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The Tax Gap

Statement of
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THE TAX GAP

SUMMARY STATEMENT OF
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The Internal Revenue Service's (IRS) objective for developing tax gap estimates is to gain some perspective on the magnitude and types of taxpayer noncompliance. IRS defines the "tax gap" as the difference between the amount of income taxes voluntarily paid by individuals and businesses and the amount of income taxes that are owed. IRS estimates that taxpayers will not pay $84.9 billion in income taxes that they owe on income derived from legal sources for tax year 1987.

Tax gap estimates can always be debated because of data limitations and different assumptions used in developing them. It is difficult to develop the estimates; and IRS is to be commended for the effort it has made.

IRS has not made public the complete details of the assumptions, methodologies, and data used in arriving at its latest estimates. However, by reviewing the current and previous IRS tax gap studies and by interviewing IRS officials, GAO identified some issues which can affect the size of the estimates. For example, (1) IRS based its estimates on existing data, but some of that data was old; and (2) some types of taxable income, such as income received on a cash basis through informal arrangements--informal supplier income--are very difficult to estimate. Even so, the tax gap estimates provide perspective on the size of the overall tax gap and identify pockets of noncompliance where IRS enforcement actions can be focused.

GAO recognizes that income from some pockets of the gap are more difficult to identify than others. However, IRS should strive to develop methods to get at all pockets of the tax gap. Over the last few years, GAO has reviewed several IRS enforcement programs and made recommendations and suggestions for program improvements. For the most part, IRS officials have been receptive to GAO's recommendations.

GAO's testimony illustrates how three of IRS' enforcement programs can be more effective in reducing the tax gap without significantly increasing IRS' resources. This testimony discusses: (1) the merits of establishing a business information returns program, (2) the adequacy of IRS' efforts to address tip income noncompliance, and (3) the effectiveness of IRS' primary enforcement program for illegal source income.

Mr. Chairman and Members of the Committee:

We are pleased to be here to discuss the tax gap and our efforts over the past several years to help the Internal Revenue Service (IRS) narrow the gap. We have been concerned about the size of the tax gap and have reported and testified on the need for IRS to take actions to better identify unreported income and collect the taxes owed the federal government. In this time of difficult choices in deliberations over the federal budget, closing the tax gap in a cost-effective manner is more important than ever. By collecting more taxes that are properly due, IRS can make contributions to lowering the federal budget deficit.

Today, Mr. Chairman, I would like to make two major points:

-- First, it is difficult to precisely measure the tax gap, but IRS' estimates show that the tax gap remains substantial.

-- Second, IRS can do more to reduce some parts of the tax gap. Our recommended improvements to several IRS enforcement programs should enable IRS to better identify unreported income and collect more taxes.

Mr. Chairman, I would now like to discuss these two points in greater detail.

THE TAX GAP ESTIMATES

IRS' objective for developing tax gap estimates is to gain some perspective on the magnitude and types of taxpayer noncompliance. IRS has issued three studies, in 1979, 1983, and 1988, on tax gap estimates. The estimates in these studies can always be debated because of data limitations and the different assumptions used in developing them. However, available evidence suggests a noncompliance problem in the billions of dollars, underscoring the need for effective IRS enforcement actions.

In order to understand IRS' most recent estimate, which was released in March 1988, it is important to understand what the estimate includes and excludes. IRS defines the "tax gap" as the difference between the amount of income taxes voluntarily paid by individuals and businesses and the amount of income taxes that are owed. IRS estimates that taxpayers will not pay $84.9 billion in income taxes that they owe for tax year 1987. This amount is for income derived from legal sources because the 1988 study did not include an estimate for illegal source income, as did the 1983 study.

IRS divides the legal source income tax gap into two parts: individuals and corporations. The individual tax gap includes sole proprietorships and partnerships. For 1987, the tax gap for individuals is estimated to be $63.5 billion, or about 75 percent of IRS' latest tax gap estimate. The tax gap for corporations is estimated to be $21.4 billion, or about 25 percent. In the 1983 study, the individual gap was estimated to be 92 percent and the corporation gap 8 percent.

The individual tax gap includes estimates for those who file incorrect tax returns as well as those who do not file at all. Of the tax gap for individuals who file returns, unreported income at $48.3 billion is the largest single portion. Unreported income can come from many sources such as wages and salaries, interest and dividends, sole proprietorship income, capital gains, and what IRS calls informal supplier income. Informal supplier income is cash income received by individuals through informal arrangements, such as those for some home repairs or day care. The largest portions of unreported income, according to IRS' study, are from sole proprietorships, informal suppliers, and capital gains, which are 34, 16 and 14 percent of the $48.3 billion total, respectively.

