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TAX GAP

Complexity and Taxpayer Compliance

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Strategic Issues

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Highlights

Highlights of GAO-11-747T, testimony before the Committee on Finance, U.S. Senate

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TAX GAP

Complexity and Taxpayer Compliance

Why GAO Did This Study

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

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

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

What GAO Recommends

GAO does not make any new recommendations in this testimony.

View GAO-11-747T or key components.
For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

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

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

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

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

Chairman Baucus, Ranking Member Hatch, and Members of the Committee,

I am pleased to be here today to discuss complexity in the tax code, taxpayer burden, and steps to improve compliance. Taxes are necessary because they fund the services provided by government. Complexity, and the lack of transparency that it can create, exacerbate doubts about the current tax system's fairness. Public confidence in the nation's tax laws and tax administration is critical because we rely heavily on a system of voluntary compliance. If taxpayers do not have confidence in the tax system or do not believe that it is easy to understand and treats everyone fairly, then voluntary compliance is likely to decline.

The current tax system is widely viewed as complex, thereby reducing the ability of individuals to understand and comply with tax laws. According to a 2010 report by the National Taxpayer Advocate, the tax code has grown so long that it has become challenging even to figure out how long it is. Important sources of tax code complexity are income documentation requirements and tax expenditure rules, which I will discuss in more detail later in my statement.

Several years ago, the Internal Revenue Service (IRS) estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $345 billion in 2001. We have said in past testimonies that there are no easy fixes to this problem. But in the face of large and growing structural deficits, it is nevertheless important that the government continues to seek out potential causes and solutions. This is in keeping with another theme that we have emphasized: that fundamental reexamination of government programs, policies, and priorities is necessary to assure that they match the needs of the 21st century. While we do not know the extent to which tax code complexity contributes to the tax gap, this hearing is an important step as Congress considers the role played by tax code complexity in either contributing to the tax gap or impeding progress towards solutions.

My statement today will cover (1) how complexity adds to taxpayer burden and economic efficiency costs; (2) how complexities in reporting income contribute to the tax gap; (3) how tax expenditures[1] add complexity and contribute to the tax gap; and (4) possible strategies for addressing the tax gap. It is based mostly on our work from 2005 through 2011 on tax compliance issues affecting individual taxpayers. Those performance audits were conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provided a reasonable basis for our findings and conclusions based on our audit objectives.

We have also updated our analyses from our previous work on the number and sum of tax expenditure provisions.[2] To determine the reliability of this data, we reviewed related documentation and tested data for obvious errors. We determined that the data were sufficiently reliable for the purposes of this testimony.

Background

Tax Gap

The gross 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 paid voluntarily and on time and what was actually paid for a specific year.[3] Of the estimated $345 billion tax gap for tax year 2001, IRS estimated that it would eventually recover

[1]Tax expenditures are preferential provisions in the tax code, such as exemptions and exclusions of income from taxation, deductions, credits, deferral of tax liability, and preferential tax rates. Deciding whether an individual provision should be characterized as a tax expenditure is a matter of judgment, and disagreements about classification stem from different views about what should be included in the income tax base. As a practical matter, the term tax expenditure has been used in the federal budget for over three decades, and the tax expenditure concept—while not precisely defined—is a valid representation of one tool that the federal government uses to allocate resources. The home mortgage interest deduction and the Earned Income Tax Credit are examples of tax expenditures.

[2]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

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

about $55 billion of that through late payments and enforcement actions, for a net tax gap of $290 billion. 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 on time.[4] We have made many recommendations over time that could address the tax gap.[5]

IRS's tax gap estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers. Underreporting of tax liabilities can occur when a taxpayer underreports income earned or overclaims deductions from income. As shown in table 1, underreporting of tax liabilities—particularly for the individual income tax—accounted for most of the tax gap estimate for tax year 2001. We have encouraged regular tax gap measurements, and IRS officials have indicated that they will be updating their tax gap estimates later in 2011 or early 2012. We believe that these estimates are important to gauge progress in addressing the tax gap and because analyzing the data used to estimate it can help identify ways to improve tax compliance.

Table 1: IRS's 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	$197	$30	$54	$4	No estimate	**$285**
Underpayment	23	2	5	2	1	**34**
Nonfiling	25	No estimate	No estimate	2	No estimate	**27**
Total	**$244**	**$32**	**$59**	**$8**	**$1**	**$345**

Source: IRS.

Note: Some figures do not sum to totals because of rounding.

Taxpayers who underreported the amount of individual income tax they owed represented an estimated $197 billion of the 2001 tax gap, and $165

[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 on time.

[5]For a summary of key outstanding recommendations, see GAO, *Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue*, GAO-11-318SP (Washington, D.C.: Mar. 1, 2011).

billion of that amount was due to individual tax filers underreporting their income. As shown in table 2, underreporting of individuals' business income and nonbusiness income accounted for $109 billion and $56 billion, respectively, of the 2001 tax gap.

