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Highlights

Highlights of GAO-12-651T, a testimony before the Subcommittee on Government Organization, Efficiency, and Financial Management, Committee on Oversight and Government Reform, House of Representatives

Why GAO Did This Study

In January 2012, IRS estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $450 billion for tax year 2006. IRS estimated that it would collect $65 billion through enforcement actions and late payments, leaving a net tax gap of $385 billion. From 2001 to 2006, IRS estimated that the gross tax gap increased by $105 billion. However, the percentage of taxes owed that were paid on time remained relatively constant at 83.1 percent in 2006, compared to 83.7 percent in 2001.

Given persistent levels of noncompliance and large and growing structural deficits, it will be important to understand the causes of tax noncompliance and develop new approaches to minimize it.

This testimony addresses two questions: (1) What types of taxpayers are responsible for the tax gap, and what is the nature of their noncompliance? (2) What are strategies for reducing the tax gap? The statement also discusses potential long-term strategies to prevent refund fraud related to identity theft. This statement is based largely on GAO's recent reports and recommendations on tax noncompliance and updates GAO's 2011 testimony on the tax gap.

What GAO Recommends

GAO has made numerous prior recommendations regarding actions to close the tax gap. Congress and IRS have acted on some, while others are reflected in the strategies presented in this testimony.

View GAO-12-651T. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

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TAX GAP

Sources of Noncompliance and Strategies to Reduce It

What GAO Found

Noncompliance does not have a single source but occurs across different types of taxes and taxpayers. For example, individual income tax accounts for the largest portion of the tax gap, but corporate income tax and employment tax are also significant. Further, misreporting by individuals involves business income, non-business income, deductions, and credits. The extent of misreporting depends on the extent to which income tax is withheld or reported to the Internal Revenue Service (IRS) by third parties. For example, nearly 40 percent, or $179 billion, of the 2006 gross tax gap is due to misreporting of non-corporate business income and related self-employment taxes. Much of this misreporting can be attributed to sole proprietors underreporting receipts or over-reporting expenses. Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is reported to IRS by third parties.

Because noncompliance has multiple causes and spans different types of taxes and taxpayers, multiple approaches are needed to reduce the tax gap. The following strategies could help and will require actions by Congress or IRS.

Enhancing information reporting by third parties to IRS could reduce tax evasion and help taxpayers comply voluntarily. However, identifying additional reporting opportunities can be challenging because third parties may not have accurate information available in a timely manner. Also, adding reporting requirements creates burden for both third parties and IRS.

Ensuring high-quality services to taxpayers, such as by telephone and correspondence or online, can help taxpayers who wish to comply with tax laws but do not understand their obligations. However, tax law changes and funding priorities have recently affected IRS's ability to provide quality taxpayer services.

Devoting additional resources to enforcement would enable IRS to contact millions of potentially noncompliant taxpayers it identifies but cannot contact. To determine the appropriate level of enforcement resources, policymakers would need to consider how to balance taxpayer service and enforcement activities and how effectively and efficiently IRS currently uses its resources.

Expanding compliance checks before IRS issues refunds would involve matching information returns to tax returns during, rather than after, the tax filing season. This approach would require a major reworking of some fundamental IRS computer systems but could help address identity theft-related fraud and allow IRS to use enforcement resources on other compliance problems.

Leveraging external resources, such as paid tax return preparers and whistleblowers, can help improve tax compliance because paid preparers' actions have an enormous impact on IRS's ability to effectively administer tax laws, and whistleblowers provide IRS information on suspected noncompliance.

Modernizing information systems would allow IRS to post more comprehensive tax return information to its computer systems, which could facilitate the examination process and expedite taxpayer contacts for faster resolution.

Simplifying the tax code could help taxpayers understand and voluntarily comply with their tax obligations and limit opportunities for tax evasion.