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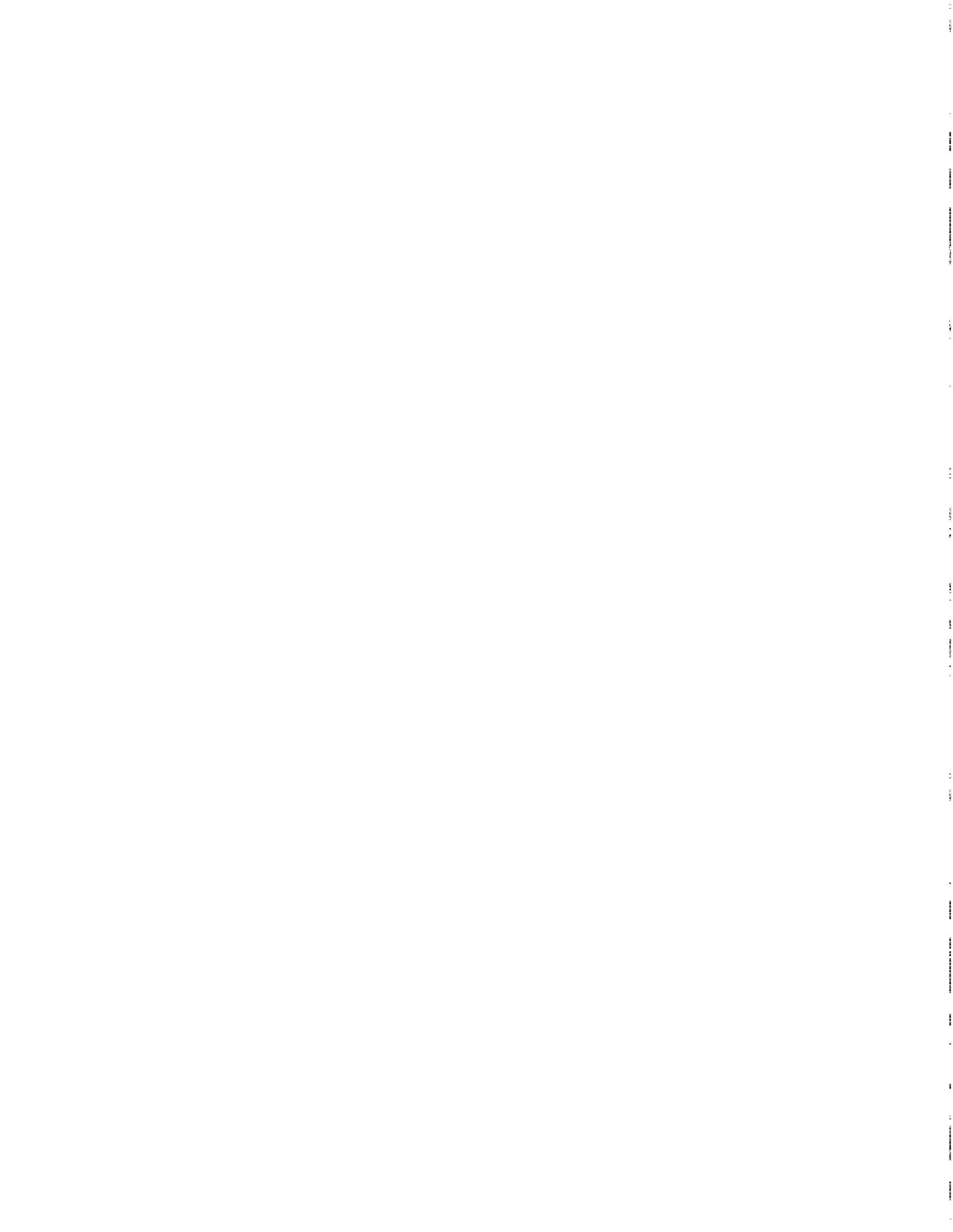
Report to the Honorable  
John W. Olver,  
House of Representatives

May 1994

## TAX GAP

Many Actions Taken,  
But a Cohesive  
Compliance Strategy  
Needed





# GAO

United States  
General Accounting Office  
Washington, D.C. 20548

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**General Government Division**

B-256512

May 11, 1994

The Honorable John W. Olver  
House of Representatives

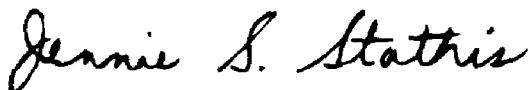
Dear Mr. Olver:

This report responds to your request for information on the income tax gap and the efforts of the Internal Revenue Service (IRS) and Congress to reduce it. The report also offers other ideas for reducing this tax gap. We have not offered new recommendations; rather, we have updated information related to our past recommendations that have not been implemented.

We are sending copies of this report to the Commissioner of Internal Revenue, the Chairman of the Senate Committee on Finance, the Chairman of the House Committee on Ways and Means, the Chairman of the Joint Committee on Taxation, and other interested parties.

This report was prepared under the overall direction of Natwar M. Gandhi, Associate Director, Tax Policy and Administration Issues. Ralph Block from our San Francisco Regional Office was the project manager. Other major contributors are listed in appendix V. Please call me on (202) 512-5407 if you or your staff have any questions.

Sincerely yours,



Jennie S. Stathis  
Director, Tax Policy and  
Administration Issues

# Executive Summary

## Purpose

The Internal Revenue Service (IRS) has estimated that individual and business taxpayers owed but did not voluntarily pay over \$100 billion in 1992 income taxes (i.e., gross tax gap). IRS further estimated that its enforcement programs did not collect about three-quarters of the gross tax gap (i.e., net tax gap). Such annual tax losses intensify pressures in funding necessary programs.

This report responds to a request by Representative John Olver as a member of the House Appropriations Subcommittee that oversees IRS. It analyzes the composition of the tax gap, congressional and IRS prior efforts to reduce the gap, IRS' ongoing and planned efforts to improve compliance, and what more could be done to reduce the gap.

## Background

IRS last estimated the gross tax gap in 1988 and net tax gap in 1990. Both estimates were projected through tax year 1992. Since then, IRS has updated statistical compliance data through detailed audits of randomly selected tax returns in its Taxpayer Compliance Measurement Program (TCMP). IRS is using the TCMP and other data to update its tax gap estimates during 1994.

IRS has various enforcement efforts to reduce the gross tax gap. IRS audits tax returns, collects delinquent taxes and returns, and computer matches amounts reported on tax returns to amounts reported on third-party information returns.

IRS is developing new approaches to reduce the tax gap. Under its Compliance 2000 strategy, IRS assumes that most taxpayers want to comply. It is looking at nonenforcement methods such as education to increase compliance, particularly if the noncompliance appears to be unintentional.

IRS is reorganizing to become more cross-functional. The collection and audit functions will fall under the compliance group. At the same time, IRS is upgrading its computer systems under its Tax Systems Modernization (TSM), which it plans to finish by 2008. As TSM comes on-line, IRS is exploring how to retrain staff whose work will be automated.

GAO developed this report by tracking its past recommendations on reducing the tax gap. In summarizing past recommendations, GAO also updated information relating to those recommendations.

## Results in Brief

IRS' estimates showed that in current dollars, the gross income tax gap is large and has grown—from \$76 billion in 1981 to \$127 billion in 1992. While imprecise, these estimates provide useful indicators of taxes that are not voluntarily paid and the composition of the gap.

Since the early 1980s, Congress has given IRS tools to help it reduce the tax gap. Tax laws have subjected more income and deductions to information returns reporting and increased penalties for noncompliance. Congress has also given IRS additional funds for specific compliance initiatives to increase its enforcement presence.

IRS has used these tools but still has not been able to increase its enforcement presence. Audit rates in fiscal year 1992 were more than 50 percent lower than in fiscal year 1981. Enforcement staffing has been declining since fiscal year 1988 and is about what it was in fiscal year 1987. Because of overall budget shortfalls, IRS has reallocated funds from compliance initiatives to nonenforcement efforts, such as returns processing.

Ongoing changes at IRS offer new ways to reduce the gap. Implementation of Compliance 2000, TSM, and the reorganization is ongoing, but progress has been slow. Also, IRS does not yet know how many displaced staff can be retrained for compliance work. As a result, it is too early to tell how these changes will improve compliance. IRS must ensure that it accounts for these changes as it develops its compliance strategy.

One key to a comprehensive compliance strategy is having data that identify noncompliance and the reasons for it. IRS is developing these data, which will not be available for several years. In the interim, IRS could use existing compliance data to focus more of its enforcement resources on such highly noncompliant taxpayers as small corporations and sole proprietors.

As reported in the past, GAO believes that IRS should not reduce its current levels of audit coverage, computer matching caseload, and collection activities. Further, IRS could attack more noncompliance through computer matching. To do this, IRS needs to better ensure that information returns are filed timely and accurately.

Congress could help by requiring information reporting on payments made to corporations and requiring withholding on payments made to independent contractors. Congress also could act on IRS' suggestion to

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allow IRS to reinvest productivity gains from TSM projects. Before doing so, Congress may want assurance that IRS will use the funds for compliance purposes.

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## **GAO's Analysis**

### **Noncompliance Threatens Our Tax System**

Our income tax system funds many government programs and relies on taxpayers to comply voluntarily. However, our tax system loses billions of dollars each year because taxpayers do not comply. As a result, the burden of funding these programs shifts to taxpayers who comply.

Estimating the tax gap is an imprecise science. Even so, IRS' estimates provide a useful indicator of the extent of tax losses from types of noncompliance across the country. Such knowledge can help IRS to better target compliance resources.

IRS' estimates show that the gross tax gap is large and growing. For 1992, IRS estimated that it had reached \$127 billion for corporations and individuals—including sole proprietors of a business. Of this \$127 billion gross tax gap, IRS estimated that \$94 billion was caused by individuals and \$33 billion by corporations. Across all individual taxpayers, the largest part of the tax gap arose from unreported income—\$63 billion. Overall, IRS estimated that taxpayers voluntarily paid 82 percent of their income tax liabilities. IRS' goal is for voluntary compliance to reach 90 percent by 2000. (See pp. 10-15.)

The tax gap can rise or fall depending on changes in tax law, economic conditions, and IRS' tax administration. For example, a more global economy creates problems in determining the tax liabilities of multinational corporations. More electronic filing creates new ways to claim false tax refunds on fraudulent returns. (See pp. 16-19.)

### **Tax Gap Remains Large Despite Past Actions**

Both Congress and IRS have tried since the early 1980s to reduce the tax gap. Even so, the tax gap is still large. Without these efforts, however, it is likely that the gap would be even larger.

Beyond funding IRS' ongoing enforcement programs, Congress helps reduce the tax gap through tax law changes. Congress expanded the filing

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requirements for information returns as well as the penalties for not filing. Information returns are a proven way to promote compliance and help IRS find noncompliance. Congress also closed the door on various ways to shelter income from taxation, which can add to the tax gap if abused. Also, Congress eliminated some individual tax deductions, such as for consumer interest, which reduced the opportunity for noncompliance by taxpayers who claim too much interest. (See pp.22-23.)

Congress funded compliance initiatives in the late 1980s to help IRS enforce tax laws. However, time lags in hiring, training, and assigning new staff prevented IRS from achieving projected revenue gains. Also, because of overall budget shortfalls, IRS redirected compliance initiative funds to nonenforcement areas and to offset unfunded labor costs. As a result, IRS has not been able to maintain the increased staffing levels sought through the compliance initiatives. After enforcement staff increased by 6,700 from fiscal years 1987 to 1988, it decreased by 6,200 by fiscal year 1992. (See pp. 24-25.)

IRS' major enforcement activities have not grown over the past decade. Audits of corporations have decreased from over 5 percent in fiscal year 1981 to less than 3 percent in fiscal year 1992. During the same period, audits of individuals decreased from 1.8 percent to less than 1 percent. (See pp. 26-28.)

Collection of delinquent taxes has not kept pace with increases in collection inventory. From fiscal years 1988 to 1992, the collection of delinquent taxes increased 6 percent—from \$22.9 billion to \$24.2 billion. Over this time, the collection inventory increased about 55 percent, going from \$75.6 billion in fiscal year 1988 to \$117 billion in fiscal year 1992. (See pp. 28-29.)

Computer matching has been reduced in recent years to absorb some of IRS' budget shortfalls. For example, in fiscal year 1992, to pay for unfunded labor costs IRS reduced the budget for the matching program that identifies taxpayers who underreport their income. As a result, underreporter assessments in fiscal year 1992 were about the same as in fiscal year 1986—\$1.8 billion. (See pp. 29-30.)

While the specific effects are unknown, nonenforcement activities such as customer service can affect the tax gap. For example, taxpayers who receive prompt and correct answers from IRS about whether they are entitled to a deduction are more likely to claim the proper amount of that

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deduction. The accuracy rate of IRS' toll-free telephone assistance increased from 63 percent in fiscal year 1989 to 89 percent in fiscal year 1994. However, during the same period, the telephone accessibility rate decreased from 58 percent to 21 percent. (See pp. 30-32.)

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**IRS Plans Changes to Reduce the Tax Gap**

IRS now does much of its compliance work under its Compliance 2000 strategy. IRS wants to encourage taxpayers to keep complying, help well-intentioned but noncompliant taxpayers to strive toward full compliance, and pursue taxpayers who did not intend to comply.

This new IRS strategy faces barriers. IRS still is seeking data to objectively sort out who is not complying and how. Making the transition from enforcement to a mindset that targets enforcement, education, and tax simplification to specific taxpayer groups has been uneven. IRS has not fully developed a system to know whether the strategy is on track or needs midcourse corrections. (See pp. 34-36.)

IRS' plans for computer systems to identify and correct noncompliance rely on TSM. Under TSM, IRS is developing an Integrated Case Processing system, which is supposed to allow authorized IRS staff access to all the information they need to work their assigned cases. However, that system is not expected to be available before 1997. Also, the success of merging the audit and collection functions into a compliance group depends on whether IRS can mold its compliance efforts into a comprehensive strategy.

It is too soon to determine whether IRS' new computer systems and organization will work. If they do not work, IRS' goal to increase voluntary compliance to 90 percent by 2000 will be difficult to meet. (See pp.36-38.)

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**GAO's Views on Reducing the Tax Gap**

While eliminating the tax gap is unlikely, striving toward this end is worthwhile. GAO supports IRS' efforts to develop a compliance strategy and new systems. In doing so, IRS must ensure that its compliance programs continually improve, making them as cost-effective as possible.

A compliance strategy begins with having statistical data to identify the nature of the noncompliance. IRS has used TCMP data in this way but is looking for new sources. GAO supports IRS efforts to improve TCMP or replace it with better systems. However, IRS does not know when such systems will be ready.

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Until it develops new compliance data, IRS could continue to use existing tax gap and TCMP data in developing an interim compliance strategy. As a starting point, IRS could focus more of its efforts on highly noncompliant groups, such as small corporations and sole proprietors, who make up 29 percent of the tax gap. Until IRS sees improved compliance in each group, it should continue the increased focus. (See pp. 40-42.)

If the budget allows, IRS also needs to increase computer matching in areas of known noncompliance, such as income from partnerships and erroneous dependent claims, which represent a tax gap of over \$4 billion. For any computer match to be effective, IRS needs to receive all required information returns in a timely fashion. (See pp. 42-45.)

GAO believes that IRS can increase its collection of delinquent taxes. For example, GAO recommended that IRS restructure its collection organization to support earlier telephone contact with delinquent taxpayers. (See p. 45.)

One way Congress could help IRS is to give it more compliance tools. For example, simplifying the definition of independent contractors, withholding on payments made to independent contractors, and requiring information reporting on payments made to corporations would help reduce the gap associated with these taxpayers. IRS believes these tools would help it to better attack the gross tax gap. (See pp. 46-48.)

IRS also believes Congress can help by allowing it to reinvest some of its productivity gains from TSM into compliance efforts. GAO does not oppose this concept. However, GAO points out that in the past IRS' use of compliance initiative funds has not resulted in additional enforcement presence. IRS has either had problems in garnering the expected productivity gains or experienced budget shortfalls. If Congress were to give IRS additional funding for compliance activities, Congress may want some assurance that IRS uses the funds to increase its enforcement presence. (See pp. 49-50.)

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## **Recommendations**

GAO is not making any new recommendations in this report.

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## **Agency Comments**

GAO requested written comments, but IRS chose not to comment because this report summarized past GAO reports and offered no new recommendations.

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**Abbreviations**

BMF	Business Master File
CRIS	Compliance Research Information System
DEFRA	Deficit Reduction Act
EITC	Earned Income Tax Credit
EIN	Employer Identification Number
ERA	Economic Recovery Act
IRS	Internal Revenue Service
MSSP	Market Segment Specialization Program
TCMP	Taxpayer Compliance Measurement Program
TEFRA	Tax Equity and Fiscal Responsibility Act
TIN	Taxpayer Identification Number
TSM	Tax Systems Modernization

# Introduction: The Tax Gap Challenge

One of the biggest challenges facing the Internal Revenue Service (IRS) is finding ways to reduce the gross income tax gap—the difference between income taxes owed and voluntarily paid.<sup>1</sup> IRS estimated that this gap was about \$127 billion in 1992—a 67-percent increase over the estimated \$76 billion gap for 1981,<sup>2</sup> which was the year that the first of several major tax compliance legislative measures were enacted.<sup>3</sup>

Tax gap estimates are important. They indicate the amount of taxpayer noncompliance and IRS' ability to reduce noncompliance over time. For example, IRS estimated that its enforcement programs reduced the gross tax gap for 1992 by about 23 percent, leaving a net tax gap of about \$100 billion. Regardless of the adequacy of these IRS programs, the tax gap could continue to grow in current dollars because of economic growth and changes in tax laws that increase opportunities for noncompliance. Tax gap estimates also indicate the potential tax revenues that could be used to help reduce the federal deficit, which is estimated to be about \$200 billion in 1994.

We have been concerned with the increase in the tax gap. We have made a number of recommendations to IRS and Congress on ways to reduce the tax gap, such as by improving IRS' enforcement programs. Representative John W. Olver is also concerned about the size of the tax gap. He asked us to analyze the nature and importance of the tax gap and actions for reducing the gap. These actions include those that Congress and IRS have already taken or that IRS is now developing, as well as additional actions that either Congress or IRS could take in the future.

## Tax Gap Estimates and Trends

IRS first estimated the tax gap in 1979. Since then, it estimated the gross income tax gap in 1983 and 1988, projecting the estimates to future tax years up through 1992. These estimates covered the amount of income taxes that individuals and corporations did not voluntarily pay because of noncompliance, such as unreported income and overstated exemptions and deductions.

