
June 2009

TAX COMPLIANCE

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



GAO

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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.

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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.

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United States Government Accountability Office
Washington, DC 20548

June 15, 2009

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

Sharing data between federal and state agencies can be a cost-effective way to improve tax compliance by uncovering information that helps identify businesses and individuals that are noncompliant with their taxes.¹ According to Internal Revenue Service (IRS) studies, small businesses with cash incomes contribute significantly to the 2001 estimated gross tax gap of \$345 billion.² IRS operates a wide variety of data-sharing arrangements with state revenue and nonrevenue agencies designed to improve tax compliance among individuals and businesses. In one type of arrangement, IRS and state agencies share information about businesses that apply for state business licenses.³ Under this arrangement, an individual applying for a business license from the state is required to be in compliance with federal tax obligations, state tax obligations, or both before the state issues a business license. Some state tax and IRS officials believe this type of data sharing has the potential to benefit both IRS and state governments since the businesses would need to initiate contact with IRS or state revenue agencies to demonstrate compliance. If the businesses cannot demonstrate compliance, they are then required to come into compliance to qualify for a business license.

¹GAO, *Taxpayer Information: Options Exist to Enable Data Sharing Between IRS and USCIS but Each Presents Challenges*, [GAO-06-100](#) (Washington, D.C.: Oct. 11, 2005).

²The gross tax gap represents the difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law. 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). IRS estimated that it would eventually collect about \$55 billion of the gross tax gap through late payments and IRS enforcement actions, leaving a net tax gap of around \$290 billion.

³Some states also engage in data sharing arrangements requiring tax compliance to qualify for professional licenses, such as licenses to practice nursing or law. This report focuses on business licenses.

The Department of the Treasury's 2006 *Comprehensive Strategy for Reducing the Tax Gap* recognizes the potential benefits of increased coordination with state governments to improve compliance and reduce the tax gap.⁴ It envisions improved document-matching programs and federal-state partnerships as a means to reduce the tax gap. In fact, we found that federal and state partnerships that involve reciprocal agreements covering collection of unpaid tax debts benefited both governments, and the use of levies and offsets showed even greater potential for collecting millions in unpaid debts. In fiscal year 2004, for example, although most states submit only personal income tax debt and not business income tax debt to the Financial Management Service (FMS) for collection, FMS still collected over \$217 million on behalf of various states through offsets of federal income tax refunds to pay state income tax debt. Conversely, IRS received over \$77 million from states' levy of state income tax refunds to pay delinquent federal taxes.⁵

You have raised questions about whether IRS is fully using data from state and local governments to reduce the tax gap. Related to this interest, and at your request, we issued a report in November 2008 on the State Reverse File Match Initiative (SRFMI) pilot program, which matches federal and state taxpayer data to identify noncompliant federal taxpayers.⁶ You also requested that we assess a data-sharing arrangement between IRS and the California Department of Industrial Relations, Division of Labor Standards Enforcement (DLSE). Under this arrangement, applicants for California business licenses in three industries—farm labor contracting, garment manufacturing, and car washing and polishing—must be in compliance

⁴Department of the Treasury, Office of Tax Policy, *Comprehensive Strategy for Reducing the Tax Gap* (Washington, D.C., Sept. 26, 2006).

⁵GAO, *Financial Management: State and Federal Governments Are Not Taking Action to Collect Unpaid Debt through Reciprocal Agreements*, [GAO-05-697R](#) (Washington, D.C.: July 26, 2005).

⁶In this report, we recommended that IRS develop a methodologically sound and documented evaluation plan to accurately and reliably assess the SRFMI pilot program's results. In response, IRS agreed that it is important to properly document and assess the SRFMI pilot program as a whole before it is expanded to additional states. IRS also agreed to develop an overall evaluation plan to accurately and reliably assess all components of the SRFMI pilot program's results and include the key evaluation features in our recommendation. GAO, *Tax Administration: IRS Needs to Strengthen Its Approach for Evaluating the SRFMI Data-Sharing Pilot Program*, [GAO-09-45](#) (Washington, D.C.: Nov. 7, 2008).

with federal employment tax obligations to qualify.⁷ You asked us 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 determine 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, we used the IRS and State of California data-sharing arrangement as a case study.⁸ To determine the potential for improving federal tax compliance, we estimated the return on investment (ROI) for the IRS Ogden/California DLSE data-sharing arrangement by determining the amount collected and estimating the cost of operating the arrangement. To determine the amount collected, we used IRS Ogden spreadsheets that record the number of federal tax returns filed by business license applicants and the amount IRS collected from businesses that IRS informed that they were not in compliance with federal employment taxes covering calendar year 2006 and 8 months in calendar year 2007.⁹ To determine the cost of operating this data-sharing arrangement, we estimated the costs of collecting the amounts owed by noncompliant businesses using actual cost categories provided by IRS Ogden officials. We then compared the ROI ratio for this data-sharing arrangement to IRS's estimates for five revenue-producing enforcement initiatives in the IRS fiscal year 2009 budget submission.¹⁰ To determine whether California businesses remained in compliance over time, we

⁷DLSE licenses farm labor contractors and registers garment manufacturers and car washing and polishing firms. DLSE requires the same tax compliance verification for both licensure and registration. In this report, we use the term business license in discussing all three California businesses.

⁸We selected the State of California data-sharing arrangement as a case study because it required federal tax compliance to qualify for a state business license, data were available on the number of businesses and amounts of unpaid assessment businesses owed IRS and the cost to operate the data-sharing arrangement, and this arrangement was established in 1992. In addition, IRS officials said that this arrangement generated big benefits relative to costs.

⁹The spreadsheets exclude 4 months for calendar year 2007. IRS Ogden misplaced data for July and August, and November and December data were not available when we obtained the data in November 2007.