Table 2: Components of the Tax Gap for Individual Income Tax Underreporting, Tax Year 2001

Type of income or offset	Tax gap amount (dollars in billions)	Net misreporting percentage
Business income	$109	43%
Nonbusiness income	56	4
Credits	17	26
Deductions	14	5
Exemptions	4	5
Adjustments	-3	-21
Total	**$197**	**18%**

Source: IRS.

Note: Figures may not sum to totals because of rounding. Net misreporting percentage is the net amount misreported on a given line item or category expressed as a percentage of the sum of the absolute values of the amounts that should have been reported for that item or category.

IRS has concerns with the certainty of the tax gap estimate for tax year 2001 in part because some areas of the 2001 estimate rely on data originally gathered in the 1970s and 1980s. IRS has no estimates for other areas of the tax gap, and it is inherently difficult to measure some types of noncompliance.[6] Some analysts believe the 2001 estimate likely underestimated the tax gap and that in absolute dollars it is likely larger now than in 2001.

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. IRS seeks to improve voluntary compliance through efforts such as education and outreach programs and tax form simplification. It also uses its enforcement authority to ensure that taxpayers are reporting and paying the proper amounts of taxes through efforts such as examining tax returns

[6]For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO, *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).

and matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns[7] it receives from third parties. In spite of IRS's efforts to improve taxpayer compliance, the rate at which taxpayers pay their taxes voluntarily and on time has tended to range from around 81 percent to around 84 percent over the past three decades.

Tax Expenditures

The sum of the estimated revenue loss due to tax expenditures was over $1 trillion in 2010.[8] Tax expenditures are often aimed at policy goals similar to those of federal spending programs. Existing tax expenditures, for example, help students and families finance higher education and provide incentives for people to save for retirement. Because tax expenditures result in forgone revenue for the government, they have a significant effect on overall tax rates—all else equal, for any given level of revenue, tax expenditures mean that overall tax rates must be higher than a tax system with no tax expenditures. In 2005, we recommended that the federal government take several steps to ensure greater transparency of and accountability for tax expenditures by reporting better information on tax expenditure performance and more fully incorporating tax expenditures into federal performance management and budget review processes.[9]

Complexity Can Have Value, but Adds to Compliance and Efficiency Costs

The federal tax system contains complex rules. These rules may be necessary, for example, to ensure proper measurement of income, target benefits to specific taxpayers, and address areas of noncompliance. However, these complex rules also impose a wide range of record keeping, planning, computational, and filing requirements upon businesses and

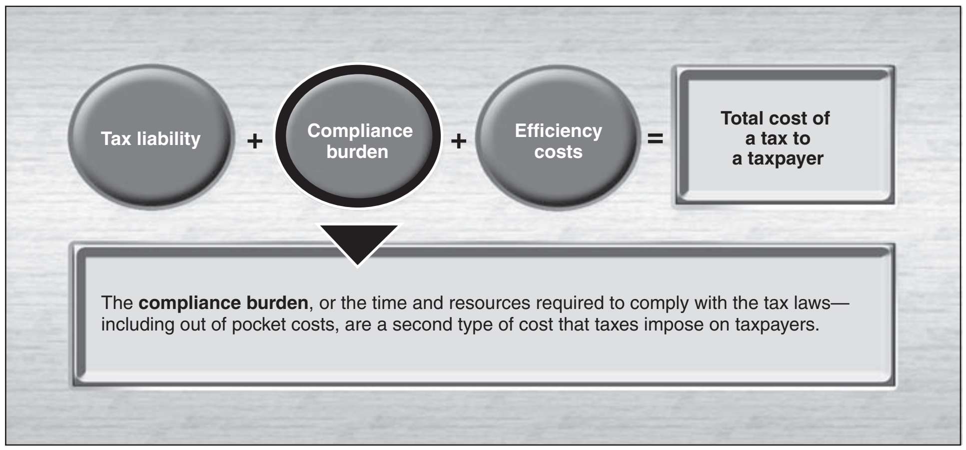
[7]An information return is a tax document businesses and some individuals are required to file to report certain business transactions to the IRS. The requirement to file information returns is mandated by the IRS and associated regulations.

[8]Sums of tax expenditure estimates are useful for gauging the magnitude of tax spending, but need to be interpreted carefully because they do not take into account possible interactions between the individual tax code provisions. These estimates are based on data from the President's Fiscal Year 2012 Budget Request's list of tax expenditures, which is based upon current tax law enacted as of September 30, 2010. On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 not only extended many tax expenditure provisions, but also extended income tax rates for the years 2011-12, thus affecting the estimates of many tax expenditures.

[9]As of May 2011, this recommendation has not been implemented.

individuals. Complying with these requirements costs taxpayers time and money. As shown in figure 1, these costs to taxpayers are above and beyond what they pay to the government in taxes.

Figure 1: Compliance Burden Is One Cost Taxpayers Face in Complying with the Tax System



Source: GAO.