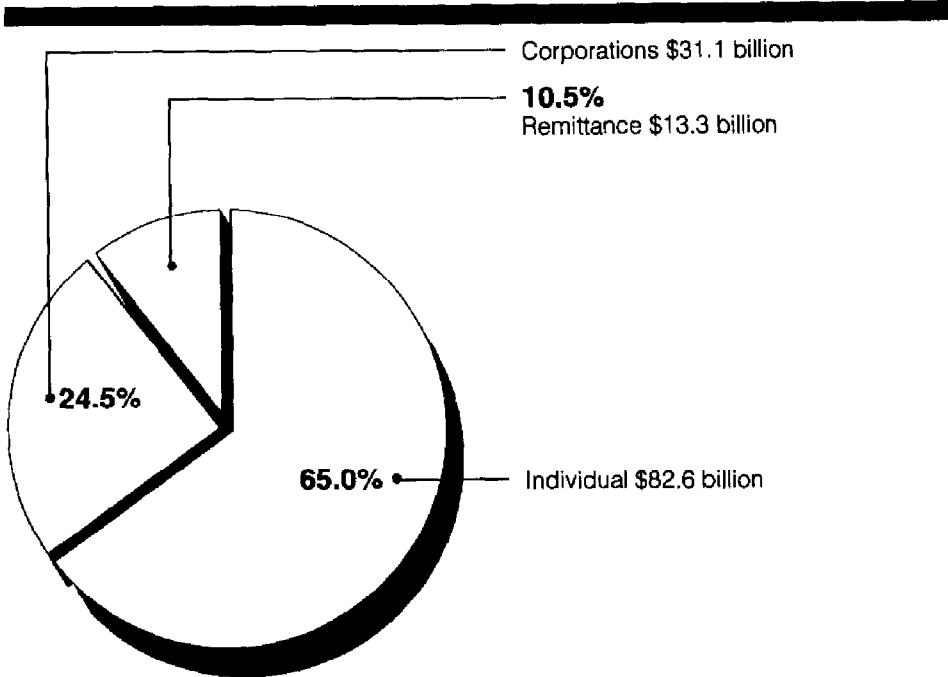
<sup>1</sup>Throughout this report, references to the "gross tax gap," "tax gap," or "gap" mean the gross income tax gap.

<sup>2</sup>IRS stated its tax gap estimates in current dollars. We used IRS' estimates throughout the chapters of this report. For a different perspective, the gross tax gap in 1992 dollars increased 8.7 percent from \$117 million in 1981 to \$127 million in 1992. We created two tables that convert IRS estimates into constant dollars. Appendix I has these tables.

<sup>3</sup>At the time we did our work, IRS had updated tax gap estimates, but these were still in draft form so IRS officials would not release the estimates to us.

During 1988, IRS estimated that the tax year 1992 gross tax gap would be \$82.6 billion for individuals and \$31.1 billion for corporations. In 1990, IRS added an estimated \$13.3 billion to account for the 1992 gross remittance gap—the amount of income taxes that taxpayers report as owed but do not pay voluntarily. Figure 1.1 shows these three major components of the \$127 billion gross income tax gap for 1992.<sup>4</sup>

**Figure 1.1: Major Components of the Tax Year 1992 Gross Income Tax Gap**



Sources: Income Tax Compliance Research, IRS Publication 1415, July 1988; and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Research Division, Publication 1415, April 1990.

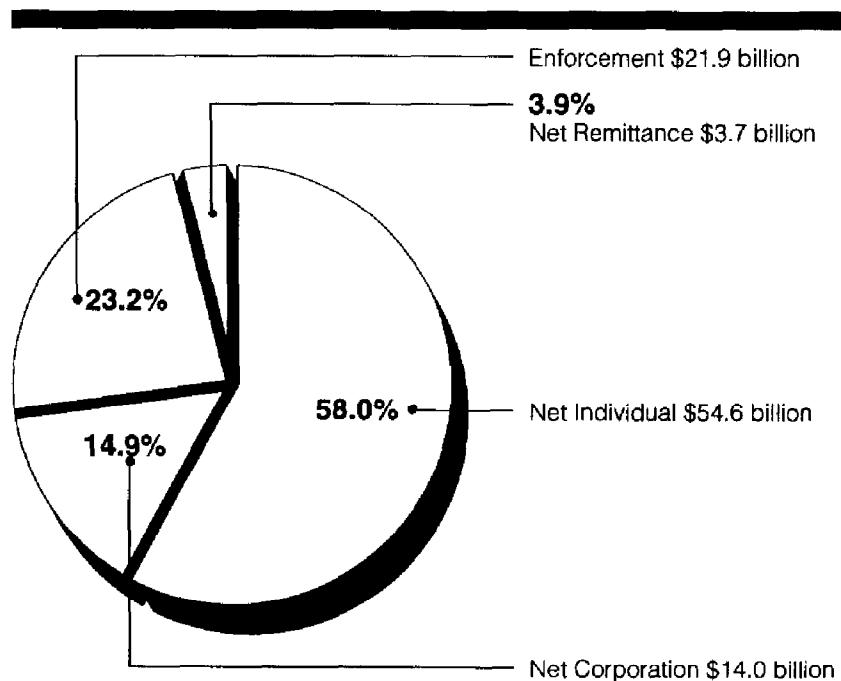
IRS has also estimated the net income tax gap, which is the gross income tax gap less the estimated amount of income taxes collected through IRS' enforcement. IRS' enforcement consists of auditing tax returns, computer matching tax return data against third-party information returns to find

<sup>4</sup>IRS also estimated the gross tax gap on the basis of the taxes that would actually be assessed after all appeals and litigation of the recommended assessments. For 1992, this estimate totaled \$110.1 billion—\$91 billion for individuals and their remittance gap and \$19.1 billion for corporations and their remittance gap, including fiduciaries and exempt organizations.

unreported income, collecting overdue taxes, obtaining delinquent returns, and correcting math errors on tax returns. IRS has estimated the net tax gaps for 1981, 1984, and 1987.

For 1987, IRS estimated that its enforcement actions reduced the \$94.2 billion gross tax gap by \$21.9 billion (23 percent), leaving a net tax gap of \$72.3 billion. This was a slight improvement over the estimated 20-percent reduction in the 1981 gross tax gap—from \$76 billion to \$60.7 billion. Figure 1.2 shows the size of the net tax gap for 1987.

**Figure 1.2: Net Income Tax Gap for 1987**



Sources: Income Tax Compliance Research, IRS Publication 1415, July 1988; and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Research Division, Publication 1415, April 1990.

### Limitations of Tax Gap Estimates

Tax gap estimates give useful indicators of noncompliance, but a number of factors limit their precision. The first two deal with the scope—or what IRS attempts to measure. The other three factors deal with potential measurement errors.

- First, the tax gap estimates covered just legally earned income of individuals and corporations and not taxes owed from illegal source income (e.g., drugs or prostitution).
- Second, the 1992 tax gap estimates did not include other types of taxes, such as excise, employment, and gift taxes.
- Third, estimates for individuals and small corporations (i.e., assets of \$10 million or less) are based on IRS' Taxpayer Compliance Measurement Program (TCMP). Under TCMP, IRS examiners do line-by-line audits of income tax returns. For each return type, IRS audits a probability sample taken for the entire population. This allows IRS to do population estimates for each line item on the return, covering many compliance issues. However, even these audits do not detect all overstated deductions or unreported income.<sup>5</sup> To account for undetected income, IRS multiplies the detected amounts by a factor derived from a special study.<sup>6</sup>
- Fourth, the estimates are necessarily based on earlier compliance data and do not reflect IRS' latest compliance data. The 1988 tax gap study used TCMP results for tax year 1982 and earlier years on individuals and tax year 1980 on small corporations. Since then, IRS has done TCMP surveys of individuals for tax years 1985 and 1988 and small corporations for tax year 1987. As a result, IRS' tax gap estimates could change. For example, small corporations' compliance dropped 20 percentage points between 1980 and 1987—from 81 percent to 61 percent.
- Finally, the estimates for large corporations (i.e., those with assets over \$10 million) are based on IRS' operational audits, which are not randomly selected. As a result, they are less precise than estimates for individuals and small corporations, which used TCMP results. Also, unlike TCMP audits, IRS' operational audits do not cover each line of the tax return and thus cannot lead to estimates for each item.

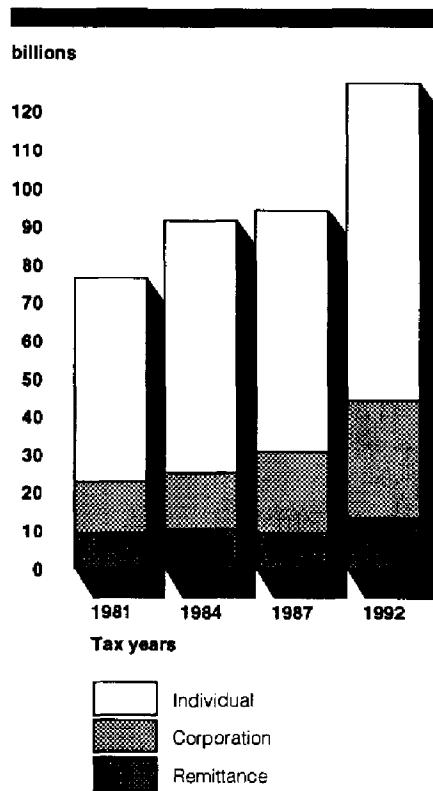
## Growth of the Tax Gap

IRS' estimates show that the gross tax gap has grown about 67 percent—from \$76 billion for tax year 1981 to \$127 billion for tax year 1992. Figure 1.3 shows this growth for selected years.

<sup>5</sup>See Tax Administration: Overstated Real Estate Tax Deductions Need To Be Reduced (GAO/GGD-93-43, Jan. 19, 1993).

<sup>6</sup>The study calculated multipliers based on additional income reported on information returns but not discovered during tax year 1976 audits.

**Figure 1.3: Gross Income Tax Gap,  
Selected Years**



Sources: Income Tax Compliance Research, IRS Publication 1415, July 1988; and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Research Division, Publication 1415, April 1990.

Specific tax gap components have also grown considerably. Table 1.1 shows the growth in tax gap components for 1981 and 1992.

**Table 1.1: Gross Tax Gap Estimates by Source of Tax Gap for Tax Years 1981 and 1992, in Current Dollars**

<b>Source of tax gap</b>	Dollars in millions		
	<b>1981 tax gap amount</b>	<b>1992 tax gap amount</b>	<b>Percent increase</b>
Individual tax gap	\$61,900	\$93,994	51.8
Unreported income	40,433	62,759	55.2
Sole proprietors	18,714	30,173	61.2
All other income	21,719	32,586	50.0
Overstated deductions <sup>a</sup>	7,449	8,081	8.5
Individual nonfiler	5,231	10,233	95.6
Individual remittance gap	8,300	11,400	37.3
Math errors	487	1,521	212.3
Corporate tax gap	14,066	33,135	135.6
Small corporation	4,461	6,999	56.9
Large corporation	8,638	23,716	174.6
Others <sup>b</sup>	167	420	151.5
Corporate remittance gap	800	2,000	150.0
<b>Total tax gap</b>	<b>\$75,966</b>	<b>\$127,129</b>	<b>67.2<sup>c</sup></b>

<sup>a</sup>Includes subtractions for erroneous deductions, exemptions, credits, and other adjustments.

<sup>b</sup>Includes unreported income and overstated deductions for exempt organizations' unrelated business income and for fiduciaries.

<sup>c</sup>As shown in appendix I, table I.2, the gross tax gap in 1992 dollars increased 8.7 percent from \$117 million in 1981 to \$127 million in 1992.

Source: Income Tax Compliance Research, IRS Publication 1415 (7-88); and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Publication 1415 (4-90).

Table 1.1 shows that the tax gap created by individuals' unreported income rose over \$22 billion between 1981 and 1992. About half of this increase as well as half of the total \$63 billion gap came from unreported sole proprietor (i.e., self-employed individuals) income. Such income is generated by "informal suppliers" (proprietors who operate their businesses informally, usually on a cash basis), farm proprietors, and nonfarm proprietors.

Many types of unreported self-employment income are difficult to detect. Some skilled and professional employees may "moonlight" on a cash basis as informal suppliers. Or, the self-employed individual may keep two sets of books, only reporting from the books with the lowest amount of income. Appendix I gives a more detailed breakdown of the tax gaps for tax years 1981 and 1992.

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## Importance of Tax Gap Estimates

In spite of the limitations of the tax gap estimates, the estimates reflect additional tax revenues the federal government might be able to apply to the deficit if ways can be found to reduce the gap. Because of this level of noncompliance, tax rates paid by compliant taxpayers have to be higher to raise the desired level of tax revenue.

Tax gap estimates also indicate the major types of taxpayer noncompliance. Knowing this, IRS has some idea of where to target enforcement resources and whether that targeting had some positive effect. Without such guideposts from the gross and net tax gap estimates, IRS is more likely to direct resources at taxpayers whose compliance is relatively high. Similarly, knowing whether the noncompliance is intentional or unintentional can provide IRS with insight on how to close portions of the gross tax gap. Given intentional noncompliance, IRS would be more likely to use enforcement over taxpayer service and seek tax law changes that reduce opportunities to not comply.

Unintentional noncompliance suggests the need to identify reasons and appropriate countermeasures such as clearer or simpler rules.

Noncompliance is more likely when complex tax laws or rules confuse taxpayers about when and how to comply. Fewer and simpler tax laws reduce the amount of information that taxpayers need to comply and reduce the opportunity to not comply. Tax withholding and information return reporting help taxpayers to comply by providing the information they need and the incentive to use it.

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## Emerging Tax Gap Issues

In addition to known tax gap issues, IRS must also be in a position to handle emerging compliance issues that could increase the tax gap. Changes in tax laws, economic conditions, and tax administration can affect the tax gap. For example, health care reform, if financed by businesses on the basis of the number of employees, may tend to increase the number of businesses that misclassify employees as independent contractors, who tend to have lower compliance. A more global economy creates problems in determining tax liabilities of multinational corporations. Adverse economic conditions could increase the number of bankruptcies as well as the remittance gap. Changes in IRS operations could increase the tax gap if, for example, questionable refund schemes increased with the growth in electronically filed returns.

## **Earned Income Tax Credit**

The Earned Income Tax Credit (EITC) is a refundable tax credit payable to working lower income families with children. It has been a source of considerable noncompliance, and IRS estimated that the EITC tax gap for 1992 would be about \$1.3 billion. After IRS made this estimate, tax law changes in 1990 made it easier for taxpayers to comply with EITC requirements, which could have reduced this tax gap. But the Omnibus Budget Reconciliation Act of 1993 significantly expanded this credit, which could increase the opportunity and incentive for noncompliance.

The 1993 act increased the maximum credit for working families with one child from \$1,434 to about \$2,038, or 42 percent, in 1994. For families with two or more children, the maximum credit will increase from \$1,511 to about \$2,527, or 67 percent, in 1994. Also, for the first time, this credit will be available to workers over the age of 22 who do not have any qualifying children, who cannot be claimed as a dependent on another return, and who earn less than \$9,000. The maximum credit for these individuals will be \$306 in 1994. Such substantial increases could lead to increased noncompliance if IRS does not develop programs that readily detect and correct improper EITC claims.

## **Misclassified Independent Contractors**

IRS estimated that the 1992 tax gap from sole proprietors (including independent contractors) not filing tax returns or not reporting income on filed returns was about \$33 billion. IRS officials had no estimate of how many sole proprietors are independent contractors, but they are concerned about employees being misclassified as independent contractors.

For 1984, IRS estimated that about 750,000 of 5.2 million employers had misclassified about 3.4 million employees as independent contractors. Assuming no increase, such misclassification led to an estimated \$2 billion tax loss for tax year 1992. However, IRS officials believe that misclassification has been increasing.

Increased misclassification has raised concerns because independent contractors tend to have lower tax compliance compared to employees. For example, one IRS study of tax year 1974 found that independent contractors reported just 74 percent of their business income. On the other hand, employees subject to withholding generally have been reporting over 99 percent of their wages.

This compliance difference can be explained. IRS has continually found lower compliance in the absence of withholding or another form of information reporting. Unlike payments to employees, payments to independent contractors are not subject to income tax withholding. Instead, businesses they serve generally should report their payments on information returns. Although such information reporting helps induce compliance, gaps exist in this reporting for independent contractors. Neither businesses using incorporated independent contractors nor nonbusiness individuals using any contractors are required to file the returns.

Health care reform could also affect the classification of employees as independent contractors. Part of the President's reform proposal is to have employers pay up to 80 percent of employees' health insurance. They would not be required to make this payment for workers that they classify as independent contractors. As a result, they may classify more workers as independent contractors.

On the other hand, the President's proposal contains a provision that could clarify the vague classification rules. This proposal would authorize the Secretary of the Treasury to prescribe rules for determining who is an employee for purposes of withholding and health care. If the rules established by Treasury tighten the requirements for independent contractor status, the number of workers who would be classified as employees could increase.

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### Multinational Corporate Taxation

Multinational corporations are becoming an increasingly larger part of the U.S. and world economy. For example, from 1980 to 1989, foreign direct investment in the United States increased almost fivefold (from \$83 billion to an estimated \$401 billion). This growth should continue with the move toward a global economy.

This trend presents a challenge to IRS because of the potential for corporations to transfer their income, through intercompany pricing of goods and services, to other countries with lower tax rates. The extent to which corporations avoid U.S. taxes by manipulating the prices of intercompany goods and services is unknown. However, IRS has identified billions of dollars of proposed changes to corporations' income due to what it considers to be improper transfer pricing. In fiscal year 1990, for example, IRS tracked 73 major examinations of international tax issues with proposed adjustments to income of \$11.9 billion.

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### **Increases in Bankruptcies**

The gross remittance gap for tax year 1992 was \$13.3 billion. This gap could increase if the trend in bankruptcy filings continues. Since 1985, bankruptcy filings have increased 167 percent. Over 970,000 individuals and businesses filed for bankruptcy in the year ending June 30, 1992—an increase of 10.5 percent over the previous year. Business bankruptcies accounted for about 8 percent of these filings and the rest were consumer cases, 35 percent of which were joint filings by a husband and wife.

In many bankruptcy cases, federal taxes are a major debt. Since 1986, the number of bankruptcy cases about which IRS has been notified has doubled. Over the same time, the dollars collected from bankrupt taxpayers have increased 165 percent. Even so, the collection rate is low. For example, just \$526 million of the \$7.2 billion of the total taxes assessed against bankrupt taxpayers in 1992 has been collected.

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### **Electronic Filing of Tax Returns**

In 1993, over 12 million individuals filed their tax returns electronically. By the year 2001, IRS estimates that about 80 million returns will be filed electronically. Electronic filing has advantages and disadvantages. One advantage is that IRS can process electronically filed returns more easily than paper returns.

At the same time, electronic filing can result in more fraudulent refunds because of the expedited processing of returns and refunds given fewer established controls. Through October 1993, IRS identified 25,633 electronically filed returns involving fraudulent refunds of \$53 million; 45 percent of those refunds were issued before IRS could stop them. Noncompliance associated with electronically filed returns could pose a larger problem in the future as more and more taxpayers file this way.

