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Report to the Committee on Finance, U.S. Senate

July 2005

TAX COMPLIANCE

Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap

G A O

Accountability ★ Integrity ★ Reliability

GAO-05-753

July 2005

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Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-05-753, a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

According to the Internal Revenue Service (IRS), a gap arises each year between what taxpayers pay accurately and on time in taxes and what they should pay under the law. The tax gap is composed of underreporting of tax liabilities on tax returns, underpaying of taxes due from filed returns, and nonfiling of required tax returns altogether or on time.

GAO was asked to provide information on (1) the estimated amount that each major type of noncompliance contributed to the 2001 tax gap and IRS's views on the certainty of its tax gap estimates, (2) reasons why noncompliance occurs, and (3) IRS's approach to reducing the tax gap and whether the approach incorporates established results-oriented planning principles.

What GAO Recommends

GAO recommends that IRS develop plans to periodically measure tax compliance with a focus on individual income tax underreporting; take steps to improve IRS data on the reasons taxpayers are not complying; and establish long-term, quantitative goals on the voluntary compliance levels, starting with individual income tax underreporting and total tax underpayment.

In commenting on a draft of this report, IRS agreed with our recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-05-753.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Mike Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

IRS estimates that underreporting of taxes accounted for about $250 billion to $292 billion of the $312 billion to $353 billion tax gap for 2001, while underpayment and nonfiling accounted for about $32 billion and $30 billion, respectively. Although IRS has collected recent compliance data, it still has concerns with some outdated methodologies and data used to estimate the tax gap. IRS is taking laudable steps intended to improve the estimate, which it plans to revise by the end of 2005. IRS has also developed a proposed schedule of compliance studies, but it has no approved plans to periodically measure compliance for the tax gap components. While it may not be feasible or necessary to measure compliance for all components at the same frequency or level of investment, periodic compliance studies would support a more data-driven and risk-based approach to reducing the tax gap.

IRS recently began to capture data on the reasons why taxpayers are noncompliant. However, IRS has concerns about the data, such as examiners assigning the same reason for noncompliance regardless of situation. Also, it is often difficult for examiners to determine a taxpayer's intent—whether the noncompliance is unintentional or intentional. Collecting better data on reasons can help IRS focus its activities on taxpayer service or enforcement. Although IRS is developing a system intended to capture better examination data, IRS does not have firm or specific plans to develop better reason data.

IRS approaches tax gap reduction through improving taxpayer service and enforcing tax laws and has two broad strategic goals and related key efforts that are intended to support this approach. However, IRS has not established long-term, quantitative compliance goals and regularly collected data to track its progress, which would complement its current, important compliance efforts. Establishing clear goals and measuring progress towards them would be consistent with results-oriented management principles. IRS has begun to consider additional goals, but it is not yet clear if they will be compliance related. Long-term, quantitative compliance goals, coupled with updated compliance data, would provide a solid base upon which to develop a more strategic, results-oriented approach to reducing the tax gap.

IRS's Preliminary Tax Year 2001 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax

Dollars in billions

	Type of tax					
Type of noncompliance	**Individual income**	**Corporate income**	**Employment**	**Estate**	**Excise**	**Total**
Underreporting	$150-$187	$30	$66-$71	$4	No estimate	$250-$292
Underpayment	19	2	7	2	1	$32
Nonfiling	28	No estimate	No estimate	2	No estimate	$30
Total	**$198-$234**	**$32**	**$73-$78**	**$8**	**$1**	**$312-$353**

Source: IRS.

Note: Figures may not sum to totals due to rounding.

Contents

Abbreviations

DCE	detection controlled estimation
EITC	Earned Income Tax Credit
GAO	Government Accountability Office
GPRA	Government Performance and Results Act of 1993
IRS	Internal Revenue Service
NRP	National Research Program
SOI	Statistics of Income
TCMP	Taxpayer Compliance Measurement Program
TY	Tax Year

United States Government Accountability Office
Washington, DC 20548

July 18, 2005

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

The federal tax system relies on taxpayers to voluntarily comply with the tax laws. However, a gap arises each year between what taxpayers pay accurately and on time in taxes and what they should pay under the law. Recognizing the need for current compliance data to update the tax gap estimate, the Internal Revenue Service (IRS) implemented a new compliance study in 2002 called the National Research Program (NRP) to produce such data for tax year 2001 while reducing taxpayer burden.[1] NRP is a significant achievement and its data should be valuable in improving IRS operations and for other uses.

Incorporating preliminary results from NRP, IRS recently estimated a "gross" tax gap from $312 billion to $353 billion for tax year 2001.[2] IRS estimated that it would eventually recover some of this amount through late payments and IRS enforcement actions, resulting in an estimated "net" tax gap for 2001 from $257 billion to $298 billion.[3] The tax gap estimate is an aggregate of estimates for the three primary types of noncompliance:[4] (1) underreporting of tax liabilities on tax returns; (2) underpaying of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or on time.

[1]GAO, *Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains*, GAO-02-769 (Washington, D.C.: June 27, 2002).

[2]IRS's most recent estimates of the tax gap are preliminary, and as such, IRS presents them as ranges.

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

[4]Estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers—individual income, corporate income, employment, estate, and excise taxes. Throughout this report, references to the tax gap estimate refer to the aggregate estimate, unless otherwise noted.

The tax gap arises when taxpayers fail to comply with the tax laws, either intentionally or unintentionally. As a result of their noncompliance, the burden of funding the nation's commitments, including funding growing budget deficits, falls more heavily on taxpayers who voluntarily pay their taxes. In addition, IRS expends substantial resources enforcing and explaining tax laws, with the goals of increasing compliance and reducing the tax gap.

Given your concern over the burden that the tax gap places on both the taxpayers who voluntarily pay their taxes and the federal budget, we testified before the Senate Committee on Finance on April 14, 2005, on a number of tax-gap-related issues.[5] As you requested, this report elaborates on the testimony by providing additional information on (1) the estimated amount that each major type of noncompliance contributed to the 2001 tax gap and IRS's views on the certainty of its tax gap estimates, (2) reasons why the noncompliance occurs, and (3) IRS's approach to reducing the tax gap and whether the approach incorporates established results-oriented planning principles.

To provide information on the estimated amount that each type of noncompliance contributed to the 2001 tax gap, we reviewed IRS's tax gap estimates for 2001. To determine IRS's views on the certainty of its tax gap estimates, we reviewed IRS studies and interviewed IRS research officials about tax gap estimation. We reviewed IRS, academic, and our prior work and interviewed IRS officials in an attempt to identify the various reasons for taxpayer noncompliance. To determine IRS's approach to reducing the tax gap and whether the approach incorporates established results-oriented planning principles, we examined IRS's strategic and performance plans and interviewed IRS officials. We asked IRS to identify its key efforts to reduce the tax gap as well as the related rationales, goals, and results. Using what we learned about IRS's approach, we determined the extent to which the approach incorporated selected planning principles consistent with the Government Performance and Results Act of 1993 (GPRA).[6] We conducted our review from June 2004 through May 2005 in accordance with generally accepted government auditing standards.

[5]GAO, *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T (Washington, D.C.: Apr. 14, 2005).

[6]Pub. L. No. 103-62 (1993).

Results in Brief

For the 2001 gross tax gap estimate of about $312 billion to $353 billion, IRS estimated in March 2005 that underreporting accounted for about $250 billion to $292 billion while underpayment and nonfiling accounted for about $32 billion and $30 billion, respectively. The actual tax gap could be higher or lower due to various factors that affect IRS's certainty of the estimate. For example, due to a lack of reliable data, IRS's estimate does not include some types of noncompliance, such as corporate income tax nonfiling. Also, IRS is concerned with some of the outdated data and methodologies used to estimate the tax gap. Finally, it is difficult for IRS to identify and measure noncompliance, such as underreported income, when IRS has little or no information from third parties about payments made or taxes withheld. IRS is taking some steps, such as updating the data and methodology for estimating individual income tax underreporting, that IRS intends to use to revise the preliminary tax gap estimate during 2005. While IRS has proposed a schedule for NRP studies over the next several years, it has no approved plans to regularly measure tax compliance, the results of which it could use to update the tax gap estimate, identify new or growing areas of noncompliance, and make informed decisions about resource allocations to address noncompliance.