Estimating total compliance costs is difficult because neither the government nor taxpayers maintain regular accounts of these costs, and federal tax requirements often overlap with record keeping and reporting that taxpayers do for other purposes. Although available estimates are uncertain, taken together, they suggest that total compliance costs are large. For example, in 2005 we reviewed existing studies and reported that even using the lowest available compliance cost estimates for the personal and corporate income tax, combined compliance costs would total $107 billion (roughly 1 percent of gross domestic product [GDP]) per year; other studies estimate costs 1.5 times as large.[10]

The tax system also results in economic efficiency costs, which are reductions in economic well-being caused by changes in behavior due to taxes, government benefits, monopolies, and other forces that interfere in the market. Efficiency costs can take the form of lost output or consumption opportunities. For example, economists generally agree that

[10]GAO, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*, GAO-05-878 (Washington, D.C.: Aug. 26, 2005).

the favorable tax treatment of owner-occupied housing distorts investment in the economy, resulting in too much investment in housing and too little business investment. Estimating efficiency costs associated with the tax system is challenging because it has extensive and diverse effects on behavior. In fact, in a 2005 report, we found no comprehensive estimates of the efficiency costs of the current federal tax system.[11] The two most comprehensive studies we found suggest that these costs are large—on the order of magnitude of 2 to 5 percent of GDP each year (as of the mid-1990s). However, the actual efficiency costs of the current tax system may not fall within this range because of uncertainty surrounding taxpayers' behavioral responses, changes in the tax code and the economy since the mid-1990s, and the fact that the two studies did not cover the full scope of efficiency costs.

Tax software and the use of paid tax return preparers may mitigate the need for taxpayers to understand complexities of the tax code. In 2010, IRS processed about 137 million returns. As we have previously reported, about 90 percent of returns are prepared by individual taxpayers or paid preparers using professional or commercial software. Software companies and paid preparers often act as surrogate tax administrators in that they keep abreast of tax law changes. A participant at the 2007 Joint Forum on Tax Compliance stated that taxpayers receiving assistance in preparing their individual tax returns, either from paid preparers or tax preparation software, are somewhat insulated from tax code complexity.[12]

However, while many paid tax preparers help taxpayers by using their expertise to help ensure that complex laws are understood, others may introduce their own mistakes. For example, in a limited investigation in 2006, all 19 of the tax return preparers who prepared returns for our undercover investigators produced errors, some with substantial consequences.[13] IRS's review of 2001 tax returns also found that tax returns prepared by paid preparers contained a significant level of errors.

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[11] GAO-05-878.

[12] GAO, *Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential*, GAO-08-703SP (Washington, D.C.: June 2008). GAO, the Congressional Budget Office, and the Joint Committee on Taxation convened the Joint Forum on Tax Compliance.

[13] GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (Washington, D.C.: Apr. 4, 2006). Our findings cannot be generalized to the entire retail tax preparation community.

IRS audits of returns prepared by a paid preparer showed a higher error rate—56 percent—than audits of returns prepared by the taxpayer—47 percent.

Complexities in Reporting Income Contribute to the Tax Gap by Providing Opportunities for Taxpayers to Misreport

Income measurement is straightforward for a large proportion of the individual taxpayer population: those who earn only labor and interest income and capital income within a retirement account generally have their income reported to them (and to the IRS) by the source of the income. However, substantial numbers of taxpayers who receive income from capital gains, rents, self-employment, and other sources often deal with complex tax laws, complicated calculations, and detailed record keeping. While complexities lead some taxpayers to make mistakes when reporting their income, some misreporting is due to intentional acts of tax evasion.

For example, IRS studies show that the majority of capital asset transactions and capital gains and losses were for securities transactions such as sales of corporate stock, mutual funds, bonds, options, and capital gain distributions from mutual funds. Taxpayers are required to report securities transactions on their federal income tax returns. To accurately report securities sales, the taxpayer must have records of the dates they acquired and sold the asset; sales price, or gross proceeds from the sale; cost or other basis of the sold asset; and resulting gains or losses.[14] They must report this information separately for short-term transactions and long-term transactions. Further, before taxpayers can determine any gains or losses from securities sales, they must determine if and how the original cost basis of the securities must be adjusted to reflect certain events, such as stock splits, nontaxable dividends, or nondividend distributions.

Complex income-reporting requirements for securities transactions may contribute to taxpayers' misreporting their income. In 2006, we estimated that 8.4 million of the estimated 21.9 million taxpayers with securities transactions misreported their gains or losses for tax year 2001.[15] A greater

[14]Basis is generally the amount of a taxpayer's investment in a property for tax purposes.