¹⁰Internal Revenue Service, *FY 2009 Congressional Budget Submission* (Washington, D.C.: Feb. 4, 2008).

matched data on California business applicants from an Access database maintained by IRS Ogden with taxpayers in IRS's Unpaid Assessments file.¹¹ We used California business applicants for calendar year 2006 only from the Access database and taxpayers in IRS's Unpaid Assessments file as of the week of September 18, 2006, and the week of August 18, 2008. We reviewed agency agreements and memoranda, regulations, and reports covering the data-sharing arrangement and interviewed IRS and California officials about the compliance value of the arrangement. The Access database did not contain data prior to calendar year 2006 because IRS Ogden purged these historical data. While data from previous years would be useful for evaluating the data-sharing arrangement, we believe that the Ogden records that were available to us were sufficiently reliable for developing an understanding of the arrangement. We did not verify the accuracy of the data IRS provided or its estimate of the revenue costs of its five new activities, including the estimated ROI of these activities.

To determine what opportunities exist for increasing data sharing that requires federal business tax compliance to qualify for state business licensing, we contacted state revenue officials in 50 states and the District of Columbia via e-mail about the extent to which their states engage in data-sharing arrangements that require applicants to be tax compliant to qualify for business licenses, reviewed and identified IRS documentation on data-sharing arrangements between IRS and state agencies that require federal tax compliance to qualify for state business licensing, and interviewed state revenue officials whose states engage in data-sharing arrangements that require businesses to demonstrate federal tax compliance to qualify for state business licenses.

We conducted this performance audit from June 2007 through June 2009 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.

¹¹Unpaid assessments are legally enforceable claims against taxpayers and consist of taxes, penalties, and interest that have not been collected or abated. GAO, *Financial Audit: IRS's Fiscal Years 2008 and 2007 Financial Statements*, [GAO-09-119](#) (Washington, D.C.: Nov. 10, 2008).

Background

IRS engages in hundreds of data-sharing arrangements with state revenue, human services, and law enforcement agencies for tax compliance and other purposes. In a small portion of IRS's federal-state data-sharing arrangements, states require federal tax compliance to qualify for a state business license. In some instances, state licensing agencies require compliance with both federal and state tax obligations, and requirements can vary among states. These arrangements can vary by industry; by type of taxes required for compliance, such as employment taxes or income taxes; and even by the type of documentation required to prove compliance. For example, in some states the businesses may self-certify that they are in compliance with taxes, and in others businesses must provide documentation from IRS or the state revenue agency that they are in compliance with tax requirements.

IRS and California's DLSE are engaged in an arrangement that requires compliance with federal employment taxes to operate a business in any one of three industries in California.¹² An individual applying for a new business license or a renewal of his/her business license to operate a farm labor contracting, garment manufacturing, or car washing and polishing business must first prove full compliance with federal employment taxes by filing all required federal employment tax returns and resolving all outstanding federal employment taxes through full payment or appeal. Each business license applicant in the three industries requiring federal tax compliance must submit a state business license application and a signed IRS Form 8821, Tax Information Authorization, allowing IRS to disclose the applicant's tax information to DLSE. IRS tax examiners in Ogden, Utah, review the tax information in IRS's Integrated Data Retrieval System (IDRS) to check the employment tax status of the applicant.¹³ If the applicant is compliant, IRS provides DLSE and the applicant with a statement that the applicant has met all filing and payment requirements. If the applicant has an outstanding employment tax liability, has not filed a federal employment tax return, or both, the tax examiner prompts the

¹²The data-sharing arrangement started in the garment manufacturing industry in the early 1990s and expanded to farm labor contracting. The state extended the arrangement to the car washing and polishing industry in December 2005.

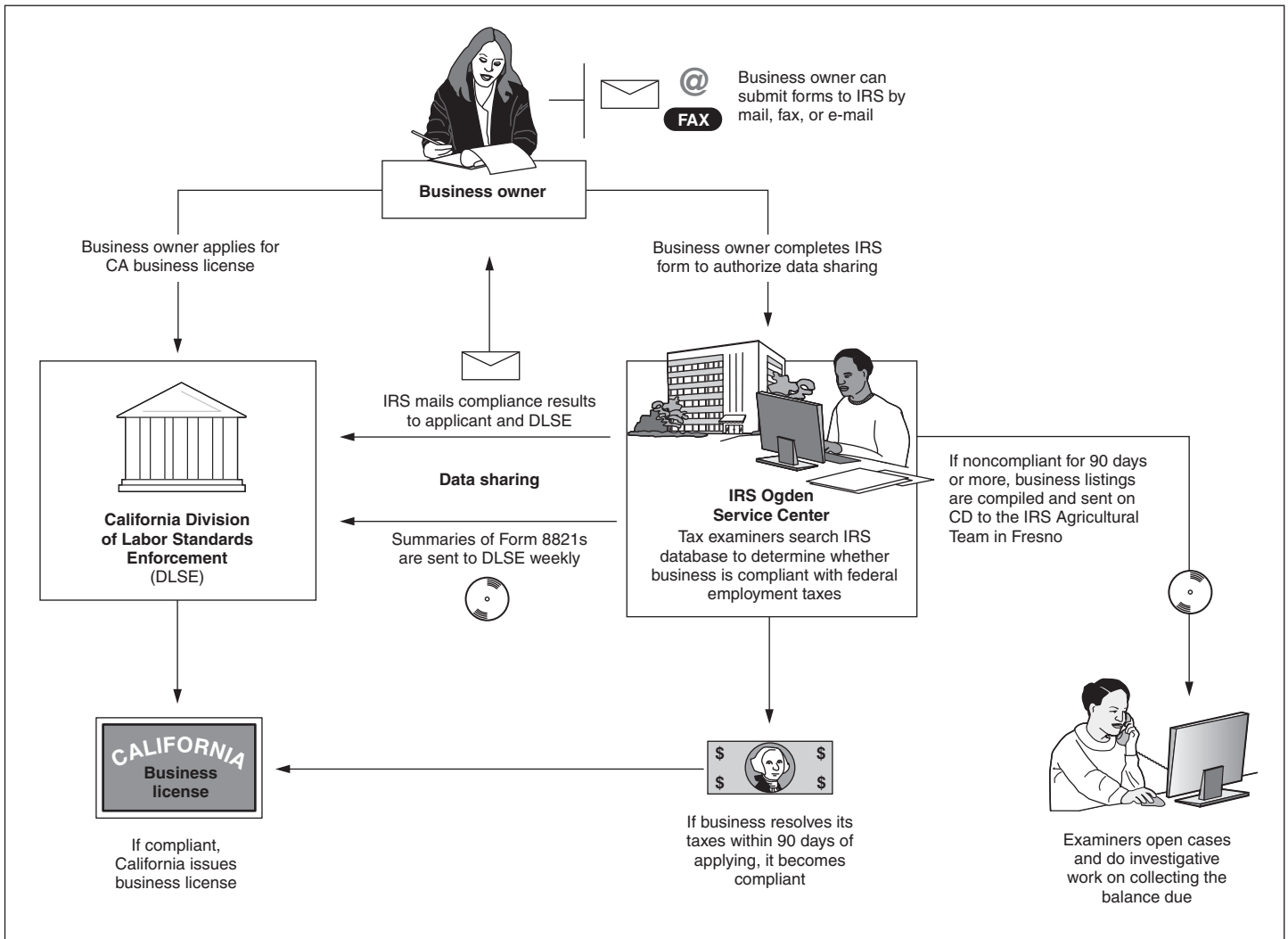
¹³IDRS is a system that consists of databases and operating programs that support IRS employees working active tax cases, allowing them to take specific actions on taxpayer account issues, track status, and post transaction updates back to the Master File. There are several master files. The most significant are the individual master file—which contains tax records of individual taxpayers—and the business master file—which contains tax records of corporations and other businesses.