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### **Prior GAO Recommendations on Ways to Reduce the Tax Gap**

Since 1982, we have made many recommendations on ways that IRS could better address tax gap components. Many of them dealt with IRS better using information returns in computer matching to identify taxpayers who underreport income; overstate exemptions, deductions, and credits; or fail to file information returns. For example:

- In 1987, we recommended that IRS establish an information returns program to identify businesses that underreported their income or failed to file tax returns.
- In 1989, we recommended that IRS use information returns to identify employers who misclassified their workers as independent contractors.

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- In 1991, we recommended changes to IRS' nonfiler and underreporter programs to allow for more efficient use of information returns.
  - In 1993, we recommended that IRS use information return data to detect small businesses that overstated expense deductions or failed to file required information returns.

We also made recommendations on collection actions, which would reduce the remittance gap. For example:

- In 1990, we reported several times on the need for IRS to establish internal controls and information systems to determine how much of the accounts receivable inventory can be collected.
- In 1993, we reported that IRS could collect more delinquent taxes if it made earlier telephone contact with delinquent taxpayers, customized its collection procedures, rewarded its collection staff, supplemented its efforts with private collection companies' services, and cooperated more with state governments.

Other recommendations targeted the effectiveness and efficiency of IRS' compliance programs. In 1991, we recommended that IRS improve its audits to check for information returns compliance. Recommendations in 1993 focused on improving the data used by IRS to make tax gap estimates.

We also made legislative recommendations directed at reducing the income tax gap. For example, Congress recently enacted legislation to implement our recommendations on information returns reporting for bad debts and for seller finance mortgages.

Appendix II summarizes the work we have done and recommendations we have made on tax gap issues since 1982.

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## **Objectives, Scope, and Methodology**

The objectives of this assignment were to analyze the nature and importance of the tax gap and actions for reducing the gap. These actions include those that Congress and IRS have already taken, that IRS is now developing, and that Congress or IRS could take in the future.

To meet our objectives, we summarized our findings and recommendations in previous reports and testimonies that dealt with tax gap issues. We issued these reports during 1982 through 1993. Using these past recommendations, we updated some of the related information and analyzed whether these recommendations still could apply.

We also analyzed IRS' tax gap studies, budget data, annual reports, and related studies. We discussed these documents with responsible National Office officials at IRS, focusing on issues related to the tax gap. Specifically, we analyzed IRS' tax gap studies done in 1979, 1983, 1988, and 1990 as well as IRS documents on its Tax Systems Modernization (TSM), organizational changes, and operating plans. We also reviewed legislative provisions that have affected tax gap components since 1981.

We requested written comments from IRS on a draft of this report. IRS officials told us they chose not to comment because the report summarized past GAO reports and offered no new recommendations. We did our work in accordance with generally accepted auditing standards between April and December 1993.

# Actions Taken to Reduce the Tax Gap

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Almost every year since 1981 has witnessed legislation to address tax gap issues. These legislative actions generally required information returns reporting on income and deductions, imposed penalties for tax noncompliance, or reduced the opportunity for noncompliance by eliminating certain tax write-offs. IRS estimated that some of these provisions resulted in additional 1990 tax revenue of \$3.4 billion. Even so, IRS' estimated tax gap increased \$50.7 billion in current dollars from tax years 1981 to 1992. However, the growth of the gap could have been higher without these legislative actions.

Congress has also appropriated additional funds for specific compliance initiatives to help IRS reduce the tax gap. However, IRS was not able to use all the funds for enforcement because of budget shortfalls. Instead, funds were shifted to nonenforcement activities such as processing tax returns. In some cases, IRS overestimated the revenues that the additional resources for specific compliance initiatives would generate and underestimated the time needed to fully implement the initiatives. As a result, these additional funds did not allow IRS to make a more significant dent in the tax gap.

IRS' enforcement programs have not prevented the tax gap from growing, even with bigger budgets. In fact, between fiscal years 1987 and 1992, the estimated tax gap grew at a faster pace than IRS' enforcement budget and estimated enforcement revenues. Nonenforcement programs such as customer service may help taxpayers to comply, which would reduce the tax gap. However, IRS' data did not measure how these programs affected compliance.

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## Tax Law Changes Have Helped IRS Address Tax Gap Issues

Many legislative actions since the early 1980s were aimed at reducing the tax gap. Most tax law changes dealt with reporting information to IRS that would allow it to more easily detect unreported income or overstated deductions. For example:

- The Economic Recovery Act (ERA) of 1981 increased penalties for negligence, filing false withholding certificates, and failure to file information returns. It also required that a copy of an information return be furnished to the person who received the payment to induce reporting the income.
- The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 imposed information reporting on proceeds from stock sales, state income tax refunds, and bearer obligations; increased penalties for failure to file

information returns; and expanded the requirement for employers to report employees' tip income.

- The Deficit Reduction Act (DEFRA) of 1984 required information reporting on mortgage interest payments and cash payments of more than \$10,000 received during the course of a trade or business.
- The Tax Reform Act (TRA) of 1986 eliminated or restricted many deductions, offsets, and exclusions to income. These changes had substantial impacts on compliance. By eliminating certain deductions and exclusions, TRA also eliminated any related noncompliance. Specifically, TRA reduced the opportunity for taxpayers to be noncompliant by restricting abusive tax shelters and eliminating itemized deductions for interest expenses and sales taxes. The act required information returns for real estate transactions and for contracts from certain federal agencies and required that taxpayers report the Social Security numbers of dependents claimed on tax returns.
- The Omnibus Budget Reconciliation Act of 1993 required certain lenders to report any discharge of indebtedness of over \$600 to IRS.

Appendix III gives a summary of legislative actions from 1981 through 1993 that addressed taxpayer compliance issues.

The tax gap increased \$51 billion from tax years 1981 to 1992, rising from \$76 billion to \$127 billion in current dollars. Yet the gap could have been higher if not for these legislative changes, especially those requiring information reporting. As discussed in chapter 1, taxpayers are more prone to report income that is also reported on information returns to IRS. IRS estimated that tax legislation from 1981 through 1986 generated \$3.4 billion in additional revenue for 1990. Table 2.1 shows IRS' estimates.

**Table 2.1: Estimates of Increased Revenues in 1990 Resulting From Tax Law Changes Between 1981 and 1986**

Dollars in millions		
Tax Gap Component	Amount	Tax Law
Interest income	\$ 233	TEFRA, TRA
Taxable dividends	154	TEFRA
State/local refunds	152	TEFRA
Self-employment income	215	ERA, TEFRA, TRA
Capital gains/losses	1,226	TEFRA
Pension income	764	TEFRA
Deductions	296	DEFRA
Exemptions	381	TRA
<b>Total</b>	<b>\$3,421</b>	

Source: Income Tax Compliance Research, IRS Publication 1415 (7-88).

## Appropriations Given to IRS to Address Tax Gap Issues

Additional appropriations given to IRS for specific compliance initiatives have not had the intended effect. Some funds intended for compliance initiatives were redirected to nonenforcement activities because of budgetary shortfalls. Several examples of these shortfalls follow.

- Through a supplemental appropriation for fiscal year 1986 and a continuing resolution for fiscal year 1987, Congress provided IRS with funds to increase its audit staff by 2,500 positions—1,618 revenue agents, 175 tax auditors, and 707 support personnel.<sup>1</sup> IRS projected that this increased staffing would enable it to audit 113,000 additional tax returns, adding \$593 million in collections during fiscal year 1987. IRS did not achieve the anticipated gain in revenue agent staffing for fiscal year 1987. Many of the agents hired through the initiative filled attrition vacancies that had gone unfilled because IRS diverted resources from enforcement to returns processing.
- IRS' fiscal year 1991 appropriation included \$191 million for 3,476 additional staff years to implement 9 compliance initiatives. These initiatives were expected to produce an additional \$5.7 billion in enforcement revenues during the 5-year period ending in fiscal year 1995. We reviewed 3 of the 9 initiatives, which accounted for \$140 million of the appropriation, 2,226 of the additional staff, and \$3.2 billion of the estimated revenue.<sup>2</sup> We found that IRS later lowered this \$3.2 billion estimate to \$2.4 billion. According to IRS, this reduction resulted from a combination of staff reductions, changes in productivity assumptions, and failure to account for the opportunity costs of taking experienced staff away from their jobs to train new hires. As a result, delinquent tax collections failed to keep pace with the growth in the accounts receivable inventory and actually declined by 5 percent from fiscal year 1990 to fiscal year 1991.
- IRS' fiscal year 1993 budget included about \$43 million for eight compliance initiatives dealing with collecting delinquent taxes, auditing high-income/high-asset individual and corporate returns, and increasing criminal investigations and international compliance efforts. These initiatives were not fully implemented because IRS had to redirect resources to offset budget shortfalls. IRS scaled back staffing and redirected resources for such activities as training and travel to offset unfunded labor costs of over \$200 million.

<sup>1</sup>See Tax Administration: IRS' Implementation of the 1987 Revenue Initiative (GAO/GGD-88-16, Dec. 2, 1987).

<sup>2</sup>Tax Administration: Congress Needs More Information on Compliance Initiative Results (GAO/GGD-92-118, July 31, 1992).

The outlook is bleak for completing fiscal year 1994 compliance initiatives. Congress has authorized about \$115 million to fund 11 compliance initiatives (e.g., for increasing delinquent tax collections, international tax compliance, and audit coverage, as well as for reducing electronic fraud). However, IRS will spend only about \$10 million on the initiatives; the other \$105 million will be diverted to pay for unfunded locality pay.

Despite the various compliance initiatives that were intended to increase enforcement staffing since fiscal year 1986, IRS has not been able to maintain enforcement staffing levels. As shown in table 2.2, IRS enforcement staffing peaked in fiscal year 1988 after experiencing an increase of 6,703 full-time equivalent staff from fiscal year 1987. However, between fiscal years 1988 and 1992, full-time equivalent staff decreased by 6,165. Decreased enforcement staffing is one reason why IRS has been unable to stem the growth of the tax gap.

**Table 2.2: Number of Full-Time Equivalent Staff Positions for the Examination, Collection, and Computer Matching Functions**

Fiscal year	Full time equivalent staff positions			Total
	Examination	Collection	Computer matching	
1986	26,120	15,571	4,844	<b>46,535</b>
1987	29,243	16,265	5,259	<b>50,767</b>
1988	31,895	18,546	7,029	<b>57,470</b>
1989	31,315	18,470	5,691	<b>55,476</b>
1990	28,788	18,034	5,683	<b>52,505</b>
1991	28,592	18,605	5,609	<b>52,806</b>
1992	28,393	18,518	4,394	<b>51,305</b>

Source: IRS Annual Reports (1986 to 1992).

## **IRS Enforcement Programs That Affect the Tax Gap**

IRS' major enforcement programs for addressing tax gap issues are its examination, collection, and computer matching programs.<sup>3</sup> As discussed in chapter 1, IRS estimated that these programs reduced the gross tax gap for tax year 1987 by \$21.9 billion, or 23 percent—from \$94.2 billion to \$72.3 billion. Table 2.3 shows how much each of IRS' enforcement programs reduced the gross tax gap for tax year 1987. IRS did not have estimates for more recent years.

<sup>3</sup>IRS' Criminal Investigations Division can affect the tax gap because some of its investigations deal with legal-source income. However, much of its resources focus on illegal source income from narcotics, money laundering, and the like, which are not part of the tax gap. IRS did not have data on how its legal-source investigations affect the tax gap.

**Chapter 2**  
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**Table 2.3: Reductions to Tax Year 1987  
Tax Gap as a Result of IRS  
Enforcement Programs**

Dollars in billions		
Enforcement program	Amount	Percent
Examination	\$12.0	54.8
Collection	5.7	26.0
Computer matching	2.3	10.5
Other <sup>a</sup>	1.9	8.7
<b>Total</b>	<b>\$21.9</b>	<b>100.0</b>

<sup>a</sup>Includes \$1.2 billion for math error corrections and \$.7 billion for delinquent tax returns obtained without computer matching.

Source: Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Research Division, Publication 1415 (4-90).

**Examination Program**

Examination is the backbone of IRS' enforcement activities. It audits filed tax returns to address that portion of the gross tax gap created by unreported income and overstated exemptions, deductions, and credits. IRS estimates that for tax year 1987 these types of noncompliance accounted for about \$76.7 billion of the \$94.2 billion gross tax gap. As shown in table 2.3, IRS estimates that the Examination Program reduced the \$76.7 billion gap by about 16 percent, or \$12 billion—\$7.3 billion from auditing corporations and \$4.7 billion from auditing individuals.

Even though audits are the primary enforcement tool for identifying a wide variety of noncompliance, audit rates have decreased over 50 percent between fiscal years 1981 and 1992. As shown in table 2.4, the corporate audit rate decreased from 5.07 percent to 2.99 percent, or 41 percent, while the audit rate for individuals decreased from 1.77 percent to 0.91 percent, or 48 percent, between fiscal years 1981 and 1992.

**Table 2.4: Corporate and Individual Audit Rates, Fiscal Years 1981 Through 1992**

Fiscal year	Corporate rate	Individual rate
1981	5.07	1.77
1982	4.74	1.55
1983	3.66	1.50
1984	2.67	1.27
1985	2.40	1.31
1986	2.25	1.12
1987	1.58	1.09
1988	1.32	1.03
1989	2.02	0.92
1990	2.59	0.80
1991	2.36	1.00
1992	2.99	0.91

Source: IRS Annual Reports.

IRS data show that audit rates for certain types of taxpayers have increased in recent years. For example, the audit rate for small corporations (those with less than \$10 million in assets) more than doubled between 1987 and 1992, increased from 1.07 percent to 2.6 percent—an increase of over 37,000 audited returns. Similarly, the audit rate grew for the least compliant group of individual taxpayers—nonfarm sole proprietors. This audit rate increased from 2.2 percent in fiscal year 1987 to 2.7 percent in fiscal year 1992, an increase of over 35,000 audits.

Even with these recent increases, overall audits for individuals and corporations decreased from 1.21 million in 1987 to 1.16 million in 1992. Moreover, the recommended assessments from income tax audits failed to keep pace with increases in the estimated income tax gap between fiscal years 1987 and 1992. Comparing year-end totals for these years, assessments increased 46 percent while the tax gap increased 76 percent.

IRS' audit rate should be viewed with caution. IRS classifies certain taxpayer contacts as audits when in fact the taxpayers' books and records were not examined. Instead, IRS sent notices of proposed tax assessments to taxpayers, using information from third-party sources.

For example, when an audit of a partnership return results in tax assessments for individual partners, IRS counts each assessment as an audit of the individual, even though the individual tax returns were not

audited. When IRS prepares a substitute tax return based on information returns for nonfilers who fail to file after being notified by IRS, IRS has counted the substitute return as an audit. In fiscal year 1991, about 370,000 such contacts were included in IRS' audit rate. If these items are subtracted from the 1.1 million individual audits that IRS data showed as completed in fiscal year 1991, the audit rate would be 0.67 percent instead of 1.00 percent.

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### Collection Program

As shown in table 2.3, IRS estimated that for tax year 1987 collection work reduced the remittance gap by \$5.7 billion—from \$9.3 billion to \$3.6 billion—a 61-percent decrease. IRS estimated that it also decreased the 1992 remittance gap by 61 percent, or \$8.1 billion—from \$13.3 billion to \$5.2 billion.

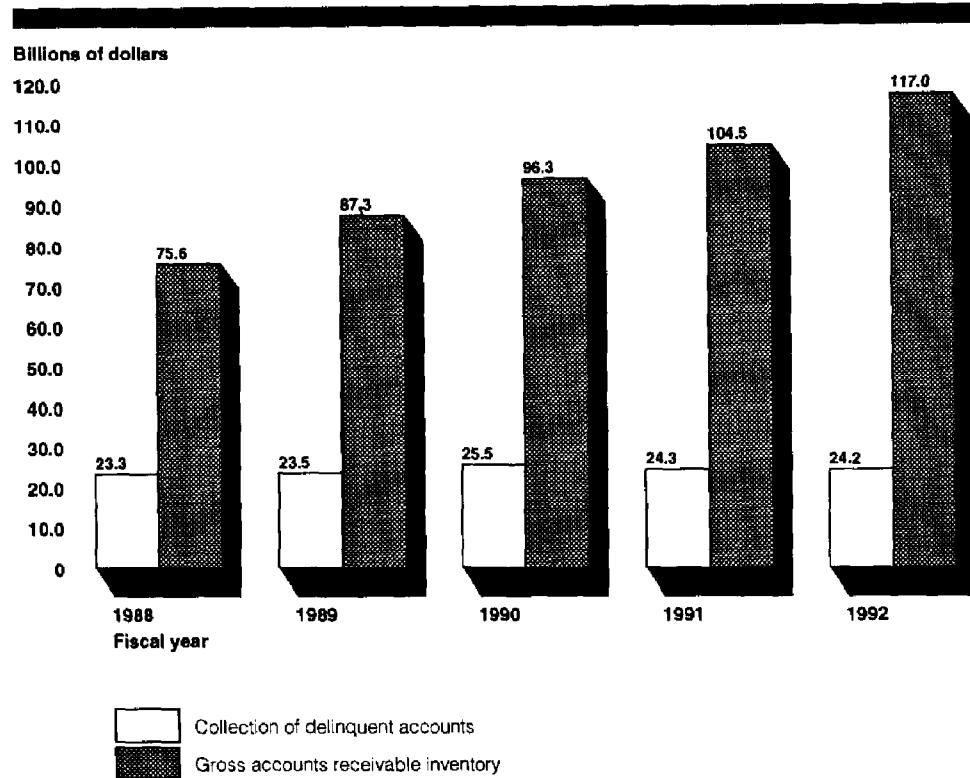
From fiscal year 1987 through fiscal year 1992, the collection budget grew from \$661 million to \$922 million, a 40-percent increase; and the number of collection staff grew from 16,265 to 18,605, a 14-percent increase. Even with increased resources, IRS gained little ground in collecting delinquent taxes.

For example, over the same time period, IRS delinquent collections increased just 6 percent—from \$22.9 billion to \$24.2 billion. Further, between fiscal years 1988 and 1992, collections of delinquent taxes did not keep pace with the growth in the collections workload, as figure 2.1 shows.<sup>4</sup>

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<sup>4</sup>Comparable accounts receivable data for fiscal year 1987 were not available.

**Figure 2.1: Comparison of Total Accounts Receivable and Collection of Delinquent Accounts, Fiscal Years 1988 Through 1992**



Note 1: Accounts receivable values for fiscal years 1991 and 1992 have been adjusted from a 10-year to a 6-year statutory collection period.

Note 2: In 1992, IRS redefined the gross accounts receivable inventory by excluding certain amounts previously included. The 1992 inventory value was calculated on the basis of the old definition and is therefore comparable to prior years.

Source: IRS data.

IRS estimated that about \$52 billion of the 1992 accounts receivable inventory is currently not collectible. Given the greater growth of the accounts receivable inventory relative to collections, much time could pass before IRS puts a dent in the collectible portion of the inventory.