IRS has concerns about its data on the reasons why taxpayers do not comply with tax laws. Taxpayer noncompliance can be unintentional or intentional in various ways. For example, taxpayers might unintentionally err on their tax returns because they misunderstand the laws or guidance explaining compliance requirements, or improperly omit income from their returns based on poor advice from tax practitioners. Alternatively, taxpayers may intentionally omit income from their tax returns to evade taxes. IRS captures data on the various unintentional and intentional reasons for noncompliance during examinations of tax returns. IRS is concerned with the reliability of the data since, for example, some examiners have assigned the same reason for all noncompliance, regardless of the situation. Also, determining taxpayer intent—whether the noncompliance is unintentional or intentional—can be difficult. Although IRS is developing a system intended to capture better examination data, IRS has no firm or specific plans to develop better data on the reasons why taxpayers do not comply, through steps such as improved data entry controls and examiner training. Without such data, it is more difficult for IRS to decide whether its efforts to address specific areas of noncompliance should focus on nonenforcement activities, such as improved forms or publications, or enforcement activities.

IRS's approach to reducing the tax gap includes improving taxpayer service to increase voluntary compliance and enhancing enforcement of tax laws by detecting and addressing noncompliance, but does not incorporate some steps consistent with results-oriented management. To support this approach, IRS has established two broad strategic goals and identified over 40 related key efforts, which include using direct enforcement actions to address high-income nonfilers and using analytical models to pursue higher priority collection cases. However, IRS has not established long-term, quantitative compliance goals and regularly collected data to track progress in reducing the tax gap, which would complement its current, important compliance efforts. Establishing long-term, quantitative compliance goals and measuring progress towards them offer several benefits to both IRS and external stakeholders and would be consistent with the performance management principles set forth in GPRA. Although IRS faces challenges in implementing a results-oriented management approach to reducing the tax gap, IRS's recently collected compliance data provide an improved foundation for setting compliance goals and reexamining programs intended to reduce the tax gap.

We are making recommendations that IRS develop plans to periodically measure tax compliance, take steps to improve its data on the reasons why taxpayers do not comply, and establish long-term, quantitative goals for voluntary compliance levels with a focus on individual income tax underreporting and total tax underpayment. Taken together, these steps can help IRS build a foundation to understand how its taxpayer service and enforcement efforts affect compliance, improve the efforts, and make progress on reducing the tax gap. The Commissioner of Interval Revenue agreed with our recommendations, highlighted challenges associated with them, and commented on various steps IRS would take to implement each recommendation.

Background

IRS develops its tax gap estimate by measuring the rate of taxpayer compliance—the degree to which taxpayers fully complied with their tax obligations. IRS uses such compliance data, along with other data and assumptions, to estimate the dollar amount of taxes not paid accurately and on time. For tax year 2001, IRS estimated that from 83.4 percent to 85 percent of owed taxes were paid voluntarily and on time, and that from $312 billion to $353 billion in taxes were not paid that should have been. IRS also estimates the amount of the gross tax gap that it will recover through enforcement and other actions and subtracts that to estimate the net annual tax gap. For tax year 2001, IRS estimated that it would eventually recover about $55 billion for a net tax gap from $257 billion to $298 billion. As we have reported in the past,[7] 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. However, given the size of the tax gap, even modest reductions would yield very significant financial benefits.

IRS has estimated the tax gap on multiple occasions, beginning in 1979. IRS's earlier tax gap estimates relied on the Taxpayer Compliance Measurement Program (TCMP), through which IRS periodically performed line-by-line examinations of randomly selected tax returns. TCMP started with tax year 1963 and examined individual returns most frequently—generally every 3 years—through tax year 1988. IRS contacted all taxpayers selected for TCMP studies. IRS did not implement any TCMP studies after 1988 because of concerns about costs and burdens on taxpayers.[8]

Under NRP, a program that we have encouraged, IRS recently completed its initial review of about 46,000 randomly selected individual tax returns from tax year 2001 (see app. I for a list of conducted TCMP and NRP surveys). Unlike with TCMP studies, IRS did not need to contact taxpayers for every tax return selected under NRP, handled some taxpayer contacts through correspondence rather than face-to-face examinations, and generally only asked taxpayers to explain information that it was otherwise unable to verify through IRS and third-party databases. In addition, unlike operational examinations, NRP examinations were randomly selected and used to measure compliance rather than target suspected noncompliance.

IRS has a strategic planning process through which it supports decisions about strategic goals, program development, and resource allocation. Under GPRA,[9] agencies are to develop strategic plans as the foundation for results-oriented management. GPRA requires that agency strategic plans identify long-term goals, outline strategies to achieve the goals, and describe how program evaluations were used to establish or revise the

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

[8]GAO, *Tax Administration: Status of IRS' Efforts to Develop Measures of Voluntary Compliance*, GAO-01-535 (Washington, D.C.: June 18, 2001).

[9]Pub. L. No. 103-62 (1993).

goals. GPRA requires federal agencies to establish measures to determine the results of their activities.

Scope and Methodology

To provide information on the estimated amount that each major type of noncompliance contributed to the 2001 tax gap, we reviewed IRS's tax gap estimate for 2001. To determine IRS's views on the certainty of its estimate, we reviewed IRS studies about tax gap estimation and interviewed IRS research officials to understand the data and methodologies used. We also spoke with IRS officials regarding planned changes to the data sources and estimation methodologies for the tax gap estimate. We determined that the tax gap estimates presented in this report are sufficiently reliable for the specific purposes of our engagement, particularly since IRS already has publicly released its tax gap estimates and disclosed their weaknesses. These purposes include discussing the major tax gap components and the orders of magnitude for various components, IRS's concerns about the certainty of its estimates, and our recommendations on IRS's compliance data and efforts.

We reviewed IRS, academic, and our own reports and interviewed IRS officials to identify the various reasons for noncompliance. We talked with IRS officials to determine the extent and reliability of data and coding on the reasons for noncompliance, and reviewed IRS's Examination Operational Automation Database, which is a database of tax return examination results that includes examiners' determinations of the reasons for any noncompliance. We also talked with IRS officials to determine any plans to develop better data on reasons for noncompliance.

To determine IRS's approach to reducing the tax gap and whether the approach incorporates established results-oriented planning principles, we reviewed IRS strategic and performance plans and interviewed IRS strategic planning officials at the agency and operating division levels. We asked IRS to identify its key efforts to reduce the tax gap as well as the related rationales, goals, and results. As part of our work on whether the approach incorporates established results-oriented planning principles, we used what we learned about IRS's approach to determine the extent to which it incorporated selected planning principles consistent with GPRA's requirements. For purposes of this review, we focused on elements of results-oriented planning that, previously, we found common to leading organizations successfully pursuing results-oriented management–defining desired results, measuring performance, and using performance information to support agency missions.[10]

IRS Lacks Approved Plans to Regularly Measure Compliance, Including Underreporting Which Accounts for the Largest Portion of the Tax Gap

IRS estimates that underreporting of taxes accounted for about $250 billion to $292 billion of the $312 billion to $353 billion tax gap for 2001, while underpayment and nonfiling accounted for about $32 billion and $30 billion, respectively. The actual tax gap could be higher or lower due to various factors that affect the certainty of the estimate, such as old compliance data. IRS is taking some steps designed to improve portions of its compliance measurement efforts and its preliminary tax gap estimate and plans to release a revised tax gap estimate by the end of 2005. While IRS has proposed a schedule for NRP studies over the next several years, IRS has no approved plans to regularly measure tax compliance, which it could use to update the tax gap estimate and guide its compliance efforts.

Underreporting Accounted for Most of the Tax Gap Estimate

As table 1 indicates, underreporting of individual income taxes represented about half of the tax gap for 2001 (the estimate ranges from $150 billion to $187 billion out of a gross tax gap estimate that ranges from $312 billion to $353 billion).

Table 1: IRS's Preliminary Tax Year 2001 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	$150-$187	$30	$66-$71	$4	No estimate	$250-$292
Underpayment	19	2	7	2	1	$32
Nonfiling	28	No estimate	No estimate	2	No estimate	$30
Total	**$198-$234**	**$32**	**$73-$78**	**$8**	**$1**	**$312-$353**

Source: IRS.

Note: Figures may not sum to totals due to rounding.

[10]GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1996).

Within the underreporting estimate, IRS attributed about $150 billion to $187 billion, or about 50 percent of the total tax gap, to individual income tax underreporting, including underreporting of business income, such as sole proprietor,[11] informal supplier,[12] and farm income (about $83 billion to $99 billion); nonbusiness income, such as wages, interest and capital gains (about $42 billion to $57 billion); overstated income adjustments, deductions, and exemptions (about $14 billion to $16 billion); and overstated credits (about $11 billion to $14 billion). Underreporting of corporate income tax contributed an estimated $30 billion, or about 10 percent, to the 2001 tax gap, which included both small corporations (those reporting assets of $10 million or less) and large corporations (those reporting assets of over $10 million). (For a more detailed table of IRS's estimates for the various components of the 2001 tax gap, see app. II).

