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TAX COMPLIANCE

Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting

Statement of David M. Walker
Comptroller General of the United States

This testimony was amended on July 7, 2006 to correct the graphic on the highlights page and the labeling of the graphs on page 6. Wording was also changed on pages 1 and 4 to clarify that \$277 billion is the amount of corporate income taxes OMB estimates will be collected in fiscal year 2006.





Highlights of [GAO-06-851T](#), a Testimony to Committee on Finance, U.S. Senate

Why GAO Did This Study

Corporate income taxes are expected to bring in about \$277 billion in 2006 to help fund the activities of the federal government. Besides raising revenue, the tax alters investment decisions and raises concerns about competitiveness in an environment of increasing global interdependency. The complexity of the tax breeds tax avoidance, including an estimated \$32 billion of noncompliance detected by the Internal Revenue Service (IRS).

This testimony provides information on trends in corporate taxes and opportunities to improve corporate tax compliance.

The committee also asked that GAO discuss recent work on the misreporting of capital gains income from securities sales and options to improve compliance.

This statement is based largely on previously published GAO work.

www.gao.gov/cgi-bin/getrpt?GAO-06-851T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

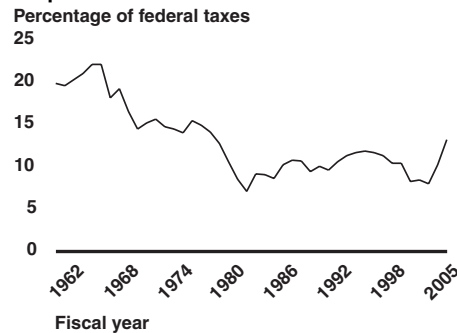
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Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting

What GAO Found

The corporate income tax is an important source of federal revenue and must be considered in dealing with the nation's long-term fiscal imbalance. Reexamining both federal spending and revenues, including corporate tax policy, corporate tax expenditures and corporate tax enforcement must be part of a multi-pronged approach to address the imbalance.

Corporate Income Tax Revenues as a Share of Federal Taxes, 1962-2005



Source: GAO Analysis of OMB Data.

The total amount of corporate tax avoidance, which includes the \$32 billion in noncompliance estimated by IRS, is unknown. A complex tax code, complex business transactions, and often multinational corporate structures make determining corporate tax liabilities and the extent of corporate tax avoidance a challenge. Opportunities exist to improve corporate tax compliance and include simplifying the tax code, obtaining better data on noncompliance, continuing to oversee the effectiveness of IRS enforcement, leveraging technology, and sending sound compliance signals through increased collections of taxes owed.

In a companion report issued today, GAO found that many taxpayers misreport capital gains or losses, sometimes inappropriately underpaying their taxes and sometimes overpaying them. IRS has efforts in place to help ensure proper reporting of capital gains and losses, but these efforts face several obstacles. GAO found that expanding third-party information reporting on the cost basis of capital assets could help mitigate this problem if related problems are addressed. GAO suggested that Congress consider requiring brokers to report adjusted basis to taxpayers and IRS and requiring IRS to work with the securities industry to develop cost-effective ways to mitigate reporting challenges. GAO also recommended that IRS clarify its guidance on reporting capital gains and losses.

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to discuss the corporate income tax with you as well as our work on options for improving taxpayers' voluntary compliance in reporting their capital gains or losses from the sales of securities. As the Committee is well aware, the U.S. position in the worldwide economy has fundamentally changed and the structure and composition of our economy has shifted. U.S. workers and firms must now succeed in a world of fast-paced technological change and constantly evolving global competition. This raises two sets of questions about the corporate income tax. The first is about reforming the overall U.S. tax system and perhaps changing the role of corporate taxes. The second set of questions is about how to administer and enforce the existing corporate income tax in a changing world. As per your request, my statement focuses principally on this question.

The complexity of the corporate income tax generates opportunities for tax avoidance that can be categorized as clearly legal, clearly noncompliant (illegal), or of uncertain legality. Corporate tax base is reduced by statutory corporate tax expenditures, legal and illegal tax avoidance, and deliberate underreporting of income. The overall amount of tax base reduction is unknown but the Internal Revenue Service (IRS) has estimated the amount of clear noncompliance to total \$32 billion for tax year 2001. Corporate tax avoidance in its various forms reduces overall federal revenue or, for the government to take in the same revenue, means that other taxpayers pay more.

My statement today makes the following points:

- Although less of a revenue source than it once was, the corporate income tax is one of the pillars of the federal tax system.¹ The \$277 billion in corporate tax revenues that the Office of Management and Budget (OMB) estimates will be paid in fiscal year 2006 must be part of overall considerations for dealing with the nation's long-term fiscal imbalance. More specifically, corporate tax policy, corporate tax expenditures and corporate tax enforcement all must be part of a multi-pronged approach that reexamines both federal spending and revenues.

¹ For purposes of this statement, when we refer to the corporate income tax or corporations, we are excluding S-corporations, which are pass-through entities whose income or losses are generally not taxed at the corporate level, but are passed through to their owners.

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- Determining corporate income tax liabilities and the extent of corporate tax avoidance is a challenge because of the complex tax code, complex business transactions and often multinational corporate structures. Opportunities exist to improve corporate tax compliance, such as simplifying the tax code, obtaining better data to the extent feasible on noncompliance, continuing to oversee the effectiveness of IRS's efforts, continuing to leverage technology, and sending sound compliance signals through such things as increased effectiveness in collecting taxes owed.

Also, at your request, I have included a section in this statement that discusses our findings in the area of capital gains basis reporting. In summary, we found that many taxpayers misreport capital gains or losses, sometimes inappropriately underpaying their taxes and sometimes overpaying them. IRS has efforts in place to help ensure proper reporting of capital gains and losses, but these efforts face several obstacles. Finally, we found that expanding third-party information reporting on the cost basis of capital assets could help mitigate this problem if related problems are addressed.

My statement today is largely drawn from previous GAO reports and testimonies, which were done in accordance with generally accepted government auditing standards. We also relied on other published information for the sections of this statement dealing with corporate taxation. The latter part of this statement discusses capital gains basis reporting and is drawn from the report on that subject we are releasing today.

