United States Government Accountability Office

Report to the Committee on Finance, U. S. Senate

October 2017

TAX GAP

IRS Needs Specific Goals and Strategies for Improving Compliance

GAO-18-39

GAO Highlights

Highlights of GAO-18-39, a report to the Committee on Finance, U.S. Senate

October 2017

TAX GAP

IRS Needs Specific Goals and Strategies for Improving Compliance

Why GAO Did This Study

The tax gap—the difference between tax amounts that taxpayers should have paid and what they actually paid—has been a persistent problem for decades. The tax gap estimate is an aggregate estimate of the five types of taxes that IRS administers—individual income, corporation income, employment, estate, and excise taxes. For each tax type, IRS attempts to estimate the tax gap based on three types of noncompliance:
(1) underreporting of tax liabilities on timely filed tax returns;
(2) underpayment of taxes due from timely filed returns; and (3) nonfiling, when a taxpayer fails to file a required tax return altogether or on time.

GAO was asked to review IRS's tax gap estimate for tax years 2008 to 2010. This report provides information on (1) the main drivers of the tax gap; (2) IRS's confidence in the tax gap estimates; (3) IRS's goals, if any, for reducing the tax gap; and (4) the extent to which IRS uses tax gap estimates and underlying data to develop strategies to reduce the tax gap. GAO reviewed IRS tax gap data and reports and interviewed IRS officials.

What GAO Recommends

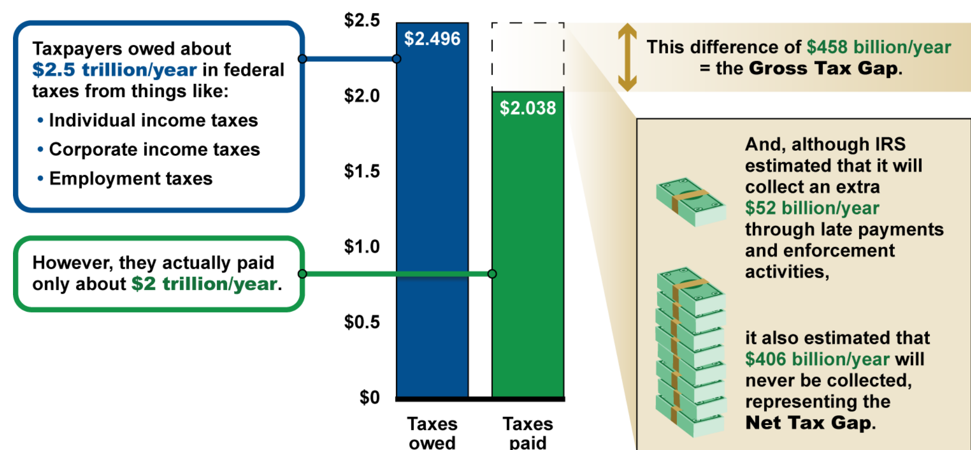
GAO recommends that IRS re-establish goals for improving voluntary compliance and develop and document a strategy that outlines how it will use its data to update compliance strategies to address the tax gap. IRS disagreed with GAO's recommendation on establishing goals and agreed with the recommendation on compliance strategies. GAO continues to believe that goals are essential for results-oriented management.

View GAO-18-39. For more information, contact James R. McTigue, Jr. at (202) 512-9110 or McTiguej@gao.gov.

What GAO Found

The Internal Revenue Service's (IRS) latest tax gap estimate found that taxpayers voluntarily and timely paid about 81.7 percent of the taxes they should have paid for tax years 2008-2010.

IRS's Annual Average Tax Gap Estimate for Tax Years 2008-2010



Source: Internal Revenue Service (IRS). | GAO-18-39

As with past estimates, underreporting of individual income taxes accounted for the largest portion of the 2008-2010 tax gap. IRS believes the tax gap estimates are sufficiently reliable to provide a snapshot of tax compliance as a whole because much of the estimates are based on the most current data available, such as from IRS's National Research Program (NRP).

IRS previously set or acknowledged goals to improve voluntary compliance. However, IRS has since moved away from that approach. IRS officials now believe there are limited benefits to establishing goals because IRS cannot control all aspects of compliance and updated methodologies may cause fluctuations in the estimates. IRS does, however, have an impact on taxpayers' compliance through its service and enforcement programs. Without long-term, quantitative goals for improving voluntary compliance, it will be difficult for IRS to determine the success of its compliance efforts and adjust its approaches.

The Internal Revenue Manual states IRS needs to measure taxpayer compliance and other factors so compliance information and tools can be improved. IRS uses tax gap data to study compliance behaviors and update computer formulas designed to identify tax returns with a high likelihood of noncompliance. Yet IRS has not documented a comprehensive strategy that shows how it intends to use NRP data to update compliance strategies. Officials said the uses of NRP are widely known from general documentation about NRP. Without developing and documenting a strategy for using the NRP data to update compliance strategies, IRS may not fully leverage the compliance data or allocate enforcement resources in the most cost-effective manner, and it may be difficult for Congress and others to understand the merits of what they are being asked to fund.

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Abbreviations

CPS	Current Population Survey
DCE	detection controlled estimation
DIF	Discriminate Function
EITC	Earned Income Tax Credit
FICA	Federal Insurance Contribution Act
FUTA	Federal Unemployment Tax Act
GPRAMA	GPRA Modernization Act of 2010
IRS	Internal Revenue Service
NMP	net misreporting percentage
NRP	National Research Program
RAAS	Office of Research, Applied Analytics, and Statistics
Treasury	Department of the Treasury
VCR	voluntary compliance rate

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U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
Washington, DC 20548

October 31, 2017

The Honorable Orrin G. Hatch
Chairman
The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate

Every year, taxpayers fail to pay hundreds of billions of dollars in taxes. This tax gap—the difference between tax amounts that taxpayers should pay and what they actually pay voluntarily and on time—has been a persistent problem for decades. In 2016, the Internal Revenue Service (IRS) estimated that taxpayers voluntarily and timely paid about 81.7 percent of the taxes they should have for tax years 2008 to 2010. The average annual gross tax gap was $458 billion for those years. IRS estimated that through late payments and enforcement actions it will collect an additional $52 billion annually for tax years 2008 to 2010. The average net tax gap of $406 billion for those years results in 83.7 percent of taxes that should have been paid ultimately being paid.

You asked us to review IRS's latest tax gap estimate for tax years 2008 to 2010. This report provides information on (1) the main drivers of the tax gap; (2) IRS's confidence in the tax gap estimates; (3) IRS's goals for reducing the tax gap; and (4) the extent to which IRS uses tax gap estimates and underlying data to develop strategies and actions to reduce the tax gap.

To address these objectives, we reviewed IRS's tax gap estimates; IRS documents on estimating compliance, estimating the tax gap, and ensuring taxpayer compliance; and past GAO and Treasury Inspector General for Tax Administration reports on the 2001 and 2006 tax gap estimates. We also interviewed IRS officials responsible for estimating the tax gap and those responsible for establishing goals and developing strategies for improving voluntary compliance. We also examined data from IRS's National Research Program (NRP) study of individual tax returns from 2008 to 2010, which IRS based part of its individual underreporting tax gap estimates, to show additional detail on aspects of compliance.

We determined that IRS's tax gap and associated compliance rate estimates were sufficiently reliable for the purposes of our reporting

objectives based on reliability tests we conducted. See appendix I for more information on scope and methodology.

We conducted this performance audit from July 2016 through October 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

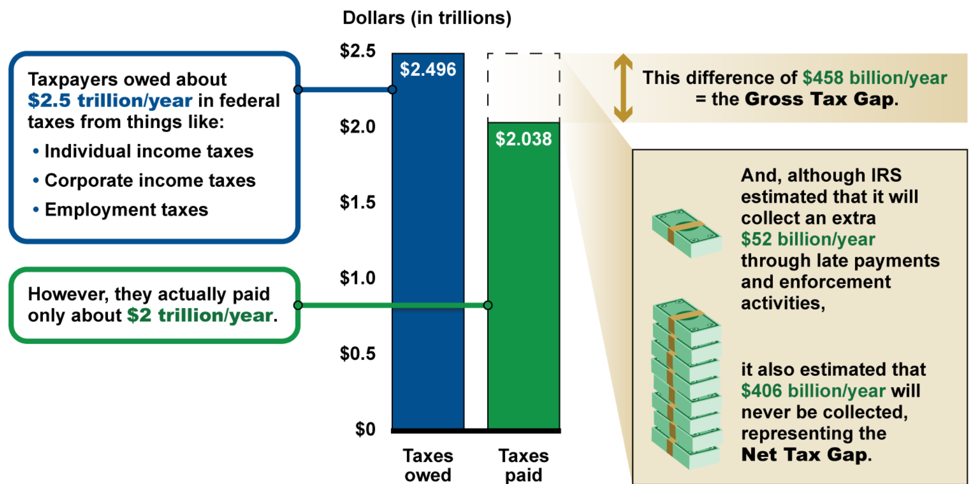
We have consistently stressed the importance of IRS conducting tax compliance research.[1] Likewise, analyzing compliance data can help IRS identify ways to enhance taxpayer compliance. Without such data, it is more difficult for IRS to decide whether its efforts to address specific areas of noncompliance should focus on non-enforcement activities, such as improved forms or publications, or enforcement activities. Analyzing the data can also help identify changes that could be made to tax laws and regulations that may improve compliance.

In April 2016, IRS released its most recent tax gap estimate. IRS estimated that taxpayers should have paid an average of about $2.5 trillion dollars per year in federal taxes for tax years 2008 to 2010. IRS also estimated that taxpayers paid approximately $2.04 trillion voluntarily and on time for those years, on average, leaving $458 billion in unpaid taxes per year.[2] However, IRS estimates that through late payments and enforcement actions it eventually will collect an additional $52 billion on average for those years, leaving the average net tax gap at $406 billion for 2008 to 2010, as shown in figure 1.

[1]GAO, *High-Risk Series: An Update*, GAO-15-290 (Washington, D.C.: Feb. 11, 2015).

[2]In its financial statements, IRS reported that taxpayers paid an average of $2.5 trillion per year for 2008–2010. However, this figure represents gross collections, which includes amounts to be refunded to taxpayers, as well as penalties, interest, and enforcement revenue, which are not paid voluntarily. Additionally, the financial statement amounts are calculated on a fiscal year basis, while the tax gap is calculated on a tax year basis.

Figure 1: IRS's Annual Average Tax Gap Estimate for Tax Years 2008–2010



Source: Internal Revenue Service (IRS). | GAO-18-39

The tax gap estimate is an aggregate estimate of the five types of taxes that IRS administers—individual income, corporation income, employment, estate, and excise taxes.[3] For each tax type, IRS attempts to estimate the tax gap based on three types of noncompliance: (1) underreporting of tax liabilities on timely filed tax returns; (2) underpayment of taxes due from timely filed returns; and (3) nonfiling, when a taxpayer fails to file a required tax return altogether or on time.[4]

IRS has not developed specific estimates for the tax gap related to income earned from illegal activities (e.g., prostitution) or certain forms of fraud. However, if IRS discovers these types of income over the course of an audit, it could be included in the tax gap estimates. In general, refund fraud related to identity theft would not be included in the tax gap estimate because it does not involve evading a tax liability. The tax gap includes unintentional errors as well as intentional evasion, such as intentionally underreporting income, intentionally overreporting expenses, and engaging in abusive tax shelters or frivolous tax schemes.

[3]Employment taxes include both employer-withheld employment taxes and self-employment taxes.

[4]By definition, legal tax avoidance (i.e., legally lowering tax liability) is not included in the tax gap.

There is no single approach to estimating all of the components of the tax gap. IRS uses NRP examinations of a stratified, random sample of tax returns along with statistical modeling to produce estimates of noncompliance for the population of individual income tax return filers. Other areas of the tax gap are estimated using payment data or other statistical models. Each approach IRS uses is subject to non-sampling error and the areas of the estimate that are samples are subject to additional sampling errors.[5] The uncertainty of the estimates is not readily captured by standard errors that typically accompany estimates based on sample data. For that reason, IRS does not report standard errors, confidence intervals, and statistical comparisons across years.

