GAO Work on Efforts to Reduce Tax Evasion and Tax Fraud
Prepared for the Internal Revenue Service Oversight Board Public Meeting
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In January 2012, the Internal Revenue Service (IRS) estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $450 billion in tax year 2006. IRS estimated that it would eventually recover about $65 billion of this amount through late payments and enforcement actions, leaving a net tax gap of $385 billion. The tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with United States tax laws has changed little over the past three decades. Because noncompliance has multiple causes and spans different types of taxes and taxpayers, multiple approaches are needed to reduce the tax gap. GAO’s work has identified various measures that IRS and Congress could take to improve taxpayer compliance and reduce the tax gap.

Enhancing Information Reporting to IRS by Third Parties

Information reporting is a powerful tool that reduces tax evasion and helps taxpayers comply voluntarily, as taxpayers are much more likely to report their income accurately when the income is also reported to IRS by a third party. By matching information received from third-party payers with what payees report on their tax returns, IRS can detect income underreporting, including the failure to file a tax return. GAO has suggested Congress consider expanding information reporting by requiring reporting for (1) service payments to corporations and (2) service payments made by landlords. Broader requirements for these two forms of information reporting, covering goods in addition to services, were enacted into law in 2010 but were later repealed. We believe the more narrow extensions of information reporting to include services, but not goods, remain important options for improving compliance.

Additionally, we recommended that IRS enhance existing information reporting requirements by

- revising the form (1098-T) on which educational institutions report information on tuition and related expenses for higher education that qualify for tax deductions or credits, and
- requiring third parties, such as mortgage lenders, to report mortgaged property addresses in addition to information they are already required to report on mortgaged properties.

IRS agreed to consider revising Form 1098-T, but has not made any revisions to date. IRS studied requiring property address to be reported with other information already required for
mortgaged properties but concluded that this change would not be worth the cost. GAO maintains that this change would be beneficial.

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Leveraging Paid Tax Return Preparers

As paid preparers prepare approximately 60 percent of all tax returns filed, their actions have an enormous impact on IRS’s ability to administer tax laws effectively. Based in part on our work and recommendations, in 2010 IRS developed new requirements for paid preparers, such as competency testing, which it has concluded will increase tax compliance. IRS is appealing a decision by a U.S. District Court to enjoin IRS from enforcing the new requirements. Regardless of the outcome of the appeal, it is critical for IRS to seek ways to leverage paid preparers to improve tax compliance.

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Expanding Compliance Checks Before IRS Issues Refunds

During 2012, IRS began to match wage and tax withholding data reported on information returns, such as Form W-2, to tax returns in March rather than later in the spring or summer after the tax return filing season. IRS is exploring the possibility of more extensive matching of
information and tax returns before issuing tax refunds. IRS is considering the implications that expanding earlier matching could have for taxpayer and compliance and tax administration efficiency. This approach could also help IRS address identity theft-related fraud.

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**Addressing Offshore Tax Noncompliance**

Given the mobility of money and proliferation of foreign financial institutions, the potential for U.S. taxpayers to evade taxes on funds held in offshore accounts is greater than ever. Likewise, foreign-source income presents a variety of compliance challenges related to the complex structure of multinational corporations, transfer pricing, and the taxation of intangible property. IRS has implemented various programs designed to entice taxpayers to voluntarily disclose their offshore accounts. Likewise, IRS is implementing recently enacted requirements related to financial institutions and taxpayers reporting to IRS on certain offshore accounts and assets of U.S. account holders. As it continues to implement its voluntary disclosure efforts and strategies for using information received on offshore accounts, IRS may be able to further its efforts to ensure offshore tax compliance. IRS agreed with GAO’s recommendation to develop a strategy for using information it obtains on foreign accounts to improve tax compliance, but has yet to implement it.

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Allocating Enforcement Resources Based on Return-on-Investment Measures

Making more effective use of available resources can help IRS mitigate the impact of shrinking budgets and increased responsibilities on its taxpayer service and enforcement efforts. Using direct revenue return-on-investment (ROI) measures of its enforcement programs could help IRS better target its enforcement resources and help maximize income tax collections. For example, in a recent analysis, GAO found that using ROI to make modest reallocations of IRS’s enforcement resources could raise billions of dollars in direct revenue with little, if any, resulting decline in voluntary compliance. GAO recommended that IRS review disparities in the ratios of direct revenue yield to costs across different enforcement programs and across different groups of cases and consider this evidence as a potential basis for adjusting its allocation of enforcement resources each year. IRS agreed with the recommendation but has yet to implement it.

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Addressing Business Noncompliance

Nearly 40 percent of the tax gap can be attributed to underreporting of business income by individuals, such as those with income from sole proprietorships, S corporations, and partnerships. Further, misreporting of non-corporate business income tax can be largely attributed to sole proprietors who understated receipts or overstated expenses. A key reason for this underreporting is the limited information reporting covering sole proprietor income. Likewise, taxpayers can control a group of related entities—such as corporations or partnerships—in a network. These networks can serve a variety of legitimate business purposes, but can be used in tax evasion schemes that are difficult for IRS to identify. Some actions GAO found that could improve compliance in this area include (1) Congress requiring S corporations to report shareholder basis to IRS and shareholders, (2) the Department of the Treasury ensuring that its strategy to address the tax gap that covers sole proprietor compliance in detail, and (3) IRS developing strategies for addressing tax evasion among networks of related entities. Congress has not enacted legislation to require S corporation basis reporting. Treasury’s strategy to
address the tax gap does not cover sole proprietor compliance in detail. IRS agreed with the recommendation to develop a strategy for addressing tax evasion among networks of related entities but has yet to implement it.

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Simplifying the Tax Code
Tax code complexity can cause taxpayer confusion and provide opportunities to hide willful noncompliance. Fundamental tax reform could result in improved tax compliance if the new system has fewer tax preferences or complex tax code provisions, reducing IRS's enforcement challenges and increasing public confidence in the fairness of the tax system. Short of fundamental reform, targeted simplification opportunities exist, such as changing tax laws to include more consistent definitions across tax provisions.

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