system to generate a noncompliance letter, which is sent to the applicant. Applicants with outstanding tax liability can pay the amounts due or contact the IRS tax examiners for more information or to make arrangements for payment. IRS officials told us that IRS Ogden does not collect employment taxes from business applicants directly. Noncompliant business applicants may pay federal employment taxes they owe at local IRS offices or mail their payments to IRS. Ogden officials are notified by e-mail or phone when business applicants have paid the employment taxes identified in the noncompliance letter. IRS informs DLSE that an applicant has paid all employment taxes, is currently working with a revenue officer to pay all balances due, or is otherwise compliant. After notification, DLSE will issue the applicant's business license.

DLSE officials told us that for purposes of business licensing, California business applicants in the three industries have resolved their taxes if they have (1) paid their tax liability, (2) entered into installment agreements, or (3) completed offers in compromise with IRS. If an applicant's tax case is in bankruptcy, California's DLSE makes the decision on whether to issue the business license.¹⁴ If an applicant does not resolve his/her tax liability within 90 days of applying, IRS staff in Ogden send the cases to the IRS Agricultural Team in Fresno, where tax examiners open the case and do investigative work on collecting the balance due. See figure 1 on how data sharing between IRS and California operates.

¹⁴According to California DLSE, in the event that a taxpayer disputes the tax assessment, DLSE would, on a case-by-case basis, make a decision about granting the business license based on the amount owed and the individual business circumstance.

Figure 1: How Data Sharing Operates between IRS and California



Source: GAO analysis of IRS information.

Section 6103 of the Internal Revenue Code (I.R.C.) prohibits the disclosure of tax returns and return information by IRS employees; other federal employees, state employees, or both; and certain others having access to the information except in specifically enumerated circumstances. Data sharing between IRS and California DLSE is authorized by a subsection of I.R.C. § 6103. Specifically, section 6103(c) authorizes IRS to disclose the

return information of a taxpayer to any other person at the taxpayer's request.¹⁵ State licensing entities that wish to review federal tax information or have IRS attest to tax compliance before issuing the license would need to require the applicant to provide a written request to IRS authorizing release of the information to the licensing entity.

Data-Sharing Arrangement Requiring Tax Compliance of California Business License Applicants Can Be a Valuable Compliance Tool

The data-sharing arrangement between IRS Ogden and California DLSE can be a valuable tool for improving compliance among certain businesses. According to IRS officials, this type of data-sharing arrangement has mutual benefits for IRS, by increasing filing and payment compliance with federal employment taxes, and for states, by minimizing concerns about the success of the business and its compliance with unemployment requirements. IRS officials noted that growth in this data-sharing arrangement can generate many compliance benefits with a relatively minimal resource allocation. According to a California DLSE official, this data-sharing arrangement is beneficial because it helps to ensure that businesses are competent and responsible and pay their taxes.

The amount of revenue in federal employment taxes collected through this data-sharing arrangement appears to outweigh the cost of operating the data-sharing arrangement. Thousands of California businesses apply for a business license each year in order to operate a business in the three industries previously mentioned, and must provide documentation to DLSE to show that they are in compliance with federal employment taxes. Many of these businesses were not in compliance with employment taxes during the time of our analysis and, therefore, had to file tax returns or pay employment taxes to rectify their compliance status. According to the IRS Ogden database on business applicants, 7,194 businesses applied for a business license in the three industries one or more times from calendar years 2006 through 2008 and requested that IRS provide California with information on their compliance with federal employment taxes. About 24 percent of businesses (i.e., 1,726 of the 7,194 that applied) had to file employment tax returns or pay or otherwise resolve overdue taxes to come into compliance with federal employment taxes.

¹⁵The taxpayer's request to release return information to another must be in writing. I.R.C. § 6103(c). IRS Form 8821 is generally used to authorize IRS's release of confidential information.

IRS staff in Ogden use spreadsheets to track the number of federal tax returns filed by noncompliant California business license applicants and the amounts IRS collected from these businesses that are attributable to the data-sharing arrangement. The spreadsheets show that businesses not in compliance with federal employment taxes when they applied for California business licenses filed hundreds of tax returns in calendar years 2006 and 2007 and IRS collected millions in federal employment taxes. California businesses filed 441 employment tax returns to come into compliance to qualify for California business licenses and IRS collected nearly \$7.4 million in employment taxes, according to IRS Ogden spreadsheets.¹⁶ IRS Ogden officials told us that the nearly \$7.4 million in employment taxes collected represents the amount business applicants paid after receiving noncompliance letters related to their DLSE business license applications. Table 1 shows the number of tax returns filed and the amount IRS collected from these applicants during calendar years 2006 and 2007.

