United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U. S. Senate

For Release on Delivery
Expected at 2:30 p.m. EDT
Wednesday, October 26, 2005

TAX GAP

Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance

Statement of Michael Brostek, Director
Strategic Issues

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GAO-06-208T

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Highlights

Highlights of GAO-06-208T, a testimony before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

Long-term budget simulations by GAO and others show that we face large and growing structural deficits due primarily to known demographic trends and rising health care costs. Reducing the annual tax gap—the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law—could help the nation cope with these long-term fiscal challenges. The tax gap arises through the underreporting of tax liabilities, underpayment of taxes due or "nonfiling" of required tax returns.

This testimony discusses the findings of GAO's recent tax gap report. It addresses the significance of reducing the tax gap, measuring the extent of the tax gap, collecting data on reasons why noncompliance occurs, and the Internal Revenue Service's (IRS) strategies for reducing the tax gap.

What GAO Recommends

GAO's July 2005 report recommended 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 on voluntary compliance levels, starting with individual income tax underreporting and total tax underpayment.

In commenting on a draft of the report, IRS agreed with GAO's recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-06-208T.

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

October 26, 2005

TAX GAP

Multiple Strategies, Better Compliance Data, and Long-term Goals Are Needed to Improve Taxpayer Compliance

What GAO Found

IRS's recent estimate of the tax gap in 2001 ranged from $312 billion to $353 billion. IRS estimates it will eventually recover some of this tax gap, resulting in a net tax gap of $257 billion to $298 billion. Reducing the tax gap will be challenging given persistent levels of noncompliance. Still, given its size, even small or moderate reductions in the net tax gap could yield substantial returns, which could improve the government's fiscal position. For example, based on IRS's most recent estimate, each 1 percent reduction in the net tax gap would likely yield more than $2.5 billion annually. Thus, a 10 percent to 20 percent reduction of the net tax gap would translate into from $25 billion to $50 billion or more in additional revenue annually.

The tax gap must be attacked on multiple fronts and with multiple strategies over a sustained period of time. These strategies could include simplifying the tax code, providing quality service to taxpayers, and enhancing enforcement of tax laws by using tools such as tax withholding and information reporting.

Regularly measuring compliance is also critical to IRS's ability to reduce the tax gap. A significant part of IRS's tax gap estimate is based on recently collected data on individual income tax reporting compliance. However, other areas of the tax gap rely on old data and outdated methodologies. IRS does not have approved plans, with one exception, to collect more current compliance data covering the various components of the tax gap.

Although it can be challenging to develop, data on the reasons why taxpayers do not comply with the tax laws could help IRS more effectively tailor its efforts to reduce noncompliance. IRS has begun to capture data on the reasons for noncompliance, but it has concerns with the data. Although IRS is developing a system intended to capture better examination data, it does not have specific plans to develop better data on the reasons for noncompliance.

IRS's strategies for reducing the tax gap involve improving taxpayer service and enforcing tax laws, but do not have a clear focus on quantitative long-term goals or results measurement. Establishing clear goals and measuring progress toward them would be consistent with results-oriented management principles and would provide IRS with a solid base upon which to develop a more strategic approach to reducing the tax gap.

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to discuss the annual tax gap—the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law—and how reducing that gap can help the nation cope with its large and growing long-term fiscal challenges. Most recently, the Internal Revenue Service (IRS) estimated a gross tax gap from $312 billion to $353 billion for tax year 2001.[1] 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.[2] The tax gap arises when taxpayers intentionally or unintentionally fail to comply with the tax laws. Their failure to pay taxes increases the burden of funding the nation's commitments on those taxpayers who voluntarily pay their taxes.

Mr. Chairman, as I know you and the Comptroller General have discussed in the past, confronting the nation's long-term fiscal challenge will require nothing less than a fundamental review, reexamination, and reprioritization of all major spending and tax policies and programs that may take a generation or more to resolve. Simply put, our nation's fiscal policy is on an imprudent and unsustainable course. Long-term budget simulations by GAO, the Congressional Budget Office (CBO), and others show that over the long term we face large and growing structural deficits due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by our children, grandchildren, and future generations. While our long-term fiscal imbalance cannot be eliminated with a single strategy, reducing the tax gap should be one part of a broader effort to repair the nation's fiscal health.

My remarks are based on our previous work on a variety of issues, in particular the Comptroller General's recent testimony and our report on

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

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

reducing the tax gap.[3] These efforts were conducted in accordance with generally accepted government auditing standards.