Prior to the 2008–2010 estimate, IRS had released two other tax gap estimates that used data from NRP examinations: (1) a tax year 2001 tax gap estimate that was released in February 2007 and (2) a tax year 2006 tax gap estimate that was released in December 2011.[6] As shown in figure 2, the gross tax gap estimate has increased, in nominal terms, from $345 billion for 2001 to $458 billion, on average, for 2008–2010, an increase of $113 billion or about 33 percent. However, when we adjusted for inflation (using fiscal year 2016 dollars), the gross tax gap estimates amount to $460 billion in 2001, $530 billion in 2006, and $509 billion in 2008–2010. The inflation-adjusted gross tax gap increased by about 11 percent from 2001 to 2008–2010; however, the 2008–2010 estimate is slightly lower, by about 4 percent, than the 2006 estimate.

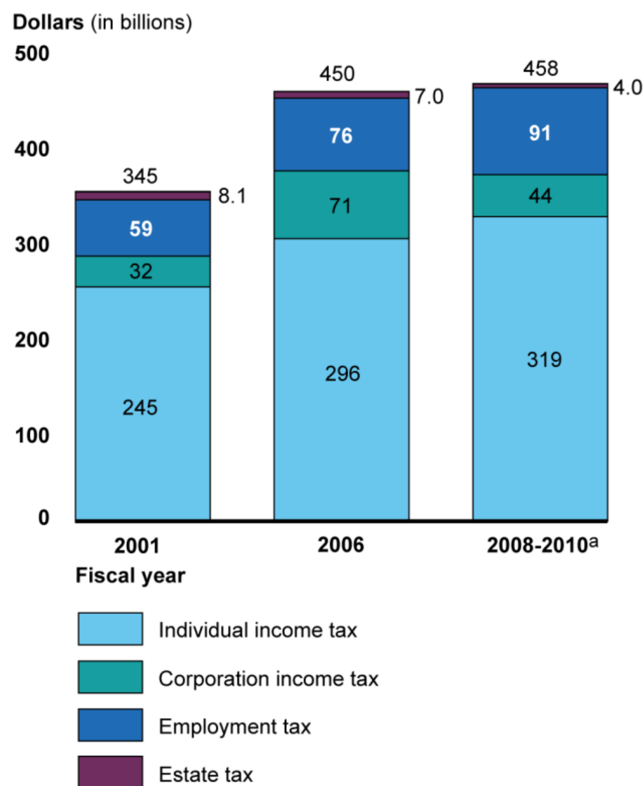
Over the three estimates, the voluntary compliance rate (VCR)—the percentage of owed tax for a given year that is paid voluntarily and timely—has decreased slightly from 83.1 percent for 2006 to 81.7, on average, for 2008–2010. IRS also estimated the VCR and distribution of tax liability for each component of the tax gap. Generally, employment taxes have the highest estimated compliance rates while individual income and estate taxes have the lowest estimated compliance rates. There was a decrease in the VCR for individual income tax from 79

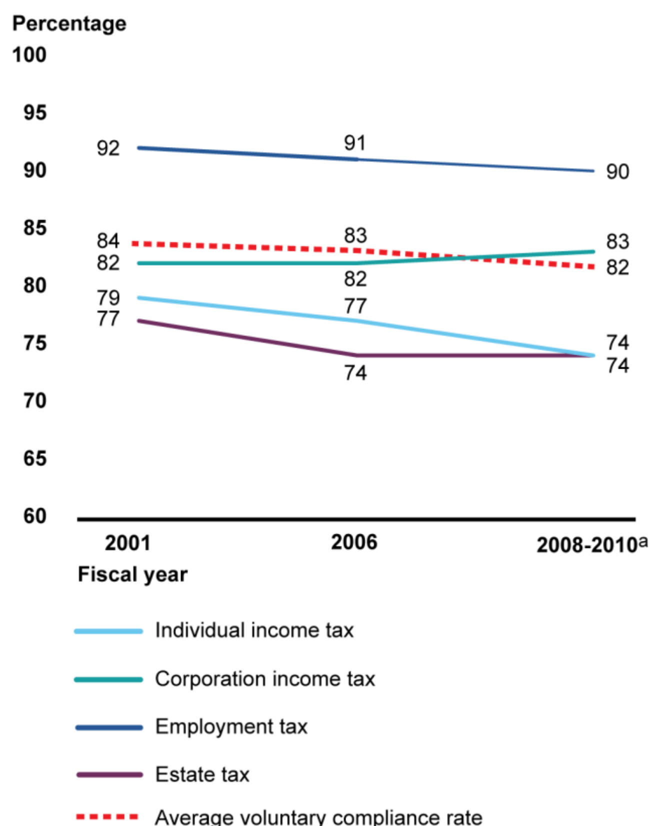
[5]Sampling errors arise due to the selection of a probability sample rather than examining the entire population of tax returns. Non-sampling errors arise from other sources such as those due to data collection and processing procedures.

[6]IRS's earlier tax gap estimates relied on the Taxpayer Compliance Measurement Program, through which IRS periodically examined statistically representative samples of tax returns. The last of these studies was conducted for tax year 1988. IRS's NRP individual income tax study for tax year 2001 resumed IRS's program of examining statistically representative samples of tax returns.

percent for tax year 2001 to 74 percent in the recent 2008–2010 estimate. According to IRS, this decline, along with the individual income tax's increase in the share of liability, contributes to the slight decline in the overall VCR.

Figure 2: Tax Gap Comparison, Tax Year 2001 to Tax Years 2008–2010





Source: GAO analysis of Internal Revenue Service (IRS) data. | GAO-18-39

Note: This graphic does not include excise taxes, which accounted for less than 0.2 percent of each gross tax gap estimate. When the gross tax gap figures are inflated to fiscal year 2016 dollars, the figures are $460 billion in 2001, $530 billion in 2006, and $509 billion in 2008–2010.

[a]The 2008–2010 tax gap estimate is an average of all 3 years.

The amount of the tax gap that IRS estimated it would collect through enforcement efforts and late payments varied across the three estimates. In 2001, IRS estimated it would collect $55 billion and that figure would increase by $10 billion, to $65 billion in 2006. However, for the 2008–2010 tax gap estimate, the enforced collections or late payments decreased by $13 billion per year, on average, from the 2006 estimate, to $52 billion. According to IRS, the methodology used to calculate prior estimates may have been too optimistic, resulting in an overstatement of as much as 25 percent. Additionally, IRS stated that the economic downturn in 2008 reduced the total tax liability from which IRS could collect revenue over this period.

However, differences in the tax gap estimates across years may not all be attributed to changes in taxpayer behavior (voluntary compliance) or IRS enforcement activities. According to IRS, the tax gap estimates have increased in part because IRS included some new tax gap components and updated some methods, which it believes increased the comprehensiveness and accuracy of the estimates. IRS reported that changes in economic activity and changes in tax law and administration also contribute to differences in tax gap estimates over time.

Enforcement of Tax Laws and GAO's High-Risk List

In our 2017 High-Risk Report we continued to include Enforcement of Tax Laws as a high-risk area.[7] Key components of this high-risk area include both addressing the tax gap and improving tax compliance. IRS enforcement of the tax laws helps fund the U.S. government by collecting revenue from noncompliant taxpayers and, perhaps more importantly, promoting voluntary compliance by giving taxpayers confidence that others are paying their fair share. However, IRS still faces challenges to its capacity for implementing new initiatives and carrying out ongoing

[7]Every 2 years, we report on agencies and program areas that are high risk due to their vulnerabilities to fraud, waste, abuse, and mismanagement or are most in need of transformation. Enforcement of tax laws was designated as a high-risk area in 1990, the first year we published a High-Risk List. See GAO, *High-Risk Series: Progress on Many High-Risk Areas, While Substantial Efforts Needed on Others*, GAO-17-317 (Washington, D.C.: Feb. 15, 2017).

enforcement and taxpayer service programs under an uncertain budgetary environment.[8]

Given the estimated size of the tax gap, even modest reductions would yield significant financial benefits for the country. We have made numerous recommendations over time to help IRS, the Department of the Treasury (Treasury), and Congress address tax noncompliance.[9] Nonetheless, as we have reported in the past, closing the entire gap is not feasible since it could entail more burdensome record keeping or reporting than the public is willing to accept or more resources than IRS is able to commit.[10] For example, third-party information reporting has shown to improve accuracy of income reporting by individual taxpayers; however, it requires increased record keeping and reporting by the third party and requires IRS resources to properly match the third-party information to individual tax returns.

Underreporting by Individual Taxpayers Accounts for the Largest Portion of the Tax Gap

Underreporting of tax liabilities accounted for most of the tax gap estimate for tax years 2008–2010, making up 84 percent of the entire estimated gross tax gap, as shown in figure 3. Individual income taxes made up the largest portion of underreporting, followed by employment taxes and corporation income taxes.[11]

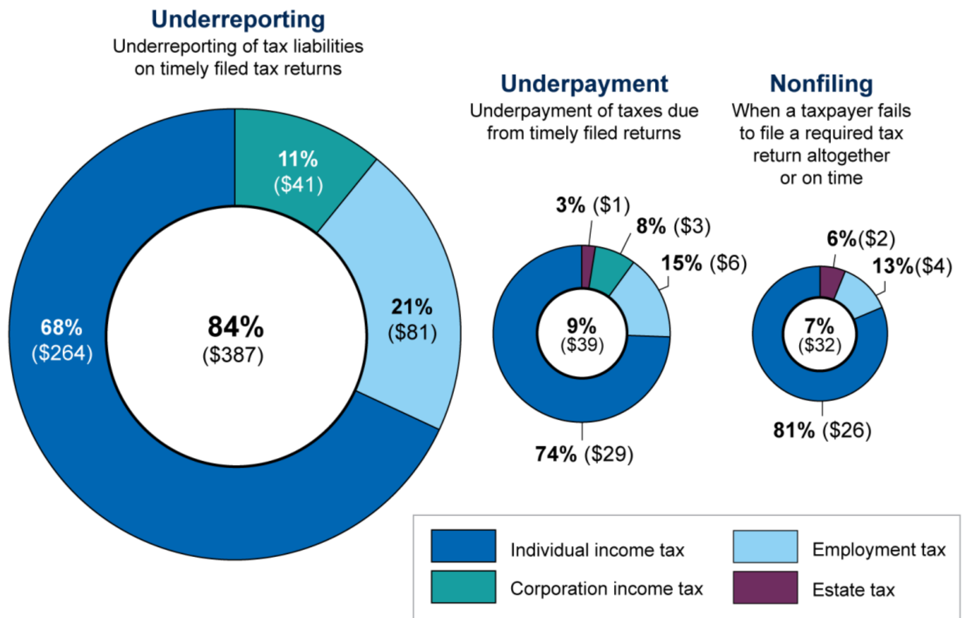
[8]In March 2016, we reported that IRS's appropriations remained about 7 percent below fiscal year 2011 levels. See GAO, Internal Revenue Service: Preliminary Observations on the Fiscal Year 2017 Budget Request and 2016 Filing Season Performance, GAO-16-459R (Washington, D.C.: Mar. 8, 2016).

[9]GAO-17-317.

[10]GAO, *Fiscal Outlook: Addressing Improper Payments and the Tax Gap Would Improve the Government's Fiscal Position,* GAO-16-92T (Washington, D.C.: Oct. 1, 2015).

[11]As we discuss later, IRS adjusts the individual income tax estimates for income undetected during examinations, but does not make this same adjustment for the corporation income or employment taxes.

Figure 3: Estimated Average Annual Gross Tax Gap by Type of Noncompliance and Tax, Tax Years 2008–2010



Source: GAO analysis of Internal Revenue Service (IRS) information. | GAO-18-39

Note: Data may sum to totals because of rounding. Individual income tax includes individual business income tax. Estate tax underreporting noncompliance is not shown in this graphic because it represents less than one-half percent of total underreporting noncompliance. Excise tax is not shown in this graphic because IRS does not have excise tax underreporting noncompliance or nonfiling noncompliance estimates, and its estimate for excise tax underpayment noncompliance represents less than one-half percent of total underpayment noncompliance. In addition, IRS does not have a corporation income tax estimate for nonfiling noncompliance.