Table 1: Number of Tax Returns Filed and Amount Collected from Businesses That Were Noncompliant at the Time of Application, Calendar Years 2006 and 2007

Calendar year	Number of federal tax returns filed	Amount collected ^a
2006	277	\$3,896,098
2007 ^b	164	3,476,509
Total	441	\$7,372,607

Source: GAO analysis of IRS data.

^aThe amounts collected are expressed in 2009 dollars.

^bSpreadsheet data for calendar year 2007 exclude 4 months. Data were not available for July, August, November, and December at the time we obtained the data in November 2007.

Even though IRS did not track all of the costs it incurred for operating the data-sharing arrangement, IRS officials noted that the arrangement resulted in high revenues relative to costs.¹⁷ In order to get some perspective on how this data-sharing arrangement compares with other

¹⁶The amounts of collections and cost dollars are expressed in 2009 dollars.

¹⁷In 2009, we reported that IRS was unable to readily determine the costs of its direct activities and programs and did not have cost-based performance information. GAO, *Financial Audit: IRS's Fiscal Years 2008 and 2007 Financial Statements*, [GAO-09-119](#) (Washington, D.C.: Nov. 10, 2008).

IRS enforcement efforts, we developed an estimate of the costs of the arrangement using cost categories provided and confirmed by IRS officials.¹⁸ The cost categories we considered included personnel costs and nonpersonnel costs, such as computers, telephones, and fax machines.

We estimated that IRS incurred about \$331,348 to operate the data-sharing arrangement in calendar years 2006 and 2007. Our cost estimate included personnel costs of about \$202,125 in pay and about \$61,042 in benefits for one General Schedule (GS) 5 clerk and two GS 7 tax examiners. We also included about \$10,197 for three computers, \$1,237 for one dedicated printer, \$313 for one fax machine with a dedicated line and two dedicated phone lines with voice mail boxes, and approximately \$56,435 for supplies, facilities, utilities, and supervision.¹⁹ These costs may be somewhat overstated because, for instance, we used approximate purchase costs for equipment and did not spread those costs over the useful life of the equipment or other uses of the equipment.

Using our estimate, the ROI for this data-sharing arrangement is 22:1.²⁰ IRS has not tracked the cost data needed to do a study comparing the ROI of the IRS Ogden/DLSE enforcement activity with those of other current enforcement activities to determine how the IRS Ogden/DLSE data-sharing arrangement ROI compares with those of IRS's other enforcement activities. However, IRS has developed ROI estimates for five new direct revenue-producing enforcement initiatives it proposed in its fiscal year 2009 budget submission.²¹ IRS estimates that the average ROI for these activities at full performance (at the end of their second year of implementation) will be 7.1:1. IRS projects the highest ROI for one of the five new initiatives (expanded document matching) at 11.4:1. IRS officials told us that IRS calculates the ROI each year for the revenue-producing

¹⁸The estimate includes costs for calendar year 2006 and 8 months in calendar year 2007 to correspond with data from the IRS Ogden spreadsheets on amounts IRS collected in calendar years 2006 and 2007. All costs are expressed in 2009 dollars.

¹⁹To develop our cost estimates, we used the guidance for preparing agency budgets in Executive Office of the President, Office of Management and Budget Circular A-11, *Preparation, Submission, and Execution of the Budget*, and GAO, *GAO Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, [GAO-09-3SP](#) (Washington, D.C.: March 2009).

²⁰Our ROI estimate does not take into account several factors that could decrease or increase the estimate. Those factors are discussed on page 14.

²¹Internal Revenue Service, *FY 2009 Congressional Budget Submission*.

initiatives included in the President's budget request. They also said that these ROI calculations are based on historical information in the Enforcement Revenue Information System and the annually updated unit cost rates used in budget formulation.²² We did not verify the accuracy of the data IRS provided or its estimate of the revenues and costs of its five new enforcement activities, including the estimated ROI of these activities.

Tax Compliance among Businesses Showed Improvement after They Applied for State Business Licenses

We identified the 2,017 businesses that applied for business licenses in calendar year 2006 only,²³ and found that 315 of these businesses had unpaid assessments at the time of applying and that tax compliance improved for these 315 businesses. We identified the businesses that applied for a California business license in 2006 only so that we could follow the tax compliance of this set of specific businesses over time. We matched data of California business license applicants for calendar year 2006 from the IRS Ogden Access database with IRS's Unpaid Assessments file at two points in time—for the week of September 18, 2006, and the week of August 18, 2008.

Our analysis of California business license applicants matched against the IRS Unpaid Assessments file database showed that 315 businesses owed employment taxes as of September 18, 2006, and by August 18, 2008, 165 of those businesses had resolved or lowered their unpaid assessment debt.²⁴ The 165 businesses resolved or lowered their 2006 unpaid assessments in either calendar year 2007 or 2008. Our analysis also revealed that 150 businesses had not resolved or reduced unpaid assessment debt by August 18, 2008. Table 2 shows business license applicants with unpaid assessments as of September 18, 2006, and businesses that resolved/did not resolve their debt by August 18, 2008.

²²IRS computed the ROI of the five new direct revenue-producing enforcement initiatives it proposed in its fiscal year 2009 budget submission by dividing the projected enforcement revenue for each new enforcement initiative by the total cost of the initiative.

²³Businesses that applied in calendar year 2006 *only* are those that applied in calendar year 2006 and not again in 2007 or in the 10 months in 2008 for which we have IRS Ogden DLSE Access database data.

²⁴We use the term resolved to include situations where the taxpayer paid all or some of the assessment, IRS abated the assessment, IRS reclassified the debt as currently not collectible, or IRS agreed to write off part of the debt in accepting an offer in compromise. We say that businesses "lowered their unpaid assessment debt" when the amounts of the businesses' unpaid assessment were less in calendar year 2008 than in calendar year 2006.