[15]GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed,* GAO-06-603 (Washington, D.C.: June 13, 2006). We are 95 percent confident that from 7.3 million to 9.5 million taxpayers misreported securities transactions and from 20.3 million to 23.5 million taxpayers had securities transactions.

estimated percentage of taxpayers misreported gains or losses from securities sales (36 percent) than capital gain distributions from mutual funds (13 percent), and most of the misreported securities transactions exceeded $1,000 of capital gain or loss.[16] This may be because taxpayers must determine the taxable portion of securities sales' income whereas they need only add up their capital gain distributions. Furthermore, about half of these taxpayers who misreported failed to accurately report the securities' basis, sometimes because they did not know the basis or failed to adjust the basis appropriately. Although we were not able to estimate the capital gains tax gap for securities, we were able to determine the direction of the misreporting. For securities sales, an estimated 64 percent of taxpayers underreported their income from securities (i.e., they understated gains or overstated losses) compared to an estimated 33 percent of taxpayers who overreported income (i.e., they overstated gains or understated losses).[17] For both underreported and overreported income, some taxpayers misreported over $400,000 in gains or losses.

Small businesses—which include sole proprietorships and S corporations, among other entities—are subject to multiple layers of filing, reporting, and deposit requirements. These requirements reflect IRS's administration of a variety of tax and other policies, including income, employment, and excise taxes, as well as pension and other employee benefit programs. In considering the number of requirements, it is important to note that the requirements reflect many decisions and compromises made by Congress and administrations to accomplish their policy goals, including those that may benefit small businesses and other taxpayers.

Sole proprietors face significant complexities in reporting income. This complexity may contribute to the estimated $68 billion of the tax gap caused by sole proprietors underreporting their net business income, which can stem either from understated receipts or overstated expenses. For example, sole proprietors report their business-related profit or loss on their individual income tax return, and they can use their losses to offset other categories of income on their returns in the year that they incur the loss. Identifying which of a sole proprietor's payments qualify as

[16]Percentage estimates have sampling errors of (+/-) 7 percent or less.

[17]Figures do not sum to 100 percent because some taxpayers misreported securities sales in a way that had no effect on the amount of income from the sales, for example in cases where taxpayers only misreported the securities' holding periods. Estimates have sampling errors of (+/-) 9 percent or less.

business expenses and the amount to be deducted can be complex. For example, two types of payments—costs of goods sold and capital improvements—must be distinguished from other types of payments because they are treated differently under tax rules.[18] Expenses that are used partly for business and personal purposes can be deducted only to the extent they are used for business.

Individual taxpayers who are shareholders in S corporations may also experience difficulty because of complexity in income measurement. An S corporation is a federal business type that provides tax benefits and limited liability protection to shareholders. S corporations are not generally taxed at the entity level: income, losses, and deduction items pass through to the individual shareholders' income tax returns, and the shareholders are taxed on any net income. S corporations are to provide their shareholders and IRS with information on the allocation of income, losses, and other items.

As we have previously reported, one source of complexity for S corporation shareholders may arise when calculating basis—their ownership share of the corporation—in order to claim losses and deductions to offset other earned income.[19] Shareholders generally can only claim losses and deductions up to the amount of basis the shareholder has in the S corporation's stock and debt.[20] While the S corporation is required to send shareholders some information that can be used to calculate basis, S corporations are not required to report any basis calculations to shareholders. IRS officials and S corporation stakeholder representatives told us that calculating and tracking basis was one of the biggest challenges in complying with S corporation rules. In 2009, we

[18]To identify the cost of goods sold, businesses that manufacture or resell merchandise must follow tax rules that require valuing their inventory at the beginning and end of the tax year. Payments for capital improvements, such as start-up costs, business assets, and improvements, usually are not fully deducted in the current tax year but instead must be depreciated over a multiyear period.

[19]GAO, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules*, GAO-10-195 (Washington, D.C.: Dec. 15, 2009).

[20]Stock basis begins with the shareholder's initial capital contribution to the S corporation or the initial cost of the stock purchased. That amount may increase or decrease each year. An income item will increase stock basis; a loss, deduction, or nondividend distribution will decrease stock basis, based on certain ordering rules. For losses and deductions that exceed a shareholder's stock basis, the shareholder is allowed to deduct the excess up to the shareholder's debt basis, which is created by loans that the shareholder personally made to the S corporation.

recommended that Congress require S corporations to calculate shareholder's stock and debt basis as completely as possible and report the calculation to shareholders and IRS.[21] In an analysis of IRS's annual examinations of individual tax returns that closed for fiscal years 2006 through 2008, we found the amount of the misreported losses that exceeded basis limitations was over $10 million, or about $21,600 per taxpayer.

Tax Expenditures Add Complexity and Contribute to the Tax Gap by Providing Opportunities for Taxpayers to Make Mistakes or Evade Taxes

The growing number of tax expenditures is among the causes of tax code complexity. Between 1974 and 2010, tax expenditures reported by the Department of the Treasury more than doubled in overall number from 67 to 173. Tax expenditures are an important means the government uses to address a wide variety of social objectives, from supporting educational attainment, to providing low-income housing, to ensuring retirement income, and many others. However, tax expenditures add to tax code complexity in part because they require taxpayers to learn about, determine their eligibility for, and choose between tax expenditures that have similar purposes. Tax expenditures also complicate tax planning, as taxpayers must predict their own future circumstances as well as future tax rules to make the best choice among provisions.