Background

The base of the federal corporate income tax includes net income from business operations (receipts, minus the costs of purchased goods, labor, interest, and other expenses). It also includes net income that corporations earn in the form of interest, dividends, rent, royalties, and realized capital gains. The statutory rate of tax on net corporate income ranges from 15 to 35 percent, depending on the amount of income earned.²

² In addition, present law imposes an alternative minimum tax (AMT) on corporations to the extent that their minimum tax liability exceeds their regular tax liability. In general, the AMT applies a lower tax rate to a broader tax base. Specifically, the regular tax base is increased for AMT purposes by adding back certain items treated as tax preferences and disallowing certain deductions and credits. Also, marginal rates are higher over limited income ranges to recapture the benefits of the rates below 35 percent.

The United States taxes the worldwide income of domestic corporations, regardless of where the income is earned, with a foreign tax credit for certain taxes paid to other countries. However, the timing of the tax liability depends on several factors, including whether the income is from a U.S. or foreign source and, if it is from a foreign source, whether it is earned through direct operations or through a subsidiary.³

Statutory and effective tax rates are not necessarily the same. An effective tax rate, which is often lower—even substantially lower—than the statutory rate, measures the amount of tax that a corporation actually pays on a dollar of its economic income, when all aspects of the tax (deductions, credits, deferrals, etc.) are taken into account. Statutory and effective rates may differ, for example, because depreciation allowances for specific types of capital investments exceed (or fall short of) the true (economic) depreciation. Other differences arise because income from foreign subsidiaries is generally not taxed until it is repatriated to the United States. Special incentives, such as the research tax credit, that are designed to encourage certain behavior, also cause the effective rate of the tax to differ from its statutory rate. A recent Congressional Budget Office (CBO) study found that the United States' statutory corporate tax rates are high relative to Organization for Economic Cooperation and Development (OECD) countries but comparable with the rates for what were then the G-7 countries.⁴ Comparisons of effective rates depend on the type of investment and the type of financing. According to CBO, U.S. effective corporate tax rates in 2003 were the G-7 median for equity-financed investments in machinery, second lowest for debt-financed investment in

³ Very generally, corporations first calculate their taxable income. Taxable income is total income, including taxable income from foreign sources, minus deductions such as for salaries and wages, depreciation, and net operating loss carryovers. The next step is to calculate the tentative tax owed (taxable income times the applicable rate). The last step is to subtract any tax credits, including the foreign tax credit, to get the taxes owed.

⁴ OECD consists of 30 market democracies and its purpose is to provide member countries a setting where governments can compare policy experiences, seek answers to common problems, and coordinate domestic and international policies. At the time of the CBO study, the G-7 consisted of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The G-7's purpose is to provide a forum for the leaders of the largest industrialized democracies to discuss major economic and political issues. When the Russian Federation participates at the meetings, the group is known as the G-8.

machinery, and second highest for equity-financed investment in industrial structures.⁵

Differences in effective tax rates across types and sources of income are pervasive, reflecting the complexity of the tax code. The corporate income tax (1) reduces the after tax return on capital income and, therefore, affects the incentive individuals have to save and invest; (2) taxes corporations differently than partnerships and sole proprietorships; (3) taxes U.S. corporations operating in foreign countries differently than those operating domestically and differently than foreign governments tax corporations; (4) taxes different types of corporate investments, such as machinery or structures, unevenly; and (5) taxes debt-financed investment at lower rates than equity-financed investment. These differences in effective tax rates alter both investment decisions and the reporting of corporate income as firms try to minimize their taxes. Such tax avoidance, much of it legal but some illegal, reduces tax revenue. Guiding investments to lightly taxed activities rather than those with high before tax productivity may reduce economic growth, further reducing tax revenue from what it otherwise would have been.

Corporate Income Taxes Are a Significant Source of Federal Revenue and Must Be Part of the Overall Considerations for Fiscal Reform

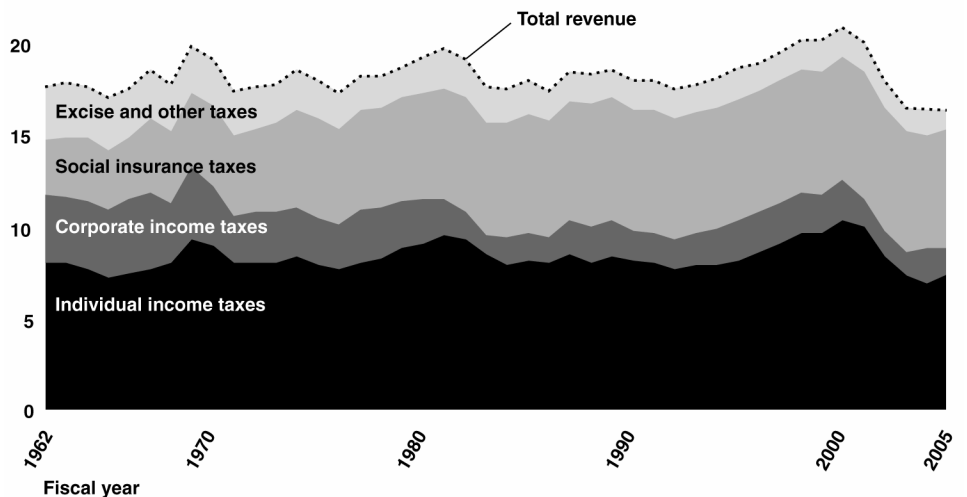
At about \$277 billion, corporate income taxes are far smaller than the \$841 billion in social insurance taxes and \$998 billion in individual income taxes that OMB estimates will be paid in fiscal year 2006 to fund the federal government.⁶ Figure 1 shows the relative importance of federal taxes.

⁵ Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons*, (Washington, D.C.: November 2005). The study focuses on how corporate income taxes affect incentives for investment by calculating marginal effective tax rates in different countries. The calculations include differences across countries in statutory tax rates and depreciation rules.

⁶ Office of Management and Budget. *Historical Tables, Budget of the United States Government, Fiscal Year 2007*. (Washington, D.C.: Feb. 2006).

Figure 1: Trend in Federal Taxes, 1962-2005

25 Percentage of GDP



Source: GAO representation of OMB data.