## Computer Matching Program

IRS considers the computer document matching program to be its primary enforcement tool for dealing with nonbusiness individual taxpayers. Compared with its audit program, this matching program is less intrusive

on taxpayers and more cost effective. As shown in table 2.3, IRS estimated that its computer document matching program for individuals reduced the gross tax gap for tax year 1987 by 2.4 percent or \$2.3 billion—\$1.2 billion for unreported income and \$1.1 billion for nonfilers.

In fiscal year 1992, IRS spent about \$169 million on the program and recommended additional assessments of \$4.3 billion in taxes, penalties, and interest on 5.3 million taxpayers who either underreported their income or failed to file tax returns. IRS estimates that information returns partially cover 99.5 percent of the total income among individual taxpayers. Further, IRS estimates that between 35 percent and 45 percent of the income reported on all individual income tax returns is based solely on data that are (or should be) reflected on information returns.

The number of information returns processed by IRS has substantially increased. In fiscal year 1992, IRS processed over 1 billion information returns compared to 492 million in fiscal year 1980. However, budget constraints in recent years have prevented IRS from taking full advantage of these information returns to reduce the gross tax gap. Faced with recent budget shortfalls, the underreporter portion of the matching program has been one of the first programs to be cut. For example, to make up for fiscal year 1992 shortfalls, IRS reduced its underreporter workload to 5.6 million cases from the 9 million cases it worked in 1991. This means that 3.4 million fewer cases were worked to assess additional taxes owed; we estimate that these cases could have contributed as much as \$1 billion in revenue.<sup>5</sup>

IRS' matching program has great potential for attacking the unreported income portion of the tax gap. Budget cuts that decrease the matching program's workload could erode the high compliance levels found for income that is subject to information reporting and increase the tax gap.

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## **IRS' Nonenforcement Efforts to Reduce the Tax Gap**

IRS has not estimated how much its nonenforcement efforts, such as taxpayer service, have reduced the tax gap. IRS' customer service activities generally account for about 40 percent of its budget. These activities include taxpayer service, returns processing, and the issuance of tax forms and publications.

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<sup>5</sup>IRS data for fiscal year 1992 show that about 3.8 million or 68 percent of the 5.6 million underreporter cases resulted in taxpayer contact, and the taxpayers were assessed about \$1.8 billion for an average of \$474 in additional taxes, penalties, and interest. If IRS could have worked the 3.4 million underreporter cases and obtained results similar to those of the 5.6 million cases, additional tax, penalties, and interest assessments could have been as high as \$1 billion.

Even though IRS has no specific estimates, customer service activities can play an important role in reducing the tax gap. IRS' 1988 TCMP data suggested that many taxpayers may not comply because of confusion about tax laws. The 1988 TCMP sample included audits of over 54,000 individual taxpayers, which represents 104 million taxpayers. TCMP data showed that if all 104 million taxpayers were audited, the tax liabilities reported by an estimated 42 million taxpayers, or 40 percent, would have increased.

The TCMP data showed that an estimated 33 million of the 42 million taxpayers (82 percent) were not assessed a fraud or negligence penalty, suggesting that much of their noncompliance was unintentional. This is the type of noncompliance more susceptible to customer service activities. Table 2.5 shows the primary reasons, according to the TCMP data, that tax liability increased for 33 million taxpayers.

**Table 2.5: Primary TCMP Reasons for Tax Increase When Taxpayers Were Not Assessed a Negligence or Fraud Penalty for 1988.**

Dollars in millions		
Reason for noncompliance	Number of taxpayers	Amount of tax increase
Multiple interpretations of tax law	1,230,202	\$1,237
Lack of substantiation	9,074,690	3,765
Incorrect accounting or computational procedures	5,215,212	2,710
Relied on a return preparer and did not help with preparation	4,964,121	3,166
Lacked knowledge of tax laws to prepare accurate return	7,648,492	3,259
Other <sup>a</sup>	5,004,042	1,549
<b>Totals</b>	<b>33,136,759</b>	<b>\$15,686</b>

<sup>a</sup>IRS' TCMP data did not explain these "other" reasons.

Source: IRS 1988 TCMP data.

As shown in table 2.5, the 33 million individuals had a total estimated tax change of \$15.7 billion. To the extent that these individuals can be helped through IRS' customer service, the tax gap could be reduced. For example, expanding outreach programs and simplifying tax return instructions could help the 7.6 million taxpayers who lacked the knowledge of tax laws to prepare accurate returns. Also, spending more customer service resources to ensure that tax preparers are familiar enough with the tax

laws could reduce noncompliance among the 5 million taxpayers who relied on such preparers for accurate returns.

Our analysis of the 1988 TCMP data for individuals also raised questions about IRS' over-the-counter taxpayer assistance and its telephone service function. Of the 33 million taxpayers, about 2 million, or 6 percent, had used these services in preparing their returns. Even so, these taxpayers owed an estimated \$923 million in taxes.

Since the tax year 1988 TCMP survey, IRS data show that its customer service activities are improving. For example, the accuracy rate of IRS' toll-free telephone assistance increased from 63 percent in 1989 to 89 percent in 1994. However, this 26 percentage point increase in the accuracy rate was accompanied by a 37 percentage point decrease in the telephone accessibility rate, which went from 58 percent in 1989 to 21 percent in 1994.

According to IRS officials, toll-free telephone accessibility was lower in 1993 primarily because the demand for telephone assistance increased sharply while resources available to provide it decreased. The resulting reduction in accessibility meant that more callers received busy signals or were placed on hold and hung up before IRS could assist them. IRS appears to be getting better at answering taxpayers' questions, which should help taxpayers to file complete and accurate tax returns. However, if taxpayers cannot get through to IRS to get their questions answered, overall taxpayer compliance may not improve.

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## Conclusions

Tax law changes have given IRS more enforcement tools to better detect noncompliance and have deterred taxpayers from misreporting their income and deductions. Congress has also given IRS additional appropriations for specific compliance initiatives, but the funds have had little impact on the tax gap. Budget shortfalls have prevented IRS from taking full advantage of these additional funds or the new enforcement tools. Revenues generated by IRS' ongoing enforcement programs have not kept pace with the growth in the tax gap. Congressional actions and IRS' enforcement activities, however, have likely prevented the tax gap from growing larger.

IRS has no data on the extent to which IRS' customer service activities affect the tax gap. IRS' tax year 1988 TCMP data did indicate that almost 9 million noncompliant taxpayers needed more assistance in

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understanding tax laws and in preparing accurate tax returns. However, in 1994 only 21 percent of the taxpayers who tried to get such assistance from IRS' toll-free telephone service were able to get through. The good news is that when they did get through, IRS answered 89 percent of their questions correctly.

# IRS' Current and Planned Efforts to Reduce the Tax Gap

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IRS is making and planning dramatic changes in the way it does business and addresses noncompliance. It has adopted a compliance strategy called Compliance 2000, which relies more on education and assistance to improve compliance. Through Tax Systems Modernization (TSM), IRS is developing new computer systems while reorganizing its work to take advantage of this new technology. IRS expects these changes to improve overall compliance levels from 83 percent in 1992 to 90 percent by the year 2000.

Once all of these changes are implemented, IRS' vision of how it will then operate calls for (1) shifting from a paper-based to an electronic tax processing system; (2) consolidating fragmented telephone assistance into fewer locations that can handle almost all taxpayer calls; and (3) developing a database that contains all pertinent account information and is readily available to all employees who need it.

IRS' reorganization and computer upgrades, together with the compliance strategies and systems, will not be fully operational before 2000. By then, IRS' goal to increase voluntary compliance to 90 percent will be difficult to meet if these new tools experience delays.

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## Compliance 2000

To help achieve the goal of increasing taxpayer compliance from 83 percent to 90 percent by the year 2000, IRS has embarked on a new strategy called Compliance 2000. This strategy recognizes that education and assistance as well as enforcement are needed to reduce the tax gap. Compliance 2000 differs from the traditional compliance approach by placing more emphasis on identifying the root causes of noncompliance and moving to address these underlying problems. Compliance 2000 relies on identifying characteristics that differentiate compliant from noncompliant taxpayers, enabling IRS to find solutions before taxpayers make mistakes, help those having difficulty complying, and focus enforcement resources in the most productive fashion on those whose noncompliance is intentional.

On the surface, the Compliance 2000 strategy is sound. However, it depends on having valid systematic data that can be used to target the most noncompliant areas. Since 1963, TCMP has provided such data. However, IRS has criticized TCMP data for not being detailed enough on the specific location and causes for each type of noncompliance. Actually, TCMP has captured such data in narrative form through the TCMP workpapers. IRS has not extracted such data to determine the specific

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nature of the noncompliance because of concerns about cost and missing data.

Recognizing the need for more detailed, systematic compliance data, IRS is developing new methods for measuring compliance, identifying noncompliant taxpayers, and allocating compliance resources. For example, the Compliance Research Information System (CRIS) will attempt to measure compliance by compiling IRS and non-IRS data into a comprehensive database and performing various analyses to identify noncompliant taxpayer segments. IRS envisions that TCMP data will be the foundation for CRIS. It plans to do a new comprehensive TCMP survey in 1996 for tax year 1994 returns.

IRS plans to manage CRIS at its new National Office of Research and Analysis. It also plans to have a network of 31 District Offices of Research and Analysis, which will use a local version of CRIS to identify compliance issues related to specific geographic areas. CRIS is scheduled to be ready by 1996. In fiscal year 1997, the compliance data from CRIS will be used to develop an Annual Compliance Plan. This will be a multiyear, multifunctional plan that will define the compliance issues to be addressed and will allocate national and field resources to priority compliance areas.

IRS is not waiting for new compliance data to become available before it changes the way it looks at compliance and audits taxpayers. Under a newly developed Market Segment Specialization Program (MSSP), IRS studies and analyzes market segments to determine levels of noncompliance. A market segment can be an industry, profession, or issue (e.g., truck drivers, garment contractors, the construction industry, passive losses). IRS is assessing noncompliance in the market segments by analyzing data from filed returns, state/federal exchange programs, and industry sources.

Under MSSP, district office staff are to (1) identify, research, and develop market segments; (2) audit returns in the segments to determine levels of compliance; and (3) produce audit guides to be used when auditing specific market segments. As of September 1993, IRS had completed 21 MSSP projects and developed 14 audit guides. Projects have covered such market segments as attorneys, mortuaries, and restaurants. Appendix IV lists the MSSP projects.

IRS' market segment approach suffers from the lack of detailed, systematic compliance data. IRS does not know whether the market segments it is

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developing are the most noncompliant segments among taxpayers. IRS will not have this data until it completes its planned TCMP survey as well as CRIS. Until then, resources may not be targeted at areas that would significantly reduce the tax gap.

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## **Tax Systems Modernization**

IRS is counting on CRIS to provide the data it needs to measure and identify the most noncompliant areas so that IRS can effectively employ its Compliance 2000 strategy. In concert with developing compliance data and strategies, IRS hopes to make its compliance programs more effective and efficient.

TSM is scheduled to become fully operational by the year 2008 at an estimated cost of \$23 billion. TSM is being designed to use new technology that will enable employees to serve taxpayers more quickly and efficiently than now. Through TSM, IRS expects to use new processes that will enable it to meet its strategic objectives—reduce taxpayer burden, improve voluntary compliance, and increase productivity and efficiency. IRS expects such productivity and efficiency to come from switching its reliance on paper filings and manual processing of tax returns and other documents to electronic filing and automated processing. In addition, IRS plans to move toward more (1) automated access to taxpayer information by IRS staff, (2) electronic transfer of data between IRS locations, and (3) reliance on telephone contacts with taxpayers to resolve problems.

One of the major initiatives under TSM that affects compliance activities is to have systems that will process information returns quicker so that potential underreporter cases can be identified at the time tax returns are processed. Currently, IRS underreporter cases are not developed and pursued until 12 to 18 months after returns are required to be filed.

Another major TSM initiative for compliance purposes will be the Integrated Case Processing system. This system is supposed to allow authorized employees, using a universal workstation, to assemble all the information they need to do their work in an electronic case folder. With all this information available, employees are supposed to be able to resolve most issues and concerns of taxpayers at initial contact.

Included in the Integrated Case Processing system will be the following TSM projects:

- **Corporate Files On-Line:** Some IRS master file data is placed on-line, facilitating accessibility by employees who can use the data to resolve taxpayer inquiries more quickly.
- **Automated Inventory Control System:** Now being tested at the Fresno Service Center, this will be used to track taxpayer correspondence and reduce delays in responding to taxpayer inquiries.
- **Automated Underreporter System:** Information returns are automatically associated to tax return data to facilitate the determination of whether taxpayers reported their income correctly.
- **Integrated Collection System:** The assignment and management of active collection are automated.
- **Totally Integrated Examination System:** Taxes, interest, and penalties on audit cases are automatically computed.
- **Automated Criminal Investigation System:** Criminal investigators are able to use information from sources throughout the law enforcement community.

If all of these and other planned systems work, administration of the tax system should improve. However, it is still too soon to determine whether IRS can successfully merge these different systems into one workable integrated system.

As TSM automates manual processes, IRS hopes to reinvest displaced staff by training them to assume higher level duties. This staff do such work as processing tax returns. IRS envisions many of them being trained to do compliance duties, such as assisting taxpayers or helping with audits. IRS' reinvestment plan has merit; however, IRS does not yet know how many staff will be displaced, how many can be retrained to handle new duties, and whether this number will be enough.

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## Core Business Systems

IRS is reorganizing its operations to better address tax gap issues and help taxpayers comply. It is implementing a systems management approach, which it calls core business systems, to improve its work systems, products, and services. This approach to management is designed to help break down the walls between functions such as Examinations, Collections, and Taxpayer Service by looking at the organization as an integrated process rather than a series of functions. To do this, IRS' business functions have been reorganized into six core business systems that integrate related activities. These six systems include one on educating and assisting taxpayers and one on ensuring compliance.

IRS is also changing its organizational structure to better implement these new systems and IRS' new approach. It has established chief officers for carrying out IRS' program objectives and strategies under these systems. For example, the Chief Compliance Officer is the principal advisor to the Commissioner on policy and operational matters affecting compliance functions. These functions include compliance research, examinations, collections, and criminal investigations. Specifically, this officer will focus on continually measuring the degree of compliant behavior, identifying noncompliance, determining the causes of noncompliance, and proposing actions to improve compliance.

IRS plans to also decrease staff positions in the national and regional offices and put more staff on-line to address compliance issues. Finally, in its new organization, IRS plans to have

- 5 submission processing sites, which will receive, control, image, and process paper tax returns, information returns, Form W-2s, and correspondence;
- 3 computing centers, which will maintain the tax account and case-related data and receive all electronically filed tax returns and payments through electronic funds transfer; and
- 23 customer service sites, which will handle taxpayer questions; problems; and issues not requiring face-to-face interaction, such as tax law and procedural questions, forms requests, installment agreements, adjustments, and nonfiler and underreporter issues.

These organizational changes are just under way and it is too early to determine whether they will create a multifunctional compliance strategy and organization at all levels of IRS or whether they will help IRS to reduce the tax gap.

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## Conclusions

For the Compliance 2000 strategy to work, IRS needs valid compliance data and the technology and organizational structure to make it effective. However, many of the current and planned changes have not been fully implemented. As a result, IRS does not know what effect, if any, the changes will have on reducing the tax gap. For example, IRS is already well on its way to instituting a market segment approach to selecting returns for audit. Without detailed, systematic compliance data, IRS does not know whether this approach is targeting the least compliant taxpayers. Because TSM initiatives are still being developed, their impact on compliance will not be known for a few years. Finally, it is too early to tell whether IRS'

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**Chapter 3**  
**IRS' Current and Planned Efforts to Reduce  
the Tax Gap**

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reorganization into its core business systems will prove more effective in addressing tax gap issues.

# Actions That Can Be Taken to Reduce the Tax Gap

While eliminating the tax gap is unlikely, working toward this end is worthwhile. In doing so, IRS must continually improve its compliance programs to make them as cost-effective as possible. Such improvements can come from better using existing compliance data to develop a strategy that focuses on noncompliant taxpayers who make up major portions of the tax gap. Part of this strategy could be to maintain, if not increase, audit coverage. Further, if the budget allows, IRS could increase computer matching and better ensure that all required information returns are filed.

Other actions to help IRS reduce the tax gap would require congressional action. Congress could pass legislation to require information reporting on payments made to corporations and income tax withholding on payments made to independent contractors. IRS also believes Congress can help by allowing IRS to reinvest—rather than give up—the productivity gains from implementing TSM into its compliance activities.

IRS also could start acting on a number of matters as it moves into TSM. Most important is cleaning up its tax records so that it can more readily determine all compliance issues associated with each taxpayer.

## What IRS Can Do to Reduce the Gap

Before IRS can effectively attack the tax gap, it needs a comprehensive compliance strategy and sound tax compliance data to target its resources. The first step toward achieving this goal is the comprehensive TCMP survey planned for tax year 1994. Until IRS completes this survey, some known compliance issues can be addressed but may require additional resources or a redirection of existing resources. For example, resources could be used to do more computer matching and to better ensure that computer matching covers all required information returns. Also, IRS could address the remittance gap by increasing the efficiency, productivity, and quality of its collection function.

### IRS Needs Better Data to Target Examination Resources

Unlike the \$13.3 billion remittance gap, which consists of known tax debts, the remaining \$113.7 billion of the gross income tax gap for tax year 1992 is more difficult to find. IRS has to find this noncompliance, which includes unreported income and overstated exemptions, deductions, and credits, and decide how best to target its resources on such noncompliance. The key to identifying and correcting such noncompliance is to know the (1) taxpayers most likely to be noncompliant; (2) income or expense in which noncompliance is most likely; and (3) reasons or causes for the noncompliance (e.g., intentional versus unintentional). With a

process to capture and analyze such information, IRS can effectively allocate the right resources to the right compliance problem.

For about 30 years IRS has relied on TCMP to identify compliance issues, measure taxpayer compliance, and help allocate examination resources. TCMP also has been the primary source for making tax gap estimates. We reported in April 1993 that IRS was planning major changes that would greatly reduce TCMP's value in making compliance and tax gap estimates.<sup>1</sup> Since then, IRS officials have told us that they will conduct a comprehensive TCMP survey without making the changes that would undercut its value.

The planned TCMP survey for tax year 1994 will consist of about 150,000 individual, corporate, and partnership returns. The survey will be directed at about 30 market segments, such as taxpayers engaged in retail industries. This approach differs from prior TCMP surveys, which examined taxpayers by type of return filed and amount of income reported on their returns. Also, unlike prior surveys, IRS plans on collecting data to more specifically identify the tax issues and reasons associated with any tax changes.