Let me begin by highlighting four major points:

- Reducing the current tax gap would contribute to our fiscal sustainability while simultaneously improving fairness for those citizens who fully and timely meet their tax obligations but must be done with multiple strategies over a sustained period.

- Regularly measuring the extent and nature of noncompliance is critical to effective efforts to reduce the tax gap given changes in the economy and tax law, but IRS does not have approved plans, with one exception, for obtaining and maintaining more current compliance data covering the various components of the tax gap beyond tax year 2001.

- Collecting data on the reasons why noncompliance occurs can help IRS more effectively tailor its efforts to improve compliance. However, IRS has no specific plans to gather better data than it already collects.

- Finally, IRS's strategies for improving compliance do not have the clear focus on quantitative long-term goals and results measurement that are associated with high-performing organizations and that are incorporated into the statutory management framework Congress has adopted.

In our July 2005 report on reducing the tax gap, we made 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 an initial 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 Internal Revenue agreed with our recommendations, highlighted challenges associated with

[3] 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), and *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005).

them, and commented on various steps IRS would take to implement each recommendation.

Background

The tax gap is an estimate of the difference between the taxes—including individual income, corporate income, employment, estate, and excise taxes—that should have been timely and accurately paid and what was actually paid for a specific year. The estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or timely.[4] Estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers.

IRS develops its tax gap estimates by measuring the rate of taxpayer compliance—the degree to which taxpayers fully and timely complied with their tax obligations. That rate is then used, along with other data and assumptions, to estimate the dollar amount of taxes not timely and accurately paid. For instance, IRS recently estimated that for tax year 2001, from 83.4 percent to 85 percent of owed taxes were paid voluntarily and timely, which translated into an estimate gross tax gap ranging from $312 billion to $353 billion.

IRS has estimated the tax gap on multiple occasions, beginning in 1979, relying on its Taxpayer Compliance Measurement Program (TCMP). IRS did not implement any TCMP studies after 1988 because of concerns about costs and burdens on taxpayers.[5] Recognizing the need for current compliance data, in 2002 IRS implemented a new compliance study called the National Research Program (NRP) to produce such data for tax year 2001 while minimizing taxpayer burden.[6]

IRS has a strategic planning process through which it supports decisions about strategic goals, program development, and resource allocation.

[4]Taxpayers who receive filing extensions, pay their full tax liability by payment due dates, and file returns prior to extension deadlines are considered to have filed timely.

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

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

Under the Government Performance and Results Act of 1993 (GPRA),[7] agencies are to develop strategic plans as the foundation for results-oriented management.

Reducing the Tax Gap Could Improve the Nation's Fiscal Position but Will Require Multiple Strategies

Given its size, even small or moderate reductions in the net tax gap could yield substantial returns, which could improve the government's fiscal position. For example, based on IRS's most recent estimate, each 1 percent reduction in the net tax gap would likely yield more than $2.5 billion annually. Thus, a 10 percent to 20 percent reduction of the net tax gap would translate into from $25 billion to $50 billion or more in additional revenue annually.[8]

However, reducing the tax gap will be challenging given persistent levels of noncompliance.[9] The tax gap must be attacked on multiple fronts and with multiple strategies on a sustained basis. For example, efforts to simplify the tax code and otherwise alter current tax policies may help reduce the tax gap by making it easier for individuals and businesses to understand and voluntarily comply with their tax obligations.[10] For instance, the multiple tax preferences for education assistance might increase taxpayers' burden in understanding and complying with the rules associated with these options. In our July 2005 report on postsecondary tax preferences, we found that hundreds of thousands of taxpayers do not appear to make optimal decisions when selecting education-related tax

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

[8] Any significant reduction of the tax gap would likely depend on an improvement in the level of taxpayer compliance. In some instances, the amount of the tax gap can change without a corresponding change in the level of compliance. For example, a reduction in marginal tax rates could result in a smaller tax gap simply because the amount of tax that should be paid has been reduced, even if the level of compliance remains unchanged.

[9] Recognizing these challenges, we have long been concerned about tax noncompliance and IRS's efforts to address it. Since 1990, we have had various aspects of tax noncompliance on our high-risk list, and this year we have affirmed our broad concern by consolidating two prior high-risk areas into one—Enforcement of Tax Laws. See GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: Jan. 2005).