Figures 1 and 2 show the trend in corporate tax revenues since 1962. Tax experts have written that corporate tax revenues fell from the 1960s to the early 1980s for several reasons. For example, corporate income became a smaller share of national income during these years, partly due to the fact that corporate debt, and therefore deductible interest payments, increased relative to corporate equity, reducing the tax base. In addition, tax expenditures, such as more generous depreciation rules and corporate tax rate reductions lowered corporate taxes.⁷ Since the early 1980s corporate

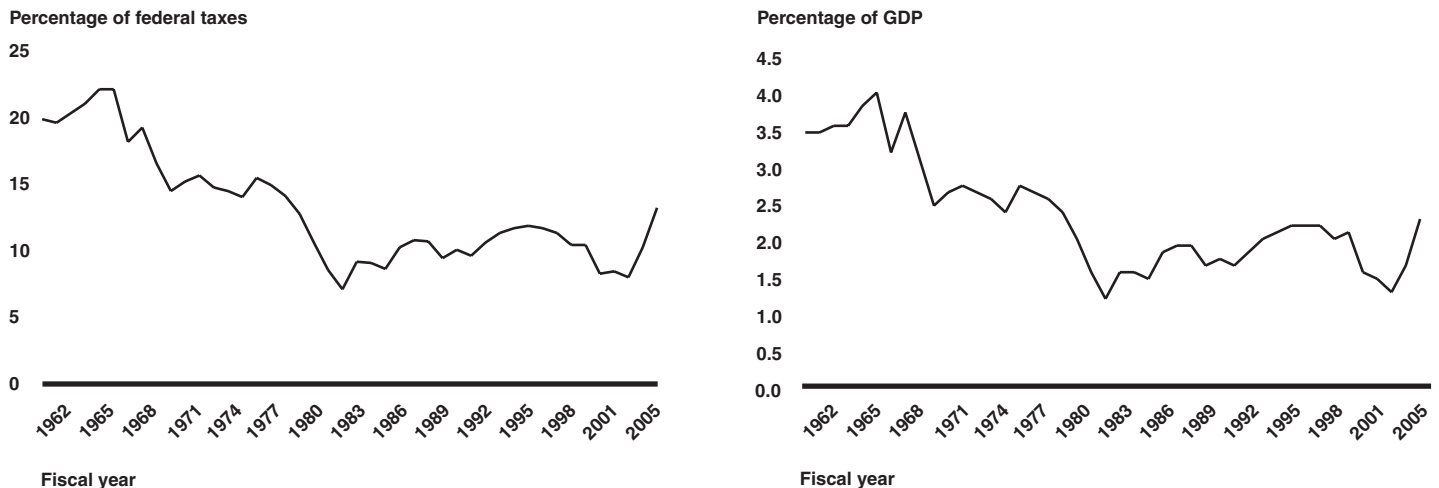
⁷ Steuerle, C. Eugene, *Contemporary U.S. Tax Policy*. Washington, D.C.: The Urban Institute Press, 2004.

Gravelle, Jane G., "The Corporate Tax: Where Has It Been and Where Is It Going?" *National Tax Journal*, vol. 57, no. 4 (2004): 903-23.

tax revenues have fluctuated in a narrower range, reflecting changes in corporate profits, tax laws, and other factors.

Since the early 1980s the corporate tax has accounted for from about 6 to 13 percent of federal revenue, as shown in figure 2. Consequently, although not the largest, it remains an important source of federal revenue. Relative to the gross domestic product (GDP), the corporate tax has ranged from a little over 1 percent to just under 2.5 percent during those same years. CBO has recently projected that despite the recent uptick, corporate tax revenue for the next 10 years as a percentage of GDP is expected to stay within this same range.

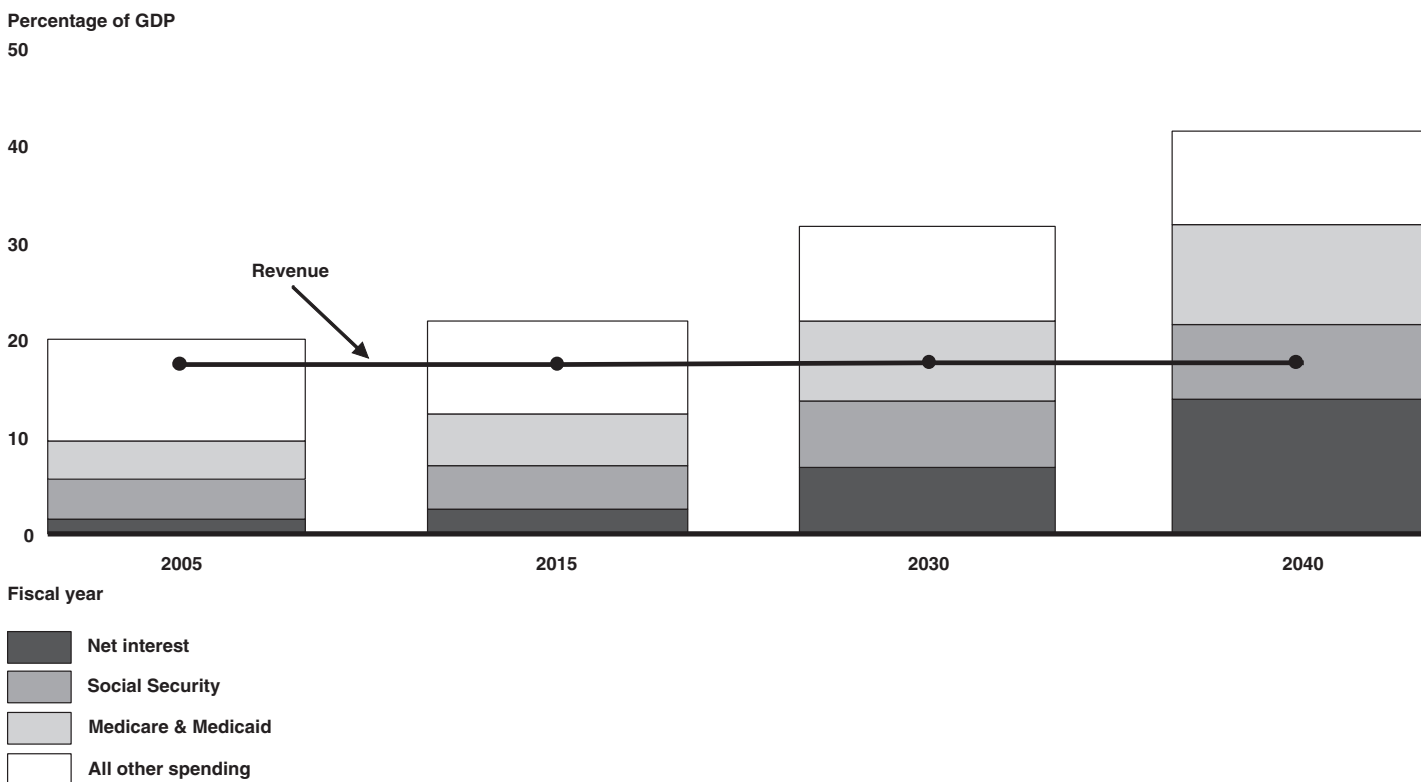
Figure 2: Corporate Income Tax Revenues as a Share of Federal Taxes and as a Share of GDP, 1962-2005