As of February 10, 1994, IRS had not made a final decision on whether the audits for this TCMP survey will be as detailed as in prior TCMP audits. As previously reported, we believe IRS should ensure that the survey is conducted in a manner that provides valid statistical data. In particular, IRS needs to audit every tax return line item on the selected returns so that it can properly identify compliance levels and trends as well as emerging noncompliance. This detailed level of audit is important for identifying the most noncompliant tax gap areas so that IRS can prioritize its use of enforcement resources.

We acknowledge that IRS is attempting to develop new systems, such as CRIS, to provide these benefits. But these systems will not be ready during the next few years. Until they are, valid TCMP data for more recent years are critical in order for IRS to develop the comprehensive compliance strategy that it envisions and needs. The last TCMP surveys covered tax year 1988 for individuals, tax year 1987 for small corporations, and tax year 1982 for partnerships. While the data for the small corporation and individual surveys are still useful, their usefulness decreases with every major tax law and economic change.

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<sup>1</sup>Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved (GAO/GGD-93-52, Apr. 5, 1993).

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**Audit Coverage Needs to  
Be Maintained**

Audits of taxpayers' books and records are the only way IRS can detect noncompliance not covered by information returns. For example, payments made to corporations are not covered by information returns reporting; thus, audits are necessary for detecting unreported corporate income. Similarly, to detect overstated business expense deductions, such as depreciation and inventory costs, IRS needs to audit taxpayers' records.

IRS estimates that sole proprietors report about 80 percent of their taxes while small corporations report 61 percent. Further, the audit rate for small corporations was 2.6 percent and 2.3 percent for sole proprietors in 1992. While these audit rates have increased in the last 5 years, they are still about half of what they were in 1981. As part of any short-term compliance strategy to reduce the tax gap, IRS cannot afford to allow current audit coverage to decrease, particularly for taxpayer groups with compliance problems. Audit levels for other taxpayers, such as large corporations and nonbusiness individuals, also need to be maintained.

Existing TCMP data, including the audit workpapers, often provide additional audit leads. Currently, under its MSSP, IRS is developing specialized audit programs by using more subjective data, such as the judgment and experience of IRS examiners in a particular market segment. While this approach may identify some noncompliant taxpayers, IRS does not know if other types of taxpayers are more noncompliant.

For example, IRS has created special audit guides to examine bed and breakfast establishments. However, IRS does not know whether these establishments are more noncompliant than other types of hotel and lodging places. Given its limited audit resources, IRS needs to be diligent in using these resources.

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**Increase Computer  
Matching**

IRS can reduce the tax gap by computer matching more of the tax data it receives. For example, IRS estimated that the 1992 tax gap for income individuals received from partnerships, S corporations, and estates and trusts exceeded \$3 billion. These types of tax entities are required to submit Schedules K-1, which show each partner's, shareholder's, or beneficiary's distributive share of the business's or estate's income and expenses. These distributions are reported by recipients on their individual income tax returns. According to IRS data, about 31.5 million Schedules K-1 for tax year 1991 were submitted. However, data from less than 13 percent of them were entered into IRS' computer for use in detecting potential nonfilers or underreporters.

Similarly, IRS could expand its computer matching of information that taxpayers report on income tax returns when claiming dependent exemptions. IRS estimates that the tax gap for erroneous exemptions for tax year 1992 exceeded \$2 billion. We reported in March 1993 that IRS does not enter in its computer all dependents' Social Security numbers as reported on the tax returns.<sup>2</sup> As a result, IRS cannot readily detect unallowable claims for dependent exemptions, including erroneous Earned Income Tax Credit claims. We estimated that IRS could have increased tax year 1988 revenues by about \$750 million if it had transcribed and matched Social Security numbers to tax returns.

We also believe that the tax gap associated with overstated business expenses could be reduced if IRS computer-matched information returns it receives. IRS' most recent TCMP data show that small corporations in 1987 and sole proprietors in 1988 overstated all business deductions by an estimated \$40 billion. In an August 1993 report, we found that if IRS were to match wages that employers reported on Forms W-2 to the wage expenses deducted on small business income tax returns, it could have identified some overstated wage expense deductions, which IRS estimated to be \$3.2 billion.<sup>3</sup> Given the \$40 billion in overstated deductions from just small businesses, significant benefits would likely emerge from expanding this reverse matching concept beyond wages to include services and other deductions—such as for forgiven debts.

For each of these and other examples, the additional data transcription, matching, and follow-up required will strain IRS' existing budget and computer capacity to some extent. However, as TSM begins to increase IRS' computer capacity and more tax documents are filed electronically, these pressures should be alleviated.

#### **Establish Comprehensive Payer Compliance Programs**

Computer matching, as just discussed, is vital to detecting noncompliance and reducing the need to do intrusive audits. To be effective, all required information returns need to be filed timely and be complete and accurate. To ensure that information returns are filed, IRS needs a comprehensive and effective payer compliance program.

IRS' most recent TCMP data showed that sole proprietors and small corporations failed to submit about 3.5 million Forms 1099 (Miscellaneous

<sup>2</sup>Tax Administration: Erroneous Dependent and Filing Status Claims (GAO/GGD-93-60, Mar. 19, 1993).

<sup>3</sup>Tax Administration: Computer Matching Could Identify Overstated Business Deductions (GAO/GGD-93-133, Aug. 13, 1993).

Income) totaling \$16.4 billion for tax years 1988 and 1987, respectively. These information returns are used for reporting such income as nonemployee compensation (income received by certain types of sole proprietors, such as independent contractors), rents, royalties, and crop insurance proceeds. IRS estimated that the 1992 tax gap associated with all types of sole proprietors, rents, and royalties exceeded \$34 billion.

Some of this tax gap could be more readily identified if required information returns were filed. For example, for the tax year 1989 underreporter program, the most recent data available, matching information returns on just one type of income—nonemployee compensation payments—to individual tax returns produced \$400 million in additional recommended tax assessments on 280,000 taxpayers.

In 1984, IRS established a Payer Master File, which contains information on the payer's name, address, and taxpayer identification number, which is the Social Security number for an individual taxpayer and an Employer Identification Number for a business taxpayer. It also shows the types of information returns filed and whether the payer filed on paper or used magnetic media. The purpose of this file was to help IRS advise and educate payers about filing requirements as well as identify payers who failed to file information returns.

IRS has used data from this file to identify payer noncompliance in its audits. For example, Payer Master File data that indicates that a business did not file information returns provides the examiner with a lead to examine business expenses for potential noncompliance with the information returns filing requirements. We reported in 1989 that examiners were not doing a very good job of identifying unfiled information returns.<sup>4</sup> In about 50 percent of the 932 completed business return audits we reviewed, examiners did not identify businesses that failed to file information returns.

We believe that IRS could use the Payer Master File to establish an ongoing computerized payer compliance program as we discussed in our August 1993 reverse document matching report.<sup>5</sup> This report describes how IRS could develop a computer matching program to identify businesses that overstated business expense deductions, such as wages. We also noted that the match could identify businesses that had not filed

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<sup>4</sup>Tax Administration: Missing Independent Contractors' Information Returns Not Always Detected (GAO/GGD-89-110, Sept. 8, 1989).

<sup>5</sup>GAO/GGD-93-133.

information returns on those expense deductions. IRS could then contact the business to determine whether information returns should have been filed. We believe that this could be a very cost-effective way to identify noncompliant payers so that more information returns can be used in computer matching programs.

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#### **Improve Use of Collection Resources**

IRS estimated that its enforcement programs have annually reduced the gross remittance gap by 61 percent since 1981. In other words, IRS collects 61 cents of every delinquent tax dollar. We believe that IRS can further reduce this gap by adopting recommendations we made in a May 1993 report.<sup>6</sup> For example, we pointed out that today's competitive collection environment forces IRS to consider new enforcement techniques, such as those used by private sector firms and state tax departments.

We recommended that IRS restructure its collection organization to support earlier telephone contact with delinquent taxpayers and determine how to use current collection staff in earlier, more productive stages of the collection process. We also recommended that IRS develop detailed information on delinquent taxpayers to be used to customize its collection procedures. Lastly, IRS needs to further cooperate with state tax departments to collect delinquent taxes faster.<sup>7</sup>

In another May 1993 report, we noted that collection staffing imbalances kept IRS from maximizing its collection of delinquent tax accounts or stemming the growth of its accounts receivables.<sup>8</sup> We recommended that IRS develop a plan for ensuring that the collection staff in field offices is balanced to maximize the assessment and collection of delinquent accounts.

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#### **Verify Earned Income Tax Credit Claims**

In the past, the Earned Income Tax Credit (EITC) has been a compliance problem. The 1992 tax gap for EITC exceeded \$1 billion. However, this gap could grow because of increases in the amount of credit that taxpayers with children will be able to receive in 1994—up to \$2,527 from \$1,511 in 1993.

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<sup>6</sup>Tax Administration: New Delinquent Tax Collection Methods for IRS (GAO/GGD-93-67, May 11, 1993).

<sup>7</sup>We made similar recommendations in other reports. See IRS' Accounts Receivable Inventory (GAO/T-GGD-90-19, Feb. 20, 1990); and Tax Administration: Improving IRS' Business Nonfiler Program (GAO/GGD-89-39, Mar. 8, 1989).

<sup>8</sup>Tax Administration: Improved Staffing of IRS' Collection Function Would Increase Productivity (GAO/GGD-93-97, May 5, 1993).

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To develop safeguards for the early identification of erroneous EITC claims, IRS could determine the types of compliance problems that it can expect. To do this, IRS officials said they are doing a study in which a random sample of EITC claims is audited early in the filing season. The results of this study should reveal whether taxpayers' errors are unintentional (because they do not understand the requirements) or intentional. Once the results are known, IRS may be able to change its processing procedures to better detect erroneous claims.

As noted earlier, one way IRS could detect erroneous claims is to transcribe qualifying children's Social Security numbers into its computers and cross-check to determine whether the numbers are valid and the qualifying children are young enough.

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## What Congress Can Do to Reduce the Tax Gap

Several enforcement tools that IRS could use to address tax gap issues require legislation. The most important tools address compliance among sole proprietors, primarily independent contractors, and small corporations. Together, these types of businesses accounted for at least \$37 billion, or 29 percent, of the estimated \$127 billion tax year 1992 tax gap. Further, changes in information reporting of capital gain income would help to reduce the estimated \$11.5 billion tax gap for this type of income. Finally, changing the definition of dependents will increase taxpayer compliance and help reduce the \$2.2 billion tax gap related to erroneous exemptions.

In the past, Congress has given IRS additional resources to reduce the tax gap, but these resources have not increased IRS' compliance presence. Even if Congress were to give IRS more enforcement resources, IRS would still need better compliance data to know where it can best use not only these additional resources but also existing resources. One approach, suggested by IRS, to funding compliance efforts is to allow IRS to reinvest productivity gains from TSM into its enforcement programs. If IRS is allowed to do so, Congress may want some assurance that IRS uses the productivity gains for compliance.

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### Clarify Independent Contractor Issues

IRS estimated that the \$127 billion tax gap for 1992 included \$30.2 billion created by unincorporated sole proprietors (informal suppliers) that did not report all their business income. Some part of this segment of the tax gap is attributable to independent contractors. We have recommended that Congress consider requiring tax withholding on payments made to

independent contractors and more information returns reporting on these payments.<sup>9</sup> IRS data show that independent contractors report 97 percent of the income that appears on information returns, while contractors who do not receive these returns report only 83 percent.

We also suggested that Congress could reduce some of this noncompliance by simplifying the rules for determining whether workers can be classified as employees or as independent contractors. The President's health care proposal contains a provision to allow the Secretary of the Treasury to prescribe classification rules.

**Require Information  
Return Reporting on  
Payments Made to  
Corporations**

IRS estimated that the corporate portion of the \$127 billion gross tax gap was about \$33 billion in tax year 1992, including about \$7 billion for small corporations. Since these estimates were made in 1988, IRS completed its small corporation TCMP, which showed that the compliance level for small corporations decreased from 81 percent in 1980 to 61 percent in 1987. Compliance of small corporations engaged in service industries fell from 69 percent to 48 percent between 1980 and 1987. In contrast, sole proprietors in the service sector had a compliance level of over 85 percent.

IRS officials contend, and we agree, that the primary reason for these different compliance rates is that unlike payments made to sole proprietors, payments made to corporations for services are not required to be reported on information returns. We have also reported on the need for information reporting on payments of investment-type income (e.g., interest and dividends) made to corporations.<sup>10</sup>

In 1993, the administration submitted legislation that would have required information returns on payments made to service corporations. Treasury estimated that this legislative proposal would increase revenues by about \$5 billion over a 5-year period. However, the Joint Committee on Taxation estimated that the proposal would raise about \$365 million over 5 years. The Senate did not pass the proposed legislation because of the burden businesses said it would impose on them.

Requiring information return reporting on payments made to corporations would impose additional costs on businesses. No estimates of these costs

<sup>9</sup>Tax Administration: Approaches for Improving Independent Contractor Compliance  
(GAO/GGD-92-108, Jul. 23, 1992).

<sup>10</sup>Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Cost  
(GAO/GGD-91-118, Sept. 27, 1991).

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have been done. However, compliant businesses now either (1) issue information returns for all payments or (2) assume some costs and burdens to track whether a payment recipient is incorporated. If the law were changed, some compliant businesses would no longer have to do this tracking. Instead, they would use their existing information reporting systems to file information returns on all corporate payments.

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**Require More Data on  
Information Returns  
Dealing With Capital Gain  
Income**

IRS' TCMP data show that individuals and small corporations significantly underreported their capital gains income by \$25 billion. In addition, capital gains represented an \$11.5 billion portion of the \$127 billion tax gap for 1992. IRS studies indicated that much of this compliance problem comes from taxpayers overstating their "basis" in the asset, which is the amount of money they originally paid for it.

Currently, businesses are required to report the sales price but not the purchase price of stocks and bonds on information returns. However, IRS would need the purchase price of stock transactions to cost effectively determine whether taxpayers properly reported their capital gain income from these transactions. This information would allow IRS to establish a nonintrusive computer matching program to check for compliance. In order to verify capital gain income, IRS currently has to audit taxpayers' books and records. The downside to requiring information returns reporting on the purchase price of stocks and bonds is the additional burden this reporting requirement may place on businesses.

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**Change the Definition of  
Dependent**

The tax gap associated with erroneous exemptions was \$2.2 billion in tax year 1992. We found that the primary source of erroneous dependent claims was the taxpayer's failure to meet the dependent support test, which requires a taxpayer to provide over 50 percent of a dependent's support to claim the exemption.<sup>11</sup> We believe that replacing the support test with a much simpler residency test, which is used to qualify children for the EITC, would substantially reduce this noncompliance. This change would also decrease taxpayer burden and generally make the tax law conform with current taxpayer behavior.

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<sup>11</sup>GAO/GGD-93-60.

**More Data and Assurances  
Could Help Make  
Compliance Resource  
Decisions**

Each year Congress considers the level of resources IRS should receive to improve compliance and stem the tax gap. If IRS receives the resources, the question becomes where should IRS invest them most cost effectively.

We asked IRS officials this question. We received a range of general ideas for using more resources, including hiring staff to audit more tax returns and collect more delinquent accounts. However, we concluded that no one knows the relative priorities for investing more compliance resources to reduce the tax gap. IRS needs detailed data on the types and amounts of noncompliance that contribute most heavily to the tax gap. Once IRS has such data, it can begin to figure out what causes the noncompliance in an effort to devise appropriate solutions. To the extent that such data are consistently and systematically collected across the country, IRS could enhance its ability to sort out relative compliance priorities and decide whether more resources are needed in the highest priority areas.

As discussed earlier, IRS already has valid compliance data through its TCMP surveys and is planning on doing a more comprehensive survey. To get more specific, detailed data on compliance to supplement TCMP, IRS is attempting to develop CRIS as a computer system for storing and analyzing compliance data from various sources. If IRS succeeds in getting more and better data and developing CRIS, it will have the foundation we believe is needed for making decisions on whether more resources are necessary and on where such resources should be targeted.

One approach suggested by IRS officials to providing more compliance resources is to allow IRS to reinvest some gains in productivity from implementing new computer systems through TSM. As discussed earlier, as TSM begins to allow IRS to automate work that has been done manually, the affected staff will no longer be needed to do that work. In the past several years, the proposed budget for IRS assumed reduced resources because of TSM productivity gains but requested additional resources for compliance initiatives.

For example, IRS' fiscal year 1994 budget included decreases of \$55 million and 1,219 full-time equivalent positions because of productivity gains from implementing systems as part of TSM.<sup>12</sup> The same budget requested an additional \$150 million for compliance initiatives in an attempt to redirect resources to address tax gap issues. In essence, the decrease in the budget for productivity gains offset a large part of the increase requested for compliance initiatives.

<sup>12</sup>Tax Administration: IRS' Budget Request for Fiscal Year 1994 (GAO/T-GGD 93-23, Apr. 28, 1993).

In our April 1993 testimony on IRS' fiscal year 1994 budget, we cautioned that the estimated productivity gains may not be realized and IRS' operating base may erode if the compliance initiatives are not funded. We cited staffing needs in IRS' computer matching program as an example of a program harmed when implementation of a new computer system led to the loss of staff due to unrealized productivity savings.

The persistent decline in audits and computer match cases and increases in known tax delinquents may suggest that IRS needs more compliance staffing. IRS' suggestion that it be allowed to reinvest productivity savings from TSM is one way to get additional enforcement resources. However, if Congress allows IRS to do this, it should make sure that IRS uses the reinvested resources for compliance purposes.

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## **What IRS Must Do to Reduce the Tax Gap Under TSM**

As IRS modernizes its computers and changes its way of doing business, several actions would help it to take advantage of its new capabilities in reducing the tax gap. IRS could clean up its master file records to help ensure that the data used in the new computer systems are complete and accurate. IRS could also review its tax returns to determine whether the data necessary to cost effectively identify noncompliance are captured.

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### **Clean Up Master File Records to Create Cross-Reference Files**

An effective and efficient enforcement program needs accurate, comprehensive, and readily accessible tax data. The types of tax data available dictate the compliance strategies that can be effectively employed. IRS currently has separate databases for each particular type of tax entity. For example, if a taxpayer is a sole proprietor with several employees and has a pension plan, then the taxpayer will have income tax return data on the Returns Transaction File, tax account data on the Individual Master File, information return data on the Payer and Information Returns Master Files, employment tax data on the Business Master File, and pension data on the Employee Plans Master File.

Currently, these files have errors. Further, IRS cannot cross-reference these files to determine all compliance issues associated with a taxpayer. IRS believes that TSM can give it this capability. As discussed in chapter 3, IRS envisions having an integrated case processing system that will allow the computer to make various compliance checks (e.g., underreporter and nonfiler). This will allow all compliance issues for a taxpayer to be handled at the same time. However, IRS needs valid taxpayer data and cross-reference files to do these checks. To our knowledge IRS is doing

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little to ensure that each taxpayer record has a valid taxpayer identification number and that these records can be cross-referenced to each other.