Individual Income Tax Underreporting

Underreporting of business income accounted for nearly half of the individual income tax underreporting gap. This includes income from sole proprietors,[12] which accounted for the largest share of individual income tax underreporting, as shown in table 1. Most business related income tax return items also had high net misreporting percentages, which is the sum of the net misreported amount divided by the sum of the absolute values

[12]Sole proprietors are self-employed individuals who should file a Schedule C with their individual tax return to report profits and losses from their business. Sole proprietors include those who provide services, such as doctors or accountants; produce goods, such as manufacturers; and sell goods at fixed locations, such as car dealers and grocers.

of the amounts that should have been reported, as a percentage. To show additional detail on aspects of the tax gap, we conducted some additional analysis on selected line items of the individual NRP data, which is presented in appendix II.

Table 1: Estimated Average Annual Individual Income Underreporting Tax Gap by Tax Return Item or Category, Tax Years 2008–2010

Tax return items or category	Tax gap estimate (dollars in billions)
Business income	125
Sole proprietor income	78
Income from partnerships, S corporations, estates/trusts	22
Rents and royalties	20
Farming income/loss	5
Non-business income	64
Other income[a]	29
Capital gains	11
Taxable Social Security benefits	7
Pensions and annuities	5
Wages	5
Business sale/Form 4797 income	4
Dividends	1
Interest	1
State income tax refunds	1
Unemployment compensation	1
Credits	40
Earned income tax credit	27
Child tax credit	7
Education credits	4
Other credits	2
Deductions	18
Unallocated marginal effects[b]	12
Exemptions	6
Filing status	5
Other taxes	1
Adjustments[c]	-5
Total individual income underreporting	**264**

Source: Internal Revenue Service data. | GAO-18-39

Note: Data may not sum to total because of rounding.

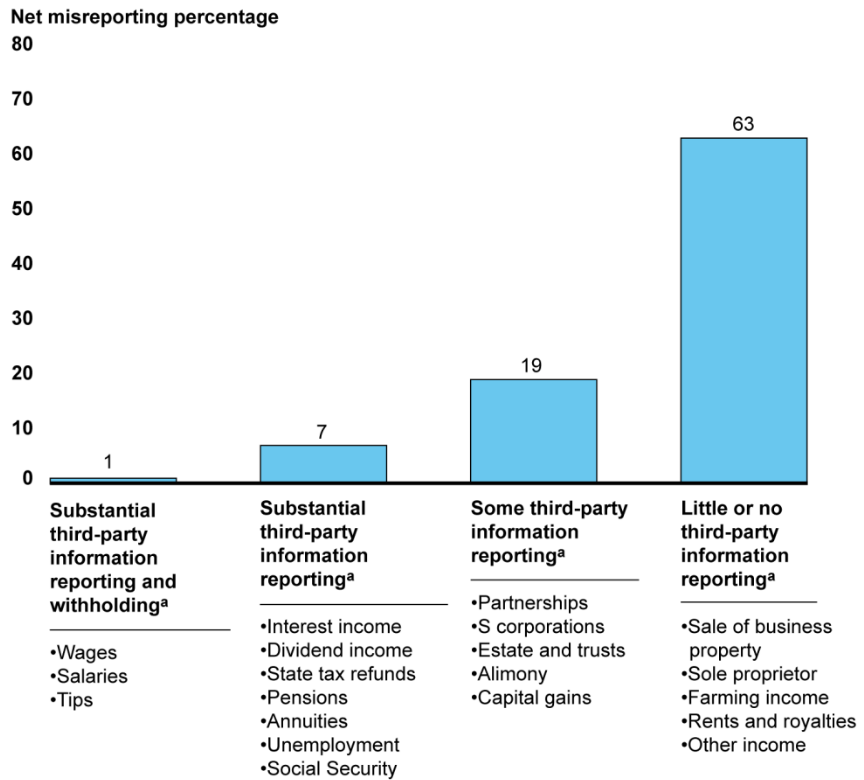
[a]Other income includes any taxable income not reported elsewhere on the tax return or other schedules—such as gambling winnings, rental of personal property, and canceled debts—as well as deductions for net operating losses.

[b]Unallocated marginal effects represent the difference between the total estimated tax gap for individual income tax underreporting and the sum of tax gap estimates of individual income tax underreporting by tax return line item. This discrepancy occurs whenever more than one line item has been underreported on the same tax return, leading to an understatement of the true tax gap.

[c]Adjustments are the line items that are subtracted from the total income line to arrive at adjusted gross income. For the 2008–2010 estimate, the majority of the adjustments can be attributed to understated individual income tax deductions for self-employment tax. Underreported self-employment income can lead to an underreported self-employment tax liability, which in turn can lead to understated income tax deductions for self-employment tax.

As we have previously reported, the extent to which individual income tax taxpayers accurately report their income is closely aligned to the amount of income that is reported to them and to IRS by third parties. For example, according to 2008–2010 IRS data, taxpayers misreported over half of the types of income for which there is little or no third-party information reporting, such as business income. In contrast, when employers withhold taxes and report the wages and salaries to employees and IRS through Form W-2, Wage and Tax Statement (W-2), there is better compliance. As shown in figure 4, 1 percent of these types of income were misreported while nearly 99 percent were accurately reported on individual income tax returns. Similarly, taxpayers misreported less than 10 percent of income for which banks and other financial institutions provided information returns (Forms 1099) to account holders and IRS that show taxpayers' annual income from some types of investments.

Figure 4: Effect of Third-Party Information Reporting on Net Misreporting Percentage, Tax Years 2008–2010



Source: GAO analysis of Internal Revenue Service (IRS) information. | GAO-18-39

Note: Net misreporting percentage is the sum of the net misreported amount divided by the absolute values (over or underreported) of the amounts that should have been reported, expressed as a percentage.

[a]IRS receives information from third parties that it uses to verify income or deduction amounts that taxpayers report on their tax returns. IRS categorized various line items on the individual income tax return into four different groupings of third-party reporting in IRS Publication 5161, Estimation of the Underreporting Tax Gap for Tax Years 2008–2010: Methodology Research, Analysis and Statistics Technical Paper, September 2016. However, IRS did not provide a scale to define the differences between substantial, some, and little or no third-party information reporting.

Generally, new requirements on third parties to submit information returns would require statutory changes. We have previously identified additional information reporting opportunities as well as improvements that IRS

could make on its own to existing forms and how it uses them.[13] For example, we suggested in August 2008 that Congress may wish to make all taxpayers with rental real estate activity subject to the same information reporting requirements as other taxpayers operating a trade or business; however, no legislative action has been taken on this suggestion.[14] We recommended in August 2010 that IRS require mortgage-secured property addresses to be reported on other forms (Forms 982 and 1099-C) to help IRS detect taxpayers who fail to pay taxes on certain forgiven mortgage debts.[15] Legislative and executive actions have been taken consistent with our recommendation. However, IRS has not revised two forms to collect specific information from taxpayers and lenders concerning the amount of forgiven debt attributable to a principle residence and the locations of a taxpayer's principle residence.

For items subject to substantial third-party information reporting, IRS is able to use automated processes to address noncompliance. The automated underreporter program, through which IRS matches amounts reported on returns with amounts reported on information returns submitted by third parties, is one such process. This computer matching program allows IRS to identify discrepancies between tax returns and information returns and propose automatic changes to taxpayers.[16]

For items with little to no third-party information reporting, IRS has to rely on more resource-intensive methods, such as correspondence or face-to-

[13]GAO, *Refundable Tax Credits: Comprehensive Compliance Strategy and Expanded Use of Data Could Strengthen IRS's Efforts to Address Noncompliance*, GAO-16-475 (Washington, D.C.: May 27, 2016); *Tax Gap: Sources of Noncompliance and Strategies to Reduce It*, GAO-12-651T (Washington, D.C.: Apr. 19, 2012); *Small Businesses: Tax Compliance Benefits and Opportunities to Mitigate Costs on Third Parties of Miscellaneous Income Reporting Requirements*, GAO-11-218T (Washington, D.C.: Nov. 18, 2010); *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238 (Washington, D.C.: Jan. 28, 2009); and *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

[14]GAO-08-956.

[15]GAO, *Tax Administration: Expanded Information Reporting Could Help IRS Address Compliance Challenges with Forgiven Mortgage Debt,* GAO-10-997 (Washington, D.C.: Aug. 31, 2010).

[16]Sometimes, if the discrepancy exceeds a certain tax threshold, an automated underreporter reviewer will contact a taxpayer asking for an explanation of the discrepancy or payment if additional taxes are assessed.

face examinations, to address noncompliance. While these examinations may be started by reviewing specific line items, they may also be expanded to cover other areas of the tax returns if there are indications of misreporting in areas of the return not previously identified. However, it is harder for IRS to detect noncompliance in areas with little third-party information reporting.

Employment Tax Underreporting

The second largest part of the underreporting tax gap is made up of employment taxes, which are comprised of three main components: self-employment tax, Federal Insurance Contribution Act (FICA) Social Security and Medicare withholding, and Federal Unemployment Tax Act (FUTA) taxes, as shown in table 2. The self-employment component is estimated from IRS's NRP individual income tax data. However, IRS lacks NRP data for other components of employment tax. Therefore, it estimates both FICA and FUTA by applying the estimated compliance rates from a 1993 employment tax gap report, which used tax year 1984 employment tax return data, to the current reported taxes.[17]

Table 2: Components of the Average Annual Employment Tax Underreporting Tax Gap, Tax Years 2008–2010

Component	Dollars in billions
Self-employment tax	65
Social Security and Medicare withholding	15
Unemployment tax	1
Total employment underreporting tax gap	**81**

Source: Internal Revenue Service data. | GAO-18-39

IRS recently completed an NRP study of employment tax returns that reviewed federal income tax withholding and FICA, the first such study IRS had conducted in over 30 years. We reported that although the examinations for the study were completed, IRS had not developed formal plans to analyze the results to (1) identify areas of noncompliance, (2) address such noncompliance, or (3) update its employment tax gap

[17]The 1984 data were from an examination-based study of a statistically representative sample of employers with a From 941 (Employer's Quarterly Federal Tax Return) filing requirement. For more information, see Internal Revenue Service, Research Division, *Federal Tax Compliance Research: Gross and Net Employment Tax Gap Estimates for 1984-1997*, Publication 1415-E (Rev. 10-93) (Washington, D.C.: 1993).

estimate.[18] According to IRS officials, they had not developed formal plans due to competing research priorities and limited resources and because the NRP results had not yet been finalized. We recommended that IRS develop plans to analyze the NRP results in 2017 to address areas of noncompliance identified and update its employment tax gap estimates. IRS agreed with our recommendations and stated that it will be determining how to use the data from this new study to update the employment tax gap estimate.

Corporation Income Tax Underreporting

As shown in table 3, IRS developed corporation income tax underreporting estimates for two types of corporations: small corporations (those without a balance sheet or with assets less than $10 million) and large corporations (those with assets of $10 million or more). IRS estimated the voluntary compliance rate for all corporations to be 83 percent for tax years 2008–2010.[19] The estimates are based on adjusted data from operational examinations, which focus on the tax returns most likely to have substantive noncompliance rather than examinations of a statistically representative sample of corporation tax returns. IRS does not have a program comparable to NRP for corporation income tax because of the difficulty of constructing a representative sample for a small group of highly diverse large corporations, among other reasons.[20]

The limited scope and selection criteria for non-NRP examinations introduce statistical bias, meaning that the examination issues and results from examinations of corporation tax returns are not necessarily representative of the overall corporation population. However, IRS has developed some methods to project the results of the examinations to the larger population of corporations, and, despite these limitations, IRS considers the corporation estimates to provide a rough gauge of corporation income tax noncompliance.