Source: GAO analysis of OMB data.

Corporate tax revenues of the magnitude shown in figure 2 make them relevant to considerations about how to address the nation's long-term fiscal imbalance. Over the long term, the United States faces a large and growing structural budget deficit primarily caused by demographic trends and rising health care costs as shown in figure 3, and exacerbated over time by growing interest on the ever larger federal debt. Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security.

Figure 3: Composition of Federal Spending as a Share of GDP, Assuming Discretionary Spending Grows with GDP after 2006 and That Expiring Tax Provisions Are Extended



Source: GAO's May 2006 analysis.

Note: This includes certain tax provisions that expired at the end of 2005, such as the increased alternative minimum tax exemption amount.

We cannot grow our way out of this long-term fiscal challenge because the imbalance between spending and revenue is so large. We will need to make tough choices using a multipronged approach: (1) revise budget processes and financial reporting requirements; (2) restructure entitlement

programs; (3) reexamine the base of discretionary spending and other spending; and (4) review and revise tax policy, including tax expenditures, and tax enforcement programs. Corporate tax policy, corporate tax expenditures, and corporate tax enforcement need to be part of the overall tax review because of the amount of revenue at stake.

Corporate tax expenditures reduce the revenue that would otherwise be raised from the corporate income tax. As already noted, to reduce their tax liabilities, corporations can take advantage of preferential provisions in the tax code, such as exclusions, exemptions, deductions, credits, preferential rates, and deferral of tax liability. Tax preferences—which are legally known as tax expenditures—are often aimed at policy goals similar to those of federal spending programs. For example, there are different tax expenditures intended to encourage economic development in disadvantaged areas and stimulate research and development, while there are also federal spending programs that have similar purposes. Also, by narrowing the tax base, corporate tax expenditures have the effect of raising either corporate tax rates or the rates on other taxpayers in order to generate a given amount of revenue.

The sum of estimated forgone revenue for the federal government because of corporate tax expenditures was \$80 billion for fiscal year 2005.⁸ In its most recent report, the Department of the Treasury (Treasury) listed 27 tax expenditures for corporate taxpayers only and another 52 provisions available to both corporations and other businesses. As of fiscal year 2005, the two largest tax expenditures used by corporations were the accelerated depreciation of machinery and equipment (\$15.9 billion) and the deferral of income of controlled foreign corporations (\$10.5 billion); these two accounted for a third of the sum of corporate revenue losses estimated by Treasury.

We reported in September 2005⁹ that the effectiveness of many tax expenditures is not subject to a level of review similar to that of programs

⁸Summing the individual tax expenditure estimates is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between individual provisions. See GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, [GAO-05-690](#) (Washington, D.C.: Sept. 23, 2005).

⁹ GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, [GAO-05-690](#) (Washington, D.C.: Sept. 23, 2005).

that spend money directly. Although some corporate income tax expenditures are reviewed by government agencies, academics, and others, all should be reviewed periodically to ensure they have not outlived their usefulness, are not redundant, or are not inefficient in accomplishing their intended purpose. In that report, we recommended that the OMB and Treasury take steps to ensure regular reexamination of tax expenditures, including the corporate provisions. OMB disagreed with the recommendations, citing methodological and conceptual issues. Our report discusses in detail the issues that OMB raised and why we continue to believe that our recommendations are valid. Also, as far back as 1994, we have suggested that Congress should review these tax expenditures, considering such things as how well the corporate tax expenditures are achieving their purposes and whether they should remain, given the potential benefits of a simpler corporate tax code, possibly with reduced tax rates.¹⁰

Opportunities Exist to Improve Corporate Tax Compliance

Ensuring corporate income tax compliance is challenging because much corporate tax avoidance is legal and the true tax liability for large corporations is difficult to determine. A wide variety of strategies will undoubtedly be needed to address corporate tax compliance. Opportunities to pursue include simplifying the tax code, obtaining better data to the extent feasible on noncompliance, continuing to oversee the effectiveness of IRS's efforts, continuing to leverage technology, and sending sound compliance signals through such things as increased effectiveness in collecting taxes owed.

Corporate Tax Avoidance Is Bred in Part by Complexity

The amount of corporate tax avoidance is unknown. A complex tax code, complicated business transactions, and often multinational corporate structures make determining corporate tax liabilities and the extent of corporate tax avoidance a challenge. Tax avoidance has become such a concern that some tax experts say corporate tax departments have become "profit centers" as corporations seek to take advantage of the tax laws in order to maximize shareholder value. Some corporate tax avoidance is clearly legal, some falls in gray areas of the tax code, and some is clearly noncompliance or illegal. Tax code simplification has the potential to reduce at least some of this avoidance.

¹⁰ GAO, *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GAO-GGD/AIMD-94-122 (Washington, D.C.: June 3, 1994).