Without clean taxpayer records and cross-reference files, IRS will not have an effective integrated case processing system. IRS will be unable to create a comprehensive compliance case on the taxpayer, making separate audits of a taxpayer's individual, corporate, and partnership returns more likely. An integrated system will enable IRS to audit the taxpayer rather than the return, resulting in more effective and timely audits.

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**Determine Data Needed From Tax Returns to Identify Noncompliance More Readily**

Under TSM, IRS envisions entering all tax return data onto its computers. According to IRS, most returns will be either electronically filed or scanned in order to convert the data into computer-readable language by the turn of the century. Currently, about 50 percent of the tax return data on individual tax returns and 15 percent of business return data are manually transcribed on to computers. As a result, paper returns have to be reviewed to determine whether enforcement action is warranted.

One step that IRS should be taking now is to ensure that tax returns capture the data needed for effective enforcement efforts. Without such data, IRS' enhanced data capabilities under TSM will be less cost-effective. For example, as we reported in July 1992, IRS does not require sole proprietors to indicate on the Schedule C (Profit or Loss From Business) the amount of payments they receive as independent contractors.<sup>13</sup> Payers are required to report these payments on Form 1099 (Miscellaneous Income). If this information were reported on Schedule C, IRS could computer match the total amount of payments that independent contractors reported on Schedule C with the information return amount to identify any unreported income.

A similar line could be added to partnership returns (Form 1065) to verify nonemployee compensation these businesses receive. If Congress required information returns on payments made to corporations, the corporate tax return would also need to be modified.

IRS could also have business taxpayers, including corporations, indicate on their tax returns the number and amounts of information returns they issued to noncorporate businesses for service payments and other payments, such as for rent and interest. This information would serve as a

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<sup>13</sup>GAO/GGD-92-108.

reminder of the need to issue information returns on certain types of payments. The information would also help IRS check business returns for payer compliance.

IRS is reviewing tax returns and schedules to identify data now required to be reported on returns but that can be eliminated from the returns. While making this review, IRS also needs to determine whether collecting other data could help IRS detect noncompliance and help taxpayers to comply.

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### **Validate Taxpayers' Identification Numbers Sooner**

The tax gap for sole proprietors, many of whom are independent contractors, is about \$30 billion. One way to reduce the sole proprietor tax gap would be to quickly identify independent contractors who give payers an incorrect TIN. Quickly identifying TINS would also be valuable for other payers, such as banks and brokerage houses, that submit information returns on interest and dividends paid to individuals. These payments account for an additional \$4 billion of the tax gap.

In fiscal year 1988, IRS received almost 1 billion information returns. Over 6 million of these were unmatchable because no TIN was present or the TIN on the information return did not match the name. Currently, it takes IRS about 1 year to notify a payer that the wrong TIN was submitted on an information return. After this amount of time, the independent contractor may no longer work for the business, making it difficult or impossible for IRS to use the information return in its underreporter or nonfiler programs.

As we reported in September 1992, independent contractor TINS could be verified more quickly if IRS had a system that would allow payers to validate TINS via telephone, using technology similar to that used to validate credit card purchases.<sup>14</sup> IRS is currently exploring a limited application of this concept.

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### **More Use of State Data**

Since we issued our December 1985 report on IRS' use of state tax data, IRS has been working with state tax administration offices to make better use of state data.<sup>15</sup> For example, IRS' Fresno Service Center is using California sales tax data to identify businesses that failed to file federal tax returns. In the past, IRS could not efficiently use these records because the state

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<sup>14</sup>Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations (GAO/GGD-92-130, Sept. 22, 1992).

<sup>15</sup>Tax Administration: The Federal/State Tax Information Exchange Program (GAO/GGD-86-8, Dec. 13, 1986).

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sales tax records did not contain taxpayers' Employer Identification Numbers (EIN). Now they do. IRS officials told us that since 1992 the sales tax data have helped IRS identify over 4,600 potential taxpayers who failed to file federal returns with tax assessments of \$81.5 million.

By continuing to seek out compatible state and local databases, IRS should be able to improve its ability to detect potential federal tax noncompliance such as corporate nonfilers. For example, one potential data source is that maintained by state offices that register corporations to do business in the state.

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## Conclusions

Just as the tax gap comprises many elements, strategies for reducing it are many as well. And while IRS needs more updated and precise data to better target its resources, existing compliance data suggest the relative sizes of various tax gap components. Using these data, we have issued many reports that recommended a number of approaches.

Until IRS produces new compliance data and a comprehensive compliance strategy, existing data could be used as part of an interim compliance strategy that directs resources at the most noncompliant taxpayers. This interim strategy could, at a minimum, be geared to maintaining current levels for audits, computer matching, and delinquent tax collection. The tax system cannot afford to have IRS misdirect its enforcement resources to areas that will not improve compliance.

According to IRS' tax gap estimates and TCMP data, areas in which substantial compliance improvements are possible include small corporations and sole proprietors. These businesses represent 29 percent or \$37 billion of the \$127 billion tax gap. Their compliance levels are also low—small corporations report about 61 percent of the taxes they owe while sole proprietors report about 80 percent.

IRS should focus resources on computer matching more tax return data. IRS data shows a \$3 billion tax gap associated with individuals who receive income from partnerships and similar tax entities. IRS should consider more computer matching of the documents received on this type of income. More computer matching for erroneous dependent and Earned Income Tax Credit claims as well as certain business deductions could also be done. To make its document matching program more effective, IRS could expand its use of the Payer Master File to better ensure that all required information returns are filed.

IRS can begin now to develop data to properly allocate its collections resources and to try different collection techniques. For example, making earlier telephone contact with delinquent taxpayers should speed up collections and prevent some accounts from becoming uncollectible.

If Congress required information returns on payments made to corporations and simplified the independent contractor definition, IRS could better attack business noncompliance. Congress can also help IRS reduce the tax gap by making sure IRS has appropriate and accurate data on how to target compliance resources. Further, Congress could also act on IRS' suggestion to reinvest productivity gains from TSM. Before doing so, Congress may want assurance that IRS will use these reinvested resources for compliance purposes.

IRS could take several steps to take full advantage of TSM. IRS could clean up its taxpayer records and better integrate use of them in enforcement efforts. IRS could also review tax returns to ensure that the data necessary to effectively and efficiently detect noncompliance are collected.

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## Recommendations

This report makes no new recommendations. Rather, this report highlights prior recommendations that would help to reduce the income tax gap.



# Estimates of the Tax Gap and Enforcement Revenue

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This appendix shows estimates of individual and corporate tax gap components for tax years 1981 and 1992 in both current and constant dollars. It also compares the overall tax gap estimate to IRS' enforcement revenue for fiscal years 1987 through 1992.

**Appendix I**  
**Estimates of the Tax Gap and Enforcement Revenue**

**Table I.1 Estimated Tax Gap by Source for 1981 and 1992, in Current Dollars**

Dollars in millions		
Description	1981 tax gap amount	1992 tax gap amount
Individual filers		
Wages and salaries	\$2,378	\$1,919
Interest	1,969	1,891
Dividends	2,075	2,142
State tax refund	127	102
Alimony	124	253
Capital gains	1,822	11,535
Form 4797	217	1,264
Pensions and annuities	456	144
Taxable unemployment	107	388
Farm income	2,350	1,909
Partnership income	2,755	2,246
Small business corporation	912	729
Estates and trusts	49	73
Rents and royalties	2,012	4,481
Nonfarm sole proprietors	18,714	30,173
Other income	4,366	3,465
Taxable Social Security	0	44
Adjustments to income	752	694
Deductions	3,540	3,889
Exemptions	1,844	2,224
Credits	1,313	1,274
Math errors	487	1,521
Individual nonfiler tax gap	5,231	10,233
Individual remittance gap	8,300	11,400
<b>Total individual tax gap</b>	<b>\$61,900</b>	<b>\$93,994</b>
Small corporation tax gap	4,461	6,999
Large corporation tax gap	8,638	23,716
Unrelated business income tax gap	56	218
Fiduciary tax gap	111	202
Corporate remittance gap	800	2,000
<b>Total corporate tax gap</b>	<b>\$14,065</b>	<b>\$33,135</b>
<b>Total tax gap<sup>a</sup></b>	<b>\$75,966</b>	<b>\$127,129</b>

<sup>a</sup>Totals may not add due to rounding.

Source: Income Tax Compliance Research, IRS Publication 1415.

**Appendix I**  
**Estimates of the Tax Gap and Enforcement**  
**Revenue**

**Table I.2: Gross Tax Gap Estimates by Source of Tax Gap for Tax Years 1981 and 1992, in 1992 Dollars**

<b>Source of tax gap</b>	Dollars in millions		
	<b>1981 tax gap amount</b>	<b>1992 tax gap amount</b>	<b>Percent increase</b>
Individual tax gap	\$94,851	\$93,994	-0.9
Unreported income	61,956	62,759	1.3
Sole proprietors	28,676	30,173	5.2
All other income	33,280	32,586	-2.1
Overstated deductions <sup>a</sup>	11,414	8,081	-29.2
Individual nonfiler	8,016	10,233	27.7
Individual remittance gap	12,718	11,400	-10.4
Math errors	746	1,521	103.9
Corporate tax gap	21,552	33,135	53.7
Small corporation	6,836	6,999	2.4
Large corporation	13,236	23,716	79.2
Others <sup>b</sup>	256	420	64.1
Corporate remittance gap	1,226	2,000	63.1
<b>Total tax gap<sup>c</sup></b>	<b>\$116,988</b>	<b>\$127,129</b>	<b>8.7</b>

<sup>a</sup>Includes subtractions for erroneous deductions, exemptions, credits, and other adjustments.

<sup>b</sup>Includes unreported income and overstated deductions for exempt organizations' unrelated business income and for fiduciaries.

<sup>c</sup>Totals may not add due to rounding.

Sources: Income Tax Compliance Research, IRS Publication 1415 (7-88); and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Research Division, Publication 1415 (4-90).

**Appendix I**  
**Estimates of the Tax Gap and Enforcement**  
**Revenue**

**Table I.3: Tax Gap Estimates and Assessments and Collections by IRS, In 1992 Dollars**

Dollars in millions				
Year	Tax gap <sup>a</sup>	Examination <sup>b</sup>	Collection <sup>c</sup>	Computer matching <sup>c</sup>
1987	\$113,855	\$19,754	\$27,668	\$3,914
1988	112,629	19,581	27,122	3,662
1989	114,483	17,843	26,176	5,490
1990	117,687	19,938	27,196	2,875
1991	122,418	27,961	24,920	3,007
1992	127,029	24,125	24,235	4,259

<sup>a</sup>Tax dollars only.

<sup>b</sup>Includes additional taxes and penalties.

<sup>c</sup>Includes additional taxes, interest, and penalties

Sources: IRS Annual Report for 1992; Income Tax Compliance Research, IRS Publication 1415 (7-88); and Tax Administration: Trends for Certain IRS Programs (GAO/GGD-93-102FS, May 26, 1993).

# Summary of Selected Tax Gap-Related Products Issued by GAO Since 1982

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This appendix summarizes the findings and recommendations from some of the reports and congressional testimonies that we have published since 1982 on issues related to the tax gap. Our summary focuses on our more recent products.

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**Further Research Into Noncompliance Is Needed to Reduce Growing Tax Losses (GAO/GGD-82-34, July 23, 1982)**

IRS estimated that the total tax revenue loss due to individual noncompliance may have been as much as \$97 billion for 1981. We found that IRS' audit program was not having the results intended. IRS had sacrificed substantial tax revenue in the audit and other enforcement programs because of efforts to stimulate voluntary compliance. Also, IRS' management information systems did not provide adequate data to optimally allocate resources within and among its various compliance programs. We recommended that IRS provide cost and revenue data on compliance programs, identify techniques for measuring and analyzing the effects of the compliance programs, determine the overall effectiveness of its current approach, reallocate compliance program resources using cost/revenue data, and plan and budget each compliance program to maximize revenue.

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**IRS Needs to Improve Its Examination Selection Process for Exempt Organizations Having Unrelated Business Income (GAO/GGD-85-64, July 8, 1985)**

We found that IRS could have better identified and examined unrelated business income (UBI) returns having the most potential for noncompliance. More revenue with fewer examinations could have resulted. We found that IRS lacked information to fully understand the nature and magnitude of UBI tax noncompliance. We recommended that IRS take the necessary action to further analyze existing data on UBI tax examinations and that information on all types of UBI organizations and specific UBI activities be developed, collected, and analyzed.

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**IRS Needs to Improve Its Reporting Procedures for Commodity Credit Loan and Crop Insurance Income (GAO/GGD-86-69, July 22, 1986)**

We found that an estimated \$53 million in crop loans and insurance indemnity payments were not reported by the recipients on their 1982 and/or 1983 tax returns. We recommended that IRS incorporate commodity credit loan and crop insurance income into its document matching program.

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**Appendix II**  
**Summary of Selected Tax Gap-Related**  
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**IRS Needs an Overall  
Strategy for Addressing Tip  
Income Reporting  
(GAO/GGD-86-119, Sept.  
30, 1986)**

IRS estimated that the highest nonreporting rate among all legal income areas was \$8.5 billion in unreported tip income, with an estimated revenue loss of \$2.3 billion. We recommended that IRS identify and evaluate detection techniques and tools that have proven effective in tip income reporting projects and design and implement an overview and evaluation process to monitor the progress of tip reporting enforcement activities.

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**IRS Should Establish a  
Business Information  
Returns Program  
(GAO/T-GGD-87-4, Mar. 17,  
1987)**

We found that a document matching program could identify businesses that underreport their income and/or fail to file tax returns. We recommended that IRS establish an information returns program within existing IRS systems to identify businesses that underreport income and/or do not file tax returns.

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**The Tax Gap—Definition,  
Studies, Assumptions, and  
Components  
(GAO/GGD-88-66BR,  
Mar. 25, 1988;  
GAO/T-GGD-88-22, Mar. 31,  
1988)**

Our overall analysis of IRS' 1988 tax gap study showed that IRS excluded tax estimates for illegal source income and remittance problems, changed the method for computing taxes on unreported income, and assumed that compliance rates would remain constant. We showed a higher gap for 1987 than for 1973, a decreased tax gap from 1986 to 1987, and an increased tax gap from 1987 through 1992. While the tax gap is difficult to measure precisely, IRS' estimates showed that it remained substantial. We pointed out that in some of our prior reports we found that IRS could help reduce the tax gap by implementing a business document matching program, more actively pursuing tax collection from closed criminal investigations, and using better tip income detection methods.

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**Opportunities Exist for  
Improving IRS'  
Administration of Alien  
Taxpayer Programs  
(GAO/GGD-88-54, Apr. 11,  
1988)**

Certain aliens are statutorily required to obtain compliance certificates before leaving the country to document that they have met their U.S. tax responsibilities. We found that IRS did not have aggregate information on the number of certificates issued or amount of tax collected. We recommended that IRS collect information on the number of certificates issued, the amount of tax collected, the number of leads obtained from the Immigration and Naturalization Service and results obtained, and the cost of administering alien compliance efforts. In addition, we recommended that IRS arrange to have embassies distribute information on the potential tax obligations of aliens, designate district office personnel to be responsible for coordinating nonresident alien compliance efforts, and revise the letter used to contact agents responsible for withholding taxes from foreign entertainers to bring it into conformity with current IRS forms and information.

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**Investigating Illegal  
Income: Success  
Uncertain, Improvements  
Needed (GAO/GGD-88-61,  
Apr. 25, 1988)**

For tax year 1981, IRS estimated that drug trafficking, gambling, and prostitution accounted for \$34 billion in unreported income and \$9 billion in unpaid taxes. IRS' Criminal Investigation Division did not have information on key objectives, such as investigating major criminals and pursuing tax revenues from completed cases. We recommended that IRS collect data on cases referred for tax assessment or collection and tax revenues generated, require special agents to consult with attorneys at the close of grand jury cases to determine where information may be forwarded for civil action, and establish district office programs to monitor the civil actions taken by various IRS components on closed criminal cases.

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**IRS Could Reduce the  
Number of Unproductive  
Business Nonfiler  
Investigations  
(GAO/GGD-88-77, May 24,  
1988)**

About 73 percent of the business nonfiler investigations in 1986 were unproductive because IRS had issued more than one EIN, businesses did not file required employment returns, and IRS did not update its records on business filing requirements. We recommended that IRS adopt additional research techniques to identify businesses with previously issued EINS, emphasize to businesses the importance of filing quarterly employment tax returns, modify criteria for deleting invalid employment tax filing requirements, and ensure that the filing status determined from nonfiler investigations is accurately recorded on the Business Master File.

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**IRS' Efforts to Establish a  
Business Information  
Returns Program  
(GAO/GGD-88-102, July 22,  
1988)**

We found that a program that would match information returns for income such as interest and dividend to tax returns filed by sole proprietors, partnerships, and corporations was feasible. We recommended that IRS proceed as rapidly as possible with its efforts to develop a business document matching program.

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**Information on IRS'  
Combined Annual Wage  
Reporting Reconciliation  
Program (GAO/GGD-89-21,  
Dec. 14, 1988)**

The purpose of the Combined Annual Wage Reporting Reconciliation Program is to ensure that employers submit correct wage and tax information to both IRS and the Social Security Administration. IRS identified 791,000 discrepancies with potential tax implications between 1981 and 1986, of which 54 percent were resolved. From 1981 to 1984, IRS assessed employers additional taxes, interest, and penalties of \$2.7 billion. However, IRS abated almost \$1.4 billion of those assessments and collected almost \$500 million, leaving an uncollected amount of \$800 million at the time of this report. We made no recommendations.

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**Periodic Evaluation  
Needed If IRS Uses Levies  
to Collect Deferred  
Accounts (GAO/GGD-89-34,  
Feb. 14, 1989)**

We found that in 1988, IRS developed a plan for taking a more active approach to resolving deferred individual taxpayer accounts that would involve annually levying taxpayer assets. We also found insufficient information for evaluating the cost-effectiveness of the plan, which had not considered business deferred accounts. We recommended that IRS establish procedures for periodically evaluating the program's effectiveness if IRS implements a levy program for deferred accounts.

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**Improving IRS' Business  
Nonfiler Program  
(GAO/GGD-89-39, Mar. 8,  
1989)**

We found that state employment tax information could be used to identify erroneous taxpayer statements and to close investigations involving businesses that owed no taxes. We recommended that IRS explore opportunities to use state employment tax information in business nonfiler investigations and correct computer coding problems so that employment tax publications are not sent to invalid addressees. IRS implemented these recommendations.

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**State and Local  
Compliance With IRS'  
Information Reporting  
Requirements  
(GAO/GGD-89-63, May 4,  
1989)**

We found that state and local governments were not complying with IRS' requirements for filing information returns to report payments made to independent contractors. They often were not in compliance because they did not understand IRS' requirements. We recommended that IRS establish an IRS focal point to assist state and local governments and develop a program for monitoring and enforcing state and local governments' information returns compliance. IRS implemented these recommendations.