[18]GAO, *Employment Taxes: Timely Use of National Research Program Results Would Help IRS Improve Compliance and Tax Gap Estimates*, GAO-17-371 (Washington, D.C.: Apr. 18, 2017).

[19]IRS did not calculate separate VCRs for small corporations and large corporations.

[20]IRS is working on two limited NRP studies of corporations: (1) tax year 2010 small corporations with a balance sheet reporting assets less than $250,000 and (2) tax year 2010-2013 corporations with reported assets between $10 million and $100 million.

Table 3: Average Annual Corporation Income Underreporting Tax Gap Estimates, Tax Years 2008–2010

Corporation size	Dollars in billions
Large corporations (assets of 10 million dollars or more)	28
Small corporations (assets under 10 dollars million)	13
Total corporation income underreporting tax gap	**41**

Source: Internal Revenue Service data. | GAO-18-39

IRS's divisions responsible for large and small corporation examinations each have management systems in place to track issues identified from corporation examinations. While this information is not derived from the tax gap estimates, IRS has identified several common examination issues for both large and small corporations, as shown in table 4.

Table 4: Common Examination Issues Identified for Large and Small Corporations

Issue	Description
Large corporations	
Transfer pricing	Issues relate to intercompany transfers (or licenses) of intangibles, as well as other intercompany transactions, such as the sale of goods, the provision of services, and the use of tangible assets.
Domestic production deduction	Issues concern computing the deduction and include domestic production gross receipts, cost of goods sold, qualified production activity expense, and allocable W-2 wages.
Subpart F issues	Issues relate to ensuring that the numerous types of Subpart F income (additional income inclusions for controlled foreign corporations) are properly accounted for.
Business expense deductions	Concerns cover a range of industries and subjects, as the deduction for business expenses is one of the most widely-used deductions.
Foreign tax credits	Issues relate to whether foreign taxes are creditable (for example, whether the foreign tax is an income tax); transactions where foreign taxes are separated from their underlying earnings; and earnings and profits of foreign subsidiary corporations which generate the foreign taxes.
Credits for research activities	Issues relate to determining qualified research expenses, a key element in calculating the credit used to increase certain research activities.
Repatriation issues	Concerns certain income earned through foreign corporations not taxed until brought back to the United States. Taxpayers use a variety of techniques to attempt to bring foreign earnings into the United States without triggering a taxable repatriation and the Internal Revenue Service commonly challenges these techniques.
Inbound financing	Issues involve arrangements of foreign-based taxpayers to finance U.S. operations without incurring U.S. tax, for example, foreign guarantees of U.S. affiliates' debt.
Withholding taxes for international transactions	Issues involve common transactions and structures used to take income and earnings from a foreign taxpayer's U.S. investments offshore without incurring U.S. withholding taxes on the expatriation of income.
Proper taxable year deduction	Concerns regarding the taxable year of a deduction, including determining the proper year for which a taxpayer may deduct accrued bonuses paid to employees.

Issue	Description
Small corporations	
Excessive compensation	Concerns regarding C corporations' excess employee compensation and reducing the corporations' salary expense deductions and increasing nondeductible dividends.
Inadequate compensation	Concerns regarding S corporations' inadequate employee compensation and increasing income subject to employment taxes.
Shareholder loans	Issues relate to ensuring that taxable dividends disguised as nontaxable loans are properly taxed as dividends.
Sale or final year of business	Issues relate to ensuring that the disposition or dissolution of both C and S corporations are properly taxed.
Research credit	Issues relate to ensuring that only qualifying expenses are taken into account in determining the credit.
Method of accounting	Issues relate to ensuring that both C and S corporations use consistent, appropriate methods of accounting.

Source: GAO analysis of Internal Revenue Service information. | GAO-18-39

Net Tax Gap

For the 2008–2010 tax gap estimate, IRS for the first time estimated the net tax gap by each type of tax, as shown in table 5. Unlike most of the tax gap, IRS can tabulate late payments. Since enforcement and other late payments often happen many years after a given tax year has ended, IRS must project into the future to estimate how much tax it will eventually collect for that tax year. IRS expects to recoup the smallest percentage of taxes from the gross individual income tax estimate.

Table 5: Average Annual Gross and Net Tax Gap Estimates by Tax Type, Tax Years 2008–2010

Dollars in billions

Type of tax	Gross tax gap	Enforced and late payments	Net tax gap	Percent of gross tax gap that IRS expects to collect
Individual income	319	(28)	291	9
Corporation income	44	(9)	35	20
Employment	91	(12)	79	13
Estate	4	(3)	1	75
Total	**458**	**(52)**	**406**	**11**

Source: Internal Revenue Service (IRS) data. | GAO-18-39

Note: IRS did not calculate the net tax gap for excise taxes.

IRS Has Confidence in Most Aspects of the Tax Gap Estimate and Is Taking Steps to Improve It

IRS officials stated IRS believes the tax gap estimates are sufficiently reliable for the intended purpose of providing a snapshot of tax compliance as a whole. The tax gap estimate is actually many estimates used together to develop one overall picture of tax compliance. IRS has more certainty in some areas of the estimate than others. Generally, IRS officials consider those components of the tax gap estimate that are based on the most current data (2008–2010 data) to be more robust. However, as shown in table 6, IRS recognizes that some component estimates of the tax gap estimate are more uncertain than others, in part because some component estimates rely on older data and it is inherently difficult to estimate some types of noncompliance. IRS has no estimates for some areas of the tax gap.

Table 6: Methodological Approaches Used to Estimate the 2008–2010 Tax Gap

Tax type	Noncompliance type	Data source and methodology	Estimate based on updated methodology?	Estimate based on 2008–2010 data?
Individual income	Nonfiling	Modeling based on third-party data and U.S. Census Bureau's (Census) Current Population Survey (CPS) data	✓	✓
	Underreporting	National Research Program (NRP) statistically representative sample and modeling of undetected underreporting	—	✓
	Underpayment	Payment data	—	✓
Corporation income	Nonfiling	Not estimated	—	
	Underreporting	Adjusted operational examination data (adjusted for selection bias)	—	✓
	Underpayment	Payment data	—	✓
Employment	Nonfiling (self-employment)	Modeling based on third-party data and Census's CPS data	✓	✓
	Nonfiling (FICA and FUTA)	Not estimated	—	—
	Underreporting (self-employment)	NRP statistically representative sample	—	✓
	Underreporting (FICA and FUTA)	1984 statistical sample[a]	—	—
	Underpayment	Payment data	—	✓

Tax type	Noncompliance type	Data source and methodology	Estimate based on updated methodology?	Estimate based on 2008–2010 data?
Estate	Nonfiling	Econometric model from 2000 university study and IRS's Statistics of Income estimates	—	—
	Underreporting	2004 operational examination data (adjusted using an econometric model)	—	—
	Underpayment	Payment data	—	✓
Excise	Nonfiling	Not estimated	—	—
	Underreporting	Not estimated	—	—
	Underpayment	Payment data	—	✓

Legend:
FICA = Federal Insurance Contribution Act
FUTA = Federal Unemployment Tax Act
— = not applicable

Source: GAO analysis of Internal Revenue Service (IRS) information. | GAO-18-39

[a]In 2017, IRS conducted its first study on employment taxes in over 30 years using NRP data from tax years 2008–2010. In GAO-17-371, we made five recommendations on how IRS might leverage information from this study to update the tax gap estimates.

According to IRS officials, IRS has higher amounts of confidence in

- all of the underpayment components, because they are based on data from systems that can distinguish enforcement and late payments from other payments (IRS has the most confidence in these components);
- the individual income nonfiling component, because it is based on a new methodology combining two methods that incorporate improvements to the methods used in prior estimates;
- the individual income underreporting component, because it is primarily based on adjusted NPR examination data, which is a statistically representative sample of individual tax returns; and
- the corporation underreporting component, because it is based on operational examination data, adjusted for selection bias.

IRS has a lesser amount of confidence in

- the estate nonfiling and underreporting data, because they are forecasts updating estimates based on assumptions made in studies completed in 2000; and

- the withholding taxes (FICA and FUCA) part of the employment underreporting data, because the data are partially a forecast based on data from an older compliance study.

The methodologies used to develop the component estimates differ by component, resulting in a mix of statistical sample and operational-based data being used, as well as forecasts from earlier estimates. IRS is therefore unable to calculate confidence intervals for any of the tax gap estimates. IRS officials stated that that they continue to try to identify a value for those components without estimates, such as corporation income, excise tax nonfiling, and excise tax underreporting, but have not yet found a sufficiently reliable data source nor method upon which to base estimates.

To increase its confidence in the estimates of underreported individual income, IRS uses an econometric technique called detection controlled estimation (DCE). This regression-based model controls for variables that could affect the amount of underreporting IRS examiners detected. IRS uses this adjustment because it knows its examiners do not detect all underreported income during examinations, and therefore it adjusts the NRP data to account for such undetected income when estimating the tax gap. The statistical technique estimates the noncompliance detected by a hypothetical "best practices" examiner—an ideal that is unattainable—and then statistically estimates the noncompliance detected by the hypothetical examiner to adjust upward the findings from research examinations conducted by actual examiners.

The DCE adjustment accounts for more than half (about $150 billion) of the total individual income tax underreporting estimate. IRS also used the DCE adjustment for the self-employment tax estimates used in the employment tax underreporting estimate. Appendix III provides more information on the extent to which DCE adjustments contributed to the 2008–2010 tax gap estimate.

IRS has taken steps to improve the tax gap estimate. For example, IRS used an updated methodology to calculate the estimated nonfiling amount for the 2008–2010 estimate that combined two prior methodologies. Specifically, IRS expanded how it matches information between the U.S. Census Bureau's annual Current Population Survey and IRS data to estimate the amount of taxes that were not filed. IRS believes this updated methodology allows it to create a better matched dataset and identify nonfilers more accurately. See appendix IV for details on changes to IRS's tax gap methodology.

IRS plans to release its next tax gap estimate in 2019 to cover tax years 2011 to 2013. IRS is also undertaking several additional studies that may offer data IRS can use to improve the tax gap estimate, including these examples:

- **Taxpayers' tipping behavior:** IRS is surveying taxpayers to help estimate total tip income and tipping rates by industry/occupation and by major method of payment (e.g., credit card, debit card, and cash).
- **Limited studies on C corporations and other midsize corporations:** IRS studied compliance of C corporations with assets less than $250,000 and with a balance sheet, and corporations with assets of $10 to $50 million for tax year 2010. These studies plan to identify potential areas of noncompliance.
- **Partnership misreporting pilot:** In 2016, IRS initiated this study to measure reporting compliance for certain partnerships, as well as to estimate tax misreported at the taxable partner level as a result of partnership misreporting. This study was initiated in response to a recommendation from a prior report.[21]
- **NRP employment tax estimates:** As previously mentioned, IRS is determining how it will use the NRP employment tax study it concluded in 2017 to improve the tax gap estimates.

[21]In reviewing IRS's efforts to measure and address partnership noncompliance, we recommended that IRS should develop and implement a strategy to better estimate (1) the extent and nature of partnership misreporting, and (2) the effectiveness of partnership examinations in detecting this misreporting. GAO, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance*, GAO-14-453 (Washington, D.C.: May 14, 2014).

IRS Has Broad Compliance Goals but Lacks Specific Quantitative Goals for Increasing Voluntary Compliance

IRS's current strategic plan (2014–2017) discusses general approaches to make voluntary compliance easier for taxpayers and to ensure taxes owed are paid.[22] However, in some areas, the plan does not include specific tactics for improving compliance strategies. Rather, it addresses the elements of voluntary compliance and enforcement actions through two of its goals:

- Delivering high-quality and timely service to reduce taxpayer burden and encourage voluntary compliance.
- Effectively enforcing the law to ensure compliance with tax responsibilities and combat fraud.