Table 2: Number of California Business License Applicants with Unpaid Employment Tax Assessments in Calendar Year 2006 and Status in Calendar Year 2008

	Number with unpaid assessments as of week of September 18, 2006	Number that resolved or lowered debt as of week of August 18, 2008	Number with unresolved or unreduced debt as of week of August 18, 2008
Calendar year 2006 business applicants	315	165	150

Source: GAO analysis of IRS data.

Note: Data on business license applicants for calendar year 2007 include 10 months. Data were available through October at the time we obtained the data in November 2007.

The 165 businesses resolved or lowered their unpaid assessments by nearly \$2 million—\$1,925,162—from the weeks of September 18, 2006, through August 18, 2008. The 115 business license applicants that completely resolved their debt before August 18, 2008, resolved nearly \$800,000 in unpaid tax assessments in calendar years 2007 and 2008.²⁵ These applicants, in total, had a nearly \$800,000 tax liability as of September 18, 2006, but the unpaid assessments file showed no tax liability for them as of the week of September 18, 2008. Fifty additional businesses lowered their tax assessments from the weeks of August 18, 2006, through September 18, 2008, by \$1,135,216. However, the 165 businesses may have resolved more than \$1,925,162 because these taxpayers may have had additional taxes assessed after the week of September 18, 2006, and may have resolved them before the week of August 18, 2008. Our analysis compares unpaid assessments at two points in time since the data file we used did not allow us to track weekly changes in the businesses' unpaid assessments. Table 3 shows the amount of unpaid tax assessments as of the week of September 18, 2006, and as of the week of August 18, 2008, and the amount of unpaid employment tax assessments resolved by the 165 businesses.

²⁵Our analysis of unpaid assessments includes unpaid taxes assessed plus accrued interest and penalties.

Table 3: Amount of Unpaid Employment Tax Assessments and Debt Resolved for 165 Business Applicants

Number of business applicants	Amount of unpaid assessments as of week of September 18, 2006	Amount of unpaid assessments as of week of August 18, 2008	Amount of debt resolved as of week of August 18, 2008 ^a
115 business applicants in 2006	\$789,946	\$0	\$789,946
50 business applicants in 2006	7,158,680	6,023,464	1,135,216
Total	\$7,948,626	\$6,023,464	\$1,925,162

Source: GAO analysis of IRS data.

^aUnpaid assessments and unresolved tax debt include accrued interest and penalties.

All but 1 of the 350 businesses that had unpaid assessments when they applied for business licenses in calendar year 2006 were small businesses. The remaining business was a medium or large business. According to IRS, “small businesses” includes businesses with assets of less than \$10 million.

The IRS Ogden/California DLSE data-sharing arrangement can be a valuable compliance tool because the requirement to renew business licenses annually provides a motivation to resolve tax debts timely. The arrangement may help flag unpaid tax assessments when they are recent and have a greater likelihood of collection. Our previous work found that the age of the unpaid assessment is an indicator of the extent to which the outstanding amounts owed are likely to be collected.²⁶ This work showed that the older an unpaid assessment the lower the probability it will be paid. In another report, we found that the IRS records we examined showed that 70 percent of all unpaid payroll taxes—estimated at \$58 billion as of September 30, 2007—were owed by businesses with more than a year (4 tax quarters) of unpaid federal payroll taxes. Over a quarter of unpaid federal payroll taxes were owed by businesses that accumulated tax debt for more than 3 years (12 tax quarters).²⁷ One reason why older debts may not be collected is that they lead to large and increasing amounts of accrued interest and penalties. The requirement that annual business license renewals depend on resolving unpaid employment tax assessments may help businesses avoid the pyramiding of interest and penalties.

²⁶GAO, *Internal Revenue Service: Composition and Collectibility of Unpaid Assessments*, [GAO/AIMD-99-12](#) (Washington, D.C.: Oct. 29, 1998).

²⁷GAO, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes*, [GAO-08-617](#) (Washington, D.C.: July 25, 2008).

The ROI for these enforcement activities can vary depending on factors such as the efficiency of operating the data-sharing arrangements and whether the data-sharing arrangements experience higher collections in the early years of operation. For example, an IRS official suggested that there may be a way to more efficiently operate this type of data-sharing arrangement and thereby obtain a higher ROI. Applying an automated filter to isolate business applicants with no taxes due, IRS staff would only need to manually review data on businesses with balances due or that have not filed required returns, and fewer IRS staff may be needed to operate the data-sharing arrangement. An IRS official in Ogden told us that the taxes collected by the IRS Ogden/California DLSE data-sharing arrangement about 10 years ago were substantially higher because there was very little compliance when the data-sharing arrangement first started. This official recalled that when the program was transferred to Ogden the numbers of noncompliant applicants were at least three or four times higher than they are now. In this official's view, consistency in enforcing the business tax compliance requirement of the three industries has steadily improved compliance and has resulted in fewer business applicants that are noncompliant with their employment tax obligations when they apply for business licenses.

A More Complete Evaluation Could Further Isolate and Quantify the Benefits and Costs of the Business Licensing Requirement

Given that our analysis indicates that the California business licensing requirement likely has a higher ROI than the direct revenue-producing enforcement initiatives IRS proposed in its 2009 Congressional budget submission, a fuller examination is warranted. A more complete evaluation could address some potential factors that could reduce or increase the ROI we calculated. For example, it could evaluate whether IRS had taken other enforcement actions against the California businesses at the same time as they were applying for licenses. If IRS had sent collection notices to the businesses or taken other enforcement action at or close to the time the businesses went through the licensing reviews, the resolution of their debts might be attributable to those enforcement actions. A more complete evaluation could also compare the results of this enforcement approach to the results for similar businesses that were not subject to the business licensing requirement. Such an analysis could help demonstrate how well the business licensing requirement fares compared to the "normal" enforcement actions that would be taken by IRS with similarly situated businesses. A more complete evaluation could take into account the resolution of debts that may have been incurred before a business applied for a license. Since the affected businesses know they must resolve their employment tax debts in order to receive business licenses, some may pay or otherwise resolve their debts in anticipation of

the licensing review by IRS. Any such advance payments or resolutions could be included.