[10] GAO's report, *Understanding the Tax Reform Debate*, discusses a number of topics, such as the growing complexity of the current tax system, that tax experts have identified as those that should be considered when evaluating tax policy. See GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: Sept. 2005).

preferences.[11] One explanation of these taxpayers' choices may be the complexity of postsecondary tax preferences, which experts have commonly identified as difficult for tax filers to use. Also, simplification may reduce opportunities for tax evasion through vehicles such as abusive tax shelters. However, for any given set of tax policies, IRS's efforts to reduce the tax gap and ensure appropriate levels of compliance will need to be based on a balanced approach of providing service to taxpayers and enforcing the tax laws.

Providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap. One method of improving compliance through service is to educate taxpayers about confusing or commonly misunderstood tax requirements.[12] For example, if the forms and instructions taxpayers use to prepare their taxes are not clear, taxpayers may be confused and make unintentional errors. One method to ensure that forms and instructions are sufficiently clear is to test them before use. However, we reported in 2003 that IRS had tested revisions to only five individual forms and instructions from July 1997 through June 2002, although hundreds of forms and instructions had been revised in 2001 alone.[13]

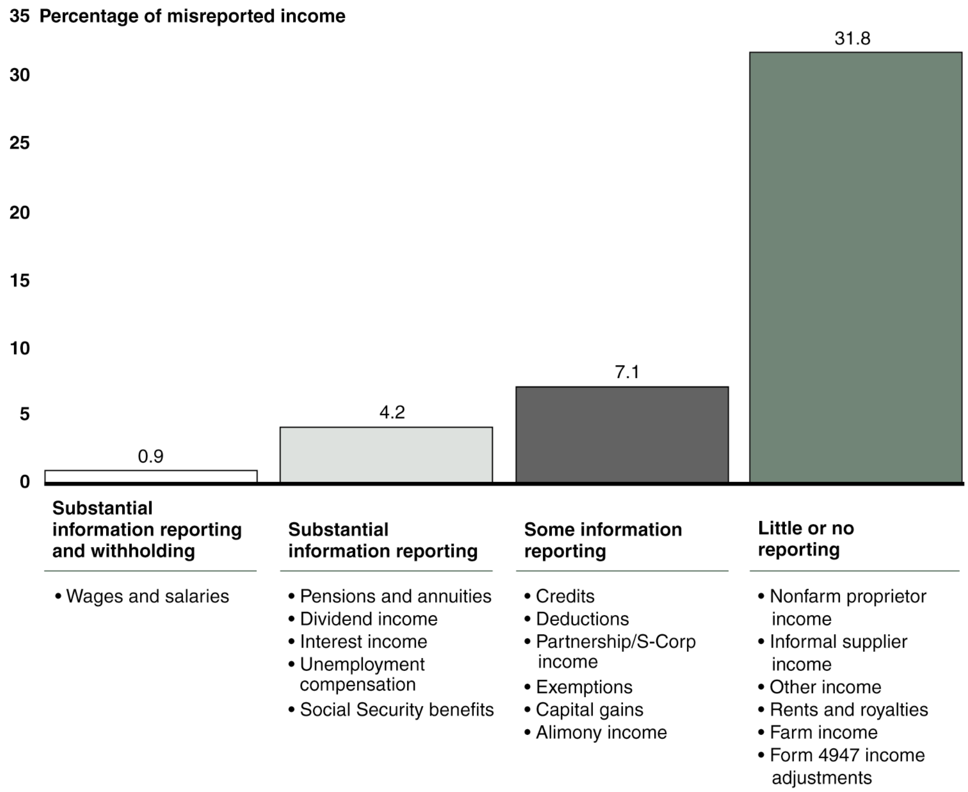
In terms of enforcement, IRS will need to use multiple strategies and techniques to find noncompliant taxpayers and bring them into compliance. In particular, as figure 1 shows, a pair of tools have been shown to lower levels of noncompliance: withholding tax from payments to taxpayers and having third parties report information to IRS and the taxpayers on income paid to taxpayers. For example, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Similarly, most wages, salaries, and tip compensation are reported by employers to employees and IRS through Form W-2. Preliminary findings from NRP indicate that more than 98.5 percent of these types of income are accurately reported on individual returns.

[11]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[12]GAO/T-GGD-97-35.

[13]GAO, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions*, GAO-03-486 (Washington, D.C.: Apr. 11, 2003).

Figure 1: Taxpayer Noncompliance Categorized by Amount of Withholding and Information Reporting, 1992



Source: IRS.

In the past, we have identified a few specific areas where additional withholding or information reporting requirements could serve to improve compliance:[14]

- Requiring tax withholding and more or better information return reporting by organizations that make payments to independent contractors for services provided.[15]

[14]GAO, *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123 (Washington, D.C.: May 11, 1994).