IRS officials stated the strategic plan goals are a component of IRS's Future State—which is a vision for agency-wide operations that aims to improve services across different taxpayer interactions such as individual account assistance, exams, and collections—and are directly reflected in three of its six themes:

- facilitate voluntary compliance by empowering taxpayers with secure innovative services, tools, and support;
- understand noncompliant taxpayer behavior, and develop approaches to deter and change it; and
- select highest value work using data analytics and a robust feedback loop.

According to IRS officials, the remaining themes support these goals indirectly by seeking to improve IRS's effectiveness. IRS officials noted the IRS Future State vision has outlined two measures that will support the overall goal of increased compliance. The first will be the percentage of compliance issues resolved within 1 year of filing. The second is the percentage of taxpayers with recurring compliance issues. However, IRS has not yet determined the target levels for these goals. According to officials, the levels for these goals will be published with the next IRS strategic plan (2018–2022), which IRS is scheduled to release in mid-2018.

[22] Internal Revenue Service, *Strategic Plan FY 2014-2017,* Publication 3744 (Rev. 6-2014) (Washington, D.C.: June 2014).

IRS Lacks Specific Quantitative Goals to Improve Voluntary Compliance

IRS previously set or acknowledged quantitative goals to improve voluntary compliance. However, IRS has since moved away from that approach. In 2005, we recommended that IRS establish a long-term quantitative voluntary compliance goal for individual income tax underreporting and for tax underpayment, as well as for other areas of noncompliance.[23] IRS agreed with the concept of our recommendation and, in response, established a voluntary compliance rate goal of 85 percent by 2009, which was published in IRS's fiscal year 2007 budget request.[24]

In 2006, Treasury issued its *Comprehensive Strategy for Reducing the Tax Gap*, with a seven-component strategy for reducing the tax gap: (1) reduce opportunities for evasion, (2) make a multiyear commitment to research, (3) continue improvements in information technology, (4) improve compliance activities, (5) enhance taxpayer service, (6) reform and simplify the tax law, and (7) coordinate with partners and stakeholders.[25] In 2007, IRS developed a more detailed report that emphasized the same seven components outlined in the Treasury report and also outlined projects, initiatives, legislative proposals, and other actions designed to combat the sources of noncompliance.[26]

In the 2007 report, IRS acknowledged the goal set by the then Chairman of the Senate Finance Committee for IRS to meet a 90 percent voluntary compliance rate by tax year 2017 and the goal set by the IRS Oversight Board of 86 percent by tax year 2009.[27] In 2009, IRS published another report that followed up on the efforts discussed in the 2006 and 2007

[23]GAO-05-753.

[24]GAO-05-753.

[25]U.S. Department of the Treasury, *A Comprehensive Strategy for Reducing the Tax Gap* (Washington, D.C.: Sept. 26, 2006).

[26]Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (Washington, D.C.: Aug. 2, 2007).

[27]As of January 1, 2015, the IRS Oversight Board did not have full membership to constitute a quorum; therefore its activities were suspended until such time as members are nominated by the President and confirmed by the Senate.

Treasury and IRS reports.[28] However, IRS has not published any reports since that time that focus on goals for reducing the tax gap.

In 2012, Treasury, along with IRS, set an agency priority goal to increase voluntary tax compliance from 83.1 to 86 percent by September 30, 2013.[29] However, Treasury and IRS decided not to renew the agency priority goal because they said the measure did not satisfy the criteria of having indicators and quarterly milestones against which to track process or being able to determine whether the goal has been achieved by the end of a 2-year period, as established by the Office of Management and Budget.[30] Since the tax gap estimates are only updated every few years, Treasury and IRS officials said there was no way for Treasury or IRS to show improvements or declines in meeting the goal on a quarterly basis or over the 2-year goal term.[31] More recently, IRS officials told us that while they want to achieve a high level of voluntary compliance, neither IRS nor Treasury has set a recent high level department- or agency-wide quantitative goal aimed at reducing the tax gap or increasing voluntary compliance.

Establishing clear compliance goals and measuring progress toward them benefit both IRS and external stakeholders and are consistent with the results-oriented performance management principles set forth in the Government Performance and Results Act of 1993 and the GPRA Modernization Act of 2010.[32] As we have previously reported, setting long-term strategic goals is essential for results-oriented management, because such goals explain in greater specificity the results an agency is

[28]Internal Revenue Service, *Reducing the Federal Tax Gap; A Report on Improving Voluntary Compliance* (Washington, D.C.: Aug. 2, 2007).

[29]Within the federal performance planning and reporting framework, agency priority goals are near-term goals that reflect agencies' highest priorities and represent an achievement that agency leaders want to accomplish within 2 years through focused leadership attention. They are to have clear completion dates, targets, and indicators that can be measured or marked by a milestone to gauge progress.

[30]Office of Management and Budget, *Preparation, Submission and Execution of the Budget*, OMB Circular No. A-11, pt. 6, § 250 (Aug. 1, 2017).

[31]The GPRA Modernization Act of 2010 (GPRAMA) does not preclude agencies, in coordination with the Office of Management and Budget, from having the discretion to renew an agency priority goal. *See,* GPRAMA, Pub. L. No. 111-352, 124 Stat. 3866, Sec. 5, (Jan. 4, 2011), *as codified at* 31 U.S.C. § 1120(a)(1) and (b)(1)(A)-(B).

[32]Pub. L. No. 103-62, § 2, 107 Stat. 285 (Aug. 3, 1993); and Pub L. No. 111-352, § 3, as codified at 31 U.S.C. §1115(b).

intending to achieve.[33] The goals form a basis for an organization to identify potential strategies for fulfilling its mission and for improving its operations to support achievement of that mission. Directly aligning strategic goals and strategies for achieving those goals is important for assessing an agency's ability to achieve those goals.[34] Further, when program results could be influenced by external factors, agencies can use intermediate goals and measure to identify the program's discrete contribution to a specific result.[35]

IRS has moved away from specific numeric goals to improve compliance because it now believes there are limited benefits to them. According to IRS officials, IRS actions alone do not determine the level of taxpayer compliance and there are also several challenges associated with establishing meaningful and useful compliance goals. IRS officials reported that many of these challenges are due to the tax gap only being estimated every few years. As a result, fluctuations in the estimate over time may not be generally attributed to changes in compliance behavior but the fluctuations might instead result from the imprecision of the estimates or updated methodologies.

According to IRS, changes in the economy may also have an effect on tax compliance rates. For example, a downturn in the economy would likely result in less tax needing to be paid, but it might also cause some taxpayers to comply less than they otherwise would. Further, separating those two effects would be difficult, particularly given the unobserved nature of most noncompliance. Finally, IRS officials stated other factors, such as IRS services, enforcement efforts, evolving social norms, or changes in legislation, may affect the overall compliance rate.

Although IRS may not have full control over all of the factors that affect voluntary compliance, it does have an impact on taxpayer's compliance through its service and enforcement programs. Furthermore, IRS is not alone in not having full control over the results it seeks to achieve. A number of methods can be used to map or model the causal relationships among the inputs, processes, and outputs produced by various strategies

[33]GAO, *Managing for Results: Critical Issues for Improving Federal Agencies' Strategic Plans*, GAO/GGD-97-180 (Washington, D.C.: Sept. 16, 1997).

[34]GAO/GGD-97-180.

[35]GAO, *Agency Performance Plans: Examples of Practices That Can Improve Usefulness to Decisionmakers*, GAO/GGD/AIMD-99-69 (Washington, D.C.: Feb. 26, 1999).

and the forces that influence achievement of outcomes, such as results mapping and logic modeling.[36] Recognizing that outside influences may present risks or challenges to achieving outcomes, OMB Circular Number A-11 states that while agencies cannot mitigate all risks related to achieving strategic objectives and performance goals, they should identify, measure, and assess challenges related to mission delivery, to the extent possible.[37]

We have previously reported that setting long-term quantitative goals for IRS offers several benefits.[38] First, compliance goals coupled with periodic measurements of compliance levels would provide IRS with a better basis for determining to what extent its various service and enforcement efforts contribute to compliance. Second, long-term, quantitative goals would help IRS consider new strategies to improve compliance, especially since these strategies could take several years to implement. Third, focusing on intended results can promote strategic and disciplined management decisions that are more likely to be effective because managers who use fact-based performance analysis are better able to target areas most in need of improvement and to select appropriate interventions. Fourth, agency accountability can be enhanced when both agency management and external stakeholders—such as Congress—can assess an agency's progress toward meeting its goals.

Likewise, a survey of the Organization for Economic Cooperation and Development countries and other advanced economies found that some governments are paying increased attention to estimating tax gaps for their major types of taxes.[39] Several countries shared their quantitative goals for reducing the tax gap or increasing their tax revenue with the survey. For example, Denmark set a target to ensure that the tax gap does not exceed 2 percent of estimated total tax liability.

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[36]For additional information about mapping or modeling these causal relationships, including an illustrative example of a logic model, see GAO, *Designing Evaluations: 2012 Revision,* GAO-12-208G (Washington, D.C.: Jan. 31, 2012).

[37]Office of Management and Budget, *Preparation, Submission and Execution of the Budget*, OMB Circular No. A-11, pt. 6, § 270.26 (Aug. 1, 2017).

[38]GAO-05-753.

[39]Organization for Economic Cooperation and Development, *Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies* (Paris: OECD Publishing, 2015).

Without long-term, quantitative voluntary compliance goals and related performance measures, it will be more difficult for IRS to determine the success of its strategies, adjust its approach when necessary, and remain focused on results, especially since factors that affect compliance change over time. Having compliance goals as IRS has had in the past, coupled with data, would provide a solid base upon which IRS could develop a more strategic, results-oriented approach to improving compliance.

IRS Uses National Research Program Data to Guide Compliance Efforts but Has Not Documented a Long-Term Strategy

IRS officials told us tax gap data are used as a high-level overview of tax compliance. IRS officials also stated they use the underlying tax gap data (i.e., NRP data and other data) in several ways to update compliance efforts. However, IRS has not documented a comprehensive strategy that shows, for example, how it intends to analyze and use the tax gap data, particularly from the NRP, to develop or improve compliance programs.

IRS officials told us they use the NRP data to study specific compliance behaviors. For example, IRS has studied taxpayer behavior in claiming the Earned Income Tax Credit (EITC), the child tax credit, and the additional child tax credit. Sometimes these studies are used to develop legislative proposals that are included as part of the annual budget process and outlined in Treasury's annual revenue proposals. Officials stated the legislative proposals are based on the knowledge of compliance derived from analysis of NRP data and they are organized into themes, such as reducing the tax gap, improving voluntary compliance, or improving tax administration. However, these revenue proposals are requests for changes to the tax laws and, ultimately, it is at Congress's discretion whether to enact them. IRS officials reported that other times NRP data are used to compute the annual improper payment rate for the EITC. According to officials, IRS also uses these data to annually categorize the root causes of EITC noncompliance.

IRS uses the NRP data to update compliance plans by updating the Discriminate Function (DIF) formulas. DIF formulas are designed to score returns for the likelihood that the tax reported on the return is significantly underreported. DIF scores help IRS ensure that noncompliant taxpayers are more likely to be selected for examination and compliant taxpayers are less likely to be unnecessarily examined. IRS determines DIF scores for individual income, small corporation income, partnership, and S corporation returns.

IRS officials described high-level concepts of how the various NRP and other studies contribute to compliance and enforcement strategies.

Officials from IRS's Office of Research, Applied Analytics, and Statistics (RAAS) said they think the various uses of the NRP are widely known from general documentation about the NRP and its study design. RAAS officials also noted the fiscal year 2009 budget justification that led to special funding for the NRP still reflects IRS's current strategy for undertaking various NRP studies. Further, IRS officials pointed us to documentation from the 2000s that discussed a need for a multiyear research commitment and IRS's goal to move NRP studies beyond the individual income tax to include other taxes. We previously recognized IRS's commitment to multiyear research and have noted the gains it has made in regularly estimating compliance.[40] Our analysis of the decade-old documents found evidence of a commitment to research that generally seemed sufficient for that period.