Employment tax underreporting accounted for an estimated $66 billion to $71 billion, or about 20 percent, of the 2001 tax gap and included several taxes that must be paid by self-employed individuals and employers. Self-employed individuals are generally required to calculate and remit Social Security and Medicare taxes to the U.S. Treasury each quarter. Employers are required to withhold these taxes from their employees' wages, match these amounts, and remit withholdings to Treasury at least quarterly. Underreported self-employment[13] and employer-withheld employment taxes respectively contributed an estimated $51 billion to $56 billion and $14 billion to IRS's tax gap estimate. The employment tax underreporting estimate also includes underreporting of federal unemployment taxes (about $1 billion).

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

[12]Informal suppliers are sole proprietors who work alone or with few workers and, by definition, operate in an "informal" manner. Informal suppliers include those who make home repairs, provide child care, or sell goods at roadside stands. These taxpayers should report business profits or losses on a Schedule C.

[13]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.

IRS's 2001 Tax Gap Estimate Is Inexact Due to Incomplete and Old Data, Outdated Methodologies, and Inherent Measurement Difficulties

Although a significant portion of IRS's new tax gap estimate is based on recent compliance data, IRS has concerns with the certainty of the overall tax gap estimate in part because of incomplete and old data, outdated methodologies, and measurement difficulties. Table 2 shows IRS's certainty level in the estimates, as well as the underlying data sources.[14]

[14] For a discussion of the data sources IRS used to estimate the tax gap, see Internal Revenue Service, *Understanding the Tax Gap*, FS-2005-14 (March 2004), http://www.irs.gov/newsroom/article/0,,id=137246,00.html (downloaded Mar. 30, 2005); Internal Revenue Service, *Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992*, Publication 1415 (Rev. 4-96) (Washington, D.C.: Apr. 1996); and Robert E. Brown and Mark J. Mazur, *IRS's Comprehensive Approach to Compliance Measurement* (Washington, D.C.: June 2003), http://www.irs.gov/pub/irs-soi/mazur.pdf (downloaded June 6, 2005).

Table 2: Data Sources for IRS's Preliminary Tax Year 2001 Tax Gap Estimates by Type of Noncompliance and Type of Tax, and IRS's Level of Certainty in the Estimates

Type of noncompliance and type of tax	Estimate data source(s)	IRS certainty level
Underreporting		—[c]
Individual income tax	• Tax Year (TY) 2001 NRP Survey • TY 1988 and earlier TCMP studies • 1981, 1985-6 University of Michigan surveys on informal suppliers • 1984 University of Illinois study on tip income	—[c]
Corporate income tax	• TY 1977 and 1980 TCMP surveys (only for small corporations) • Operational examinations (only for mid-sized and large corporations) – averaged over 3 years in the mid-1980s • TY 1982 TCMP study of unrelated business income tax of tax-exempt organizations • TY 1975 TCMP study on fiduciaries	Weaker
Employment tax	• TY 2001 NRP Survey • TY 1984 withholding noncompliance study • 1981 and 1985-6 University of Michigan surveys on informal suppliers • 1984 University of Illinois study on tip income	—[c]
Estate tax	• IRS's Statistics of Income (SOI) program data for filed estate tax returns for TY 1992	Reasonable
Excise tax	• No estimate	Not applicable
Underpayment (all types of tax)[a]	• IRS Master File	Actual figures
Nonfiling[b]		Reasonable
Individual income tax	• TY 1988 Nonfiler (TCMP)	Reasonable
Corporate income tax	• No estimate	Not applicable
Employment tax	• No estimate	Not applicable
Estate tax	• 2 University of Michigan longitudinal surveys (begun in 1992 and 1993 and interviews participants every 2 years) • TY 1992 IRS's SOI	Reasonable
Excise tax	• No estimate	Not applicable

Source: IRS.

[a] Unlike the other components of the 2001 tax gap, the underpayment component is not an estimate, but rather represents the tax amounts that taxpayers reported on time, but did not pay on time.

[b] IRS's nonfiler estimate for individual income tax is net of amounts of true tax liability that are paid on time (e.g., through withholding). Refunds that are due to nonfilers do not reduce the nonfiling gap, since they are not associated with a tax liability.

[c] These estimates are based on more recent NRP data, but IRS has not finalized the certainty level for these estimates because it has not yet completed its assessment of the quality of the NRP data.

Tax Gap Estimate Is Incomplete

As table 2 shows, IRS's estimate for the 2001 tax gap does not include estimates of excise tax underreporting and nonfiling. According to IRS, the reason for this omission is that numerous federal excise taxes, many of which have specific exclusions or varying applications, complicate excise tax computations. Further, data on excise tax transactions are typically maintained at the state level and are often incomplete. Also, according to an IRS research official, the estimate does not include corporate income tax and employment tax nonfiling because IRS lacks good, representative data for corporate and employment tax nonfilers. Further, data from IRS's operational programs to identify nonfilers exclude those whom IRS does not know about and do not include the full tax liability of nonfilers whom IRS has identified.

The 2001 tax gap estimate also does not include any estimates for taxes due from illegal source income, as the magnitude of such income is difficult to estimate.[15] Moreover, the federal government seeks to eliminate most illegal activities altogether, rather than derive revenue from these activities.[16]

Estimates for Some Components of the Tax Gap Are Based on Old Data

Old data also contribute to IRS's "weaker" level of certainty for certain segments of the underreporting portion of its 2001 tax gap estimate. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes. For large corporate income tax underreporting, IRS based its estimate on the amount of tax recommended from operational examinations rather than the tax ultimately assessed as part of the total tax liability. According to IRS officials, IRS relies on the amount of tax recommended because it is difficult to determine the true tax liability of large corporations due to complex and ambiguous tax laws that create opportunities for differing interpretations and that complicate the determination. These officials further stated that because these examinations are not randomly selected and are not focused on identifying all tax noncompliance, the estimate produced from the examination data is not representative of the tax gap for all large corporations. They also explained that due to these complexities and the costs and burdens of collecting complete and accurate data, IRS has not systematically measured large corporation tax compliance through statistically valid

[15] Illegal source income may include drugs, illegal gambling, prostitution, etc.

[16] IRS's Criminal Investigation division pursues illegal activities that have tax consequences, but does not measure the revenue generated by the cases it pursues.

studies, even though the officials acknowledged that such studies would be useful in estimating the related tax gap.[17]

Tax Gap Estimates Are Affected by Outdated Methodologies

Further, some methodologies IRS used to estimate the tax gap are based on older data and contribute to the uncertainty surrounding the tax gap estimate. For example, because IRS knew that it would not detect all underreporting noncompliance, IRS multiplied the detected amounts of underreporting to help calculate a total estimate for underreported individual income tax. IRS officials explained that they used a number of "multipliers," including one derived from the 1976 TCMP study of individual tax returns, which was before IRS expanded and improved its computer matching programs to better detect various types of underreported income.[18] In addition, IRS estimated individual income tax nonfiling based on the assumption that the relationship between individual income nonfiling and underreporting has been constant since the 1988 TCMP survey was conducted.

Tax Gap Is Inherently Difficult to Estimate

Finally, it is inherently difficult for IRS to observe and measure some types of underreporting or nonfiling. For example, underreporting of income or nonfiling of tax returns by informal suppliers can be hard for IRS to detect because the tax laws generally do not require third parties to withhold income tax or file information returns on payments made to informal suppliers, as are required with other types of individuals such as wage earners. Similarly, academic studies have discussed the difficulty in tracking cash payments that businesses make to their employees, as businesses may not report these payments to IRS in order to avoid paying employment taxes and employees may not report these payments on their income tax return to avoid paying income taxes.

[17]GAO, *Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement*, GAO/GGD-94-70 (Washington, D.C.: Sept. 1, 1994); *Tax Administration: Factors Affecting Results from Audits of Large Corporations*, GAO/GGD-97-62 (Washington, D.C.: Apr. 17, 1997); *Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128 (Washington, D.C.: June 23, 1998).

[18]IRS's computer matching programs use third-party information documents to verify information reported on tax returns. IRS established the multiplier by comparing the amount of income detected through TCMP examinations conducted without information documents and matching the income detected with the aid of these tools.

IRS Plans to Issue a Revised Tax Gap Estimate but Has No Approved Plans to Regularly Collect Compliance Data

IRS is taking several steps that could improve the preliminary tax gap estimate for tax year 2001. IRS intends to publish a revised tax gap estimate by the end of 2005 based on the results of these steps.

For example, IRS officials stated that IRS plans to further analyze the preliminary NRP results in an attempt to improve the certainty of the estimate. NRP is a significant achievement and its data should be valuable in improving IRS operations and for other uses. However, those officials added that because IRS is still assessing the quality of the NRP data, it has not yet finalized the certainty levels for the preliminary estimates for individual income tax and self-employment tax underreporting. Likewise, we cannot yet be certain about the quality of the NRP data collected because IRS is still assessing the data.