Savings incentives within the tax code illustrate how tax expenditures add to complexity. While the tax code includes numerous types of savings incentives—including those for healthcare and higher education—my statement will focus on retirement savings as a key example. Taxpayers can choose between traditional Individual Retirement Arrangements (IRA) and Roth IRAs for retirement savings.[22] Although the tax rules for distributions diverge for traditional and Roth IRAs, taxpayers may not know that a 10 percent early withdrawal penalty, with some exceptions, applies to both IRA types. Taxpayers also get confused over which IRA early withdrawals are not subject to penalties, in part because the exceptions differ for employer pension plans. Additionally, both types of IRAs have rules governing eligibility to contribute, and contributions to

[21] As of December 2010, no action has been taken.

[22] The traditional IRA allows tax deferral on investment earnings until retirement distribution with an up-front tax deduction from taxable income for contributions by eligible taxpayers, and retirement distributions are taxable. In contrast, the Roth IRA allows nondeductible, after-tax contributions for eligible taxpayers, and retirement distributions, including investment earnings, are generally tax-free.

each are subject to an annual limit. However, taxpayers may not understand that the annual contribution limit applies across traditional IRAs and Roth IRAs in combination, which may lead them to overcontribute. With regard to record-keeping burden, taxpayers with traditional or Roth IRAs must track the total amount of contributions in a given year and reasons for distributions to accurately report this information on their tax returns. Frequent changes to IRA rules (such as increasing contribution limits and allowing workers to tap IRA assets for certain nonretirement purposes without an early withdrawal penalty) have also made tax planning more difficult for taxpayers.

As we reported in 2008, IRS research and enforcement data show that—in the aggregate—many taxpayers misreported millions of dollars in traditional IRA contributions and distributions on their tax returns.[23] We reported that in tax year 2001 the following occurred:

- Of the taxpayers who made deductible traditional IRA contributions, an estimated 14.8 percent[24] (554,657 taxpayers)[25] did not accurately report the IRA deduction on their individual tax returns—10.4 percent overstated their deductible contributions (that is, exceeded the applicable limit) and 4.4 percent underreported their deductible contributions (that is, reported less on their returns than they actually could deduct).[26] The understated net income due to these misreported traditional IRA contribution deductions was $392 million,[27] including both taxpayers who either overstated or understated their contribution deductions to a traditional IRA.

[23]GAO, *Individual Retirement Accounts: Additional IRS Actions Could Help Taxpayers Facing Challenges in Complying with Key Tax Rules*, GAO-08-654 (Washington, D.C.: Aug. 14, 2008).

[24]We are 95 percent confident that from 11.8 percent to 17.8 percent did not accurately report their traditional IRA deductions.

[25]Estimate has a margin of error of less than or equal to (+/-) 124,057.

[26]We are 95 percent confident that from 7.9 percent to 13.3 percent overstated their traditional IRA deductions. We are 95 percent confident that from 2.8 percent to 6.5 percent understated their traditional IRA deductions.

[27]Estimate has a margin of error of less than or equal to (+/-) $192 million.

- Of the taxpayers who had taxable traditional IRA distributions, an estimated 14.6 percent[28] (1.5 million taxpayers)[29] misreported withdrawals from their traditional IRA distributions—13.7 percent understated (that is, reported an amount less than what the taxpayer withdrew) and 0.9 percent overstated IRA distributions (that is, reported an amount greater than what the taxpayer withdrew).[30] The underreported net income due to misreported IRA distributions was $6.3 billion,[31] including taxpayers who failed to report early distributions and the associated tax.

Taxpayers also make costly mistakes when choosing higher-education tax incentives. In a 2008 testimony, we reported that among tax filers who appeared to be eligible for a tax credit or tuition deduction in tax year 2005, about 19 percent, representing about 412,000 returns, failed to claim any of them.[32] The amount by which these tax filers failed to reduce their tax averaged $219; 10 percent of this group could have reduced their tax liability by over $500. In total, including both those who failed to claim a tax credit or tuition deduction and those who chose a credit or a deduction that did not maximize their benefit, we found that in 2005, 28 percent, or nearly 601,000 tax filers, did not maximize their potential tax benefit.

Some tax expenditures also provide taxpayers who intend to evade taxes with opportunities to do so. For example, the Treasury Inspector General for Tax Administration (TIGTA) reported in 2011 that the First-time Homebuyer Credit (FTHBC) and the subsequent changes made to the credit have confused taxpayers and allowed individuals to make

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[28]We are 95 percent confident that from 12.7 percent to 16.6 percent did not accurately report their traditional IRA distributions.

[29]Estimate has a margin of error of less than or equal to (+/-) 220,026.

[30]We are 95 percent confident that from 11.8 percent to 15.7 percent underreported their traditional IRA distributions. We are 95 percent confident that from 0.5 percent to 1.4 percent overreported their traditional IRA distributions.

[31]Estimate has a margin of error of less than or equal to (+/-) $2.2 billion.