Similarly, although our tracing of businesses' compliance from calendar years 2006 to 2008 shows improvement in the resolution of many firms' debt, a more complete evaluation could compare their improvement to similarly situated businesses that were not subject to the licensing requirement. Such a comparison would help show whether this continued improvement in the delinquent debts was better than what could have occurred absent the licensing requirement.

During the period we reviewed, Ogden staff responsible for the business licensing reviews discarded older operational data when they were no longer needed for their purposes. Further, a few months of data were lost even before they would have normally been discarded. Although these data may not be needed to administer the program, they are needed to support a more complete review of the program's ROI.

Many Opportunities Exist to Require Federal Tax Compliance to Qualify for State Business Licenses, but Challenges Exist

We contacted revenue officials in every state and the District of Columbia to ask whether their states have business licensing requirements and, if so, whether they require demonstration of state tax compliance before business licenses are granted.²⁸ Of the 47 states and the District of Columbia that responded, 20 revenue officials told us that the states require demonstration of compliance with one or more state taxes for businesses to qualify for state business licenses, and these requirements exist for one or more industries.²⁹ Based on these responses, the tax compliance requirement is typically limited to a few industries, requires compliance with selected taxes, and varies on the amount of documentation required to show compliance with tax requirements. Table 4 summarizes responses on the number of states that require businesses to

²⁸We also asked state revenue officials about compliance with federal taxes to qualify for state business licenses to determine if there were any additional states with federal tax compliance beyond those in the information IRS had on federal tax compliance and state business licenses. Not surprisingly, the state revenue officials did not provide any additional information since that type of data-sharing arrangement is typically between IRS and state licensing functions.

²⁹Kansas, Massachusetts, and Ohio did not respond to our request on whether their states have business licensing requirements and, if so, whether they require demonstration of state tax compliance before business licenses are granted.

be tax compliant to qualify for state business licenses in one or more industries as of April 6, 2009.

Table 4: Number of States That Require Businesses to Be Compliant with Certain State Taxes to Qualify for State Business Licenses in One or More Industries

Tax compliance requirement	Number of states
Require state tax compliance	20
Do not require state tax compliance	20
Do not have a business license requirement at the state level	8
No response	3
Total	51

Sources: Revenue agencies from the 50 states and the District of Columbia.

Of the 19 states and the District of Columbia that require business applicants to be compliant with state taxes, only the District of Columbia requires applicants in all industries to be state tax compliant to qualify for business licenses. Nineteen states require business license applicants in one or more industries to be state tax compliant to qualify for business licenses.

Most of the states that responded do not require compliance with three types of taxes, employment, income, or sales and use, except for the District of Columbia, which requires compliance with all three types of taxes. Of the 19 states that identified compliance with state taxes to qualify for a state business license, 15 identified the specific type of tax or taxes being reviewed. Seven states require compliance with their employment taxes, 8 states require compliance with state sales and use taxes, and 10 states require compliance with state income taxes. State requirements also vary in the amount and kind of documentation required to prove compliance with tax requirements. For example, Rhode Island allows businesses to self-certify that they are in compliance with state tax requirements. Pennsylvania requires licensing agencies to request verification of state tax compliance from the state tax agency when a business owner applies for or renews a license.

Federal Tax Compliance Requirements to Qualify for State Business Licenses Differ by State

IRS maintains information on data-sharing arrangements that include requirements for federal tax compliance to qualify businesses for state business licenses. According to an IRS document, 13 data-sharing arrangements exist that require compliance with federal taxes to qualify

for state business licenses. For example, the State of Oregon requires farm/forest labor contractors comply with federal and state taxes to qualify for state business licenses. Each farm/forest labor contractor applicant must submit IRS Form 8821 with the application. In addition, applicants can be denied licenses if state and federal taxes are owed. Similarly, the State of Connecticut requires applicants for gaming licenses to be compliant with federal and state income taxes to qualify for business licenses. Applicants for gaming licenses must submit complete copies of their most recent federal and state income tax returns and certify that there are no outstanding tax delinquencies or unresolved disputes.

Officials See Benefit in Requiring Tax Compliance to Qualify for Business License but Acknowledge That Challenges Exist

While most states told us that they do not track tax collections and program costs associated with these data-sharing arrangements, those revenue officials that provided comments and participate in data-sharing arrangements requiring state tax compliance told us that the state arrangements improve state tax collections and promote voluntary compliance. For example, a revenue official said that data sharing is used as another tool to collect outstanding taxes due the state. This official also said that the data-sharing arrangement has been very effective in furthering the state's tax collection efforts. He added that without a license, a business cannot operate. Another state revenue official told us that the individual or business must keep all state tax obligations current in order to prevent the denial or revocation of the applicable license. In this official's view, this causes the affected individuals or businesses to be less likely to have delinquent returns and outstanding tax bills that are not on payment agreements. Our analysis shows that 19 states and the District of Columbia allow the taxpayer to obtain a business license if the taxpayer sets up a payment agreement with the state's revenue agency.

IRS staff in Ogden told us that requiring tax compliance makes the businesses think about the consequences of not being tax compliant. They added that the data-sharing arrangement itself becomes a deterrent after a while, since businesses, for which IRS is checking compliance, learn that they cannot get licenses without being compliant.

While some state revenue officials see benefit in requiring tax compliance to qualify for a business license, they recognize certain challenges their agencies face from linking state business licensing with tax compliance. One of the challenges is coordination between state agencies. For example, a revenue official said that obtaining key information from state agencies, such as tax identification numbers and licensee names, and acting on her agency's request to suspend the licenses are ongoing

challenges. A 2008 state study noted that agency coordination is crucial to the success of any tax clearance program. In order for the program to be effective, each agency must be prepared to share information with other agencies and to act on information received from other agencies.³⁰ Finally, states also face technical issues with linking tax compliance with business licensing. For example, a revenue official said that her state does not have electronic linking between its Division of Alcoholic Beverages and Tobacco and the Department of Revenue for verification of applicant sales and use tax information. This official also said that the challenge would be to link their present licensing computer system with the Department of Revenue system. Another official said that her agency's computer programs vary, are outdated, and are not integrated.