Often corporate tax avoidance is legal. For example, multinational corporations can locate active trade or business operations in jurisdictions that have lower effective tax rates than does the United States and, unless and until they repatriate the income, defer taxation in the United States on that income, thus reducing their effective tax rate. Similarly, making investments that qualify for accelerated depreciation can lower a corporation's current effective tax rate, although in the future its rate would be higher.¹¹

Corporate tax planners may find legal ways to exploit tax code complexity to play one provision of the code off another in ways that Congress never intended. In response, Congress has sometimes acted to address what it considered to be abusive tax shelters. For example, the American Jobs Creation Act of 2004¹² limited the tax benefits of leasing transactions involving tax-exempt entities, such as transit authorities. One type of transaction the act limited was the sale-in/lease-out (SILO) arrangement, which involved a taxable entity buying assets, such as railcars, from a tax-exempt entity, for example, a metropolitan transit system, and leasing them back to the tax-exempt entity. The estimated revenue gain from the 2004 act's provision covering leasing transactions with tax-indifferent parties was about \$26.6 billion for 2005 through 2014.

Complicating corporate tax compliance is the fact that in many cases the law is unclear or subject to differing interpretations. In fact, some have postulated that major corporations' tax returns are actually just the opening bid in an extended negotiation with IRS to determine a corporation's tax liability. An illustration is transfer pricing. Transfer pricing involves setting the appropriate price for such things as goods, services, or intangible property (such as patents, trademarks, copyrights, technology, or "know-how") that is transferred between the U.S.-based operations of a multinational company and a foreign affiliate. If the price paid by the affiliate to the U.S. operation is understated, the profits of the U.S. operation are reduced and U.S. taxable income is inappropriately reduced or eliminated. The standard for judging the correct price is the price that would have been paid between independent enterprises acting at "arm's length." However, it can be extremely difficult to establish what an arm's length price would be. Given the global economy and the number

¹¹ Accelerated depreciation lowers a corporation's marginal effective tax rate on investments by increasing the present value of these deductions.

¹² Pub. L. No. 108-357 (2004).

of multinational firms with some U.S.-based operations, opportunities for transfer pricing disputes are likely to grow.

Tax shelters are one example of how tax avoidance, including corporate tax avoidance, can shade into the illegal. Some tax shelters are legal though perhaps aggressive interpretations of the law, but others cross the line. In a 2003 testimony, we reported that IRS had identified 27 kinds of abusive shelter transactions—called listed transactions—promoted to corporations and others. As of June 2006, IRS's web site lists 31 such listed transactions. IRS also had a number of other transactions that had to be reported to IRS and may have had some characteristics of abusive shelters but were not, and possibly never would be, listed.

Abusive shelters often are complex transactions that manipulate many parts of the tax code or regulations and are typically buried among legitimate transactions reported on tax returns. Because these transactions are often composed of many pieces located in several parts of a complex tax return, they are essentially hidden from plain sight, which contributes to the difficulty of determining the scope of the abusive shelter problem. Often lacking economic substance or a business purpose other than generating tax benefits, abusive shelters have been promoted by some tax professionals, often in confidence, for significant fees, sometimes with the participation of tax-indifferent parties, such as foreign or tax-exempt entities. These shelters may involve unnecessary steps and flow-through entities, such as partnerships, which make detection of these transactions more difficult.

For example, a company had a sizable gain from the sale of a subsidiary and wanted to avoid or minimize paying tax on the gain. An investment bank proposed forming an offshore partnership with a foreign corporation (a tax-indifferent party) for the express purpose of sheltering the capital gains of its corporate client. The partnership purchased and quickly resold notes in a contingent installment sale transaction. The partnership earned a large capital gain, most of which it allocated to the foreign corporate partner. Later, related losses were allocated to the U.S. corporation, generating approximately \$100 million in capital loss for the investment bank's client. The corporation used this capital loss to shelter its U.S.-based capital gains. Both the Tax Court and the Third Circuit Court of Appeals ruled that the transaction lacked economic substance. The Third Circuit, in addition to requiring economic substance, held that a

transaction must have a subjective nontax business motive to be respected for tax purposes.¹³ For this transaction, the investment bank was to earn a fee of \$2 million.

In part because tax shelters are intentionally hidden, IRS has not been able to produce a reliable estimate of the revenues lost because of shelters. As we reported in October 2003, one estimate, which had a number of methodological limitations, suggested an average annual tax gap because of tax shelters (both corporate and individual) that could have been from about \$11.6 billion to about \$15.1 billion for the years 1993 through 1999.¹⁴ Because the methodological limitations were serious, the true amount of the revenue loss could be lower or higher than this range. Furthermore, this estimate does not cover non-abusive tax shelters.

Establishing a presence in a low-tax country is another technique for avoiding corporate income tax. Some low-tax countries are called tax havens. The company's presence in a tax haven in some cases may be nominal, nothing more than a file in an office. Use of a tax haven can be questionable when combined with abusive transfer pricing or techniques, such as interest stripping, to artificially shift income to the tax haven. In several reports since 2002, we reported on federal contractors' use of tax havens. We reported that 4 of the top 100 federal contractors that were publicly traded corporations in 2001 were located in tax havens and that 3 of these were originally U.S.-headquartered corporations. Later, we reported that large tax haven contractors in both 2000 and 2001 had a tax cost advantage compared to large domestic contractors.¹⁵

¹³ *ACM Partnership v. Commissioner*, 157 F. 3d 231 (3d Cir. 1998), *aff'g*, 73 T.C.M. 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999).

¹⁴ GAO, *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters*, [GAO-04-104T](#), (Washington, D.C.: Oct. 21, 2003).

¹⁵ GAO, *Information on Federal Contractors That Are Incorporated Offshore*, [GAO-03-194R](#) (Washington, D.C.: Oct. 1, 2002) and *International Taxation: Tax Haven Companies Were More Likely to Have a Tax Cost Advantage in Federal Contracting*, [GAO-04-856](#) (Washington, D.C.: June 30, 2004).

IRS's Incomplete and Dated Estimates of Corporate Tax Noncompliance Can Be Improved

In large part because of the complexity and uncertainty in the application of tax laws, the actual level of corporate income tax noncompliance (illegal tax avoidance) is poorly understood. IRS estimates a corporate tax gap in the tens of billions of dollars, but also acknowledges that this estimate is not based on robust, recent, and reliable research.¹⁶

As noted above, IRS's published estimate of the corporate tax gap—the difference between what corporations pay voluntarily and on time in taxes and what they are required to pay under the law—is \$32 billion for tax year 2001. This is out of an overall gross tax gap of \$345 billion for that year. Underreporting of income was the largest component of the corporate tax gap, contributing an estimated \$30 billion. The IRS estimate included both small corporations (those reporting assets of \$10 million or less) and large corporations (those reporting assets of over \$10 million). Underpayment of taxes due accounted for \$2 billion of the corporate tax gap for tax year 2001. IRS has no estimate for nonfiling of corporate income tax returns for tax year 2001.