[32]GAO, *Higher Education: Multiple Higher Education Tax Incentives Create Opportunities for Taxpayers to Make Costly Mistakes*, GAO-08-717T (Washington, D.C.: May 1, 2008).

fraudulent claims for the refundable credit.[33] For example, TIGTA reported many taxpayers claiming the credit appeared not to be first-time homebuyers because tax information indicated they had owned homes within 3 years prior to their new home purchase. The 2008 FTHBC provided taxpayers a refundable credit of up to $7,500 that must be repaid in $500 increments each year over 15 years beginning in the 2011 filing season.[34] According to recent IRS data, the total amount to be repaid by taxpayers is $7 billion. The American Recovery and Reinvestment Act of 2009 increased the maximum FTHBC credit to $8,000, with no payback required unless the home ceases to be the taxpayer's principal residence within 3 years. In 2009, we testified that IRS faced significant challenges in determining if taxpayers were complying with the numerous conditions for the credit.[35] For example, to determine eligibility, IRS had to verify that taxpayers had not owned a house in the previous 3 years and verify the closing date on home purchases. Other challenges included enforcing the $500 per year payback provision in the 2008 credit.

Strategies to Reduce the Tax Gap Present Challenges and Trade-offs

Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since the noncompliance has multiple causes and spans different types of taxes and taxpayers. While the tax gap will remain a challenge into the future, the following strategies could help. These strategies could require actions by Congress or IRS.

Enhancing Information Reporting

Enhancing information reporting can reduce complexity for taxpayers. It can also reduce the opportunities available for taxpayers to evade taxes by, for example, underreporting business income or filing fraudulent claims for tax credits. Generally, new requirements on third parties to submit information returns would require statutory changes, whereas

[33]Treasury Inspector General for Tax Administration, *Recovery Act: Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits*, 2011-41-035 (Washington, D.C.: Mar. 31, 2011).

[34]The FTHBC is a refundable tax credit, meaning that it is paid out even if there is no tax liability or the credit exceeds the amount of any tax due.

[35]GAO, *First-Time Homebuyer Tax Credit: Taxpayers' Use of the Credit and Implementation and Compliance Challenges*, GAO-10-166T (Washington, D.C.: Oct. 22, 2009).

improvements to existing information-reporting forms may be done administratively by IRS.

The extent to which individual taxpayers accurately report the income they earn has been shown to be related to the extent to which the income is reported to them and IRS by third parties or taxes on the income are withheld. For example, employers report most wages, salaries, and tip compensation to employees and IRS through Form W-2. Also, 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. Findings from IRS's study of individual tax compliance indicate that nearly 99 percent of these types of income are accurately reported on individual tax returns. For types of income for which there is little or no information reporting, individual taxpayers tend to misreport over half of their income.

One area where improved information reporting could help is higher-education expenses. Eligible educational institutions are required to report information on qualified tuition and related expenses for higher education to both taxpayers and IRS so that taxpayers can determine the amount of educational tax benefits that can be claimed.[36] However, the information currently reported by educational institutions on tuition statements sent to IRS and taxpayers (on Form 1098-T) may be confusing for taxpayers who use the form to prepare their tax returns and not very useful to IRS. IRS requires institutions to report on Form 1098-T either the (1) amount of payments received, or (2) amount billed for qualified expenses. IRS officials stated that most institutions report the amount billed and do not report payments. However, the amount billed may not equal the amount that can be claimed as a credit.[37] In order to reduce taxpayer confusion and enhance compliance with the eligibility requirements for higher-education benefits, in 2009 we recommended that IRS revise Form 1098-T

[36]26 U.S.C. § 6050S. Qualified expenses are tuition and fees a student must pay to be enrolled at or attend an eligible educational institution, and other course-related fees and expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

[37]Currently, educational institutions are required to report information on the form 1098-T for qualified tuition expenses as well as information on the institution itself and the student. These requirements include, for example, reporting name, address, and taxpayer identification number (TIN) of the institution; name, address, and TIN of the student; and amount of payments received or the amount billed for qualified expenses during the calendar year.

to improve the usefulness of information on qualifying education expenses.[38]

Another area where improved information reporting could improve compliance is rental income. In 2008, we estimated that at least 53 percent of individual taxpayers with rental real estate misreported their rental real estate activities for tax year 2001, resulting in an estimated $12.4 billion of net misreported income.[39] IRS enforcement officials cited limited information reporting as a major challenge in ensuring compliance because without third-party information reporting, it is difficult for IRS to systematically detect taxpayers who fail to report any rent or determine whether the rent and expense amounts taxpayers report are accurate. In 2008, we recommended that IRS require third parties to report mortgaged property addresses to help IRS identify who may have misreported their rental real estate activity, but IRS did not adopt our recommendation because of third-party burden and a lack of an IRS compliance program to use such information. We made a similar recommendation in a 2009 report, which IRS is still evaluating as of December 2010.[40]

While information reporting reduces the complexity of reporting income for individual taxpayers, this tool can create costs for the third parties responsible for reporting the income to the taxpayer and IRS. For example, we previously reported that expanding information reporting on securities sales to include basic information would involve challenges for brokers and the IRS.[41] In particular, brokers would bear costs and burdens—even as taxpayers' costs and burdens decrease somewhat—and

[38]GAO, *2009 Tax Filing Season: IRS Met Many 2009 Goals, but Telephone Access Remained Low, and Taxpayer Service and Enforcement Could Be Improved*, GAO-10-225 (Washington, D.C.: Dec. 10, 2009). In December 2010, IRS agreed to consider the feasibility of using Form 1098-T information in conjunction with its examination program.