IRS plans to implement three changes to its estimation methodology for its revised tax gap estimate. Although it is too soon to know whether these changes will improve the estimate, IRS expects that the changes will help address known methodological weaknesses. According to IRS, these changes include the following:

- IRS plans to replace the multiplier it derived in the 1970s and used to estimate individual income tax underreporting. IRS is developing a new methodology, known as detection controlled estimation (DCE). DCE is a regression-based model that will use 2001 NRP data and control for variables that could affect the amount of underreporting detected.[19]
- IRS plans to develop a new technique as well as replace the data from the 1981 and 1985-1986 University of Michigan surveys to estimate the individual income tax underreporting portion of the tax gap attributable to informal suppliers.
- IRS intends to update its estimate of individual income tax nonfiling, which is currently based on 1988 nonfiler TCMP data, by using “Exact Match” data provided by the U.S. Census Bureau.[20] Census will match data from its Current Population Survey against the IRS Master Files to identify the extent of nonfiling by individual taxpayers. The Census data to be provided to IRS will be aggregated and not contain information on specific individuals.

[19] By fall 2005, IRS plans to have determined which variables to include in the DCE model.

[20] IRS has used “Exact Match” data for past tax gap estimates.

In addition, IRS research officials are planning a compliance measurement study that will allow IRS to update underreporting estimates involving flow-through entities. This study, which IRS intends to begin in October 2005, would take 2 to 3 years to complete. Because individual taxpayers or corporations may be recipients of income (or losses) from flow-through entities, this study could affect IRS's underreporting estimates for individual and corporate income tax.

While these data and methodology updates could improve the tax gap estimates, IRS has no approved plans to periodically collect more and better compliance data over the long term beyond the study of flow-through entities. IRS Research officials said that they recently proposed a schedule for additional NRP studies over the next several years. However, these officials also said this proposal is under consideration but has not been finalized. IRS has indicated that given its current research priorities, it could not begin another NRP study of individual income tax returns before 2008, at the earliest, and would not complete such a study until at least 2010.

According to IRS officials, IRS has not committed to regularly collecting compliance data because of the associated costs and burdens. Taxpayers whose returns are examined through compliance studies such as NRP bear costs in terms of time and money. Also, IRS incurs costs, including direct costs and opportunity costs (or revenue that IRS potentially forgoes by examining randomly selected returns, which are more likely to include returns from compliant taxpayers than returns selected because they are likely to contain noncompliance that would produce additional tax assessments).

Regularly Measuring Compliance Can Be Beneficial, but Determining the Frequency of Measurement Involves Considering Several Factors

Regularly measuring compliance can offer many benefits, including helping IRS identify new or growing types of noncompliance, identify changes in tax laws and regulations that may improve compliance, more effectively target examinations of tax returns, understand the effectiveness of its programs to promote and enforce compliance, and determine its resource needs and allocations.[21] For example, by analyzing 1979 and 1982 TCMP data, IRS identified significant noncompliance with the number of dependents claimed on tax returns and justified a legislative change to address the noncompliance. As a result, for tax year 1987,

[21]GAO, *Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved*, GAO/GGD-93-52 (Washington, D.C.: Apr. 5, 1993).

taxpayers claimed about 5 million fewer dependents on their returns than would have been expected without the change in law.

Tax compliance data are useful outside of IRS as well. Other federal agencies and offices use compliance data for tax policy analysis, revenue estimating, and research. For example, the Department of Commerce's Bureau of Economic Analysis had used TCMP data to adjust its national income and product accounts.[22] Additionally, state tax authorities have used IRS compliance data to develop state compliance programs and estimate state tax gaps. Also, policy makers in the executive branch and Congress can use the results from compliance measurement studies to help decide on appropriate funding levels for IRS.

As we have reported in the past, the longer the time between compliance measurement surveys, the less useful they become given changes in the economy and tax law.[23] According to IRS, without current compliance data, it has limited capability to determine key areas of noncompliance to address and actions to take to maximize the use of its limited resources. For example, the formulas that IRS creates from compliance data to select returns for examination have enabled IRS to focus examination resources on noncompliant returns rather than burdening compliant taxpayers. When IRS updated the formulas in the early 1990s with compliance data from the 1988 TCMP, IRS selected a lower percentage of compliant tax returns for examination. However, after 3 years of using formulas based on the 1988 data, the percentage of compliant tax returns examined increased each year through 1998, placing additional burdens on compliant taxpayers and leaving less time for IRS to examine noncompliant returns that resulted in an additional tax assessment.

Historically, IRS has varied how frequently it measured compliance for particular types of taxpayers and taxes. As appendix I shows, the period between measurements of individual income tax reporting compliance, which consistently has accounted for the largest portion of the tax gap, never exceeded 4 years between 1963 and 1988. In planning the 2001 NRP to measure individual income tax compliance, IRS envisioned doing the NRP on a 3-year cycle. Appendix I also shows that IRS measured compliance less frequently for other types of taxpayers and taxes, such as

[22] These accounts include measures of personal income that are used to allocate funds for a number of federal programs.

[23] GAO/GGD-93-52.

for small corporation income taxes, and that IRS never measured compliance for large corporations or for excise taxes.

Although regularly measuring tax compliance can be beneficial, how often measurements should be made is a judgment that depends on many potential criteria including (1) the amount that a particular type of noncompliance is thought to contribute to the tax gap, (2) whether IRS has reason to believe that compliance may have changed (e.g., due to tax law changes), and (3) costs, particularly when IRS officials said that resources to conduct operational examinations are already limited. Using these criteria, IRS would likely vary the frequency of compliance measurement studies. Based on these criteria as well as our previous reports,[24] decisions about compliance measurement would also be affected by the following factors.

- Precision. The costs and benefits of measuring compliance can vary with how precisely IRS wishes to measure compliance to achieve an intended use (e.g., tax gap estimation or examination return selection). Obtaining more precise and more detailed compliance data for more detailed populations of taxpayers or tax issues (e.g., types of income or deductions) would likely be more costly but potentially more useful.
- Capacity. Each compliance measurement study requires having enough resources such as staffing, training, tools, and systems to capture the data. Regular compliance measurement through smaller efforts targeted at particular types of taxpayers or taxes and sampling designs that collect data across consecutive tax years rather than for one year could help reduce costs and sustain long-term compliance measurement.

[24]GAO/GGD-93-52; GAO, *Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program*, GAO/GGD-95-39 (Washington, D.C.: Dec. 30, 1994); and GAO, *Tax Administration: Alternative Strategies to Obtain Compliance Data*, GAO/GGD-96-89 (Washington, D.C.: Apr. 26, 1996).

IRS Has Concerns with Its Data on Reasons for Noncompliance but Does Not Have Firm or Specific Plans to Develop Better Data

Several factors concern IRS about its data on the reasons for noncompliance, which can be unintentional or intentional. Although IRS is developing a system intended to capture better examination data, IRS does not have firm or specific plans to develop better data on the reasons for noncompliance, even though the lack of such data makes it harder to decide whether it should address specific areas of noncompliance through nonenforcement efforts, such as designing clearer forms or publications, or enforcement efforts.

IRS Has Concerns with Its Data on Reasons for Noncompliance

IRS has concerns with its data on the unintentional and intentional reasons for noncompliance. Various types of unintentional or intentional reasons could explain why taxpayers fail to comply with the tax laws.[25] Unintentional reasons can include being unaware of recordkeeping requirements, accidentally entering an item on the wrong line of a tax return, or following inaccurate advice from a tax practitioner. Intentional reasons for noncompliance can include intentionally omitting income from a tax return or interpreting vague tax laws to evade tax liability.

IRS collects data on the reasons for noncompliance for specific tax issues during its operational examinations of tax returns.[26] In many of these cases, it is difficult for examiners to determine a taxpayer's intent– whether the noncompliance is unintentional or intentional. Unless the evidence clearly points to the reason, the examiner would have to make subjective judgments about why the noncompliance occurred. IRS has a number of other concerns with the data:

[25] Academic research on the reasons for taxpayer noncompliance is fairly limited. That research includes a "typology of noncompliance," developed by Robert Kidder and Craig McEwen, to describe the various categories of noncompliance. These categories include procedural (failure to follow rules on which forms to file); taxpayer laziness; classic tax cheating; brokered (involves use of a tax preparer); symbolic (due to perceived unfairness in the tax laws); and social (based on the extent that taxpayers believe others are complying with the law). See Robert Kidder and Craig McEwen, "Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance," in Jeffrey A. Roth and John T. Scholz, Eds. *Taxpayer Compliance, Volume 2: Social Science Perspectives* (Philadelphia, Pa.: University of Pennsylvania Press, 1989).