Some challenges identified by states likely would be especially important for any expansion of requirements for federal tax compliance to obtain state business licenses. For example, some of the revenue officials we contacted identified legal issues relating to data sharing. A state revenue official said that various licensing statutes do not permit the revocation or threat of action against a licensee due to tax noncompliance. An additional revenue official said that with limited resources, implementing the legal requirement to review licenses is difficult.

Opportunities Exist to Expand Federal Tax Compliance Requirements to Qualify for State Business Licenses

The potential to increase data-sharing opportunities between IRS and state business licensing entities exists, but pinpointing the exact number of opportunities is difficult. According to the Small Business Administration, business licensing requirements vary from state to state. For example, a state "business license" is the main document required for tax purposes and conducting other basic business functions. However, some states have separate licensing requirements based on the product sold, such as licenses to sell liquor, lottery tickets, gasoline, or firearms. Ultimately, it is up to each state to determine what industries, occupations, and professions must be licensed and the licensure requirements that applicants must meet.

Some states and some business types may represent more of an immediate opportunity for establishing arrangements that require federal tax compliance to qualify for state business licenses. States that currently

³⁰Virginia Department of Taxation, *Tax Clearance Study to the Governor and the General Assembly of Virginia*, Senate Document No. 7 (Richmond, Va., 2008).

require compliance with state taxes for selected business license applicants may be more amenable to requiring federal tax compliance than states that do not even require state tax compliance since they already recognize tax compliance as important for the businesses. For example, North Carolina, Texas, and Missouri have a requirement for tax compliance with state taxes for retail sales businesses. These states do not require compliance with federal taxes. In addition, states that currently require compliance with federal employment taxes may be amenable to extending the requirement to include federal income taxes. For example, California's DLSE requires applicants for the three industries requiring licensing to be compliant with federal employment taxes only. California's garment manufacturing, farm labor contracting, and car washing and polishing license applicants have no requirement to be in compliance with federal income taxes to qualify for business licenses.

Conclusions

Increasing data sharing between IRS and state governments to help reduce the tax gap can be beneficial to IRS when such data-sharing arrangements demonstrate firm compliance value. Data-sharing arrangements requiring tax compliance among business license applicants show real potential to be a valuable tool to improve tax compliance among certain businesses. Our estimated ROI of the data-sharing arrangement between IRS Ogden and California DLSE suggests that requiring tax compliance to qualify for state business licenses can be a cost-effective way of collecting tax debt. In fact, the data-sharing arrangement's estimated ROI is higher than the estimated ROI for the new direct revenue-producing tax enforcement initiatives in IRS's fiscal year 2009 budget submission.³¹ However, a more complete evaluation could take into account all the factors that could affect ROI. To be in a better position to evaluate these data-sharing arrangements, IRS needs to ensure that program data are retained.

Recommendations for Executive Action

We recommend that the Commissioner of Internal Revenue take the following three actions:

- Collect and retain the cost and revenue data needed to develop ROI estimates for programs requiring businesses to demonstrate federal tax compliance to obtain state business licenses.

³¹Internal Revenue Service, *FY 2009 Congressional Budget Submission*.

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- Evaluate the ROI of existing arrangements where states require federal tax compliance to qualify for state business licenses to determine whether the ROI of these programs is sufficient to merit their expansion.
 - To the extent that existing data-sharing arrangements have a sufficiently high ROI, coordinate with states to expand requirements to comply with federal taxes to qualify for state business licenses and monitor the ROI of these expansions to gauge their success.

Agency Comments

On behalf of the Commissioner of Internal Revenue, the Deputy Commissioner for Services and Enforcement provided written comments on a draft of this report in a June 8, 2009, letter. The Deputy Commissioner agreed with our recommendations. IRS plans to gather appropriate data to develop ROI estimates for this program, evaluate the results to determine whether these programs merit expansion, and if so, work with states to expand the programs.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 from the report date. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. This report will also be available at no charge on GAO's Web site at <http://www.gao.gov>.

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



Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

Our objectives were 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. This report focuses on data-sharing arrangements that require compliance with federal or state tax obligations to qualify for state business licensing. We did not include licensing requirements at the local level or licensing for professions or occupations.

To provide background on data-sharing arrangements that require compliance with tax obligations to qualify for state business licensing, we reviewed relevant Internal Revenue Service (IRS) and California Department of Industrial Relations, Division of Labor Standards Enforcement (DLSE) documents and interviewed IRS and California officials. We also reviewed laws and regulations related to taxpayer disclosure.

To determine 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, we used the IRS and State of California data-sharing arrangement as a case study. To determine the potential for improving federal tax compliance, we estimated the return on investment (ROI) for the IRS Ogden/California DLSE data-sharing arrangement. To determine the amount collected, we used IRS Ogden/California DLSE spreadsheets that record the number of federal tax returns filed by applicants for business licenses in the three industries and the amount IRS collected from businesses that were notified by IRS that they were not in compliance with federal employment taxes covering calendar year 2006 and 8 months in calendar year 2007.¹ Spreadsheet data for calendar year 2007 excluded 4 months. Ogden misplaced data for July and August, and data for November and December were not available when we obtained the data in November 2007. We also reviewed agency agreements and memoranda, regulations, and reports covering the data-sharing arrangement between IRS and California DLSE and interviewed IRS and California officials about the value of the data-sharing arrangement to IRS and the state.

¹We applied an inflator factor derived from the Department of Labor's Bureau of Labor Statistics *Databases, Tables & Calculators by Subject* to capture collections for calendar year 2009. See <http://data.bls.gov/PDQ/servlet/SurveyOutputServlet> (accessed Apr. 24, 2009).