However, the available tax gap estimates are highly uncertain and incomplete. IRS has not systematically measured the level of compliance for large corporations, and the last measure of noncompliance for small corporations was from the 1980s. IRS's level of certainty with regard to the accuracy of the corporate tax gap estimate is low for reasons such as use of incomplete and old data, interpretation of complex laws, and resource constraints. The 2001 estimate used data from the 1970s and 1980s to estimate underreporting of corporate income taxes. For large corporate income tax underreporting, IRS based its estimate on the amount of tax recommended from operational examinations. As we reported in July 2005,¹⁷ according to IRS officials, IRS relies on the amount of tax recommended because it is difficult to determine the true tax liability of large corporations because of complex and ambiguous tax laws that create opportunities for differing interpretations and that complicate the determination. Because these examinations do not cover all firms and do not test all items on a tax return, the estimate produced from the

¹⁶ The tax gap estimate is an aggregate of estimates for three primary types of noncompliance: underreporting of tax liabilities on tax returns; underpaying of taxes due from filed returns; and nonfiling, which refers to the failure to file a required tax return altogether or on time.

¹⁷ GAO, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C. July 18, 2005).

examinations is incomplete. IRS officials also explained that because of these complexities and the costs and burdens of collecting complete and accurate data, IRS has not systematically measured large corporation tax compliance through statistically valid studies.

As of June of this year, IRS did not have approved plans to update the corporate tax gap estimate. Although measuring corporate tax compliance can be challenging and costly, such compliance data aid in identifying new or growing types of noncompliance, identifying changes in tax laws and regulations that may improve compliance, more effectively targeting examinations of tax returns, understanding the effectiveness of its programs to promote and enforce compliance, and properly determining its resource needs and allocations. In order to improve efforts to reduce the tax gap, we have recommended that IRS develop plans to periodically measure tax compliance for areas that have been measured, and study ways to cost effectively measure compliance for other components of the tax gap that have not been measured, such as excise taxes and corporate taxes. IRS agreed with our recommendations.¹⁸

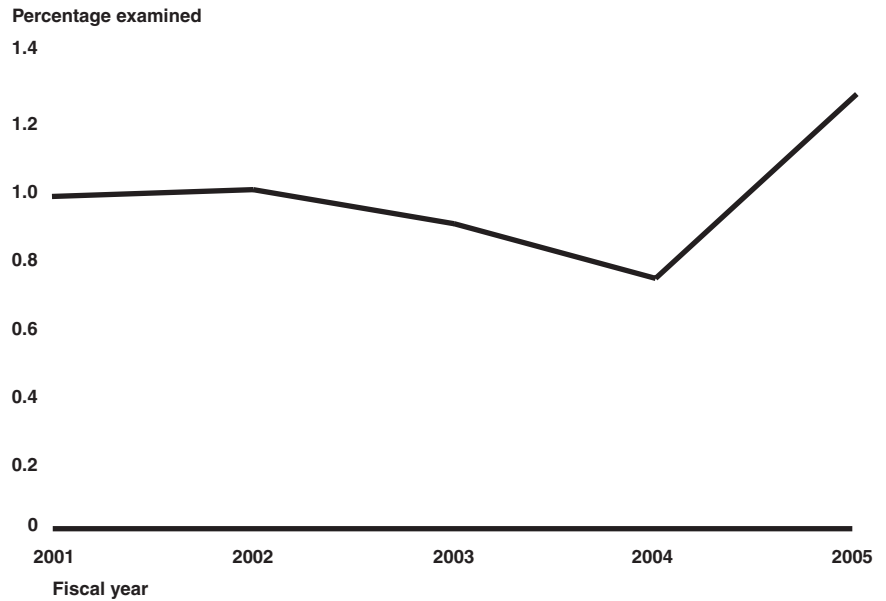
IRS Has Strengthened Corporate Tax Compliance Efforts, but Continued Oversight Will Be Warranted

IRS has recently increased the number of corporate audits and recommended tax assessments. These trends are promising. However, given the lack of a reliable measure of the extent of corporate noncompliance and other factors, continued oversight of these efforts will be warranted to make informed judgments about their overall effectiveness.

As shown in figure 4, the number of corporate income tax returns that IRS examined rose from its recent low of 0.71 percent in fiscal year 2004 to 1.25 percent in fiscal year 2005. This number includes examinations of 20 percent of large corporations in fiscal year 2005 as well as audits of all 1,100 of the nation's largest corporations with assets of more than \$250 million.

¹⁸ GAO, *Tax Administration: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, [GAO-05-753](#) (Washington, D.C.: July 18, 2005).

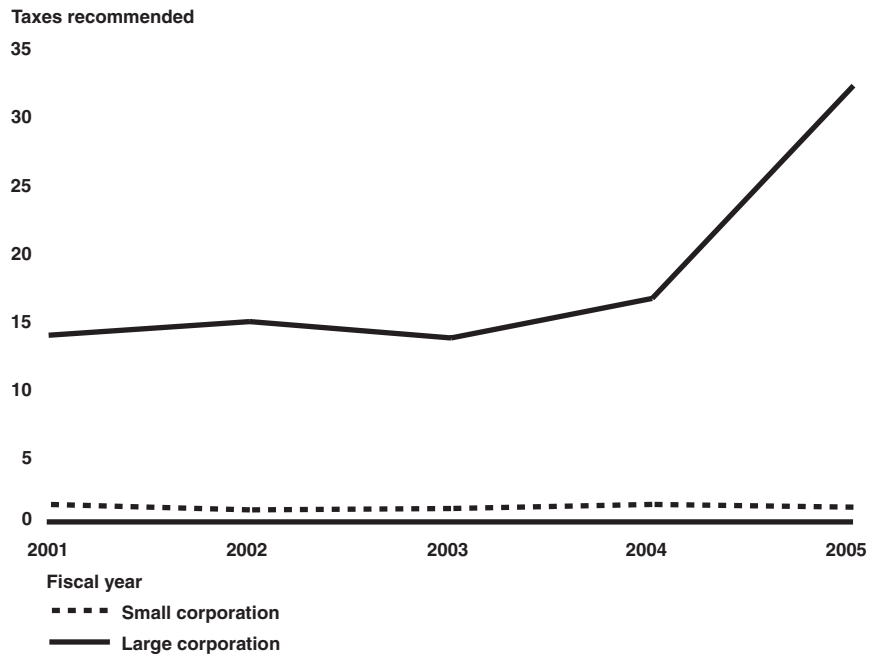
Figure 4: Percentage of Corporate Tax Returns IRS Examined, Fiscal Years 2001-2005



Source: IRS.

