing burdens and costs that our society may not accept.

IRS is hoping that its enhanced research efforts will allow it to target noncompliance in a systematic way and thus guide enforcement and educational activities while minimizing costs and burdens. We have reported[7] that IRS' approach of supplementing its enforcement efforts with research into the causes of noncompliance strikes us as being intuitively logical. However, we found mixed support among IRS officials for this approach causing tensions that could have an adverse impact on its success. Further, IRS had not completed the infrastructure for planning and managing the research, although progress has been made. If the research efforts fall short of expectations, IRS may have to rely on other means, some possibly more intrusive or more burdensome, to select taxpayers for enforcement activities such as audits.

In summary, I would like to reiterate how important it is for IRS (or any other tax administrator) to invest resources in measuring compliance. It is also important for IRS to use the results to balance efforts among its competing goals of (1) maximizing collection of taxes owed, (2) promoting uniform compliance, and (3) minimizing taxpayer burden. I would welcome any questions.

[7]Tax Research: IRS Has Made Progress but Major Challenges Remain (GAO/GGD-96-109, Jun. 5, 1996).

Selected Tax Gap Statistics

Table I.1: Gross Tax Gap Estimates for Tax Year 1992 (Dollars in Billions)

Source of tax gap	Tax gap amount	Tax gap distribution (percent)
Individual tax gap	$95.3	74.3%
Unreported income on filed returns	58.6	45.6
Sole proprietors	29.2	22.7
All other income	29.4	22.9
Overstated deductions[a]	14.4	11.2
Nonfiler	13.8	10.7
Individual remittance gap	8.4	6.5
Math errors	0.1	0.1
Corporate tax gap	33.1	25.8
Small corporations	7.0	5.5
Large corporations	23.7	18.5
Other[b]	0.4	0.3
Corporate remittance gap	2.0	1.6
Total tax gap[c]	**$128.4**	**100.0%**

[a]Includes subtractions for erroneous deductions, exemptions, credits, and other adjustments.

[b]Includes unreported income and overstated deductions for exempt organizations' unrelated business income and for fiduciaries.

[c]Totals may not add due to rounding.

Source: Income Tax Compliance Research, IRS Publication 1415 (7-88); Income Tax Compliance Research, IRS Publication 1415 (4-90); and Federal Tax Compliance Research, IRS Publication 1415 (4-96).

Table I.2: 1992 Underreporting—Individual Tax Gap by Source (Dollars in Billions)

Description	1992 tax gap amount	Net reporting percentage
Underreported income		
Wages and salaries	$3.2	99.1%
Interest	0.9	97.7
Dividends	1.3	92.2
State tax refund	[a]	99.2
Alimony	0.1	86.7
Capital gains	2.5	92.8
IRS Form 4797	0.7	72.0
Pensions and annuities	1.8	96.0
Taxable unemployment	0.3	93.1
Farm income	3.4	67.8
Partnership and small business corporation income	3.6	92.5
Rents and royalties	3.7	82.8
Informal suppliers	12.3	18.6
Other sole proprietors	16.9	67.7
Other income	7.6	75.1
Taxable Social Security	0.2	95.8
Overstated offsets		
Adjustments to income	0.2	98.0
Deductions	5.1	95.6
Exemptions	2.9	95.5
Credits	6.2	59.8
Total underreporting tax gap[b]	**$73.1**	

[a]Less than $0.1 billion dollars.

[b]Totals may not add due to rounding.

Source: Federal Tax Compliance Research, IRS Publication 1415 (4-96).

Table I.3: Gross Income Tax Gap for Selected Tax Years 1985, 1988, and 1992 (Dollars in Billions)

	Gross income tax gap		
Tax year	Total	Individual income tax	Corporate income tax[a]
1985	$85.9	$70.4	$15.5
1988	105.2	80.9	24.3
1992	128.4	95.3	33.1

[a]Amount may be understated since the corporate income tax nonfiler number is not available for inclusion in the total.

Source: Income Tax Compliance Research, IRS Publication 7285 (3-88); Income Tax Compliance Research, IRS Publication 1415 (4-90); Federal Tax Compliance Research, IRS Publication 1415 (4-96); and Information from IRS' Research Division.

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