However, IRS officials did not provide us more recent documents that describe its current efforts to study compliance or show how it plans to use NRP data to update compliance strategies. IRS officials also provided us with business plans for some of their other business units and divisions. The plans we reviewed noted, at a high level, that data and analysis will be used to improve workload selection but did not discuss how specific research efforts or the results of those efforts would be integrated into the missions.

The Internal Revenue Manual section on the NRP states that IRS needs to measure taxpayer compliance with federal income tax laws along with contributing factors so that customer-focused programs and services can be enhanced or developed and so that compliance information and tools can be improved.[41] A 2001 NRP prospectus states the NRP will help to increase public confidence in the fairness of our tax system by helping IRS identify where compliance problems occur and focus its resources accordingly. Further, it states that for strategic planning and budget purposes, IRS requires regular estimates of compliance. The NRP research efforts support this critical need. According to IRS, the NRP will also improve IRS's ability to detect noncompliance; reduce the burden of unnecessary IRS contacts on compliant taxpayers; and support the

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[40]GAO-17-317.

[41]The Internal Revenue Manual is an official compendium of internal guidelines for IRS personnel. Internal Revenue Service, *Internal Revenue Manual*, IRM Part 4, Chapter 22, Section 1.2(4), accessed Oct. 18, 2017, https://www.irs.gov/irm/.

strategic goals, program development, and resource allocation of IRS operating divisions.[42]

Using quality information, such as NRP data, to achieve the agency's objectives is one of the 17 principles for internal controls.[43] Further, the standards for internal controls also recognize documentation is a necessary part of an effective system, but the level and nature of documentation vary based on the size of an entity and the complexity of the operational process. Documentation is required to demonstrate the design, implementation, and operating effectiveness of a system. Considering the size and relative importance of the tax gap, documenting a strategy for how IRS plans to use NRP data to reduce the tax gap would be consistent with internal controls. However, without a strategy that provides an overall picture of how NRP data are used, it may be difficult for Congress and other decision makers to understand the merits of what they are being asked to fund. Further, without developing and documenting a strategy for incorporating the results of NRP data, IRS risks not fully leveraging the compliance data it collects or not allocating enforcement resources in the most cost-effective manner.

We have a long-standing history of reporting on the need for IRS to develop a comprehensive compliance strategy:

- In 1994, we concluded that until IRS produces a comprehensive compliance strategy, existing data could be used as part of an interim compliance strategy that directs resources at the most noncompliant taxpayers.[44] We found that using such a starting point, IRS could focus more of its efforts on highly noncompliant areas, such as small corporation income and sole proprietorship income that made up almost a third of the tax gap.
- In 2005, we concluded that reducing the tax gap will be a challenging task given persistent levels of noncompliance and will not likely be achieved through a single solution.[45] Rather, the tax gap must be

[42]IRM Part 4, Chapter 22, Section 1.2(3).

[43]GAO, *Standards for Internal Control in the Federal Government,* GAO-14-704G (Washington, D.C.: September 2014).

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

[45]GAO-05-753.

attacked on multiple fronts and with multiple strategies over a sustained period, thus building a foundation to help taxpayers voluntarily comply.

- Between 2005 and 2007, we testified six times on the need for IRS to develop a strategy to attack the tax gap on multiple fronts with multiple approaches.[46]
- In 2007, we reported on the need for IRS to develop a strategy to address noncompliant sole proprietor income, which accounts for a significant share of the tax gap.[47]

Further, documenting a strategy for using NRP data to guide compliance efforts would be consistent with two key criteria for removal from the High-Risk List:

- **Action plan:** A corrective action plan exists that defines the root cause and solutions and that provides for substantially completing corrective measures, including steps necessary to implement solutions we recommended.
- **Demonstrated progress:** Ability to demonstrate progress in implementing corrective measures and resolving the high-risk area.

Conclusions

The nation's long-term fiscal projections show that the federal government is on an unsustainable fiscal path. One way to help improve the nation's fiscal position would be to reduce the tax gap. Reducing the tax gap will be a challenging task given persistent levels of taxpayer noncompliance. However, even modest reductions would yield significant financial benefits and help improve the government's fiscal position.

[46]GAO, *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap* GAO-07-488T (Washington, D.C.: Feb. 16, 2007); *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap*, GAO-07-391T (Washington, D.C.: Jan. 23, 2007); *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches,* GAO-06-1000T (Washington, D.C.: July 26, 2006); *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions*, GAO-06-453T (Washington, D.C.: Feb. 15, 2006); *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance,* GAO-06-208T (Washington, D.C.: Oct. 26, 2005); and *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T (Washington, D.C.: Apr. 14, 2005).

[47]GAO, *Tax Gap: A Strategy for Reducing the Gap Should include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2017).

IRS has shown a continued commitment to study sources of noncompliance and has made strides in improving NRP and other tax gap data. However, additional efforts could further assist IRS in addressing the tax gap. A long-term, quantitative goal for improving voluntary compliance may provide IRS with a concrete target the agency can use in fulfilling its mission. Without a quantitative goal, it will be more difficult for IRS to determine the success of its strategies, adjust its approach when necessary, and remain focused on results, especially since factors that affect compliance change over time. Likewise, a strategy that outlines how IRS plans to use NRP data to update compliance strategies would help IRS determine resource tradeoffs and more fully leverage the investment it makes in compliance research, while providing Congress with a better understanding of the merits of the research it is being asked to fund.

Recommendations

We are making the following two recommendations to IRS:

The Commissioner of Internal Revenue should re-establish long-term, quantitative goals for improving voluntary compliance. (Recommendation 1)

The Commissioner of Internal Revenue should instruct the appropriate officials to develop and document a strategy that outlines how IRS will use National Research Program data to update compliance strategies that could help address the tax gap. (Recommendation 2)

Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of Internal Revenue. IRS provided written comments, which are summarized below and reprinted in appendix V. IRS also provided technical comments, which we incorporated where appropriate.

IRS disagreed with our recommendation that it re-establish long-term, quantitative goals for improving voluntary compliance. In its letter, IRS stated that the voluntary compliance rate is ill-suited as a strategic or performance metric for IRS for various reasons. For example, IRS stated that improving voluntary compliance, determining the success of its strategies, and adjusting its approach could be accomplished in the absence of a quantitative goal. However, as we note in the report, setting long-term strategic goals is essential for results-oriented management, because such goals explain in greater specificity the results an agency is intending to achieve. Further, focusing on intended results can promote

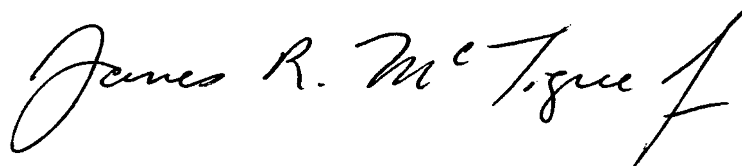
strategic and disciplined management decisions that are more likely to be effective because managers who use fact-based performance analysis are better able to target areas most in need of improvement and to select appropriate interventions.

IRS also stated that its actions alone do not determine the level of voluntary compliance, which is determined by the interaction of many factors, such as taxpayer behavior, tax law complexity, and IRS resources. We agree that IRS may not control all factors that affect voluntary compliance. However, IRS does influence taxpayer compliance through its service and enforcement programs. Furthermore, as we point out in the report, while agencies cannot mitigate all outside influences that may present risks or challenges to achieving outcomes, they should identify, measure, and assess such challenges to the extent possible. Given the benefits of setting long-term quantitative goals—as discussed in this report—we continue to believe it is prudent for IRS to establish such goals.

IRS agreed with our recommendation that it develop and document a strategy that outlines how IRS will use National Research Program data to update compliance strategies that could help address the tax gap.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We will also send copies of the report to the Commissioner of Internal Revenue and other interested parties. In addition, this report will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff has any questions about this report, please contact me at (202) 512-9110 or mctiguej@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs are on the last page of this report. GAO staff members who made major contributions to this report are listed in appendix VI.



James R. McTigue, Jr.
Director, Tax Issues
Strategic Issues Team

Appendix I: Objectives, Scope, and Methodology

Our objectives were to determine (1) the main drivers of the tax gap; (2) the Internal Revenue Service's (IRS) confidence in the tax gap estimates; (3) IRS goals, if any, for reducing the tax gap; and (4) the extent to which IRS uses tax gap estimates and underlying data to develop strategies and actions to reduce the tax gap.

To determine the main drivers of the tax gap and IRS's confidence in the estimates, we reviewed IRS's tax gap estimates and underlying data; IRS technical papers and reports; third-party reviews of the data; and past GAO and Treasury Inspector General for Tax Administration reports on the 2001, 2006, and 2008–2010 tax gap estimates. We also interviewed officials from IRS's Office of Research, Applied Analytics, and Statistics (RAAS) who are responsible for estimating the tax gap. We determined that IRS's tax gap and compliance estimates were sufficiently reliable for the purposes of this report, particularly since IRS already has publicly released its tax gap estimates and disclosed their limitations. These purposes include discussing the major tax gap components, the orders of magnitude for various components, and IRS's opinions about the certainty of its estimates.

To determine IRS's goals for increasing voluntary compliance, we reviewed IRS's and the Department of the Treasury's (Treasury) strategic plans and Treasury's *General Explanations of the Administrations Fiscal Year Revenue Proposals* (commonly referred to as the Green Book) from 2011 to 2017. We also reviewed other IRS and Treasury documentation, such as the strategies for improving voluntary compliance that were developed in the mid-2000s. Additionally, we reviewed Treasury's agency priority goals, including the goal it set in 2012 to increase voluntary compliance. We also reviewed the statutory requirements for agency performance goals under GPRAMA. We interviewed Treasury officials in the Office of Tax Analysis and the Office of Strategic Planning and Performance Improvement about prior goals that were set and the goal-setting process. We interviewed IRS officials responsible for developing strategies and establishing goals to reduce the tax gap, specifically officials in the Deputy Commissioner's Office for Service and Enforcement and the Small Business/Self-Employed, Large Business and International, and Wage and Investment divisions.

To determine the extent to which IRS uses the tax gap and other underlying data to update compliance efforts, we requested documentation on any plans or strategies that show how the various tax gap and other compliance studies work together toward a larger compliance strategy. We found that the agency had not developed these

documents. We interviewed staff from the Deputy Commissioner's Office for Service and Enforcement and RAAS about the agency's plans to use tax gap data and other compliance studies when developing compliance strategies.

To show additional detail on aspects of compliance using the same data upon which the individual income tax underreporting tax gap estimates are based, we examined IRS's tax gap estimates for tax years 2008–2010 and the underlying data from its National Research Program (NRP) study of individual income tax returns. This information is presented in appendix II. Unlike other IRS examinations, NRP examinations can be used to estimate taxpayer reporting compliance because they are drawn from a stratified, statistically representative sample of the population of individual income tax returns. We interviewed IRS officials from RAAS about their research and analysis of the NRP data, and we gathered related documentation where available. IRS officials described the quality review and data reliability processes they used to collect data from the NRP examinations.

Because the NRP sample was based on random selections, the sample was only one of a large number of samples that IRS could have drawn. Since each sample could have provided different estimates, we express our confidence in the precision of our estimates based on the sample as a 95 percent confidence interval plus or minus a margin of error. This is the interval that would contain the actual population value for 95 percent of the samples that could have been drawn. The estimates presented in appendix II have margins of error of less than 10 percent or 10 percentage points. In analyzing the NRP data, we conducted several reliability tests to ensure the data we used were sufficiently complete. For example, we electronically tested the data for obvious errors. We concluded that the data were sufficiently reliable for the purposes of this report based on these steps and on our previous reviews of tax gap estimates and NRP data.

We conducted this performance audit from July 2016 to October 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Additional Analyses of National Research Program Individual Data

We analyzed the raw National Research Program (NRP) data for individual income tax returns, including itemized deductions, for tax years 2008–2010.[1] These data do not account for the undetected income that the Internal Revenue Service (IRS) adjusts for when developing tax gap estimates. Therefore these data are not comparable to the tax gap data presented elsewhere in this report, but they allow additional analysis of areas of misreporting.