[15]GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

- Requiring information return reporting on payments made to corporations for services provided.

- Require that information returns dealing with capital gain income report the purchase price, or other cost basis data, as well as the sales price for stocks and bonds.

Although withholding and information returns are highly effective in encouraging compliance, such additional requirements generally impose costs and burdens on the businesses that must implement them. However, continued examination of opportunities to expand information reporting and tax withholding has the potential to increase the transparency of the tax system and the level of compliance.

Finally, making progress on closing the tax gap requires that the tools and techniques being used to promote compliance are evaluated to ensure that they actually are effective. IRS evaluates some of its efforts to assess how well they work—perhaps most notably, its current effort to test new procedures designed to reduce noncompliance with the Earned Income Tax Credit[16]—but misses other opportunities. For example, we reported in 2002 that the effectiveness of the Federal Tax Deposit Alert program—a program that since 1972 has been intended to reduce delinquencies in paying employment taxes—could not be evaluated because IRS had no system to track contacts IRS made with delinquent employers.[17]

[16]GAO, *Earned Income Credit: Qualifying Child Certification Test Appears Justified, but Evaluation Plan Is Incomplete*, GAO-03-794 (Washington, D.C.: Sept. 30, 2003), and *Earned Income Tax Credit: Implementation of Three New Tests Proceeded Smoothly, But Tests and Evaluation Plans Were Not Fully Documented*, GAO-05-92 (Washington, D.C.: Dec. 30, 2004).

[17]GAO, *Tax Administration: IRS's Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 2002).

Regular Compliance Measurement Can Support Informed Decisions to Reduce the Tax Gap, but IRS Lacks Approved Plans for Such Measurement

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

Tax compliance data are also useful outside of IRS. Other federal agencies and offices use compliance data for tax policy analysis, revenue estimating, and research. Further, the longer the time between compliance measurement surveys, the less useful they become given changes in the economy and tax law.[19] Without current compliance data, IRS has limited capability to determine key areas of noncompliance to address and actions to take to maximize the use of its limited resources.

Underreporting Accounted for Most of the Tax Gap Estimate

Using its recently collected compliance data, IRS has estimated that 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), as indicated in table 1.

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

[19]GAO/GGD-93-52.

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.

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,[20] informal supplier,[21] 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).[22]

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

[20]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.

[21]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.

[22]GAO-05-753.

are required to withhold these taxes from their employees' wages, match these amounts, and remit withholdings to Treasury at least quarterly. Underreported self-employment[23] 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).

IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and outdated methodologies. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes. IRS has no estimates for other areas of the tax gap, such as for corporate income, employment, and excise tax nonfiling or for excise tax underreporting. For these types of noncompliance, IRS maintains that the data are either difficult to collect, imprecise, or unavailable. In addition, it is inherently difficult for IRS to observe and measure some types of underreporting or nonfiling, such as tracking cash payments that businesses make to their employees, as businesses and employees may not report these payments to IRS in order to avoid paying employment and income taxes, respectively.[24]

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 tax gap estimate for tax year 2001. IRS plans to further analyze the preliminary results from NRP and expects to publish a revised estimate by the end of 2005. The revised estimate will incorporate new methodologies, including those for estimating overall individual income tax underreporting as well as for the portion attributable to self-employed individuals who operate businesses informally, and for estimating individual income tax nonfiling. In addition, IRS has begun a compliance measurement study that will allow IRS to

[23]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.

[24]For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO-05-753.

update underreporting estimates involving S corporations.[25] This study, which IRS began in July 2005, is scheduled to take 2 to 3 years to complete. Because individual taxpayers may be recipients of income (or losses) from S corporations, this study could affect IRS's estimates for the underreporting gap for individual income tax.

Beyond this study of S corporations, IRS has no approved plans to periodically collect more or better compliance data over the long term. Also, IRS has indicated that given its current research priorities, it would not begin another NRP study of individual income tax returns before 2008, and would not complete such a study until at least 2010. When IRS initially proposed the tax year 2001 NRP study, it had planned to study individual income tax underreporting on a 3-year cycle.

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 both direct costs and opportunity costs—revenue that IRS potentially forgoes by using its resources to examine randomly selected returns, which are more likely to include returns from compliant taxpayers and less likely to produce additional tax assessments compared to traditional examinations. One IRS official also emphasized that IRS has fewer resources than in the past to conduct examinations as well as compliance studies.

