

Why GAO Did This Study

Taxes are necessary because they fund the services provided by government. Several years ago, the Internal Revenue Service (IRS) estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was \$345 billion for 2001. In the face of large and growing deficits, it is important to seek out potential causes and solutions to the tax gap.

Achieving high levels of voluntary compliance is made more challenging as the tax code expands. Tax expenditures—preferential provisions in the code such as exemptions, exclusions, deductions, credits, and deferral of tax liability—have expanded the tax code, more than doubling in number since 1974.

GAO's statement focuses on four key areas: (1) how complexity adds to taxpayer burden and economic efficiency costs; (2) how complexities in reporting income contribute to the tax gap; (3) how tax expenditures add complexity and contribute to the tax gap; and (4) possible strategies for addressing the tax gap. The statement is based largely on GAO's previous work conducted on tax compliance issues affecting individual taxpayers from 2005 through 2011.

What GAO Recommends

GAO does not make any new recommendations in this testimony.

TAX GAP

Complexity and Taxpayer Compliance

What GAO Found

The federal tax system contains complex rules. These rules may be necessary, for example, to ensure proper measurement of income, target benefits to specific taxpayers, and address areas of noncompliance. However, these complex rules also impose a wide range of recordkeeping, planning, computational, and filing requirements upon businesses and individuals. Complying with these requirements costs taxpayers time and money. In 2005 GAO reviewed existing studies and reported that even using the lowest available compliance cost estimates for the personal and corporate income tax, combined compliance costs would total \$107 billion (roughly 1 percent of gross domestic product) per year; other studies estimate costs 1.5 times as large. Economic efficiency costs, which are reductions in economic well-being caused by changes in behavior due to taxes, are estimated to be even larger.

Although many taxpayers have simple forms of income, others do not—especially those who receive income from capital gains, rents, self-employment, and other sources—and they may be required to do complicated calculations and keep detailed records. This complexity can engender errors and underpaid taxes. For example, GAO has documented millions of taxpayer errors in following complex rules for determining taxpayers' "basis"—generally the taxpayer's investment in a property—in securities they sold or corporations they own.

Tax expenditures add to tax code complexity in part because they require taxpayers to learn about, determine their eligibility for, and choose between tax expenditures that have similar purposes. Tax expenditures also complicate tax planning, as taxpayers must predict their own future circumstances as well as future tax rules to make the best choice among provisions. Taxpayer errors contribute to the tax gap. For example, in 2001 taxpayers underreported \$6.3 billion in net income due to misreported Individual Retirement Arrangement (IRA) distributions. But taxpayers also may underclaim benefits to which they are entitled. According to GAO's past analysis, of tax filers who appeared to be eligible for a higher-education tax credit or tuition deduction in tax year 2005, about 19 percent, representing about 412,000 returns, failed to claim any of them.

No single approach is likely to fully and cost-effectively address the tax gap, but several strategies could improve taxpayer compliance. These strategies could require actions by Congress or IRS. For example, Congress can simplify the tax code by eliminating some tax expenditures and by making definitions more consistent across the tax code. IRS and Congress could take steps to enhance information reporting by third parties or expand compliance checking before refunds are issued.