Figure 5 shows that the amount of taxes that IRS recommended as a result of examinations performed grew from its recent low of \$13.5 billion in fiscal year 2003 to \$32 billion in fiscal year 2005.

Figure 5: Amount of Taxes Recommended from Examinations of Corporations in Billions of Dollars, Fiscal Years 2001-2005



Source: IRS.

According to IRS, about a third of the increase in recommended assessments comes from tax shelter examinations, and nearly all of the increase comes from examinations of the largest corporations. IRS notes, not surprisingly, that a large portion of the recommended taxes were not agreed to by the corporations. In the past, we found that under IRS's examination program of the nation's largest corporations, the amount of taxes IRS actually assessed has been about 20 percent of the amount initially recommended during examinations.¹⁹ Further, the amounts assessed often are not ultimately collected after cases are reviewed in IRS's Appeals function or in the courts. Because the various review and appeal options can be time consuming, it may be a number of years before actual collection occurs on some cases.

¹⁹ GAO, *Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128 (Washington D.C.: June 23, 1998).

The shelter-related results come from IRS's multiyear effort to attack tax shelters. In 2003 we reported that IRS had shifted resources to create a broad-based strategy to combat what it considered to be a high priority challenge—abusive tax shelters. IRS had adopted a broad-based strategy for addressing abusive shelters, including

- targeting promoters to head off the proliferation of shelters;
- making efforts to deter, detect, and resolve abuse;
- offering inducements to businesses to disclose their use of questionable tax practices; and
- using performance indicators to measure outputs and some outcomes and intending to go down the path it had started and develop long-term performance goals and measures linked to those goals. We said that without these latter elements, Congress would find gauging IRS's progress difficult.

In addition to examinations, IRS has undertaken a number of initiatives to address corporate tax compliance. Some of these initiatives are intended to resolve tax issues beyond the examination process. The Advance Pricing Agreement (APA) program, the Fast Track Settlement program, the Pre-Filing Agreement program, and the Industry Issue Resolution program all work to some degree to resolve contentious tax issues outside of the examination process. For example, the APA program is intended to address transfer pricing issues up front so that they do not arise during subsequent examinations.

IRS has also been revising the corporate tax examination process. For instance, IRS reports that it has shortened the cycle time of examinations. According to IRS, reducing cycle time allows IRS to examine additional taxpayers and reduces administrative burdens on taxpayers. Similarly, IRS's Limited Issue Focused Examination process seeks to have IRS and corporations reach a formal agreement to govern key aspects of the examination.

Future success in following through on these initiatives will require replenishment of IRS's staff, which could be challenging given the increasing numbers of key employees who are eligible for retirement or who are otherwise leaving key occupations. The Large and Mid-Size Business Division (LMSB), which is responsible for the compliance of the largest corporations, reported in its fiscal year 2006 strategic assessment that it will continue to lose substantial experience as revenue agents leave. The Small Business and Self Employed Division, which covers the rest of corporations, also has growing numbers of employees eligible for

retirement or leaving their enforcement positions. Although hiring to fill positions is occurring, past experience suggests that training these new employees and giving them on-the-job experience will take time and likely adversely affect the divisions' overall productivity to some extent. The Treasury Inspector General for Tax Administration has designated managing human capital a management and performance challenge for IRS.

In part because IRS does not have a reliable measure of corporate tax compliance, it will be challenged to demonstrate the effectiveness of the increased audits and the various initiatives it has undertaken. The effectiveness of IRS's efforts will depend on the extent to which the taxes recommended are actually collected given past data showing that a relatively small portion of recommended assessments is ultimately collected. For these reasons, as well as human capital management challenges, IRS's increased compliance efforts will warrant continued oversight.

Continuing to Leverage Technology

Judicious use of technology has already helped IRS improve its productivity, and continued, well-managed technology initiatives have the potential to further improve the use of its resources. According to IRS, electronic filing of individuals' tax returns has enabled it to reduce the amount of staffing devoted to processing paper tax returns and to transfer staffing allocations to other endeavors, including compliance work. Further, because of the software used in electronically preparing and filing returns, these returns have fewer errors, thus saving IRS and taxpayers needless time and effort to correct avoidable errors.

Starting in 2006, many larger corporations are now required to file their tax returns electronically. This is no small undertaking, and some transition issues are likely to occur. However, electronic returns offer the potential to speed examinations—if for no other reason than often very voluminous corporate tax returns can be moved to appropriate locations for review immediately. IRS believes electronically filed returns will also speed analysis of corporate tax returns and the identification of issues and taxpayers most in need of examination or other resolution of potential compliance issues. IRS plans to gradually expand the number of firms required to electronically file. This and other opportunities to leverage modern technology can serve to help IRS deal with the complex tax issues in corporate tax returns.

Improving the Collection of Delinquent Taxes Would Send a Compliance Signal

When any taxpayer has been found to owe taxes and those amounts are no longer in dispute, failure to collect the taxes sends an adverse compliance signal. While not collecting these debts may send a message to corporations that IRS is not serious about enforcing the tax law, developing and exploiting opportunities to improve collections sends the opposite signal and can contribute to reducing corporate noncompliance. In February 2004, we reported that some Department of Defense (DOD) contractors abuse the federal tax system with little consequence.²⁰ We reported that based on our analysis of a limited number of DOD disbursement systems, more than 27,000 DOD contractors owed nearly \$3 billion in unpaid federal taxes. In June 2005, we reported that many contractors of civilian agencies throughout the federal government also abuse the federal tax system.²¹ Our analysis showed that about 33,000 contractors that received substantial federal payments from civilian agencies during fiscal year 2004 owed a total of more than \$3 billion in unpaid taxes. The unpaid taxes owed by DOD and civilian agency contractors included corporate income, excise, unemployment, individual income, and payroll taxes.²² We also found evidence of abusive and potentially criminal activities on the part of both DOD and civilian agency contractors.²³

In our reports on this issue, we made numerous recommendations intended to improve the Federal Payment Levy Program by expanding the amount and type of tax debt eligible for inclusion in the program, expanding the volume of federal payments subject to levy, and correcting process and control deficiencies that hindered the program's ability to

²⁰ GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-95](#) (Washington, D.C.: Feb. 12, 2004). Although some of the contractors were corporations, we did not estimate how many were corporations.