[26] IRS also collected reason data in NRP, but we did not determine to what extent IRS's concerns about the reason data from operational examinations also applied to NRP data.

- The database is incomplete because not all examination results, including data on reasons for noncompliance, were being entered into the database.[27]

- IRS has not tested the adequacy of the controls for data entry or the reliability of the data being collected. IRS has found instances where examiners close examinations without assigning a reason for noncompliance or by assigning the same reason to all instances of noncompliance, regardless of the situation.[28]

- IRS has not trained all examiners to ensure consistent understanding and use of the various codes to indicate the reason for noncompliance.

- The data do not represent the population of noncompliant taxpayers but rather only those who had their tax returns examined.

IRS Does Not Have Firm or Specific Plans to Develop Better Data on Reasons for Noncompliance, which Could Help IRS's Efforts to Address Tax Noncompliance

According to IRS officials, the agency does not have firm or specific plans to develop better data on the reasons for noncompliance. One official explained that IRS decided not to improve the consistency of its current reason data because it is devoting its limited resources to other efforts, such as developing the Examination Desktop Support System (EDSS). Although this system is intended to allow examiners to capture better examination data, specific system features have not yet been identified to improve examiners' selection of reason codes. IRS officials said that the system could be enhanced in the future to improve the reason data and that they plan to consider such enhancements.

As the National Taxpayer Advocate recently testified,[29] data on whether taxpayers are unintentionally or intentionally noncompliant with specific tax provisions are critical to IRS for deciding whether its efforts to address specific areas of noncompliance should focus on nonenforcement activities, such as improved forms or publications, or enforcement

[27] In October 2004, IRS started implementing a system to improve case processing and data capture, particularly for adjusted tax amounts.

[28] An IRS official said that managers are to review the accuracy of the data entry of examination results but that they do not know the extent to which managers actually review the entry of reason data.

[29] Testimony of Nina E. Olson, National Taxpayer Advocate, before the Senate Committee on Finance, April 14, 2005.

activities to pursue intentional noncompliance. For example, taxpayers may unintentionally claim the Earned Income Tax Credit (EITC) because they do not understand the child residency requirements for this credit (i.e., a dependent must live with the taxpayer for more than half of the year). This type of unintentional noncompliance may require IRS to more clearly explain the EITC requirements within related forms and publications. However, other taxpayers may file false EITC claims with the intent of evading tax liability, which may suggest a strategy that relies on IRS's enforcement programs and tools. Similar situations could exist for other tax code provisions.

If IRS is to develop better data on the reasons for noncompliance, it will be important for IRS to consider factors in data collection such as the following.

- Data reliability. To minimize examiner subjectivity and ensure that the data are complete and accurate, IRS would need to refine the reason categories, provide adequate training, establish system and data entry controls, and provide supervisory oversight.

- Scope. IRS would need to decide whether the reason categories are to be captured for selected types of noncompliance or all types of noncompliance.

- Examination selection. IRS currently collects reason data annually through hundreds of thousands of operational examinations. IRS also collected reason data through NRP. In the future, IRS would need to decide whether to collect reason data (1) during all operational examinations, (2) for a statistical sample of operational examinations, or (3) for examinations performed through periodic compliance studies such as NRP. Collecting data for a sample of examinations or through periodic compliance studies might be done with a smaller cadre of examiners specially trained and overseen to maximize consistency of decisions about the reasons why taxpayers are noncompliant. Also, data from samples of examinations could be used to generalize reasons for noncompliance for all examinations, and data from compliance studies of all taxpayers could be used to generalize these reasons for the population of taxpayers.

Our past reports[30] have supported the concept of rigorously researching the causes of noncompliance. Recognizing the benefits of better

[30]GAO, *Tax Research: IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109 (Washington, D.C.: June 5, 1996).

compliance data, the National Taxpayer Advocate has also urged IRS to consider performing additional research into causes of noncompliance.[31]

IRS's Approach to Reducing the Tax Gap Focuses on Service and Enforcement but Lacks Long-term, Quantitative Compliance Goals and Measures That Are Consistent with Results-Oriented Management Principles

IRS approaches tax gap reduction through improving service to taxpayers and enforcing tax laws and has established two broad strategic goals and related key efforts that are intended to support this approach. However, IRS has not established long-term, quantitative compliance goals and regularly collected data to track progress in reducing the tax gap, which would complement its current important compliance efforts. Establishing clear compliance goals and measuring progress towards them benefits both IRS and external stakeholders and are consistent with the results-oriented performance management principles set forth in GPRA. Although IRS has lacked such data in the past and faces other challenges, NRP and EITC data provide an improved base for setting compliance goals and reexamining existing programs intended to reduce the tax gap.

IRS Approaches Tax Gap Reduction through Broad Goals and Numerous Efforts to Improve Taxpayer Service and Enforce Tax Laws

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. Through efforts such as education and outreach programs, IRS seeks to improve voluntary compliance with the tax system by helping people understand their tax obligations. In addition, IRS attempts to simplify the tax process, such as by revising forms and publications to make them more easily understood by diverse taxpayer communities and electronically accessible. In conjunction with taxpayer service, IRS uses its enforcement authority to ensure that taxpayers are reporting and paying the proper amount of taxes. Through efforts such as examining tax returns and collaborating with state governments to share leads on abusive tax avoidance transactions, IRS seeks to detect and deter noncompliance.

[31]Testimony of Nina E. Olson, National Taxpayer Advocate, before the Senate Committee on Finance, July 21, 2004, and Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004).

Two of IRS's three strategic goals, along with their associated objectives and strategies, are intended to directly support this approach.[32]

- Goal 1—Improve Taxpayer Service—is intended to promote voluntary compliance. This goal has three objectives (1) improve service options for the tax paying public (2) facilitate participation in the tax system by all sectors of the public and (3) simplify the tax process.
- Goal 2—Enhance Enforcement of the Tax Law—is intended to ensure, through IRS's enforcement authority, that taxpayers are meeting their tax obligations. The four objectives for this goal are (1) discourage and deter noncompliance with emphasis on corrosive activity by corporations, high-income individual taxpayers, and other contributors to the tax gap; (2) ensure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law; (3) detect and deter domestic and off-shore-based tax and financial criminal activity; and (4) deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes. To achieve these objectives, IRS has 15 strategies, such as "re-examine and adjust audit processes to target likely areas of noncompliance."

In addition to these goals, IRS's service and enforcement efforts outlined in its strategic plan are also intended to support tax gap reduction. IRS's strategic plan mentions over 60 service and enforcement efforts targeted at improving taxpayer compliance. Because the plan did not prioritize these efforts, we asked IRS officials to identify the key efforts in reducing the tax gap. In response, IRS provided over 40 key efforts. Enforcement efforts included pursuing high income nonfilers (taxpayers with income over $100,000 who have not filed a tax return) through direct enforcement actions and identifying higher priority collection cases through analytical models. Service, or nonenforcement, efforts included a taxpayer education program on tip reporting. (See app. III for a summary of the key efforts provided.)

[32] Modernization objectives and strategies under Strategic Goal 3 are intended to support tax gap reduction by helping IRS manage its employee and technology resources effectively and efficiently. Because this goal helps IRS meet its service and enforcement goals, this report does not discuss the goal separately.

IRS's Tax Gap Reduction Approach Does Not Establish Long-term, Quantitative Compliance Goals or Regular Data Collection to Measure Progress

IRS has developed a strategic planning and budgeting process[33] to help the agency comply with GPRA requirements. However, IRS's strategies for improving compliance generally lack a clear focus on long-term, quantitative goals and results measurement. IRS has established broad qualitative goals and strategies for improving taxpayer service and enhancing enforcement of the tax laws. IRS has also identified measures, such as compliance rates for tax reporting, filing, and payment as well as the percentage of Americans who think it is acceptable to cheat on their taxes,[34] which are intended to gauge the progress of its strategies toward its broad goals. However, IRS does not collect recent data to update all of these compliance measures and has not established quantitative goals against which to compare the measures and judge any progress made through its compliance strategies.

Although IRS has not focused on quantitative, results-oriented goals for improving voluntary compliance, IRS has established many output-related goals and measures that track activity level, such as the number of taxpayers contacted, collection cases closed, or returns examined. In contrast, IRS has fewer outcome-related goals and measures that track results, such as refund timeliness or examination quality.

In the past, IRS had set a long-term goal of improving overall compliance to 90 percent by 2001. This goal was to be achieved through a research approach rooted in IRS's Compliance 2000 philosophy.[35] The Compliance 2000 philosophy envisioned using nonenforcement efforts to correct unintentional noncompliance and reserving enforcement efforts for

[33]IRS implemented a new strategic planning, budgeting, and performance management process during fiscal year 2000. The process begins with the operating divisions preparing strategic assessments. After receipt and review of the strategic assessments, the commissioner provides detailed guidance to the operating divisions for developing their strategy and program plans. These plans are then incorporated into an IRS-wide performance plan (which sets out measurable objectives such as the number of audits to be done). These plans are, in turn, incorporated into IRS's budget justification (which sets out its resource requests to Congress). The remaining steps involve allocating resources across IRS divisions and programs and monitoring division adherence to the planning and budgeting decisions.