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**IRS Can Improve the  
Process for Collecting  
100-Percent Penalties  
(GAO/GGD-89-94, Aug. 21,  
1989)**

We found that IRS can assess 100-percent penalties more efficiently and effectively. We recommended that IRS improve the processing of 100-percent penalty cases and improve internal controls.

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**Options for Civil Penalty  
Reform (GAO/GGD-89-81,  
Sept. 6, 1989)**

We provided information on various civil tax penalties and analyzed proposals to respond to concerns about those penalties. We recommended that Congress establish a time-sensitive failure to file penalty for all delinquent taxpayers. We also recommended that Congress should (1) ensure that any legislation enacted should maintain and enhance the value of penalties in deterring noncompliance, (2) consider setting higher penalty rates, and (3) increase return preparer penalties.

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**Missing Independent  
Contractors' Information  
Returns Not Always  
Detected**  
(GAO/GGD-89-110, Sept. 8,  
1989)

We found that IRS audits of business tax returns did not effectively identify businesses that failed to file information returns for payments made to independent contractors. In the closed audits, revenue agents did not identify 1,261 information returns that 467 businesses should have filed, involving \$6.2 million in payments. IRS procedures for doing compliance checks were vague, and data that could help check compliance were not used.

We recommended that IRS improve compliance checks of information reporting by (1) requiring that field managers and quality reviewers stress the importance of compliance checks, enforce workpaper standards, and assess the effectiveness of the checks; (2) establishing minimum requirements for agents in doing compliance checks; and (3) requiring that businesses' information return filings be made available to agents. IRS agreed to stress the importance of the checks as well as provide more information to the revenue agents.

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**Information Returns Can  
Be Used to Identify  
Employers Who  
Misclassify Workers**  
(GAO/GGD-89-107, Sept.  
25, 1989)

We found that IRS needs a system for identifying employers who misclassify employees as independent contractors. We recommended that IRS identify employers who are misclassifying employees as independent contractors. To target audit resources better, IRS should match independent contractors' information returns with their tax returns. We also suggested that Congress may want to consider repealing the restriction against requiring employers to prospectively reclassify employees who have been misclassified as independent contractors. IRS adopted our recommendation.

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**IRS Can Use Tax Gap Data  
to Improve Its Programs  
for Reducing  
Noncompliance**  
(GAO/GGD-90-53BR, Apr. 4,  
1990; and  
GAO/T-GGD-90-32, Apr. 19,  
1990)

IRS estimated the gross tax gap to be \$85 billion in 1987 and projected that it would reach \$114 billion by 1992. Sole proprietors, informal suppliers, small corporations, and large corporations accounted for over half of IRS' estimate. We found that sole proprietors underpaid 23 percent of their tax liability, income from informal suppliers was not documented, and noncompliance by small corporations was equally divided between underreported income and overstated deductions. Noncompliance among large corporations involved improper accounting of reported income and deductions.

We also found that IRS did not design its major enforcement programs to specifically reduce the tax gap. As a result, such programs had limited impact in reducing the tax gap. Further, IRS examined only 1 percent of

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individual returns and 2 percent of corporate returns, could not match all information returns, and lacked resources to investigate all underreporting identified by matching. We cited several ideas for improving enforcement: Use information returns to identify employers who misclassify workers as independent contractors, develop a business document matching program, get help from state and local authorities to verify that federal tax returns have been filed by informal suppliers, and expand the use of information reporting and withholding.

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**Erroneous Penalties for Failure to File Returns or Pay Taxes Can Be Reduced (GAO/GGD-90-80, Apr. 13, 1990)**

We found that statistics on assessment and abatement decisions relating to civil tax penalties for failing to file a timely tax return and failing to pay taxes due overstated the number and dollar value of actual abatements. We recommended that IRS tax examiners document their penalty abatement cases, isolate and delete changes that are merely computer adjustments, and clarify the requirements for coding tax returns.

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**Status of IRS' Test of a Business Information Returns Program (GAO/GGD-90-38, May 29, 1990)**

IRS developed an action plan to test the feasibility of developing a business document matching program similar to its program for individual taxpayers. At the conclusion of IRS' test, we found a slight variance in the "success rate" for identifying delinquent returns. As a result, IRS agreed to explore how to use information returns to supplement its current program to identify business nonfilers.

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**Correcting Taxpayer Identification Is Possible Without Disclosing Tax Data (GAO-GGD-90-90, June 5, 1990)**

As part of IRS' Information Returns Program, banks and other financial institutions file information returns reporting interest and dividend income paid to individuals. IRS was unable to match over \$10 billion of interest and dividend information returns for calendar year 1988 because the name and/or identification number did not match information in either Social Security or IRS files. We recommended that IRS encourage financial institutions to obtain information about name changes not reported to Social Security.

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**IRS Needs More Reliable Information on Enforcement Revenues (GAO/GGD-90-85, June 20, 1990)**

We found that IRS did not know how much revenue its enforcement programs actually generated. The Enforcement Resource Allocation Model was not being used as intended. We recommended that Congress monitor IRS' progress in improving its enforcement revenue data. We also recommended that IRS provide Congress with information on actual

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revenues generated by its enforcement programs and explore ways to link revenue data with proposed staffing increases.

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**Management Mistakes  
Caused Delays in  
Automated Underreporter  
System (GAO/IMTEC-90-51,  
July 10, 1990)**

IRS' Automated Underreporter System was intended to help IRS process cases in which taxpayers underreported their income. We found that IRS officials' haste to complete the system led them to use incomplete system designs and shortcut important system development steps. These problems, compounded by a lack of technical expertise, delayed the implementation of the system. To compensate for delays, IRS developed an interim system to track the locations of underreporters and planned to deploy the system to all service centers by the end of 1990. We recommended that IRS might want to use the interim system as the starting point for completing the full system. In addition, IRS needed to verify staffing needs, establish realistic milestones, and assign experienced technical staff to key positions.

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**Information on IRS'  
Accounts Receivable  
Inventory  
(GAO/T-GGD-90-19, Feb.  
20, 1990;  
GAO/GGD-90-111FS,  
July 30, 1990; and  
GAO/T-GGD-90-60, Aug. 1,  
1990)**

IRS' accounts receivable grew three times faster than collections of delinquent taxes and twice as fast as total net tax receipts. We found that IRS lacked internal controls and information systems to determine how much of the inventory could be collected. We discussed the need for IRS to focus on existing accounts, possibly increase collection staffing levels, and improve human resources.

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**IRS Preparer Penalty Data  
Inaccurate and Misleading  
(GAO/GGD-90-92, Aug. 15,  
1990)**

We found that statistics on return preparer penalties did not accurately reflect preparer noncompliance with the tax laws. The data understated the number of penalties, did not distinguish among penalties assessed for different types of noncompliance, and contained erroneous data. We recommended that IRS ensure that its statistics more accurately reflect preparer penalty activity.

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**IRS' Improved Estimates of  
Tax Examination Yield  
Need to Be Refined  
(GAO/GGD-90-119, Sept. 5,  
1990)**

We found problems with the methodology that IRS used to estimate the additional revenues generated from increasing examination staff. We recommended that IRS develop empirical data to show whether hiring new staff allows more experienced staff to work on high-yield cases.

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<b>IRS' Accounts Receivable Inventory (GAO/GGD-91-2, Oct. 18, 1990; and GAO/GGD-91-45, Apr. 16, 1991)</b>	We found that taxpayer or IRS errors accounted for a high number of erroneous receivables from federal agencies in its accounts receivable inventory. Erroneous receivables could be reduced through improvements to the tax deposit system and IRS' accounting and information processing systems. We recommended that Treasury undertake a governmentwide program to improve federal agency tax processing and develop methods to improve accountability among top agency management.
<b>Extent and Causes of Erroneous Levies (GAO/GGD-91-9, Dec. 21, 1990)</b>	We found that IRS had initiated more than 16,000 erroneous levies and erroneously levied the assets of businesses to a much greater extent than those of individuals. We recommended that IRS establish a nationwide levy verification program.
<b>Effectiveness of IRS' Return Preparer Penalty Program Is Questionable (GAO/GGD-91-12, Jan. 7, 1991)</b>	We found that IRS examiners were reluctant to pursue return preparer penalties because of the low dollar value of the penalties, and cases were often not opened when potential preparer misconduct was evident on returns. We recommended that IRS be more diligent in opening preparer penalty cases, assess them appropriately and consistently, and make referrals when required.
<b>IRS' Compliance Programs to Reduce the Tax Gap (GAO/T-GGD-91-11, Mar. 13, 1991)</b>	IRS estimated the gross tax gap to be \$85 billion for 1987 and projected that it would reach \$114 billion by 1992. IRS' estimates showed that nonfilers and underreporters accounted for \$7 billion and \$48 billion, respectively, of the 1987 tax gap. We found that IRS could use information returns better to pursue people who do not file a tax return or who underreport income. IRS could also improve its computer matching of information returns with tax returns to reduce unproductive underreporter cases.
<b>IRS Does Not Investigate Most High-Income Nonfilers (GAO/GGD-91-36, Mar. 13, 1991)</b>	We found that IRS could investigate high-income nonfilers and could do so more effectively by using the Substitute for Return Program. We recommended that IRS estimate tax yields for high-income nonfilers, modify the Substitute for Return Program to include high-income nonfilers, and develop a system to check delinquent high-income returns. IRS took actions on all of our recommendations.

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**IRS Can Improve Its Program to Find Taxpayers Who Underreport Their Income (GAO/GGD-91-49, Mar. 13, 1991)**

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**IRS' Budget Request for Fiscal Year 1992 (GAO/T-GGD-91-17, March 20, 1991)**

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**Expanded Reporting on Seller-Financed Mortgages Can Spur Tax Compliance (GAO/GGD-91-38, Mar. 29, 1991)**

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**IRS' Efforts to Ensure Corporate Tax Compliance (GAO/T-GGD-91-21, Apr. 17, 1991)**

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**Refund Offset Program Benefits Appear to Exceed Costs (GAO/GGD-91-64, May 14, 1991)**

We found that IRS' underreporter program had been cost-effective but could have been more so. From 1982 to 1988, the percent of nationwide underreporter cases that were unproductive had increased from 54 percent to 66 percent. We recommended that IRS make its computer matching more effective.

The fiscal year 1992 budget request for IRS totaled \$6.73 billion, a net increase of \$622 million over the authorized level for fiscal year 1991. Because of the more stable fiscal condition in 1991, IRS would be able to more fully implement congressionally authorized compliance initiatives. The most significant compliance initiative proposed in the budget request for fiscal year 1992 provided an additional \$34 million for IRS to collect delinquent accounts. Another initiative provided \$5.5 million to increase the number of audits of high-dollar returns.

As much as \$200 million in 1989 federal taxes may not have been reported because of noncompliance in reporting seller-financed mortgage interest income and deductions. We found that third-party information reports might help increase taxpayer compliance with the requirements for reporting interest payments made under seller-financed mortgages. We recommended that Congress enact legislation to require buyers who deduct seller-financed mortgage interest to report the name and Social Security number of the seller, and authorize IRS to penalize buyers and sellers who do not cooperate. Congress enacted this legislation.

The corporate tax gap has grown three times faster than that for individuals. IRS estimated that corporations accounted for \$31 billion of the \$114 billion estimated tax gap for 1992. Long-standing problems have challenged IRS' ability to check voluntary compliance among large corporations through audits.

We found that IRS offset about \$4 billion in taxpayer refunds during 1982 through 1990 for the nonpayment of child and spousal support payments and student loans. We evaluated the effects of the refund offset program on filing behavior of student loan defaulters and compared the program's benefits resulting from increased debt collection with the program's costs of increased noncompliance. The refund offset program had a less adverse effect on tax compliance than suggested by IRS studies. The debt collected

from the offset was at least four times greater than the potential revenue loss. We recommended that IRS carry out its plans for future studies of the refund offset program.

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**IRS Needs to Implement a Corporate Document Matching Program (GAO/T-GGD-91-40, June 10, 1991); and (GAO/GGD-91-118, Sept. 27, 1991)**

In 1987, small corporations reported only 61 percent of the taxes they owed—a 25-percent drop from 1980, when they reported 81 percent. Audit coverage also declined. In 1990, IRS audited about 2.6 percent of all corporations compared with 6.5 percent in 1980. We found that a limited corporate document matching program involving interest, dividends, rents, royalties, and capital gains would generate about \$1 billion in revenue. We said that Congress needs to pass legislation that would require payments to corporations be reported on information returns and to appropriate the necessary funds for IRS to implement the program. Congress has considered but has not enacted this legislation.

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**Collecting Back Taxes: IRS Phone Operations Must Do Better (GAO/IMTEC-91-39, June 18, 1991)**

We found that Automated Collection Sites (ACS) were not working as well as they should have been. Specifically, calls were not placed to taxpayers when they might be at home, and ACS staff spent too much time on things other than working on tax cases. We recommended that at all ACS call sites IRS automate outgoing calls, automate receiving and directing incoming calls, and standardize hours of operation. We also recommended that IRS evaluate the performance of call sites.

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**Management Challenges Facing IRS (GAO/T-GGD-91-20, June 25, 1991)**

We found that IRS' workload has continued to grow each year. It included assisting over 70 million taxpayers, processing over 200 million tax returns and related documents, collecting and accounting for over \$1 trillion in revenues, narrowing a \$100 billion a year tax gap, and dealing with a growing accounts receivable inventory that was pushing \$100 billion. We concluded that a new balance could be struck between traditional compliance activities and more preventative approaches, such as tax law simplification and expanded information reporting, to improve compliance in a more cost-effective manner.

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**Negligence and Substantial Understatement Penalties Poorly Administered (GAO/GGD-91-91, July 3, 1991)**

We found that about one-third of penalties for negligence and substantial understatement contained erroneous penalty determinations because IRS generally was too lenient. We recommended that IRS establish a National Quality Improvement Project to examine problems we identified; determine the effectiveness of solutions through a subsequent review of

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audit cases both with and without penalty assessments; and take actions to ensure that taxpayers are provided with explanations of penalties assessed.

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**Efforts to Prevent, Identify,  
and Collect Employment  
Tax Delinquencies  
(GAO/GGD-91-94, Aug. 26,  
1991)**

Over two-thirds of all federal tax revenue is collected through employment taxes (\$707 billion of the \$1 trillion in federal gross tax receipts). We found that at the end of fiscal year 1990, delinquent employment taxes accounted for about \$29.7 billion, or 31 percent, of the \$96.3 billion accounts receivable balance. We recommended that IRS develop a comprehensive plan to prevent, identify, and collect employment tax delinquencies. We also said that IRS should designate an official to oversee the function.

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**Opportunities to Increase  
Revenue Before Expiration  
of the Statutory Collection  
Period (GAO/GGD-91-89,  
Sept. 30, 1991)**

Annual write-offs of assessed taxes and assessed interest and penalties from IRS' two major master files—individual and business—grew from \$2.3 billion to \$4.6 billion between fiscal years 1986 and 1990. We found a substantial amount of accounts receivable that remained outstanding at the end of each year. We recommended that IRS develop more specific information on accounts written off, systematically collect and analyze review results on accounts classified as uncollectible, and send reminder notices to taxpayers with accounts in the queue awaiting investigation.

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**Earned Income Credit:  
Advance Payment Option  
Is Not Widely Known or  
Understood by the Public  
(GAO/GGD-92-26, Feb. 19,  
1992)**

Congress enacted EITC to assist low-income wage earners, offset the effects of Social Security taxes they paid, and encourage these workers to seek employment. When advance payments were made, they did not appear to impose a major burden on employers. We found that out of an estimated 8,000 individuals who filed returns and received the advance payment, almost half did not report that receipt on their tax returns. We recommended that IRS send a notice to individuals who did not file a return, explaining their requirement to file. We also recommended that IRS explore ways to identify those individuals who claim EITC in advance, but do not report it, to keep them from receiving additional credit amounts.

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**Federal Contractor Tax  
Delinquencies  
(GAO/T-GGD-92-23,  
Mar. 17, 1992)**

IRS records showed that federal contractors owed \$773 million in taxes as of July 1991. Over one-quarter of the 26,000 federal contractors we reviewed were delinquent on IRS' records either for the payment of taxes or the filing of tax returns. IRS had not developed procedures to fully use the information received on federal contracts and had no procedure to ensure all required information was properly reported. We found that IRS

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had not fully used contract payments as a means to collect delinquent taxes.

We recommended that IRS establish a mechanism to ensure that federal agencies report all required information on federal contracts, work with federal agencies to ensure all information is shared, and complete the project that shows IRS staff how to use federal contract information. We also recommended that Congress expressly authorize IRS to use administrative offsets and consider whether tax compliance should be made a prerequisite to the award of federal contracts.

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**Compliance 2000: A Worthy Idea That Needs Effective Implementation (GAO/T-GGD-92-48, June 3, 1992)**

Compliance 2000 is IRS' most recent effort to improve voluntary compliance with the tax laws. However, IRS has not yet developed a structure for planning, managing, and monitoring the program to ensure it remains focused and objective. TCMP has not been integrated with Compliance 2000 to provide objective data on noncompliance and measure IRS' effectiveness, and IRS has not yet determined how Compliance 2000 will affect the already low audit rates. We recommended that IRS develop a structure for planning, managing, and evaluating Compliance 2000; integrate Compliance 2000 efforts with TCMP to ensure statistically based measures of compliance; and ensure that Compliance 2000 efforts do not erode already low audit rates.

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**Money Laundering Forms Could Be Used to Detect Nonfilers (GAO/T-GGD-92-56, June 23, 1992)**

Businesses must file Form 8300 with IRS for any cash payment received that exceeds \$10,000. The forms include the name, address, and tax identification number of the purchaser. We tested a sample of 1,000 forms. Over one-third were of little or no use for identifying nonfilers because they either had no tax identification number or a number that may have been incorrect. IRS did not use the forms to identify potential nonfilers until tax year 1991.

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**Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992); and GAO/T-GGD-92-63, July 23, 1992)**

IRS' Employment Tax Examination Program focuses on small business compliance with the common law rules for classifying workers as either "employees" or "independent contractors" (self-employed individuals who provide services). We found that common law rules for classifying workers remain unclear and subject to conflicting interpretations. IRS estimated that self-employed individuals (including independent contractors) would underpay \$20.3 billion in 1992 taxes by not reporting income. We recommended that Congress clarify the rules for classifying

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workers. We also recommended that Congress should consider legislation to improve independent contractor compliance through withholding and/or improved information reporting. Congress has considered various legislative proposals along these lines but has not enacted any of them.

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**Federal Agencies Should Report Service Payments Made to Corporations (GAO/GGD-92-130, Sept. 22, 1992)**

Federal agencies awarded \$68 billion for service contracts. Because information reporting generally excludes payment to corporations, federal agencies did not have to inform IRS of \$61 billion in payments. We recommended that the Office of Management and Budget (OMB) require that agencies issue information returns on payments to corporations providing services, validate TINs of those contractors before the first payment is made, withhold 20 percent of contract payments to contractors providing invalid TINs, and certify annually that the required information returns on payment have been issued. OMB established a pilot test, in concert with IRS and other federal agencies, to improve federal compliance in issuing information returns and validating TINs.