Table 7 provides greater details on certain line items from the individual income tax return that align with various third-party information reporting levels determined by IRS. Line items with substantial or some information reporting tended to have lower overall misreporting percentages. Line items that had the largest percentage of taxpayers with misreported income were those for sole proprietor and farming income, both of which are subject to little to no information reporting.

Table 7: Selected National Research Program (NRP) Individual Income Estimates, Annual Average for Tax Years 2008–2010

	Number of returns claiming selected line item	Total percent misreporting (both under and over misreporting)	Percent of misreported amounts that were underreported	Mean dollar amount of underreporting for those returns with an underreported amount	Percent of misreported amounts that were overreported	Mean dollar amount of overreporting for those returns with an overreported amount
Substantial information reporting						
Wages[a]	114,487,049	7	76	6,403	24	4,190
Interest	66,757,622	23	82	508	18	344
Qualifying dividends	29,955,303	22	91	527	9	733
Ordinary dividends	33,532,301	22	86	621	14	1,035
State income tax refunds	26,082,651	19	87	500	13	643
Individual Retirement Account income	12,227,266	12	89	4,029	11	4,521
Pension income	26,168,911	11	89	3,591	11	5,750
Unemployment compensation	13,154,065	12	92	1,992	8	3,162

[1]For more information on our data analysis steps and assessment of data reliability, see appendix I.

	Number of returns claiming selected line item	Total percent misreporting (both under and over misreporting)	Percent of misreported amounts that were underreported	Mean dollar amount of underreporting for those returns with an underreported amount	Percent of misreported amounts that were overreported	Mean dollar amount of overreporting for those returns with an overreported amount
Taxable Social Security benefits	15,531,871	30	81	1,139	19	2,249
Some information reporting						
Capital gains	23,554,966	23	69	3,942	31	5,833
Little or no information reporting						
Sole proprietor income	23,393,929	76	87	4,013	13	10,654
Farm income/loss	2,024,908	78	83	4,448	18	9,214
Supplemental income/loss[b]	17,309,441	51	77	7,915	23	9,617
Other income	12,982,136	42	81	9,577	20	11,899
Business sale	1,936,754	30	70	18,513	30	21,191

Source: GAO analysis of the Internal Revenue Service's NRP individual income data. | GAO-18-39

Note: All percentage estimates in this table have a margin of error of plus or minus 10 percentage points or fewer and all estimated mean dollar amounts have a relative error of 10 percent or less.

[a]Wages are also subject to withholdings.

[b]This category can include income from rental real estate, royalties, partnerships, S corporations, trusts, or other items from Schedule E, Supplemental Income and Loss.

Based on the analysis of these data, we also estimate that

- line items with the largest mean amounts of underreporting are business sale and supplemental income or loss;
- the business sale line item also has the largest mean amount of overreporting, averaging $21,000 per return; and
- sole proprietor income and farm income have very similar misreporting data; over 75 percent of the income is misreported and,

- of that, over 80 percent is under reported while under 20 percent is overreported.[2]

We also analyzed selected credits and deductions to determine the average noncompliance rates of these line items, as shown in table 8. Because credits and deductions offset taxpayers' income or tax owed, taxpayers who underreported a credit or deduction overreport their tax liability or tax owed; taxpayers who overreport a credit or deduction underreport their tax liability or tax owed. However, we did not determine the extent to which misreporting was because of issues specific to how taxpayers claimed the credits and deductions or because taxpayers misreported their income, which could affect eligibility for certain credits and deductions. For example, the 2016 income limit to claim the Earned Income Tax Credit (EITC) is $39,296 for single, surviving spouse, or head of household taxpayers with one qualifying child. If IRS determined that such taxpayers who claimed the EITC and reported less than $39,296 in income on their tax returns had underreported their income in order to stay under the threshold, those taxpayers would no longer be eligible for the credit and would have overreported the credit.

[2]For more information on sole proprietor income see, GAO, *Tax Gap: Limiting Sole Proprietor Loss Deductions Could Improve Compliance but Would Also Limit Some Legitimate Losses*, GAO-09-815 (Washington, D.C.: Sept. 10, 2009) and *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007).

Table 8: Average Annual Misreporting of Selected Credits and Deductions, Tax Years 2008–2010

	Number of returns claiming credit or deduction	Total percent misreporting (both under and over misreporting)	Percent of misreported amounts that were underreported	Mean dollar amount of underreporting for those returns with an underreported amount	Percent of misreported amounts that were overreported	Mean dollar amount of overreporting for those returns with an overreported amount
Selected credits						
Earned Income Tax Credit	25,906, 736	49	14	1,485	86	462
Child tax credit[a]	25,665,060	35	66	592	34	561
Additional child tax credit[a]	19,431,380	55	19	795	81	359
Education credits[b]	0,817,162	45	31	623	69	484
Foreign tax credit	7,267,303	16	86	290	14	323
Child care credit	6,270,132	28	32	479	68	205
Energy credits	4,998,924	34	13	669	87	334
Selected deductions						
Real estate taxes	41,330,568	25	35	1,360	65	1,095
Mortgage interest	37,557,008	13	51	5,078	49	4,001
Charitable cash contributions	35,286,820	53	18	1,252	83	552
Charitable non-cash contributions	22,538,084	43	17	812	83	489
Unreimbursed employee expenses	15,067,577	55	9	5,537	91	3,301
Allowable medical expenses[c]	10,092,803	89	20	3,221	80	1,790
Tuition	4,143,920	48	62	1,834	38	1,769
Qualified mortgage insurance premiums	3,947,499	37	40	1,865	60	1,881

	Number of returns claiming credit or deduction	Total percent misreporting (both under and over misreporting)	Percent of misreported amounts that were underreported	Mean dollar amount of underreporting for those returns with an underreported amount	Percent of misreported amounts that were overreported	Mean dollar amount of overreporting for those returns with an overreported amount
Individual Retirement Account contributions	2,714,746	21	24	3,073	76	2,392
Health savings accounts	1,163,391	15	34	1,963	66	844

Source: GAO analysis of the Internal Revenue Service's (IRS) National Research Program individual income data. | GAO-18-39

Note: All percentage estimates in this table have a margin of error of plus or minus 10 percentage points or fewer and all estimated mean dollar amounts have a relative error of 10 percent or less.

[a]According to IRS, child tax and additional child tax credits often have offsetting errors where an increase in one tax credit results in a decrease in the other.

[b]Hope and Lifetime Learning nonrefundable credits are included in this category.

[c]Allowable medical expenses are those medical expenses subject to adjusted gross income limits.

Based on the analysis of these data, we estimate that

- of the selected credits, EITC is the most claimed credit and about half of the time it is misreported;[3]
- thirty-five percent of the time the child tax credit was misreported with about two- thirds of that being underreported, which is inconsistent with filing patterns for most of the other credits and deductions;[4]
- of the selected deductions, the deduction for real estate taxes is most often claimed and about a quarter of the time it is misreported;[5]

[3]In 2016, we reported on refundable tax credits, including the EITC and the additional child tax credit, and we recommended that IRS develop a comprehensive compliance strategy that includes all refundable tax credits. See, GAO, *Refundable Tax Credits: Comprehensive Compliance Strategy and Expanded Use of Data Could Strengthen IRS's Efforts to Address Noncompliance*, GAO-16-475 (Washington, D.C.: May 27, 2016).

[4]According to IRS, child tax and additional child tax credits often have offsetting errors where an increase in one tax credit results in a decrease in the other.

[5]For more information on rental real estate deductions see, GAO, *Tax Gap: Actions that Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

- the medical expenses line item has the highest percentage of misreporting; 80 percent of the time the deduction is overreported; and
- the mortgage interest deduction has the highest average overreported amount, over $4,000 per return.[6]

[6]For more information on the mortgage interest deduction see, GAO, *Home Mortgage Interest Deduction: Despite Challenges Presented by Complex Tax Rules, IRS Could Enhance Enforcement and Guidance*, GAO-09-769 (Washington, D.C.: July 29, 2009).

Appendix III: Detection Correction Factor's Effect on Tax Gap Estimation

In estimating the individual income tax gap, the Internal Revenue Service (IRS) applies an econometric technique called detection controlled estimation (DCE), which is a regression-based model that controls for variables that could affect the amount of underreporting detected. The statistical technique first produces a hypothetical "best practices" examiner—an ideal which is unattainable—based on who conducted the examinations and the observed examination results. It then statistically estimates the noncompliance detected by the hypothetical examiner to adjust upward the findings from research examinations conducted by actual examiners. The technique estimates total undetected underreporting by imputing the average underreporting undetected by IRS's National Research Program (NRP) examination to the detected underreporting, controlling for certain return line item characteristics. According to IRS officials, this approach is reasonable and the best currently available to attempt to estimate the full amount of underreported individual income. As shown in table 9, more than half of the underreporting component of the tax gap consists of income that IRS did not detect during examinations. DCE is not applicable to the underpayment and nonfiling components of the tax gap.

Table 9: Individual Income Tax Underreporting Tax Gap Figures With and Without Undetected Income, Tax Years 2008–2010

Dollars in billions

Tax return items or category	Estimates without undetected income	Estimates with undetected income
Business income	$33	$125
Sole proprietor income	23	78
Income from partnerships, S corporations, estates/trusts	4	22
Rents and royalties	5	20
Farm income/loss	1	5
Non-business income	16	64
Other income[a]	5	29
Capital gains	2	11
Taxable Social Security benefits	1	7
Pensions and annuities	3	5
Wages	3	5
Business sale/Form 4797 income	1	4
Dividends	1	1
Interest	*	1
State income tax refunds	*	1

Tax return items or category	Estimates without undetected income	Estimates with undetected income
Unemployment compensation	*	1
Credits	36	40
Earned income tax credit	22	27
Child tax credit and additional child tax credit	8	7
Education credits	4	4
Other credits	2	2
Deductions	17	18
Unallocated marginal effects[b]	2	12
Exemptions	5	6
Filing status	4	5
Other taxes	1	1
Adjustments[c]	-1	-5
Total individual income underreporting	**113**	**267**

Legend:
* = Less than $0.5 billion

Source: GAO analysis of Internal Revenue Service data. | GAO-18-39

Note: Data may not sum to totals because of rounding.

[a]Other income includes any taxable income not reported elsewhere on the tax return or other schedules—such as gambling winnings, rental of personal property, and canceled debts—as well as deductions for net operating losses.

[b]Unallocated marginal effects represent the difference between the total estimated tax gap for individual income tax underreporting and the sum of tax gap estimates of individual income tax underreporting by tax return line item. This discrepancy occurs whenever more than one line item has been underreported on the same tax return, leading to an understatement of the true tax gap.

[c]Adjustments are the line items that are subtracted from the total income line to arrive at adjusted gross income. For the 2008–2010 estimate, the majority of the adjustments can be attributed to understated individual income tax deductions for self-employment tax. Underreported self-employment income can lead to an underreported self-employment tax liability, which in turn can lead to understated income tax deductions for self-employment tax.

Appendix IV: Additional Information on IRS's Tax Gap Methodology Changes

In efforts to improve the tax gap estimates, the Internal Revenue Service (IRS) updated two areas of the 2008–2010 tax gap estimate by developing updated methodologies.

- **Nonfiling individual income tax:** IRS summed together the total of taxpayers who do not file tax returns and those who filed late. The 2008–2010 estimate of taxpayers not filing a return was made by combining the two methods used to estimate the 2006 and 2001 tax gap estimates. In 2006, IRS used a sample of individuals not appearing on filed tax returns. In 2001, IRS conducted an "exact match" between the Census Bureau's annual Current Population Survey and IRS data. The 2008–2010 estimate of late filers was based on the total balance due from late filed tax returns, adjusted for income reported to IRS on information returns. IRS believes its current methodology is an improvement over the 2006 estimate as it uses the population data rather than a sample, avoiding disadvantages resulting from sampling. IRS reported improvements in the Census and IRS information associated with nonfilers allowed them to create a better matched dataset and identify nonfilers more accurately.
- **Nonfiling self-employment data:** The methodology IRS used to calculate self-employment tax nonfiling is the same that it used for individual income tax. However, for the 2008–2010 estimate, IRS changed where it reports self-employment tax nonfiling within the tax gap estimate. For the 2008–2010 estimate, this tax is now reported in the employment tax category, whereas for the 2001 and 2006 estimates it was reported in the individual income tax category. IRS officials stated that for the 2006-2010 estimate IRS decided to break self-employment out separately and report it with the employment tax because they believe it allows a more comprehensive view of employment taxes.