[34]Other measures for enhancing enforcement are (1) the percentage of priority guidance list items published (percentage of tax issues IRS will address through regulations, notices, and other forms of guidance) and (2) average cycle time between receipt and completion of an audit case.

[35]GAO/GGD-96-109; GAO, *Tax Administration: Compliance 2000—A Worthy Idea that Needs Effective Implementation*, GAO/T-GGD-92-48 (Washington, D.C.: June 3, 1992).

intentional noncompliance. To carry out this philosophy, in the early 1990s, IRS initiated many research projects across IRS's 63 district offices to identify noncompliant market segments, root causes for the noncompliance, and innovative ways to improve compliance. However, the lack of objective compliance data, among other factors, limited the success of this approach. Recently, external stakeholders, such as the IRS Oversight Board, have supported the concept of setting a numeric, long-term goal for increasing the voluntary compliance rate.

In response to a President's Management Agenda[36] initiative to better integrate budget and performance information, IRS officials said that they are considering various long-term goals for the agency. IRS has not yet set a time frame for publicly releasing the goals.[37] Nor have IRS officials indicated whether any goals will be related to improving taxpayer compliance or whether they will be quantitative and results-oriented.

Long-term, Quantitative Compliance Goals and Measures Are Beneficial and Consistent with Results-Oriented Management Principles

Focusing on outcome-oriented goals and establishing measures to assess the actual results, effects, or impact of a program or activity compared to its intended purpose can help agencies improve performance and stakeholders determine whether programs have produced desired results. As such, long-term, quantitative compliance goals offer several benefits for IRS, as discussed below.

Perhaps most important, compliance goals coupled with periodic measurements of compliance levels would provide IRS with a better basis for determining to what extent its various service and enforcement efforts contribute to compliance. Additionally, long-term, quantitative goals may help IRS consider new strategies to improve compliance, especially since these strategies could take several years to implement. For example, IRS's progress toward the goal of having 80 percent of all individual tax returns electronically filed by 2007[38] has required enhancement of its technology,

[36]The President's Management Agenda is intended to help the federal government become more results-oriented and encourage federal managers to ask whether their programs are working as intended and, if not, what can be done to achieve greater results.

[37] According to IRS officials, developing long-term, results-oriented goals is a complex process that requires sustained management commitment. These factors contribute to IRS's uncertainty about when it will publicly release its goals.

[38]Congress established this electronic filing goal in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998).

development of software to support electronic filing, education of taxpayers and practitioners, and other steps that could not be completed in a short time frame. Focusing on intended results can also promote strategic and disciplined management decisions that are more likely to be effective because managers who use fact-based performance analysis are better able to target areas most in need of improvement and select appropriate interventions. Likewise, agency accountability can be enhanced when both agency management and external stakeholders such as Congress can assess an agency's progress toward meeting its goals. Finally, setting long-term, quantitative goals would be consistent with results-oriented management principles that are associated with high-performing organizations and incorporated into the statutory management framework Congress has adopted through GPRA.

Updated Compliance Data Provide Opportunities for IRS to Establish a More Results-Oriented Tax Gap Reduction Approach

Not unlike other agencies we have reported on in the past,[39] IRS faces challenges in implementing a results-oriented management approach, such as identifying and collecting the necessary data to make informed judgments about what goals to set and to subsequently measure its progress in reaching its goals. However, having completed the NRP review of income underreporting by individuals, IRS now has an improved foundation for setting goals for improving taxpayers' compliance.[40]

IRS's effort to address noncompliance with the EITC provides an example of how a more data-driven planning approach can help IRS become more results-oriented over time.[41] IRS's most recent EITC compliance study estimated that between $8.5 billion and $9.9 billion, or between 27 percent and 32 percent, respectively, of the EITC claims filed for tax year 1999 should not have been paid. Following the release of this study, a task force

[39]GAO, *Results-Oriented Government: GPRA Has Established a Solid Foundation for Achieving Greater Results*, GAO-04-38 (Washington, D.C.: Mar. 10, 2004).

[40]The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998), specifically prohibits IRS from using its records of tax enforcement results to evaluate employees or to impose or suggest production quotas or goals with respect to such employees. That restriction does not, however, prevent IRS from using its records of tax enforcement results to examine whether its current enforcement efforts are effective in deterring noncompliance and to in turn establish long-term strategies and priorities for improvement.

[41] GAO, *Earned Income Tax Credit: Implementation of Three New Tests Proceeded Smoothly, but Tests and Implementation Plans Were Not Fully Documented*, GAO-05-92 (Washington, D.C.: Dec. 30, 2004).

of IRS and Treasury officials determined the three leading types of errors that accounted for about $7 billion annually in overclaims. On the basis of compliance data and other research, IRS started an initiative to improve service, fairness, and compliance and designed specific corrective actions targeting the three types of errors. IRS is evaluating these actions to determine their effectiveness at reducing the overclaim rate in each of the three errors. Because IRS targeted its EITC effort based on data on the sources and extent of taxpayer errors, it was better able to determine what actions to take and how well, using systematic data collection and program evaluation, the effort is meeting its intended purpose.

Measuring progress toward any goals that may be set could be challenging. For example, IRS researchers have found it difficult to determine the extent to which its enforcement actions deter noncompliance or its services improve compliance among taxpayers who want to comply. Although widespread agreement exists that IRS enforcement programs generally increase voluntary tax compliance, challenges such as collecting reliable compliance data, developing reasonable assumptions about taxpayer behavior, and accounting for factors outside of IRS's actions that can affect taxpayer compliance, such as changes in tax law, make it difficult to estimate the effect of IRS's enforcement and service activities. Even if IRS is unable to empirically estimate the extent to which its actions directly affected compliance rates, periodic measurements of compliance levels can indicate the extent to which compliance is improving or declining and provide a basis for reexamining existing programs and triggering corrective actions if necessary.

Recently, several research studies have offered insights to better understand the direct tax revenue effects of IRS's activities as well as the indirect effects on voluntary tax compliance.[42] IRS researchers have

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[42] Two types of indirect effect are (1) the increase in voluntary compliance in the larger population resulting from examinations, or other enforcement and nonenforcement actions, on targeted taxpayers, and (2) the increase in voluntary compliance of the targeted taxpayer in subsequent years. Economists have estimated the indirect effect of an examination on voluntary compliance to range between 6 and 12 times the amount of the proposed adjustment. See Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), (Washington, D.C.: Nov. 1996), 2, 35-36; Jeffrey A. Dubin, Michael J. Graetz and Louis L. Wilde, "The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986," *43 National Tax Journal*, (1990), 395, 396, 405; and Jeffrey A. Dubin, "Criminal Investigation Enforcement Activities and Taxpayer Noncompliance" (paper written for the IRS Research Conference, June 2004), http://www.irs.gov/pub/irs-soi/04dubin.pdf (downloaded July 1, 2005).

hypothesized that the indirect effect of an examination varies among taxpayer segments. Further, a recent study concluded that criminal investigations have positive direct and indirect tax effects. Although these studies generally indicate that IRS activities have positive tax effects, the magnitude of these effects is not yet known with a high level of confidence given compliance measurement challenges, as mentioned earlier. According to IRS, these studies serve as a valuable baseline for further research, but it has not yet determined how it will use these studies to make operational decisions.

Conclusions

As discussed in our recent testimony on the tax gap before the Senate Committee on Finance, and underscored by IRS, periodic tax compliance measurement is critically important to IRS's ability to estimate the tax gap and design compliance programs intended to reduce the tax gap. Without current, reliable compliance data, it can be difficult for IRS to monitor trends or identify new types of noncompliance, determine its compliance resource needs and how to allocate such resources, and justify budget and staffing requests to policy makers in Congress and the executive branch. Consequently, completion of NRP, which covered the largest portion of the tax gap and was designed and implemented with an eye to reducing the costs and burdens of data collection, is a substantial achievement. However, although IRS has recently proposed a schedule for future NRP studies, it has no approved plans to repeat this study or periodically measure compliance across the various components of the tax gap. Doing periodic compliance studies in areas that have previously been measured, such as individual income tax underreporting, would provide valuable information to support a more data-driven and risk-based approach towards improving compliance and reducing the tax gap. Although it may not be feasible or necessary to measure compliance for all components of the tax gap at the same frequency or with the same level of investment, where practical methodologies exist, periodic measurements should be taken. Where practical methodologies do not yet exist, such as for excise tax or for large corporations, looking for ways to overcome challenging compliance measurement difficulties would be worthwhile.