The corporation tax gap, from underreporting income and overstating deductions and credits, includes an approximate $16 billion tax gap for large and medium corporations--those with $10 million or more in assets--and about a $5 billion tax gap for small corporations--those with less than $10 million in assets.

IRS has not made public the complete details of the assumptions, methodologies, and data used in arriving at its latest estimates. However, by reviewing the current and previous IRS tax gap studies and by interviewing IRS officials, we identified some issues which could affect the size of the estimates.

-- First, IRS based its estimates on existing data, but some of that data was old. IRS used 1972 and 1977 data to estimate the amount of income that should have been reported by individual nonfilers. To estimate the amount of underreported income from taxpayers who filed, IRS relied on the results of its Taxpayer Compliance Measurement Program examinations of 1982 individual returns. For small corporations, IRS used 1981 program data.

-- Second, IRS' assumptions and methodologies could affect the size of the tax gap estimates. For example, IRS assumed in its latest study that overall compliance would remain constant through 1992. This assumption was based in part on the results of examinations and the potential impact of changes in the tax laws since 1982, including the significant changes from the Tax Reform Act of 1986. In its 1983 study, IRS assumed that compliance would decline because voluntary compliance rates were down. IRS' current study is not clear on how much this change in assumption affects the tax gap estimates or IRS' projections of those estimates.

-- Third, IRS' published estimates of the legal sector gap are on a recommended basis; that is, they include some taxes that would be recommended by IRS' examiners, but which would not be assessed if successfully appealed. As the IRS study explains, on an assessed basis, the tax gap estimates are lower.

-- Fourth, IRS has excluded items from its 1988 tax gap estimates that it previously included in its 1983 study. As previously stated, IRS excluded any estimate for illegal source income from the 1988 study. In the 1983 study, IRS estimated a $9.0 billion tax gap for 1981 from 3 illegal activities--gambling, drug trafficking, and prostitution.

-- Fifth, some types of taxable income are very difficult to estimate. The $7.7 billion estimate for informal supplier income is based on data gathered from individuals about the extent to which they purchased various items or services from street vendors or others on a cash basis. From this data, IRS attempted to estimate the amount of unreported informal supplier income, making various assumptions about applicable tax rates, deductions, etc. of the individuals receiving this income.

Further, IRS is already collecting a portion of what it considers the overall tax gap. IRS' own definition of the tax gap includes all income taxes not voluntarily paid, but owed. Thus, all the amounts IRS collects through enforcement programs, like the examination of tax returns, could be deducted from IRS' estimate to arrive at a net tax gap. For example, if IRS enforcement programs resulted in several billion dollars in additional taxes collected, and this amount were applied to the tax gap estimate, the tax gap would be reduced by the taxes IRS collected.

The issues associated with developing tax gap estimates make it difficult for Congress to have a firm base from which to measure the overall impact of IRS' enforcement programs in reducing the gap. Developing these estimates is difficult, and IRS is to be commended for the effort it has made. The tax gap estimates provide perspective on the size of the overall tax gap and identify pockets of noncompliance where IRS enforcement actions can be focused.

IRS CAN TAKE ADDITIONAL STEPS TO CLOSE THE TAX GAP

Some types of unreported income, such as wages, interest, and dividends, can be more easily identified than others through IRS enforcement actions. Other types of unreported income, such as informal supplier and sole proprietor income, as well as income illegally obtained, are more difficult to identify, and thus taxes are more difficult to collect. Even so, we believe that IRS should strive to develop methods to get at all pockets of the tax gap.

Over the last few years, we have reviewed several IRS enforcement programs that are designed, in part, to reduce the tax gap. We have made various recommendations and suggestions for program improvements, some of which could be made without significantly increasing IRS' resources. For the most part, IRS has been receptive to our recommendations and has either taken action or plans to take action on them. Attached to this statement is a list of reports and testimonies on selected reviews of IRS' enforcement programs. Three of those reviews illustrate how IRS' enforcement programs can be made more effective in reducing the tax gap.

In 1987 we testified on the merits of establishing a business information returns program. This program would be similar to IRS' information returns program for individuals, which is designed to detect unreported income. IRS matches income, such as interest or dividends, reported on information returns it receives from banks and other payors against income reported by individual taxpayers on tax returns. IRS considers this matching program for individuals a successful enforcement program, and IRS officials said it yielded $17 in tax assessments for every $1 in cost to IRS in 1985.