[39]GAO, *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

[40]We recommended that IRS require third parties to provide information on the address of a home securing a mortgage, among other items. GAO, *Home Mortgage Interest Deduction: Despite Challenges Presented by Complex Tax Rules, IRS Could Enhance Enforcement and Guidance*, GAO-09-769 (Washington, D.C.: July 29, 2009).

[41]GAO-06-603. We reported that, among other things, Congress may wish to consider requiring brokers to report to both taxpayers and IRS the adjusted basis of securities that taxpayers sell. Congress included a provision requiring brokers to report basis information to IRS and taxpayers in the Energy Improvement and Extension Act of 2008. The provision took effect on January 1, 2011, and the Joint Committee on Taxation estimated the provision is expected to raise $6.7 billion in revenue through 2018.

many issues would arise about how to calculate adjusted basis, which securities would be covered, and how information would be transferred among brokers.

In some cases it is difficult to identify third parties for whom a reporting requirement could be enforced without an undue burden on both the third parties and IRS. In a 2009 report, we found that a major reason why little information reporting on sole proprietor expenses exists is because of the difficulty identifying third parties.[42] For example, there is no third party who could verify the business use of cars or trucks by sole proprietors.

Ensuring High-Quality Services to Taxpayers

Ensuring high-quality services is a necessary foundation for voluntary compliance, so action by IRS to improve the quality of services provided to taxpayers would be beneficial. High-quality services can help taxpayers who wish to comply but do not understand their obligations. IRS taxpayer services include education and outreach programs, simplifying the tax process, and revising forms and publications to make them electronically accessible and more easily understood by diverse taxpayer communities. For example, if tax forms and instructions are unclear, taxpayers may be confused and make unintentional errors. Ensuring high-quality taxpayer services would also be a key consideration in implementing any of the approaches for tax gap reduction. For example, expanding enforcement efforts would increase interactions with taxpayers, requiring processes to efficiently communicate with taxpayers. Changing tax laws and regulations would also require educating taxpayers about the new requirements in a clear, timely, and accessible manner. For example, we previously reported that while taxpayers' access to telephone assistance in tax year 2009 was better than the previous year, it remained lower than in 2007, in part because of calls about tax law changes.[43] Despite heavy call volume, the accuracy of IRS responses to taxpayers' questions remained above 90 percent.

Simplifying the Tax Code or Fundamental Tax Reform

Congressional 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. One way to simplify the tax code is to eliminate or combine

[42]GAO, *Tax Gap: Sole Proprietor Loss Deductions Could Improve Compliance but Would Also Limit Some Legitimate Losses*, GAO-09-815 (Washington, D.C.: Sept. 10, 2009).

[43]GAO-10-225.

tax expenditures, thereby helping reduce taxpayers' unintentional errors and limiting opportunities for tax evasion. As we have previously testified, the Government Performance and Results Act (GPRA) Modernization Act of 2010 (GPRAMA)[44] could help inform reexamination or restructuring efforts and lead to more efficient and economical executive-branch service delivery in overlapping program areas. The act is intended to identify the various agencies and federal activities—including spending programs, regulations, and tax expenditures—that contribute to crosscutting outcomes.[45]

While simplification can have benefits, it can also have drawbacks. Eliminating tax expenditures would reduce the incentives for the activities that were encouraged. Also, in 2005, we stated that changes to the tax system can create winners and losers.[46] The government may attempt to mitigate large gains and losses by implementing transition rules. Deciding if transition relief is necessary involves how to trade off between equity, efficiency, simplicity, transparency, and administrability.

Similar trade-offs exist with possible fundamental tax reforms that would move away from an income tax system to some other system, such as a consumption tax, national sales tax, or value-added tax. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few tax preferences or complex tax code provisions and if taxable transactions are transparent. However, these characteristics are difficult to achieve in any system and experience suggests that simply adopting a fundamentally different tax system, whatever the economic merits, may not by itself eliminate any tax gap. For example, in 2008, we reported that some available data indicate a value-added tax may be less expensive to administer than an income tax. However, we found that like other systems, even a simple value-added tax—one that exempts few goods or services—has compliance risks and, largely as a consequence, generates

[44]Pub. L. No. 111-352, 124 Stat. 3866 (Jan. 4, 2011). GPRAMA amends the Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285 (Aug. 3, 1993).

[45]GAO, *Government Performance: GPRA Modernization Act Provides Opportunities to Help Address Fiscal, Performance, and Management Challenges*, GAO-11-466T (Washington, D.C.: Mar. 16, 2011).

