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TAX COMPLIANCE

Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies

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Comptroller General of the United States

GAO
Accountability * Integrity * Reliability

GAO-05-527T

Multiple Service and Enforcement Strategies, Periodic Compliance Measurement, and A Results-Oriented Compliance Approach May Help IRS Reduce the Tax Gap

Reducing the tax gap would be a step toward improving our fiscal sustainability while simultaneously enhancing fairness for those citizens who meet their tax obligations. That said, reducing the tax gap is a challenging task, and closing the entire tax gap is not practical. Reducing the tax gap will not likely be achieved through a single solution, but will likely involve multiple strategies that include reducing tax code complexity, providing quality services to taxpayers, and enhancing enforcement of the tax laws through the use of tools such as tax withholding and information reporting that increase the transparency of income and deductions to both IRS and taxpayers. Also, as IRS moves forward in continuing to address the tax gap, building and maintaining a base of information on the extent of, and reasons for, noncompliance as well as defining desired changes in the tax gap and measuring results of efforts to address it will be critical.

Reducing the Tax Gap Could Have a Positive Fiscal Impact but Will Require Multiple Strategies

Given its size, even small or moderate reductions in the net tax gap could yield substantial returns. 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.[14]

Although reducing the tax gap may be an attractive means to improve the nation's fiscal position, achieving this end will be a challenging task given persistent levels of noncompliance. IRS has made efforts to reduce the tax gap since the early 1980s; yet the tax gap is still large—although without these efforts it could be even larger. Also, IRS is challenged in reducing the tax gap because the tax gap is spread across the five different types of taxes that IRS administers, and a substantial portion of the tax gap is attributed to taxpayers who are not subject to withholding or information reporting requirements. Moreover, as we have reported in the past,[15] closing the entire tax gap may not be feasible nor desirable, as it could

[14]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.

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

entail more intrusive recordkeeping or reporting than the public is willing to accept or more resources than IRS is able to commit.

Although much of the tax gap that IRS currently recovers is through enforcement actions, a sole focus on enforcement will not likely be sufficient to further reduce the net tax gap. Rather, 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 business to understand and voluntarily comply with their tax obligations. For instance, reducing the multiple tax preferences for retirement savings or education assistance might ease taxpayers' burden in understanding and complying with the rules associated with these options. 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.

Furthermore, providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap. As we have reported in the past,[16] one method of improving compliance through service is to educate taxpayers about confusing or commonly misunderstood tax requirements. 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.[17]

Finally, in terms of enforcement, IRS will need to use multiple strategies and techniques to find noncompliant taxpayers and bring them into compliance. However, a pair of tools has been shown to lead to high levels of compliance: withholding tax from payments to taxpayers and having

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

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

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.

In the past, we have identified a few potential areas where additional withholding or information reporting requirements could serve to improve compliance:[18]

- **Requiring tax withholding and more or better information return reporting on payments made to independent contractors.** Past IRS data have shown that independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. We have also identified other options for improving information reporting for independent contractors, including increasing penalties for failing to file required information returns, lowering the $600 threshold for requiring such returns, and requiring businesses to separately report on their tax returns the total amount of payments to independent contractors.[19]

- **Requiring information return reporting on payments made to corporations.** Unlike payments made to sole proprietors, payments made to corporations for services are generally not required to be reported on information returns. IRS and GAO have contended that the lack of such a requirement leads to lower levels of compliance for small corporations. Although Congress has required federal agencies to provide information returns on payments made to contractors since 1997,[20] payments made by others to corporations are generally not covered by information returns.

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

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

[20]Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

PAUL R. HOLVEY
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OREGON HOUSE OF REPRESENTATIVES

June 4, 2013

Co-Chair Representative Greg Smith and Co-Chair Senator Elizabeth Steiner Hayward:
Joint Committee on Ways and Means, SubCommittee on General Government:

House Bill 2464 has been forwarded to this committee with a do-pass recommendation from the House Revenue Committee. This bill is aimed at enhancing tax compliance and reducing unreported income. Compliance to our tax laws are often times ignored resulting in a loss of resources for needed government services and creating an unfair business advantage for those that do not fully report income they receive. This problem is largely present in income received by independent contractors which are very prevalent in the construction industry. Current law requires third party transaction reporting by payors to the payee and the Department of Revenue. These transaction reports are known as IRS forms 1099 and W- 2's. This reporting is required for payments for service to all entities except C corporations.

If passed, HB 2464 would help address this issue by extending the current reporting requirements for payments to C- corporations in the construction industry. The bill also clarifies that the reporting requirements do not apply to payments for goods or materials alone, only to payments that include services or labor.

The bill also provides for penalties to entities that fail to provide the transaction reports. This is important because there is currently nothing to compel compliance for providing the reports; and if a payee does not receive these reports of income they are less likely to report that income to the Department of Revenue. These additional requirements for reporting have been recognized by the United States Government Accountability Office and the Internal Revenue Service as areas that would improve tax compliance. I have provided some documents from these agencies recommending these proposals to increase tax compliance. Additionally these agencies in their 2011 report stated:

"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 from 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."

Fairness in a level playing field in the marketplace is extremely important, especially in the construction industry. I hope you view this proposed legislation as good policy and move it to the floor with a do-pass recommendation. Thank you.

Respectfully,

Paul

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