IRS also updated how the underlying data supporting the tax gap are organized in two ways:

- **Changes in net tax gap estimates:** As previously mentioned, IRS published net tax gap estimates by each tax type (individual income, corporation income, employment, and estate tax) for the first time in the 2008–2010 estimate.[1] IRS officials stated that they made progress

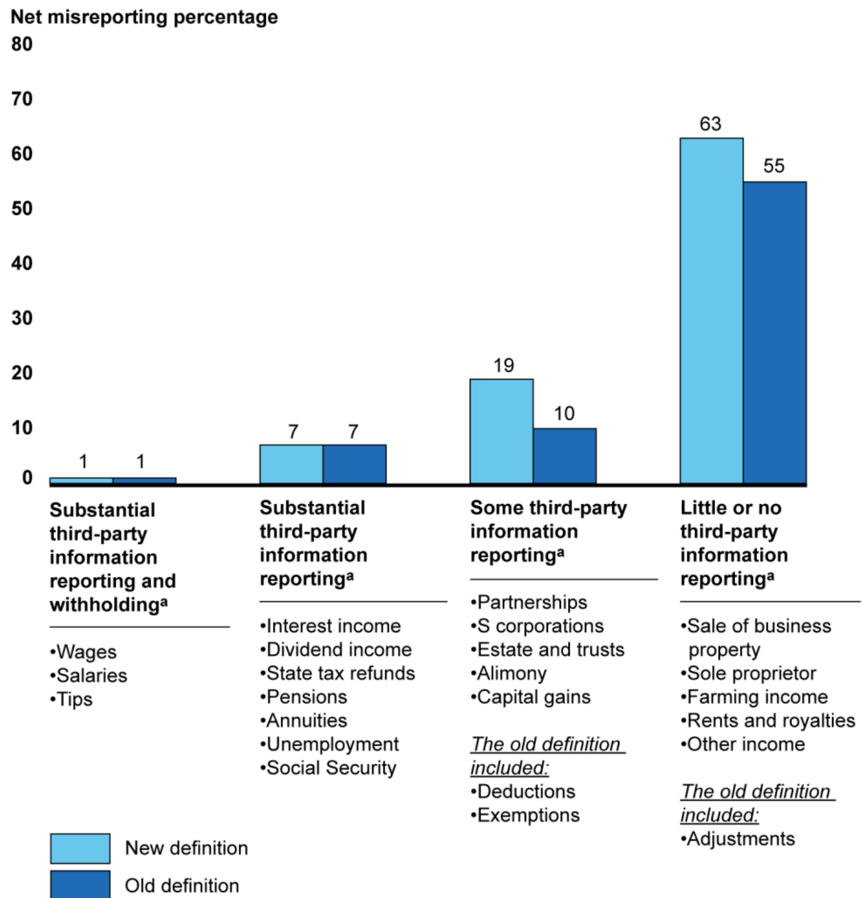
[1]IRS calculated this for both the 2006 and 2008–2010 estimates in its technical paper on the net tax gap.

by providing this data. However, IRS is unable to break out the net tax gap further by tax component because during examinations, adjustments are not categorized by component (i.e., underreporting, underpayment, and nonfiling).

- **Changes in individual income underreporting:** Starting in 2008–2010, IRS modified the categories it uses to break down the individual income underreporting component. These changes affect how IRS calculates the net misreporting percentage (NMP) for individual income tax, but not how it calculates the tax gap.[2] IRS uses the NMP to show the relationship between third-party information reporting and individual income tax reporting compliance. IRS reported the changes reflect an improvement in methodology. IRS cautions that any comparison of the 2008–2010 NMP to the 2006 NMP estimates should consider those improvements. The prior calculation method involved adding offsets to income, such as deductions, exemptions, and adjustments, which distorted the comparison across categories. IRS determined a better approach was to combine income items into categories and to report offsets to income as a separate category. (See figure 5.)

[2]NMP is defined as the sum of the net misreported amount divided by the sum of the absolute values of the amounts that should have been reported.

Figure 5: Effect of Third-Party Information Reporting on Taxpayer Compliance, 2008–2010, Calculated under Old and New Net Misreported Amount Definitions



Source: GAO analysis of Internal Revenue Service (IRS) information. | GAO-18-39

Note: Net misreporting percentage is the sum of the net misreported amount divided by the absolute values (over or underreported) of the amounts that should have reported, expressed as a percentage.

[a]IRS receives information from third parties that it uses to verify income or deduction amounts that taxpayers report on their tax returns. IRS categorized various line items on the individual income tax return into four different groupings of third-party reporting in IRS Publication 5161, Estimation of the Underreporting Tax Gap for Tax Years 2008-2010: Methodology Research, Analysis and Statistics Technical Paper, September 2016. However, IRS did not provide a scale to define the differences between substantial, some, and little or no third-party information reporting in that publication.

Appendix V: Comments from the Internal Revenue Service

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

October 13, 2017

James R. McTigue, Jr.
Director, Tax Issues, Strategic Issues Team
United States Government Accountability Office
Washington, DC 20548

Dear Mr. McTigue:

Thank you for the opportunity to review the draft report entitled, *Tax Law Enforcement: IRS Needs Specific Goals and Strategies for Reducing the Tax Gap* (GAO-18-39).

The release of tax gap estimates draws attention to the non-tax policy aspects of taxation, namely compliance and administration. The tax gap and associated concepts are a particular way of defining and analyzing tax compliance. These estimates provide a rough gauge of the extent of overall compliance as defined by the timely, voluntary payment of the correct amount of tax. The gross tax gap and voluntary compliance rate measures provide estimates that reflect the ability and willingness of taxpayers, preparers, and advisors to comply with the law given the infrastructure and resources available for tax administration. The net tax gap and net compliance rate measures provide estimates that incorporate the results of Internal Revenue Service (IRS) enforcement actions in detecting and collecting some of the tax that was not paid voluntarily and timely.

The IRS promotes voluntary compliance with the tax laws through taxpayer service and through enforcement. The IRS's Future State efforts illustrate our ongoing commitment to a continuous focus on voluntary compliance through service and enforcement as well as through infrastructure enhancements. While the report correctly notes that we do not plan to set a specific target goal for a voluntary compliance rate measure, we believe that the strategic measures and target goals being developed as part of our Fiscal Year (FY) 2018 - FY 2022 strategic plan will ensure appropriate IRS management focus on sustaining and improving voluntary compliance and have practical advantages in terms of estimation, tracking, and monitoring.

While the tax gap voluntary compliance rate measure has been used previously as a strategic and/or performance metric for the IRS, we consider the tax gap-related measures ill-suited for those purposes for the reasons we mentioned during the audit. Key among these is the fact that IRS actions alone do not determine the level of voluntary compliance - that the level of voluntary compliance is determined by the interaction of many factors. Among these are the willingness and ability of taxpayers,

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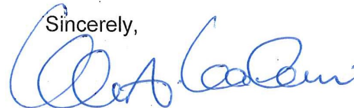
tax preparers, and other persons involved in filing, reporting, and paying tax to comply with the law; the complexity of the tax law and the ease with which taxpayers can understand their tax obligations; the administrability of the law itself; and the level of resources provided to tax administrators and others (primarily the IRS but also the Departments of the Treasury and Justice, and the Tax Court and other Courts) to educate and assist taxpayers and to address cases of identified noncompliance. The tax gap-related concepts and measures are best characterized as *compliance indicators* and we are committed to estimating them on a periodic basis for that purpose. Other projects in our compliance research portfolio are designed to evaluate the effectiveness of potential program enhancements, including the effect on compliance, because the scope of nearly all potential program enhancements is not large enough to be noticeable in fluctuations in the tax gap estimates.

The report goes on to highlight the importance of National Research Program (NRP) data for developing the tax gap estimates and in particular for the individual income tax underreporting tax gap estimates. The report also notes the potential value of more focused analysis of NRP data directed specifically at enhancing compliance programs. While the report outlines some of the ways the IRS uses the NRP data and mentions historical documentation of plans for various NRP studies, we recognize that these documents are dated and priority should be given to revise and expand them to reflect current plans and priorities.

The report concludes by noting that "reducing the tax gap" would improve the nation's fiscal position. While that is true, the reality of the IRS budget reductions over the last few years have resulted in significant staff reductions and associated contractions of IRS activities. This leaves the IRS ill-positioned to have our activities driving these desirable improvements in voluntary compliance and "reductions" in the tax gap. Even as the IRS continually works to enhance the effectiveness of our operations, those improvements cannot offset the negative effects of the reductions in IRS service and enforcement activities. Improving voluntary compliance and "reducing the tax gap" will require the combined efforts of taxpayers, tax writers, and tax administrators.

Thank you again for the valuable feedback the report has provided. We provided technical comments on the draft separately. If you have questions, please contact me, or a member of your staff may contact Ben Herndon, Director, Research, Applied Analytics & Statistics, at 202-317-4276.

Sincerely,



John A. Koskinen

Enclosure

Enclosure

GAO Recommendations and IRS Responses to GAO Draft Report
Tax Law Enforcement: IRS Needs Specific Goals and Strategies for Reducing the Tax Gap (GAO-18-39)

Recommendation 1:
The Commissioner of Internal Revenue should re-establish long-term, quantitative goals for improving voluntary compliance.

Comment:
We strongly agree that improving voluntary compliance is core to IRS's mission as tax administrator. However, quantifying that as a goal will do little to advance that purpose and is more likely to create substantial reporting burden that will divert resources from other projects that are more likely to further this underlying goal.

This report suggests that "without a quantitative goal, it will be more difficult for the IRS to determine the success of its strategies, adjust its approach when necessary, and remain focused on results." However, there is no reason that these same goals could not be accomplished in the absence of a quantitative voluntary compliance rate goal nor is this metric well-suited to this purpose. The voluntary compliance rate estimate could easily rise over time without any IRS help, but it could as easily decline in spite of significant IRS efforts that mitigated some of the declines resulting from non-IRS factors. Therefore, the IRS does not agree with this recommendation.

As long as the Service remains committed to estimating the tax gap and voluntary compliance rate, the IRS will still be able to ascertain whether it is broadly making progress toward the goal of increasing voluntary compliance, even without a quantitative target. Beyond that basic purpose, the voluntary compliance rate is not effective for making strategic and operational decisions. Because of the practical constraints on measurement, this metric is unlikely to produce data that is helpful to "determine the success of strategies" in a timely fashion, nor can the voluntary compliance/tax gap data provide sufficiently granular insights to "adjust approach when necessary," since it will be next to impossible to isolate the effects of any given action on such an all-encompassing measure that is affected not only by IRS actions but by numerous non-IRS factors.

Recommendation 2:
The Commissioner of Internal Revenue should instruct the appropriate officials to develop and document a strategy that outlines how IRS will use the National Research Program data to update compliance strategies that could help address the tax gap.

Comment:
The IRS recognizes that documentation about IRS plans for conducting NRP studies and eventual uses of the data collected are outdated and/or implicit in various activities and analyses that make use of the NRP data. Therefore, the IRS concurs that there is value to updating and expanding existing documentation, and agrees with this recommendation.

Appendix VI: GAO Contact and Staff Acknowledgments

GAO Contact:

James R McTigue, Jr. (202)-512-9110 or McTiguej@gao.gov

Staff Acknowledgments:

In addition to the contact named above, Jeff Arkin (Assistant Director), James Ashley, Jehan Chase, Charles Fox, John Hussey, Donna Miller, John Mingus, Edward Nannenhorn, Cynthia Saunders, Robyn Trotter, and Elwood White made significant contributions to this report.

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