Although the costs and burdens of compliance measurement are legitimate concerns, we believe compliance studies to be good investments.[26] The lack of firm plans to continually obtain fresh compliance data is troubling because the frequency of data collection can have a large impact on the quality and utility of compliance data. Any plans for obtaining and maintaining reasonably current information on compliance levels for all portions of the tax gap would need to take into account costs, burdens, and compliance risks in determining which areas of compliance to measure and the scope and frequency of such measurement.

[25] S corporations, as well as partnerships, are businesses commonly referred to as flow-through entities as they do not generally pay taxes on income. Instead, they distribute net income and losses to partners, shareholders, and beneficiaries, who are subsequently required to report net income or losses on their individual tax returns and pay any applicable taxes. According to an IRS research official, IRS expects to conduct a compliance measurement study of partnerships at a later date.

[26] GAO/GGD-93-52.

Knowing the Reasons for Noncompliance Could Help Guide Compliance Efforts, but IRS Has Concerns with Its Data on These Reasons

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 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 qualifying child 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. Recognizing the benefits of better compliance data, we, as well as the National Taxpayer Advocate, have urged IRS to consider performing additional research into causes of noncompliance.[27]

IRS collects data on the reasons for noncompliance for specific tax issues during its operational examinations of tax returns. 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:

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

- 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.

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

- 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.

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. 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 data on reasons for noncompliance and that they plan to consider such enhancements. If IRS enhances the data on reasons for noncompliance, it will be important to consider factors such as how complete and reliable such data need to be, and whether to collect the data for all types of noncompliance or for all examinations (as opposed to a targeted random sample).

Long-term, Quantitative Goals for Improving Taxpayers' Compliance Would Be Consistent with Results-Oriented Management

Focusing on outcome-oriented goals and establishing measures to assess the actual results of a program compared to its intended purpose can help agencies improve performance and stakeholders determine whether programs have produced desired results. Furthermore, 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. As such, establishing long-term, quantitative compliance goals coupled with periodic measurements of compliance levels offers several benefits for IRS. These benefits include providing a better basis for determining to what extent its various service and enforcement efforts contribute to compliance, considering new strategies to improve compliance over time,[28] and promoting strategic and

[28]For example, IRS's progress toward the goal of having 80 percent of all individual tax returns electronically filed by 2007 has required enhancement of its technology, 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. Congress established this electronic filing goal in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998).

disciplined management decisions that target areas most in need of improvement.

IRS's strategies for improving compliance, which involve improving taxpayer service and enhancing enforcement of the tax laws, generally lack a clear focus on long-term, quantitative goals and results measurement. In response to a President's Management Agenda[29] initiative to better integrate budget and performance information, IRS officials said that they are considering various long-term goals for the agency. However, IRS has not yet set a time frame for publicly releasing the goals or indicated how many goals will be related to improving taxpayer compliance or whether they will be quantitative and results-oriented. 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.

Like other agencies,[30] IRS faces challenges in implementing a results-oriented management approach. For example, 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.[31] However, even if IRS is unable to show that 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. Moreover, having completed the NRP review of individual

[29]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.

[30]GAO, *The Government Performance and Results Act: 1997 Governmentwide Implementation Will Be Uneven*, GAO/GGD-97-109 (Washington, D.C.: June 2, 1997), and *Results-Oriented Government: GPRA Has Established a Solid Foundation for Achieving Greater Results*, GAO-04-38 (Washington, D.C.: Mar. 10, 2004).

[31]As discussed in our July 2005 tax gap report, several research studies have offered insights to better understand the direct and indirect effects of IRS's activities on tax revenue and voluntary compliance. Indirect effects arise when voluntary compliance increases in the larger population or in subsequent years due to examinations, or other enforcement and service actions, on targeted taxpayers. 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.

income tax underreporting, IRS now has an improved foundation for setting a goal or goals for improving taxpayers' compliance.

Concluding Observations

Reducing the tax gap is one approach that would help address the looming fiscal challenges facing the nation. While our long term-fiscal imbalance is too large to be eliminated by one strategy, reducing the tax gap can ease the difficult decisions that are needed. Toward that end, in our July 2005 report on reducing the tax gap, we made recommendations to IRS to 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 an initial 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 Internal Revenue agreed with our recommendations, highlighted challenges associated with them, and commented on various steps IRS would take to implement each recommendation.

Mr. Chairman and Members of the Subcommittee, this concludes my testimony. I would be happy to answer any questions you may have at this time.

Contact and Acknowledgments

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