²¹ GAO, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-05-637](#) (Washington, D.C.: June 16, 2005).

²² Payroll taxes are amounts that businesses withheld from employees' wages for federal income taxes, Social Security, and Medicare but failed to remit to IRS, as well as the related employer matching contributions for Social Security and Medicare taxes.

²³ We considered activity to be abusive when a contractor's actions or inactions, though not illegal, took advantage of the existing tax enforcement and administration system to avoid fulfilling federal tax obligations and were deficient or improper when compared with behavior that a prudent person would consider reasonable. We characterized as potentially criminal any activity related to federal tax liability that may be a crime under a specific provision of the Internal Revenue Code.

maximize the amount levied from payments to contractors with unpaid federal taxes. In our 2004 report, we also recommended that OMB develop options for prohibiting federal contract awards to businesses and individuals that abuse the federal tax system, including designating such tax abuse as a cause for government wide debarment or suspension. The agencies involved did not agree with all of our recommendations. We discuss their views and our responses in detail in our reports, as well as our continued belief that our recommendations are valid. Consistent with our recommendation to OMB, I believe Congress should consider suspending government business with contractors who are delinquent on their taxes as of a specific and prospective effective date, with a provision for limited waivers if necessary in unique circumstances.

Capital Gains Basis Reporting

Finally, you also asked us to testify on a report—done at your request—that we are issuing today on individual taxpayers’ compliance in reporting capital gains’ income from the sale of securities.²⁴ Misreporting such income²⁵ contributes to the annual tax gap, which is the gap between tax amounts that taxpayers should pay under the law and do pay voluntarily and on time. For tax year 2001, the IRS estimated a gross tax gap of \$345 billion, of which at least \$11 billion is attributed to individual taxpayers who misreported their income from capital gains or losses.²⁶ Taxpayers are to determine their capital gains or losses by subtracting the “basis” amount, which is generally the cost for an asset, from the gross proceeds amount when selling the asset.

²⁴ GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

²⁵ Taxpayers are to report gains or losses from selling securities on Schedule D of the federal income tax returns as well as the purchase and sale dates, adjusted cost basis, and gross proceeds from the sale.

²⁶ The overall capital gains tax gap could be larger than \$11 billion if IRS had estimated the portion of the \$48 billion tax gap for unfiled tax returns or unpaid taxes that is related to capital gains. According to an IRS research official, in mid-2006, IRS plans to publish its final report on the 2001 tax gap that will include an updated tax gap estimate based on a refined methodology. It is possible that the updated tax gap figures could differ from the current estimates.

In summary:

- For tax year 2001, an estimated²⁷ 36 percent (over 7 million) of individual taxpayers who sold securities misreported capital gains or losses. Using the wrong cost basis for the securities was a primary type of noncompliance leading to this misreported income. About two-thirds of the misreporting taxpayers understated gains or overstated losses, while about one-third overstated gains or understated losses. Additionally, a few taxpayers with securities sales misreported whether their gains or losses were short-term or long-term.²⁸
- IRS attempts to address misreported securities sales' income through enforcement and taxpayer service programs, which are to find noncompliance or help taxpayers comply voluntarily. Various challenges limit the impact of these programs, such as that IRS enforcement programs contact relatively few taxpayers and the lack of cost basis information impedes efficient use of IRS's enforcement resources. IRS also faces difficulties in ensuring that taxpayers understand their obligations for determining and reporting their capital gains and losses.
- Expanding information reporting²⁹ to taxpayers and IRS on securities sales to include cost basis has potential to improve taxpayer voluntary compliance and help IRS verify securities gains or losses. Basis reporting would raise challenges, many of which can be mitigated to some extent. For example, broker costs would increase but could be constrained by limiting the scope of any reporting requirement and by building on the basis reporting to taxpayers that many brokers already do. For example, reporting basis for only future purchases would

²⁷ Our estimates are based on a review of a probability sample of IRS examinations selected from the nearly 46,000 randomly selected individual tax returns for tax year 2001 in its National Research Program, IRS's most recent study of individual tax compliance. We express our confidence in our estimates as a 95 percent confidence interval, plus or minus the margin of error. Our estimate for the percentage of misreporting taxpayers has a sampling error of (+/-) 7 percent or less, and we are 95 percent confident that from 6.2 million to 8.3 million taxpayers misreported securities sales.

²⁸ Securities assets sold after being held for 1 year or less are considered short-term while others sold are considered to be long-term and are generally taxed at lower tax rates.

²⁹ Information reporting involves third parties filing returns with IRS and taxpayers to report certain income. Brokers are required to file Form 1099-B with IRS and the taxpayer to report such information for securities sales as the dates, number of shares, and gross proceeds of the sale, but not the cost basis.

mitigate challenges when brokers do not know the basis for securities purchased in the past. To the extent that actions to mitigate the challenges to basis reporting delay its implementation or limit coverage to only certain types of securities, the resulting improvements to taxpayers' voluntary reporting compliance would be somewhat constrained. IRS's broad authority to require information reporting for securities sales may not be enough to require all the actions necessary to implement cost basis reporting and mitigate the challenges.

Based on these results, our report includes matters that Congress may want to consider, including requiring brokers to report to both taxpayers and IRS the adjusted basis of sold securities and ensuring that IRS has sufficient authority to implement the requirement. Congress could also require brokers to report whether the securities sold were short- or long-term and IRS to work with brokers to develop rules that mitigate the challenges. Further, we recommend that IRS modify the instructions for the individual tax return to (1) clarify the appropriate use of capital losses to offset capital gains or other income and (2) provide guidance on resources available to taxpayers to determine basis. IRS agreed with our recommendations.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

Contacts and Acknowledgments

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