The tax gap is both a measure of the burden and frustration of taxpayers who want to comply but are tripped by tax code complexity and of willful tax cheating by a minority who do not wish to pay their fair share to support government programs. As such, collecting data on the reasons why noncompliance occurs can help IRS more effectively tailor its efforts to improve compliance. It can be difficult for IRS examiners to consistently determine the reasons why taxpayers have failed to comply with the tax laws. However, IRS has no specific plans to address this issue and, as a result, is missing opportunities to gather better data than it already collects. Certain immediate steps, like improving reason codes, better training examiners in applying the codes, and possibly reducing the number of examiners who would be responsible for making judgments on the reasons taxpayers are noncompliant may improve the data IRS currently collects. Nevertheless, given the difficulty of consistently determining why taxpayers are noncompliant, sustained research on these reasons also would be needed to develop a better understanding.

Reducing the tax gap will be a challenging task given persistent levels of noncompliance and 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. Without long-term, quantitative voluntary compliance goals and related performance measures, it will be more difficult for IRS to determine the success of its strategies, adjust its approach when necessary, and remain focused on results, especially since factors that affect compliance change over time. Having compliance goals, coupled with recently collected NRP data, would provide a solid base upon which IRS can develop a more strategic, results-oriented approach to reducing the tax gap.

Taken together, these steps—periodically measuring compliance, determining the reason taxpayers are noncompliant, and setting results-oriented long-term goals—can help IRS build a foundation to understand how its taxpayer service and enforcement efforts affect compliance, improve its efforts, and make progress on reducing the tax gap.

Recommendations for Executive Action

To establish a stronger foundation for improving IRS's efforts to reduce the tax gap, the Commissioner of Internal Revenue should do the following.

- Develop plans to periodically measure tax compliance for areas that have been previously measured, such as for individual income tax underreporting, and study ways to cost effectively measure compliance for other components of the tax gap that have not been measured, such as for excise tax and large corporations. Those plans and that study should take into account risk management factors such as the amount the component contributes to the gap, changes that may have affected compliance levels since a measurement was last taken, and the cost of measuring compliance.

- Take steps to ensure that IRS regularly collects complete, accurate, and consistent data, to the extent possible, on the reasons taxpayers are noncompliant and that sufficient broader research is undertaken to continue learning about the reasons why noncompliance occurs.
- Establish a long-term, quantitative voluntary compliance goal for individual income tax underreporting and for tax underpayment, as well as for other areas of noncompliance as data become available.

Agency Comments and Our Evaluation

The Commissioner of Internal Revenue provided written comments on a draft of this report in a letter dated July 6, 2005, which is reprinted in appendix IV. In the letter, the Commissioner agreed with our recommendations. In response to the recommendation that IRS develop plans to periodically measure tax compliance, the Commissioner recognized the need for and value of developing and regularly updating compliance measures for various taxpayer populations and said that IRS will continue to consult with stakeholders to develop and refine its compliance measurement plans. In response to our recommendation that IRS take steps to regularly collect complete, accurate, and consistent data on the reasons for noncompliance, the Commissioner agreed that a better understanding of taxpayer noncompliant behavior would be useful in shaping strategic priorities and defining efforts to improve compliance. He further said that the operating divisions will continue to partner with the IRS research community to identify and better understand specific reasons for noncompliance and that IRS will ensure that auditors are trained to properly apply reason codes in the new report-writing system IRS is developing. In response to the recommendation that IRS develop long-term quantitative compliance goals, the Commissioner agreed with the concept of developing such goals and discussed factors that make goal-setting challenging. We appreciate IRS's current actions related to our recommendations and recognize the challenges involved in balancing a number of complex issues related to obtaining and using tax compliance data.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Chairman and Ranking Minority Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties. We will make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov/.

If you or your staff have any questions, 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 V.

Michael Brostek
Director, Tax Issues
Strategic Issues

Appendix I: IRS Compliance Measurement Surveys

The following table summarizes the Internal Revenue Service's (IRS) efforts to measure voluntary compliance using TCMP surveys and the National Research Program (NRP) survey of individual income tax returns for tax year 2001. Years provided for individual income tax surveys refer to tax years. Years provided for surveys for all other types of tax refer to return processing years.

Table 3: Types of Surveys by Return Type and Year

Return type	Year	Sample size
Individual income tax	1963	92,000
	1965	50,000
	1969	53,000
	1971	26,000
	1973	55,000
	1976	50,000
	1979	55,000
	1982	50,000
	1985	50,000
	1988	54,000
	2001	46,000
Small corporations	1969	16,000
	1973	20,000
	1978	33,000
	1981	33,000
	1988	19,000
Estate returns	1971	4,600
Exempt organization returns	1974	11,400
	1979	20,000
	1988	3,000
Fiduciary returns	1975	8,900
Employee plan returns	1982	18,000
Partnership returns	1982	27,000
S corporation returns	1985	10,000
Delinquent returns—non farm business	1963	27,000
	1966	114,000
	1969	70,000
Delinquent returns—individual	1979	25,000
	1988	25,000

Return type	Year	Sample size
Surveys of delinquent accounts	1963	178,000
	1964	166,000
	1969	1,800,000
	1970	1,800,000
	1971	1,800,000
	1981	1,800,000
	1984	1,800,000

Source: GAO, *Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved*, GAO/GGD-93-52 (Washington, D.C.: Apr. 5, 1993); IRS, *Understanding the Tax Gap*, FS-2005-14, (March 2005).

Appendix II: Detailed Tax Gap Estimates, Data Sources, and Level of Certainty

The following table shows estimates for the various portions of the preliminary 2001 tax gap, the sources, including the age, of the data the Internal Revenue Service (IRS) used for these estimates, IRS's level of certainty for each estimate, and areas for which IRS could not develop an estimate because of insufficient data.

Table 4: IRS's Preliminary Tax Year 2001 Gross Tax Gap Estimates, Data Sources, and Level of Certainty by Tax Gap Component and Type of Tax

Tax gap component & type of tax	Estimate dollars (in billions)	Estimate data source(s)	IRS certainty level
Underreporting	$250-$292		—[c]
Individual income tax	$150-$187	• Tax Year (TY) 2001 National Research Program (NRP) • TY 1988 and earlier TCMP studies • 1981 and 1985-6 University of Michigan surveys of consumers (informal suppliers) • 1984 University of Illinois study of restaurants and other eating places (tip income)	—[c]
Business income	$83-$99		—[c]
Non-business income	$42-$57		—[c]
Adjustments, deductions, exemptions	$14-$16		—[c]
Credits	$11-$14		—[c]
Corporation income tax	$30		Weaker
Large corporations	$25	• Operational audits averaged over 1984, 1985, & 1986 • TY 1982 TCMP study of unrelated business income tax of tax-exempt organizations • TY 1975 TCMP study on fiduciaries	Weaker
Small corporations	$5	• TY 1977 and 1980 TCMP surveys	Weaker
Employment tax	$66-$71		—[c]
Self-Employment tax	$51-$56	• TY 2001 NRP • TY 1984 withholding noncompliance study • 1981 and 1985-6 University of Michigan surveys on informal suppliers	—[c]
Employer-withheld employment tax (FICA)	$14	• 1984 University of Illinois study on tip income • TY 1984 withholding noncompliance study	Weaker
Unemployment tax	$1	• 1984 University of Illinois study on tip income • TY 1984 withholding noncompliance study	Weaker
Estate tax	$4	• IRS's Statistics of Income (SOI) associated with filed estate tax returns for TY 1992	Reasonable
Excise tax	no estimate	N/A	N/A

Tax gap component & type of tax	Estimate dollars (in billions)	Estimate data source(s)	IRS certainty level
Underpayment[a]	$31.7	IRS Master File	Actual
Individual income tax	$19.4	IRS Master File	Actual
Corporation income tax	$2.3	IRS Master File	Actual
Employment tax	$7.2	IRS Master File	Actual
Estate tax	$2.3	IRS Master File	Actual
Excise tax	$0.5	IRS Master File	Actual
Nonfiling[b]	$30		Reasonable
Individual income tax	$28	• TY 1988 Nonfiler TCMP	Reasonable
Corporation income tax	no estimate	N/A	N/A
Employment tax	no estimate	N/A	N/A
Estate tax	$2	• 2 University of Michigan longitudinal surveys (begun in 1992 and 1993 and interviews participants every 2 years) • TY 1992 IRS's SOI	Reasonable
Excise tax	no estimate	N/A	N/A
Total	**$312-$353**		

Source: IRS.

Notes: Figures may not sum to totals due to rounding. N/A = not available.

