

# 2014

## Oregon Department of Revenue RESEARCH SECTION

### COMPLIANCE WITH OREGON'S PERSONAL AND CORPORATE TAX PROGRAMS

#### EXECUTIVE SUMMARY

JANUARY 2014



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In 2013, the legislature included a budget note in the Department of Revenue (DOR) appropriation bill.

*The Department of Revenue shall submit a report to the Legislature during the 2014 session that describes the cause of noncompliance in the personal and corporation tax programs, including a discussion of tax gap estimates. The Department shall create a specific, systemic plan to reduce the tax gap including performance measures, benchmarks, and timelines, and report progress from this plan to the Legislature in 2015. Where possible, the Department shall incorporate the results of the work performed for the Enforcement Revenue Budget Note in 2011.*

There are two parts of our response to the budget note. The first sentence of the budget note requests a report from DOR related to noncompliance in the personal and corporation tax programs including a discussion of tax gap estimates. The report summarized here is the first part of the response to the budget note and addresses the requests made in that first sentence.

This executive summary describes the information contained in the report. The summary does not substitute for a detailed reading of the report, but it should familiarize the reader with the general concepts and themes.

The goals of the report are:

- to describe taxpayer's motives and opportunities for noncompliance,
- to describe one method of measuring and reporting the results of compliance programs, and
- to explain how estimates of noncompliance are made and in what circumstances the estimates are useful.

### ***Why are taxpayers noncompliant?***

A widely accepted definition of tax compliance consists of three broad characteristics: filing tax information on time, reporting complete and accurate information, and paying tax obligations on time. There are many points in time and decisions made by taxpayers where one of these components of tax compliance is at risk.

There are two complementary views of how taxpayers decide whether to comply, one focused on noncompliance as a deliberate decision and the other view looking at several reasons for noncompliance.

The first theory of noncompliance is a model of deterrence, which assumes taxpayers comply because of the threat of sanctions if the tax agency discovers the noncompliance. This model treats taxpayer decision making about how much tax to underreport as a gamble. The model is predicated upon the taxpayer having an idea of the likelihood of being caught if they cheat, and the penalty that will be imposed. Using that knowledge, the taxpayer attempts to minimize the expected tax and penalty they will pay. Some researchers believe tax compliance in the United States is much higher than this model predicts.

The second view of tax noncompliance relies on a set of theories that explain taxpayers' compliance decisions in terms of less quantifiable factors. These theories state that taxpayers consider factors such as their satisfaction with government leaders and services, their perception of their peers' tax compliance, their belief that the tax system is equitable, and the effort required to comply compared to their motivation to comply.

## ***Complexity Increases Noncompliance***

For taxpayers who want to comply, complexity heavily influences their efforts and associated costs. Even taxpayers intending to file completely and accurately may be unable to do so if they do not understand the laws and rules that determine their eligibility for deductions or credits, or their requirements to report certain types of income but not others.

For taxpayers who want to evade tax, complexity offers a way to accomplish that aim. As stated by the National Taxpayer Advocate, “Many law firms, accounting firms and investment banking firms have made tens of millions of dollars by scouring the tax code for ambiguities and then advising taxpayers to enter into transactions, with differing levels of business purpose or economic substance, to take advantage of those ambiguities”(Olson, 2011).

Because most noncompliance is likely due to complexity, it is advisable to structure a moderate compliance enforcement program that is flexible and able to respond to the underlying causes of taxpayer noncompliance. It may be inappropriate and could possibly be perceived as unfair for tax agencies to respond identically to inadvertent noncompliance that arises due to complexity, and noncompliance that arises due to a taxpayer’s intention to evade.

## ***Measuring DOR’s Impact on Noncompliance***

In 2011, the legislature requested that DOR develop a method to report the results of enforcement efforts. In response, DOR developed a way to categorize each payment received that is directly due to the enforcement efforts of DOR employees. This effort resulted in a way to sum receipts from audits and tax liabilities in active collections. This enforcement revenue series can provide a useful way to identify the direct results of enforcement activities.

This measurement cannot include indirect impacts. For example, a taxpayer that is audited may improve future compliance, or share the story of the audit, which may lead to improved compliance by a larger group of taxpayers. Such indirect effects cannot be measured. In addition, identification of taxpayer noncompliance does not automatically lead to payment(s) received from that taxpayer. Often, following an audit a taxpayer may be unable to pay, or may resist payment.

Enforcement efforts also affect DOR’s accounts receivable. For instance, nearly all of the net growth in personal income tax accounts receivable during fiscal year 2013 can be attributed to DOR’s increased efforts to identify noncompliance of tax nonfilers (people that don’t voluntarily file tax returns are generally more difficult to collect tax debt from). It is only after these nonfilers are identified and some form of payment has been received will that amount show up in the enforcement revenue series.

## ***Amount of Noncompliance and Estimating the Tax Gap***

Because noncompliance cannot be directly observed, several methods have been used to make estimates of the total level of noncompliance (the tax gap). The estimates vary widely based on the method of estimation, and ultimately, any estimate of total noncompliance is speculative. Given the speculative nature of estimates and the variance in estimation methods, comparisons of tax gap estimates over time or between tax jurisdictions are generally not meaningful.

While the gap estimate is large, efforts to identify and collect more of the tax gap are limited by the information available to DOR and by the burden placed on taxpayers that is necessary to achieve increased compliance. There is agreement among researchers that only a small part of the tax gap is collectible.

In Appendix A of the report, we present estimates of the overall tax gap in Oregon's personal and corporate income taxes. The value DOR derives from the tax gap is in understanding the sources of noncompliance. Knowing and understanding the motivation for and methods that facilitate noncompliance allow appropriate compliance strategies to be developed and effectively administered.