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**IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992)**

IRS can improve its screening of electronic filing applicants by using a national database that has information on federal, state, and local criminal convictions. We found that IRS has problems detecting questionable returns and stopping fraudulent refunds. We recommended that IRS improve the processes for preventing the filing of fraudulent electronic tax returns and for detecting fraudulent returns during service center processing.

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**Opportunities to Increase the Use of Electronic Filing (GAO/GGD-93-40, Jan. 22, 1993)**

We found that IRS needs to develop a strategy for making electronic filing more appealing and available to a wider population. We also found that IRS needs to address various operational issues that could enhance the appeal of electronic filing and help taxpayers more fully realize its available benefits. We recommended that IRS take steps to increase electronic filing of individual income tax returns by assessing the feasibility of letting taxpayers file through their personal computers. We also recommended that IRS should determine tax forms and schedules that could be added to the list of documents that can be filed electronically.

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**Information Returns Can Improve Reporting of Forgiven Debts  
(GAO/GGD-93-42, Feb. 17, 1993)**

We found that 1 percent of taxpayers voluntarily reported forgiven debts when they had no information returns compared to 48 percent when they had information returns. By matching the information returns, IRS determined that another 20 percent failed to report their forgiven debt income and owed taxes for 1986. We recommended to Congress that it require the Federal Deposit Insurance Corporation and Resolution Trust Corporation to issue information returns on forgiven debts that exceed \$600 and include the date of the compromised or charged-off debt on the return. We also recommended that if Congress enacts related legislation, IRS should use the information returns on forgiven debts in its enforcement programs. Both Congress and IRS acted on our recommendations.

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**Erroneous Dependent and Filing Status Claims  
(GAO/GGD-93-60, Mar. 19, 1993)**

We found that the dependent support test was too complex and burdensome for many taxpayers to voluntarily comply with; about 73 percent of dependent claims failed to meet the dependent support test. We recommended that Congress consider enacting legislation that would substitute a residency test for the support test and consider eliminating the household maintenance test from head of household filing status. We recommended that IRS correct the problems in its limited matching program and implement a 100-percent computer matching program to identify erroneous dependent claims. Neither Congress nor IRS has yet implemented our recommendations.

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**IRS' Plan to Measure Tax Compliance Can Be Improved  
(GAO/GGD-93-52, Apr. 5, 1993)**

IRS was planning to change the scope of TCMP audits, which would have reduced TCMP's value. We found that if IRS did fewer audits and did not examine every tax return line, estimates of voluntary compliance would be less precise. We recommended that IRS not implement the proposed TCMP changes; ensure that any proposed changes to TCMP meet four criteria (measure compliance, allow IRS to select returns for audit, support enforcement programs, and meet the needs of various users); shorten the time needed to produce final TCMP results; and not postpone the next TCMP beyond tax year 1993 returns. IRS agreed to postpone the changes we reviewed and to ensure that any changes to TCMP will meet our four criteria. IRS plans to do the next TCMP for tax year 1994.

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**Improved Staffing of IRS' Collection Function Would Increase Productivity (GAO/GGD-93-97, May 5, 1993)**

IRS has faced a continually growing workload of delinquent taxpayers but has not allocated its Collection field staff to ensure that each field office has the appropriate number of staff. While IRS recognized that some offices have staffing imbalances, it has not identified the full extent of the imbalances and has not been able to rectify those imbalances because of its informal policies. We recommended that IRS develop a plan for ensuring that the Collection staff in field offices is balanced to maximize the assessment and collection of delinquent taxes. We also recommended that IRS reconsider its decision to not transfer Collection staff among field offices.

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**Improvements for More Effective Tax-Exempt Bond Oversight (GAO/GGD-93-104, May 10, 1993)**

We found that IRS has not used tax-exempt bond return information to monitor issuers' compliance and IRS' plan for improving its tax-exempt bond oversight does not provide a clear direction for integrating tax-exempt bond efforts throughout IRS. We recommended that IRS partially redirect existing Expanded Bond Audit Program efforts to include active testing of current market compliance, identify and make better use of information to detect noncompliance, and develop and implement a plan to guide efforts throughout IRS to make more effective use of resources to promote voluntary compliance in the tax-exempt bond industry.

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**New Delinquent Tax Collection Methods for IRS (GAO/GGD-93-67, May 11, 1993)**

We found that IRS and state tax departments currently cooperate in many tax administration projects, but only 10 percent of these projects are directly related to tax collection. We also found that IRS competes with private collection companies and state governments for payments from debtors. We recommended that IRS restructure its collection organization to support earlier telephone contact, develop detailed information on delinquent taxpayers, use the information to customize collection procedures, and identify and implement ways to increase cooperation with state governments in collecting delinquent taxes.

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**IRS Activities to Increase Compliance of Overseas Taxpayers (GAO/GGD-93-93, May 18, 1993)**

We found that IRS still cannot measure the full extent of overseas noncompliance because it has limited information about Americans living overseas. IRS did not collect significant additional federal tax revenues in three overseas enforcement initiatives that we studied.

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**Trends for Certain IRS  
Programs  
(GAO/GGD-93-102FS,  
May 26, 1993)**

We found that (1) resource, workload, and output indicators reflect the level of performance at IRS as opposed to program results or program impact; (2) IRS has started to develop performance measures for increasing voluntary compliance, reducing taxpayer burden, and improving productivity and customer satisfaction; (3) IRS plans to measure how its components contribute to mission accomplishment; (4) IRS has traditionally relied on voluntary compliance and the tax gap to measure its progress; (5) the Enforcement Management Information System is generating various management information reports on revenue generated from each IRS enforcement program, but IRS is not using the data for management decisionmaking; (6) IRS is trying to prevent erroneous receivables from being added to the accounts receivable inventory; (7) IRS needs to develop impact measures for some of its collections activities; (8) IRS has improved its taxpayer assistance activities since the 1991 filing season, but taxpayers are having trouble getting through to IRS over the telephone; and (9) IRS publishes numerous forms, publications, and instructions to help taxpayers understand tax laws and meet their filing requirements. We did not make any recommendations.

**Many Benefits and Few  
Costs to Reporting Net  
Operation Loss Carryover  
(GAO/GGD-93-131, Sept.  
23, 1993)**

We found that IRS instructions on the amounts that corporations should report on the net operating loss deduction line were incomplete and confusing. We also found that three of every four of the nation's corporations that claimed the deduction in 1989 did just the opposite—they reported this deduction even when they had no taxable income or reported more of this deduction than taxable income. We recommended that IRS revise its instructions on reporting the deduction to clarify amounts that can be deducted, clearly define net operating loss carryover, require corporations to annually report their carryovers, and use the reported amounts to track corporate deductions of these losses. IRS has implemented our recommendations.

**Earned Income Tax Credit  
Design and Administration  
Could Be Improved  
(GAO/GGD-93-145, Sept.  
24, 1993)**

We found that EITC appears to be achieving its goals. Those workers who receive the credit and are below the poverty line have their overall federal tax burden substantially reduced, while those qualified workers who are above the poverty line have their taxes reduced somewhat. Also, work incentives for some workers appear to be enhanced by the credit. However, we also found that one-third of the taxpayers who received the credit were not entitled to it. This occurred primarily because tax filers claimed the wrong filing status. We recommended that IRS modify the tax return to capture all the requisite qualifications information, send nonfiler

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notices that explain credit requirements to nonfilers with low earned incomes, and modify returns processing procedure to ensure that all potentially eligible taxpayers who submit similar information are treated consistently.

# Summary of Major Tax Compliance Legislation Enacted Since 1981

This appendix summarizes some major tax law provisions that deal with taxpayer compliance and that were enacted between 1981 and 1993.

## Economic Recovery Act of 1981 (P.L. 97-24)

Information Reporting	A copy of an information return must be furnished to the person who received the payment reported on the return.
Penalties	<p>A new penalty was imposed for underpayment of income tax resulting from overstatement of value of property by an individual, a closely held corporation, or a personal services corporation.</p> <p>A specific civil penalty was created for persons who overstate their tax deposit claims. This penalty equals 25 percent of the overstated deposit claim.</p> <p>The penalty was increased from \$50 to \$500 for any individual who files false information in connection with wage withholding.</p> <p>The negligence penalty was increased by an amount equal to 50 percent of the interest payable on the underpayment caused by the negligence. This new penalty adds to the 5-percent negligence penalty already in effect.</p> <p>The penalty for failure to file most information returns was increased from \$1 per return up to a maximum of \$1,000, to \$10 per return up to a maximum of \$25,000.</p>
Interest	The interest rate for tax deficiencies (and overpayments) was tied more closely to the actual cost of borrowing by setting it annually at the average prime rate for the month of September.
Estimated Taxes	The portion of the current year's tax liability that corporations whose taxable income exceeds \$1 million must pay as estimated tax was increased.

## **Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248)**

### **Information Reporting**

A separate provision was added on the reporting requirements of persons engaged in a trade or business for payments made to any persons for services performed.

The definition of reportable interest was expanded to include interest on all obligations issued to the public. This included obligations issued by state and local governments.

Information reporting imposed on brokers was modified to permit regulatory requirements on reporting gross proceeds from customer transactions, require brokers to furnish statements of the information filed with IRS to customers, and clarify the definition of broker.

An information reporting requirement was imposed on certain direct sellers of consumer goods. This requirement applied to any person who, in the course of trade or business, sells consumer products on a buy-sell basis, deposit-commission basis, or any similar basis to any buyer who sells the products in a home or other nonpermanent retail establishment.

This legislation required information reporting of state and local income tax refunds.

Information reporting requirements for tip income were expanded. Large food or beverage establishments must report aggregate amounts of tips shown on charge receipts and reported tip amounts together with mandatory service charges of less than 10 percent.

This legislation required information reporting by employers and administrators of pension plans that permit designated distributions.

### **Penalties**

The penalty for failure to file an information return was increased from \$10 per failure, not to exceed \$25,000, to \$50 per failure, not to exceed \$50,000.

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The category of information returns subject to the general penalty for failure to file timely was expanded to include returns for transactions carried out by brokers for their customers, returns filed by direct sellers, and returns for withholding.

The penalty for failure to provide information statements to taxpayers was increased from \$10 per statement to \$50 per statement, not to exceed \$50,000 per calendar year.

The penalty for failure to file information returns for certain deferred compensation plans, and certain term, annuity, and bond purchase plans was increased from \$10 to \$25 for each day the failure continues. The maximum penalty increased from \$5,000 to \$15,000.

The penalty for failure to furnish a taxpayer identification number (TIN) was increased from \$5 per failure to \$50 per failure, not to exceed \$50,000 in any calendar year.

A minimum penalty was established for the extended failure to file any income tax return if the tax is underpaid. The penalty will be imposed if the return is not filed within 60 days of the due date (with extensions).

A new penalty was established for promoting abusive tax shelters.

A penalty was established for substantial understatement of income tax. An understatement of income tax is substantial if the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000 (\$10,000 for corporations other than S corporations and personal holding companies).

A new penalty was established for aiding and abetting the understatement of tax liability.

A penalty for frivolous returns was created.

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**Interest**

Daily compounding of interest payable was required.

A rate of interest must be determined semiannually and based on average adjusted prime rate for the 6-month period.

<b>Withholding</b>	<p>Withholding was imposed at the source where the taxpayer fails to provide a TIN or provides an incorrect TIN to a person who must file an information return for the payment to the taxpayer.</p> <p>Withholding was imposed on designated distributions from pensions, annuities, and certain other plans.</p> <p>Withholding was imposed at a rate of 10 percent on payments of dividends, interest, and certain patronage dividends paid to individuals.</p>
<b>Partnerships</b>	The tax treatment of partnerships items must be established at the partnership level in a unified proceeding rather than in separate proceedings with each partner.
<hr/>	
<b>Interest and Dividend Tax Compliance Act of 1983 (P.L. 98-67)</b>	
<b>Backup Withholding</b>	Backup withholding was established on reportable payments, including situations in which IRS notifies the payor that the payee's TIN is incorrect, the payee has been notified by IRS of an underreporting of interest or dividends, or the payee fails to certify to the payor that he/she is not subject to withholding. The amount of withholding increased to 20 percent of payment.
<b>Returns on Magnetic Tape</b>	Payers of interest and dividends who file at least 50 information returns are required to file the returns on magnetic media.
<hr/>	
<b>Deficit Reduction Act of 1984 (P.L. 98-369)</b>	
<b>Information Reporting</b>	Taxpayers who, in the course of their trade or business, receive mortgage interest are required to issue an information return to the payor of the mortgage interest, and a penalty was established for failure to do so.

A taxpayer operating a trade or business who receives more than \$10,000 in cash in one transaction (or two or more related transactions) was required to file an information return reporting the transaction, and a penalty was established for failure to do so.

A taxpayer who acquires an interest in secured property through foreclosure or abandonment was required to report such acquisition, and a penalty was established for failure to do so.

Reporting of certain sales or exchanges of partnership interests was required. A partnership must file an information return reporting an exchange, described in section 751(a), of any interest in the partnership.

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#### Tax Shelters

A statutory definition of tax shelter was created.

A registration requirement for tax shelters was created.

A penalty was created for failure to register a tax shelter or provide a tax shelter identification number.

The penalty that can apply to a tax shelter promoter who makes false or fraudulent statements or gross valuation overstatements was increased.

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#### Tax Reform Act of 1986 (P.L. 99-514)

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#### Information Returns

Gross proceeds from certain real estate transactions must be reported.

Heads of federal executive agencies must report the name, address, and TIN of persons receiving federal contracts.

A new provision was created requiring reporting of royalties to any person aggregating more than \$10 per calendar year.

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#### Penalties

The maximum penalty for failure to file an information return was increased to \$100,000 and consolidated with the penalty for failure to supply a copy of the return to the payee.

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A new penalty was created for providing incorrect information on information returns filed with IRS or provided to a taxpayer.

The penalty for failure to pay tax increased from .5 percent per month, up to a maximum of 25 percent, to 1 percent per month when IRS has notified the taxpayer that IRS will impose a levy upon the taxpayer's assets.

The fraud penalty was modified by increasing the rate but applying it only to the amount of underpayment attributable to the fraud.

The scope of the negligence penalty was expanded to include all taxes.

The penalty for substantial understatement of tax liability increased from 10 percent to 20 percent of the underpayment of tax attributable to the understatement.

The accuracy-related, failure to file, and fraud penalties were coordinated.

The penalty for failure to make timely deposits of tax was modified by establishing a 4-tiered penalty structure.

<b>Interest</b>	A differential rate was created for interest paid by a taxpayer to the Treasury and for interest paid by the Treasury to a taxpayer. The taxpayer pays a higher rate of interest.
<b>Dependent Social Security Number</b>	Taxpayers were required to provide a Social Security number for each dependent claimed who is at least 5 years old.
<b>Tax Exempt Interest</b>	Taxpayers were required to show on their returns the amount of tax-exempt interest received during the year.
<b>Tax Shelters</b>	<p>The definition of tax shelter subject to registration requirements was altered, and the penalty for failure to register was increased.</p> <p>The penalty for failure to register a tax shelter increased from the lesser of \$10,000 or 1 percent of the aggregate amount invested in the tax shelter, to the latter amount. The \$10,000 cap was therefore deleted.</p>

The penalty for failure to report a tax shelter identification number on a tax return was increased from \$50 to \$250.

The maximum penalty for failure by organizers to maintain a list of investors for any calendar year was increased from \$50,000 to \$100,000.

<b>Estimated Tax Payments</b>	<p>The proportion of current year's tax liability a taxpayer must make as estimated tax payments in order to avoid a penalty was increased from 80 percent to 90 percent.</p> <p>Private foundations are required to make quarterly estimated tax payments of the excise tax due on net investment income.</p> <p>Tax-exempt organizations are required to make quarterly estimated tax payments of tax on unrelated business income.</p>
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<b>Collections</b>	<p>The statute of limitations on collection after assessment was extended from 6 years to 10 years.</p>
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**Revenue  
Reconciliation Act of  
1989 (P. L. 101-239)**

<b>Penalties</b>	<p>Uniform penalties for failure to comply with certain information reporting requirements were established. A three-tier penalty structure was established for failure to file an information return on time in which the penalty varies depending on when, if at all, the taxpayer corrects the failure.</p> <p>The accuracy-related penalties were consolidated, and a general 20-percent rate was established for negligence or disregard of the rules, substantial understatement of tax, and over/undervaluation penalties.</p> <p>The penalties for professionals who prepare tax returns were modified to include a penalty of \$250 per return if any part of a return or claim for refund is based on an unreasonable position.</p>
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The penalty for negligent or fraudulent failure to file a return was increased from 5 percent to 15 percent of the net amount of tax due per month. The maximum penalty increased from 25 percent to 75 percent.

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## **Revenue Reconciliation Act of 1990 (P.L. 101-508)**

<b>Dependent Social Security Number</b>	Taxpayers are required to provide a Social Security number for each dependent claimed who is at least 1 year old.
<b>Large Cash Transactions</b>	Cash transactions of more than \$10,000 must be reported to IRS by those operating a trade or business. The definition of "cash" subject to information reporting was expanded to include "cash equivalent monetary instrument" (e.g., checks, travelers' checks, drafts, money orders).  The penalty was increased for intentional disregard by a recipient of the requirement to report receipt of more than \$10,000 in cash or cash equivalent.

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## **Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66)**

<b>Information Reporting</b>	Certain financial entities are required to file information returns with IRS and provide debtors with statements for any discharged indebtedness of \$600 or more. Entities include the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, and the National Credit Union Administration, as well as other federal agencies, banks, and credit unions. A penalty for failure to furnish information returns was established.
<b>Penalties</b>	The standard for the accuracy-related penalty was raised, and the "not frivolous" standard was replaced with the stricter "reasonable basis"

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standard. To avoid the penalty, a taxpayer must have at least a reasonable basis for the position taken on his/her return.

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**Withholding**

The withholding rate on supplemental wage payments (bonuses, commissions, and overtime pay) was increased from 20 to 28 percent.

# Market Segment Specialization Program

This appendix lists the 21 market segments that IRS has developed as of September 30, 1993, as part of its Market Segment Specialization Program. The listing indicates the market segments for which IRS has developed or has under development audit guides.

## Market Segments With Audit Guides Released

Air charters  
Attorneys  
Bed and breakfasts  
Gas retailers  
Mortuaries  
Taxicabs  
Trucking

## Market Segments With Audit Guides Under Development<sup>1</sup>

Auto dealerships  
Construction  
Entertainment  
Fishing  
Garment contractors  
Garment manufacturing  
Health care  
Laundromats  
Oil and gas operators  
Reforestation  
Rehabilitation tax credit  
Restaurants  
Travel agencies  
Wineries

<sup>1</sup>IRS also has 66 research and development projects underway that may result in audit guides in additional market segments.

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