[a] Unlike the other components of the 2001 tax gap, the underpayment component is not an estimate, but rather represents the tax amounts that taxpayers reported on time, but did not pay on time.

[b] IRS's nonfiler estimate for individual income tax is net of amounts of true tax liability that are paid on time (e.g., through withholding). However, refunds that are due to nonfilers do not reduce the nonfiling gap, since they are not associated with a tax liability.

[c] These estimates are based on more recent NRP data, but IRS has not finalized the certainty level for these estimates because it has not yet completed its assessment of the quality of the NRP data.

Appendix III: IRS Key Efforts to Reduce the Tax Gap

The Internal Revenue Service's (IRS) strategic plan outlines, but does not prioritize, service and enforcement efforts to improve compliance. Therefore, we asked IRS officials to identify IRS's key efforts to reduce the tax gap. IRS's divisions provided lists that totaled 47 efforts, which are described in the following examples.

The Small Business/Self-Employed Division identified 15 efforts such as models to identify higher priority collection cases to pursue, a computer matching program to identify underreported income, initiatives on high income nonfilers, attempts to improve tip income reporting, and efforts to identify abusive tax avoidance transactions.

The Wage and Investment Division identified 7 efforts including various initiatives on tax collection, Earned Income Tax Credit, and using private contractors to collect certain types of tax debts.

The Large and Mid-Sized Business Division identified 5 efforts such as identifying compliance risks, starting examinations sooner and doing them faster, and improving the treatment of abusive tax avoidance transactions.

The Tax Exempt and Government Entities Division identified 8 efforts including abusive tax avoidance transactions in employee plans, abuses in tax-exempt bond financing, pension plan noncompliance, and abuses by credit counseling organizations.

The Criminal Investigation Division identified 12 efforts including those involving questionable refunds, nonfilers, employment tax evasion, corporation fraud, and offshore abusive tax schemes.

Appendix IV: Comments from the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

July 6, 2005

Mr. Michael Brostek
Director, Tax Issues
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Brostek:

I have reviewed the draft Government Accountability Office (GAO) report titled "Tax Compliance: Better Compliance Data and Long Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap" (GAO-05-753). We agree with the recommendations contained in the report and have enclosed detailed comments.

The Internal Revenue Service realizes the importance of the Tax Gap – the difference between actual tax liability and what American taxpayers voluntarily remit on a timely basis. In March, the Service released preliminary estimates of the Tax Gap, indicating that the gross tax gap for Tax Year 2001 was in excess of $300 billion. While the Service receives about $55 billion of this gap in late payments and due to enforcement efforts, more can be done to ensure that everyone pays their fair share.

Congress asked the GAO to review the way the IRS estimates the size of the Tax Gap and the steps the Service is taking to address the tax gap. This report confirms that IRS has a strong set of tax administration activities (both service and enforcement) underway. In the short term, funding the President's budget request is the most important step that Congress can take to support our efforts to reduce the size of the Tax Gap.

I appreciate your continued support and the valuable assistance and guidance from your staff. If you have any questions, or if you would like to discuss this response in more detail, please contact Mark Mazur, Director, Research, Analysis, and Statistics, at (202)-874-0100.

Sincerely,

Mark W. Everson

Enclosure

Enclosure

Recommendation One:

"To establish a stronger foundation for improving IRS's efforts to reduce the tax gap, the Commissioner of Internal Revenue should develop plans to periodically measure tax compliance for areas that have been previously measured, such as for individual income tax underreporting, and study ways to cost effectively measure compliance for other components of the tax gap that have not been measured, such as for excise tax and large corporations. Those plans and that study should take into account risk management factors such as the amount the component contributes to the gap, changes that may have affected compliance levels since a measurement was last taken, and the cost of measuring compliance."

Response:

The IRS agrees with this recommendation and recognizes the need to develop and regularly update measures of compliance for various taxpayer populations. To meet that need, the IRS started the National Research Program (NRP) in Fiscal Year (FY) 2000 to measure compliance with filing, reporting, and payment requirements for different types of taxes and various sets of taxpayers. The NRP is now providing payment compliance measures for all types of taxes and taxpayers and is working with the IRS Office of Research to produce measures of filing compliance for individual income taxpayers. NRP recently completed the first reporting compliance study of individual income taxpayers since Tax Year 1988, and is poised to examine the reporting compliance of Form 1120-S filers starting in FY 2006, the first study of this set of taxpayers in more than 20 years. NRP has also developed a preliminary plan for future reporting compliance studies through FY 2011, subject to approval from IRS senior leadership.

It is important, however, to note that there are significant costs, both to taxpayers and the IRS in conducting these studies. While the IRS agrees that there is substantial value in better measuring taxpayer compliance, the costs must be weighted against other IRS priorities. Therefore, in looking toward future measurement studies, the IRS will consider a variety of factors, including the impact a compliance study might have on improving measurement of the overall tax gap, the value a study may provide beyond obtaining better tax gap measurements (such as improved audit selection criteria), and the costs associated with such studies. The IRS will continue to consult with both internal and external stakeholders in the development and refinement of its plans to measure tax compliance.

Recommendation Two:

"To establish a stronger foundation for improving IRS's efforts to reduce the tax gap, the Commissioner of Internal Revenue should take steps to ensure that IRS regularly collects complete, accurate, and consistent data, to the extent possible, on the reasons taxpayers are noncompliant and that sufficient broader research is undertaken to continue learning about the reasons why noncompliance occurs."

Response:

The IRS agrees with GAO that a better understanding of taxpayer noncompliant behavior would be useful. Therefore, the Operating Divisions will continue to partner with the IRS Research Community to identify and better understand specific reasons for noncompliance. This information has been and will continue to be used in shaping strategic priorities and in defining efforts to improve compliance.

The IRS recognizes the value of a systematic approach to understanding noncompliant taxpayer behavior for use in addressing and preventing expansion of the tax gap. As we develop a new report writing system for IRS auditors, we will include appropriate reason codes for noncompliance for auditors to use. We will ensure the proper use of these reason codes by incorporating this material in training for the new system, and will make their use part of managerial responsibilities. We agree with GAO that examiners are limited to the explanations given by taxpayers as to intent and reasons. Thus, use of any reason codes may or may not accurately reflect the true intent of the taxpayer, and caution will be needed in interpreting the data.

In the interim, we will expand the reason codes available to examiners for the upcoming NRP study of Subchapter S corporations. We will rely upon managerial review of cases and reports for error correction and data perfection. This will provide the IRS with valuable experience in collecting and interpreting data on reasons for non-compliance.

Recommendation Three:

"To establish a stronger foundation for improving IRS's efforts to reduce the tax gap, the Commissioner of Internal Revenue should establish a long-term, quantitative voluntary compliance goal for individual income tax underreporting and for tax underpayment, as well as for other areas of noncompliance as data become available."

Response:

The IRS agrees with the concept behind GAO's recommendation to develop long-term, quantitative goals for various areas of non-compliance. The IRS has begun to study ways of achieving this objective, in the context of developing a set of long-term outcome-oriented goals or indicators for the agency as a whole. However, we need to proceed cautiously to ensure that any goals we may set are: (1) based on data that can be collected at reasonable cost to the agency and to taxpayers; (2) updated regularly (perhaps annually); and (3) not be translated into inappropriate production quotas or goals for IRS employees, a violation of Section 1204 of the IRS Restructuring and Reform Act of 1998. Moreover, any such compliance goals would need to be placed in the context of taxpayer service or quality goals to avoid the perception that only one

3

dimension matters for agency performance. Given this, success in developing compliance goals is still uncertain.

As the GAO report points out, the IRS today devotes a much smaller portion of resources to compliance measurement efforts than in the past. For example, the number of reporting compliance audits of small corporations and partnerships completed as part of the TCMP program in the 1980s exceed the total number of such audits today. Therefore, the IRS must be more selective and more efficient with future reporting compliance studies than in the past. A major challenge will be obtaining the resources to undertake the types of efforts needed to collect high-quality compliance data and to obtain support from the various oversight bodies for these efforts. Without this level of support from the Congress and elsewhere, it will not be possible to credibly establish long-term compliance goals and to know with any degree of certainty whether they are being met.

One final factor that affects the IRS' ability to establish long-term compliance goals is the nature of the tax law itself. The constant changes to the Internal Revenue Code affect compliance among taxpayers. The instability of the law makes extrapolation from prior compliance studies less reliable, and hence the ability to establish and meet long-term goals is compromised.

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110

Acknowledgments

In addition to the contact named above, Jeff Arkin, Ralph Block, Elizabeth Curda, Elizabeth Fan, Evan Gilman, Shannon Groff, George Guttman, Michael Rose, Sam Scrutchins, and Tom Short made key contributions to this report.

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