To determine the cost of operating this data-sharing arrangement, we estimated the costs of collecting the amounts owed by noncompliant businesses using actual cost categories provided by IRS Ogden officials. We used the guidance for preparing agency budgets in Executive Office of the President, Office of Management and Budget, Circular A-11, Preparation, *Submission, and Execution of the Budget*, and our *Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, GAO-09-3SP (Washington, D.C.: March 2009). We estimated personnel costs using the Office of Personnel Management Salary Table 2009-RUS, for the locality pay area “of rest of U.S.,” effective January 2009, for General Schedule (GS) 5 and 7 personnel at step 5. We used step 5 to capture the midpoint of the GS 5 and 7 grade levels so as not to bias pay in the direction of a low or high estimate. We estimated the cost of benefits for these employees using the Department of Labor’s Bureau of Labor Statistics 30.2 percent average compensation cost for calendar year 2008.² We estimated the cost of fax machines and printers by averaging the costs for these items as shown on the Web sites for federal government customers of two leading manufacturers of these products. We shared our estimates with IRS officials to obtain concurrence with our estimates of nonpersonnel costs. We did not analyze the taxes IRS may collect or the costs it may incur after the noncompliant cases leave Ogden. We then compared the ROI ratio for this data-sharing arrangement to IRS’s estimates for five revenue-producing enforcement initiatives in the IRS fiscal year 2009 budget submission.³ The Ogden Service Center sends information on the taxpayers that have unpaid assessments 90 days after Ogden first receives their application materials to the Fresno Service Center for collection.

To determine whether California businesses remained in compliance over time, we matched data on California business applicants from an Access database maintained by IRS Ogden with taxpayers in IRS’s Business Master File Unpaid Assessments file. We selected the businesses that according to the Access database, applied for California DLSE business licenses in calendar year 2006 *only*—that is, applied in calendar year 2006 and did not reapply in calendar year 2007 or in the 10 months in 2008 for which we have IRS Ogden DLSE Access database data. The Access

²Department of Labor, Bureau of Labor Statistics, *NEWS: Employer Costs for Employee Compensation—December 2008* (Washington, D.C.: Mar. 12, 2009). See <http://data.bls.gov/PDQ/servlet/SurveyOutputServlet> (accessed Apr. 24, 2009).

³Internal Revenue Service, *FY 2009 Congressional Budget Submission*.

database contained January 2006 through October 2007 data on business license applicants in the three covered industries. For our analysis, we matched records of the California businesses that we selected from the Access database because they applied in calendar year 2006 only with IRS's Unpaid Assessments file as of the weeks of September 18, 2006, and August 18, 2008; identified the number of businesses with unpaid assessments and the amounts of their tax debt as of the week of September 18, 2006; and identified the applicants for business licenses in 2006 only that had resolved their unpaid assessments as of August 18, 2008, and the amounts of their tax debt they resolved. Our analysis compares unpaid assessments at two points in time since the data file we used did not allow us to track weekly changes in the businesses' unpaid assessments. We could not follow the tax compliance of earlier applicants into the present because IRS Ogden purged data from the Access database for calendar years earlier than 2006. Unpaid assessments in this report include the total tax assessment plus interest and penalties where these exist.

To determine what opportunities exist for increasing data sharing for arrangements that require federal tax compliance to qualify for state business licensing, we (1) analyzed and summarized which states and the District of Columbia have data-sharing arrangements that require state tax compliance to qualify for state business licensing, which states do not have such arrangements, and which states do not require businesses to obtain business licenses on the state level; (2) contacted revenue officials in 50 states and the District of Columbia via e-mail with structured questions about the extent to which their states engage in data-sharing arrangements that require demonstration of tax compliance before business licenses are granted; and (3) sent a follow-up e-mail to 21 state revenue officials who confirmed that their states require applicants to be compliant with state taxes to qualify for business licenses, by requesting information on the amount of taxes collected, the costs associated with operating the data-sharing arrangements, and benefits of these data-sharing relationships to the states. Three states did not respond to our structured questions about the extent to which their states engage in data-sharing arrangements that require demonstration of tax compliance before businesses qualify for business licenses. We also (1) summarized IRS information on existing data-sharing arrangements between IRS and state agencies that require compliance with federal taxes to qualify for state business licensing, (2) interviewed IRS officials to determine which states have state licensing requiring federal tax compliance, and (3) reviewed IRS documentation on data-sharing arrangements between IRS and state

agencies that require businesses to demonstrate federal tax compliance to qualify for state business licensing.

Our review was subject to some limitations. We did not verify the accuracy of the data IRS provided or its estimate of the revenues and costs of its five new enforcement activities, including the estimated ROI of these activities. IRS Ogden's Access database on California business applicants did not contain data prior to calendar year 2006 because IRS Ogden purged these historical data. While data from previous years would be useful for evaluating the data-sharing arrangement, we believe that the Ogden records that were available were sufficient to attain an understanding of the potential value of this arrangement as a compliance tool. The IRS Ogden spreadsheet used to track the number of federal tax returns filed by noncompliant California business license applicants and the amount IRS collected from these businesses attributable to the data-sharing arrangement did not contain data for the months of July, August, November, and December 2007. We acknowledge that data for the entire calendar year of 2007 would affect the number of tax returns filed and the amount IRS collected from applicants during those months. Our estimate of the cost of IRS and California's data-sharing arrangement may be somewhat overstated because, for instance, we used approximate purchase costs for equipment and did not spread those costs over the useful life of the equipment or other uses of the equipment and used calendar year 2009 costs. Additionally, our analysis did not address some other potential factors that could reduce, or increase, the ROI we calculated. We did not verify the responses from the states about tax compliance to qualify for state business licenses. We recognize that the state revenue officials may not be knowledgeable about all of their states' requirements for tax compliance to qualify for business licenses, but they are a credible source of information about state tax compliance to qualify for state business licenses.

We conducted this performance audit from June 2007 through June 2009 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.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, Signora J. May, Assistant Director; Amy R. Bowser; Jennifer K. Echard; Amy C. Friedlander; Arthur L. James, Jr.; Stuart M. Kaufman; Edward J. Nannenhorn; Lou V. B. Smith; Jessica Thomsen; and James J. Ungvarsky made key contributions to this report.

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