[46]GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

administrative costs and compliance burden.[47] Similar to other taxes, adding complexity through exemptions or reduced rates for some goods or services generally decreases revenue and increases compliance risks because of the incentive to misclassify purchases and sales. Such complexity also increases the record-keeping burden on businesses and increases the government resources devoted to enforcement.

Any tax system could be subject to noncompliance, and its design and operation, including the types of tools made available to tax administrators, will affect the size of any corresponding tax gap. Further, the motivating forces behind tax reform include factors beyond tax compliance, such as economic effectiveness, equity, and burden, which could in some cases carry greater weight in designing an alternative tax system than ensuring the highest levels of compliance.

Policymakers may find it useful to compare any proposed changes to the tax code based on a set of widely accepted criteria for assessing alternative tax proposals. These criteria include the equity, or fairness, of the tax system; the economic efficiency, or neutrality, of the system; and the simplicity, transparency, and administrability of the system. These criteria can sometimes conflict, and the weight one places on each criterion will vary among individuals. Our publication, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, may be useful in guiding policymakers as they consider tax reform proposals.[48]

Devoting Additional Resources to Enforcement

Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement

[47]GAO, *Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition*, GAO-08-566 (Washington, D.C.: Apr. 4, 2008). The value-added tax is a consumption tax that is widely used around the world. A value-added tax is levied on the difference between a business's sales and its purchases of goods and services. Typically, a business calculates the tax due on its sales, subtracts a credit for taxes paid on its purchases, and remits the difference to the government.

[48]GAO-05-1009SP.

resources, the amount that the tax gap could be reduced depends in part on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Providing IRS with additional funding would enable it to contact millions of potentially noncompliant taxpayers it currently identifies but cannot contact given resource constraints.

However, devoting additional resources to enforcement will not completely close the tax gap. For example, in a 2009 report, we reported that IRS's compliance programs focused on sole proprietors' underreporting of income addressed only a small portion of sole proprietor expense noncompliance.[49] Despite investing nearly a quarter of all revenue agent time in 2008, IRS was able to examine (audit) about 1 percent of estimated noncompliant sole proprietors. These exams are costly and yielded less revenue than exams of other categories of taxpayers, in part because most sole proprietorships are small in terms of receipts.

Expanding Compliance Checks Before IRS Issues Refunds

IRS could reduce the tax gap by expanding compliance checks before issuing refunds to taxpayers. In April 2011, the Commissioner of Internal Revenue talked about a long-term vision to increase compliance activities before refunds are sent to taxpayers. In one example, IRS is exploring a requirement that third parties send information returns to IRS and taxpayers at the same time as opposed to the current requirement that some information returns go to taxpayers before going to IRS. The intent is to move to matching those information returns to tax returns during tax return processing. IRS currently matches data provided on over 2 billion information returns to tax returns only after the normal filing season. Matching during the filing season would allow IRS to detect and correct errors before it sends taxpayers their refunds, thereby avoiding the costs of trying to recover funds from taxpayers later.[50] This approach could also allow IRS to use its enforcement resources on other significant compliance problems. However, the Commissioner made clear that his vision for more prerefund compliance checks will take considerable time to implement. One prerequisite would be a major reworking of some

[49] GAO-09-815.

[50] GAO, *Taxpayer Account Strategy: IRS Should Finish Defining Benefits and Improve Cost Estimates*, GAO-11-168 (Washington, D.C.: Mar. 24, 2011).

fundamental IRS computer systems. To the extent that implementing this vision would require additional budgetary resources or changes in tax policies, Congress would play a key role.

Using Consistent Definitions

If Congress changed the law to include more consistent definitions across tax provisions, then taxpayers could more easily understand and comply with their obligations. Higher-education tax preferences provide an example of inconsistent definitions for qualified education expenses. What tax filers are allowed to claim as a qualified higher-education expense varies between some of the various savings and credit provisions in the tax code. For example, while Coverdell education savings accounts and qualified tuition programs under section 529 of the Internal Revenue Code permit tax filers to include room and board as qualified expenses if the student is enrolled at least half time, the American Opportunity Credit and the Lifetime Learning Credit do not. These dissimilar definitions require that tax filers keep track of expenses separately, applying some expenses to some tax preferences, but not others.

There are no easy solutions to the tax gap, but addressing the tax gap is as important as ever before in the face of the nation's fiscal challenges. Innovative thinking and the combined efforts of IRS and Congress will be needed now and in the years to come.

Chairman Baucus, Ranking Member Hatch, and Members of the Committee, this completes my prepared statement. I would be happy to respond to any questions you may have at this time.

Contact and Acknowledgments

For further information on this testimony, please contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov. In addition to the individual named above, David Lewis, Assistant Director; Shannon Finnegan, analyst-in-charge; Sandra Beattie; Amy Bowser; Barbara Lancaster; John Mingus; Erika Navarro; Melanie Papasian; and Jonathan Stehle made key contributions to this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement.

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