Although IRS received about 31 million information returns for businesses in calendar year 1986, it had not established a matching program for businesses. We concluded in our testimony that IRS could initiate a matching program to identify unreported income of sole proprietorships and to identify business nonfilers. We also suggested alternatives to IRS to help overcome impediments associated with establishing a full-scale matching program for partnerships and corporations. Not all proprietorship and business income is subject to information reporting. However, we believe that portions of the currently estimated tax gap of $16.6 billion for proprietorships and $21.4 billion for corporations can be reduced through cost-effective matching programs. IRS is testing the feasibility of an information returns matching program for identifying unreported income of sole proprietorships and for identifying business nonfilers. IRS is also testing the use of information returns to detect unreported corporate income.

In 1986, we reported that tip income reporting could be increased. For calendar year 1981--the latest year for which information was available--IRS estimated that individuals did not report or pay taxes on over $8.5 billion in tip income. This unreported income translated into an estimated tax loss of $2.3 billion. IRS further estimated that the tip income noncompliance rate was about 84 percent, the highest noncompliance rate among all legal source income areas.

We identified tip income detection methods that were being used in some IRS regions but not in others. We pointed out this inconsistency as well as the need for an overall strategy to reduce unreported tip income. IRS officials generally agreed with our recommendations and identified activities that IRS had underway to aid in the formulation and implementation of an overall strategy. One of the activities included a congressionally mandated study of tip income noncompliance that, among other things, will provide information on the nature and level of tip noncompliance. This study is expected to be issued this summer.

With respect to IRS' efforts to address the illegal source income tax gap, we will soon issue a report on IRS' Special Enforcement Program--its primary means of detecting illegal source income. This program seeks to prosecute major criminals for tax law violations and tax the proceeds of illegal activities, thus making them less profitable. Our work showed that for the program cases closed in 1982--the latest data available--IRS collected about $11 million, of which $2 million represented taxes on illegal income. While we agree with IRS that it is difficult to identify and tax illegal source income, we believe that IRS could do more to address the tax aspects of criminal cases. IRS officials informed us that in order to ensure more effective tax assessment and collection, they plan to implement a district level program to monitor civil actions on closed criminal cases.

We are currently doing other work related to reducing the tax gap. At this committee's request, we are reviewing how much revenue IRS actually generates through examinations. We are also looking at the effectiveness of IRS' efforts with regard to independent contractors' compliance with the tax laws, the adequacy of levies to promote better compliance, and the effect that past declining audit coverage may have had on the tax gap.

We have recognized the importance of IRS having adequate resources to maintain effective enforcement programs. We have testified on IRS' budget requests and recommended that IRS be given additional resources, which Congress has provided. We also believe, however, it is incumbent upon IRS to continue to identify those opportunities and innovative techniques that will enhance the effectiveness of its enforcement programs in reducing the tax gap.

This concludes my prepared statement. I would be happy to answer your questions.

SELECTED GAO REPORTS AND TESTIMONIES SINCE 1981 ON IRS ENFORCEMENT PROGRAMS

Investigating Illegal Income--Success Uncertain, Improvements Needed (GAO/GGD-88-61, issuance due in spring of 1988)

Gas Guzzler Tax Compliance Can Be Increased (GAO/GGD-87-85, 7/16/87)

Testimony Before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations on The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, 3/17/87)

Tip Income Reporting Can Be Increased (GAO/GGD-86-119, 9/30/86)

Information Returns Should Increase Proper Reporting of Farm Income (GAO/GGD-86-69, 7/22/86)

Testimony Before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations on IRS' Information Returns Matching Program, 4/29/86

Protecting Tax Revenue When Businesses File for Bankruptcy (GAO/GGD-86-20, 2/21/86)

The Federal/State Tax Information Exchange Program (GAO/GGD-86-8, 12/13/85)

IRS' Examination Selection System for Exempt Organizations' Unrelated Business Income (GAO/GGD-85-64, 7/8/85)

IRS is Taking Action to Improve the Quality of Its Small Corporation Audits (GAO/GGD-85-26, 6/12/85)

Testimony Before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations on U.S. Citizens Living in Foreign Countries and Not Filing Federal Income Tax Returns, 5/8/85

Administrative Changes Could Strengthen IRS' Claims for Rewards Program (GAO/GGD-85-11, 4/19/85)

Further Research into Noncompliance is Needed to Reduce Growing Tax Losses (GAO/GGD-82-34, 7/23/82)

What IRS Can Do To Collect More Delinquent Taxes (GAO/GGD-82-4, 11/5/81)

IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (GAO/GGD-81-81, 9/30/81)