

California's Tax Gap

LEGISLATIVE ANALYST'S OFFICE



INTRODUCTION

California collects a majority of its General Fund revenue from the personal income tax (PIT) and the corporation tax (CT) levy on business income. For 2005-06, the PIT is expected to raise almost \$43 billion and the CT is expected to raise slightly over \$9 billion. Together, these two sources of revenue constitute over 60 percent of the General Fund. Both taxes are administered by the Franchise Tax Board (FTB).

At both the federal and state levels, officials have for some time noted discrepancies between what is owed by taxpayers under their respective income taxes and what is actually remitted to the federal or state governments. The difference between the amount owed and the amount actually collected is referred to as the “tax gap.” The tax gap at the state and federal levels has long been in evidence (the federal government has monitored it since the 1970s), but officials are concerned that the gap is not only persisting, but may actually be increasing in size relative to the tax base. In addition, tax administrators believe that the tax system may be susceptible to further erosion.

California also relies heavily on the sales and use tax (SUT) for General Fund support, as do many city and county governments throughout the state. In 2005-06, the SUT is forecasted to raise revenues of \$27 billion, constituting almost one-third of General Fund resources. The federal government, as well as other states, have identified that a tax gap also exists for consumption-based taxes such as the SUT. While it is likely that a similar tax gap exists for California’s SUT, no estimates are available from the Board of Equalization (BOE), which administers the tax.

In the following discussion, we first address the significance of the tax gap and why it matters for California. We then outline the magnitude of the income tax gap, describe its component parts, and indicate ways that FTB has attempted to address the gap. Finally, we describe the administration’s tax gap proposals and suggest additional measures that the Legislature could consider. We also provide similar types of information regarding the SUT tax gap.

THE SIGNIFICANCE OF THE TAX GAP

The tax gap problem poses a significant tax administration challenge. The tax gap presents an issue that not only has a direct impact on state finances but also an indirect effect on individual and business taxpayer behavior throughout the state.

Higher Tax Rates. The existence of a substantial tax gap means that for the state to raise any given level of revenue, it must impose higher tax rates on taxpayers. That is, tax rates must be set at levels that are higher than would be the case if there were no tax gap. As a result, compliant taxpayers are not only faced with paying taxes when other individuals and businesses do not, but they must pay at rates higher than would otherwise prevail absent a tax gap.

Weakened Tax System. One of the corrosive, long-term effects of a large, persistent tax gap is that taxpayers begin to doubt the effectiveness and fairness of the system

itself. If taxpayers perceive that other individuals and businesses are not shouldering their share of the tax burden, they are likely to question their own compliance with the tax laws. The result—if not checked—can lead to increased noncompliance based on the belief that “no one else is complying,” which can undermine the tax system itself.

THE INCOME TAX GAP

Current estimates of the federal tax gap are reliant on the validity of data collected some years ago, and many states—including California—rely on these federal estimates as a starting point in the calculations of their own tax gaps. Despite this somewhat less than ideal estimation process, the estimates do provide a good sense of the magnitude of the problem faced by federal and state revenue collection agencies.

Magnitude of the Tax Gap

Federal Tax Gap. The most recent (2001) Internal Revenue Service (IRS) estimate of the gross income tax gap for the federal personal and corporate income taxes is \$311 billion, for a noncompliance rate of about 15 percent. This figure represents the difference between the amount taxpayers pay voluntarily and in a timely fashion and the amount of their actual tax liabilities.

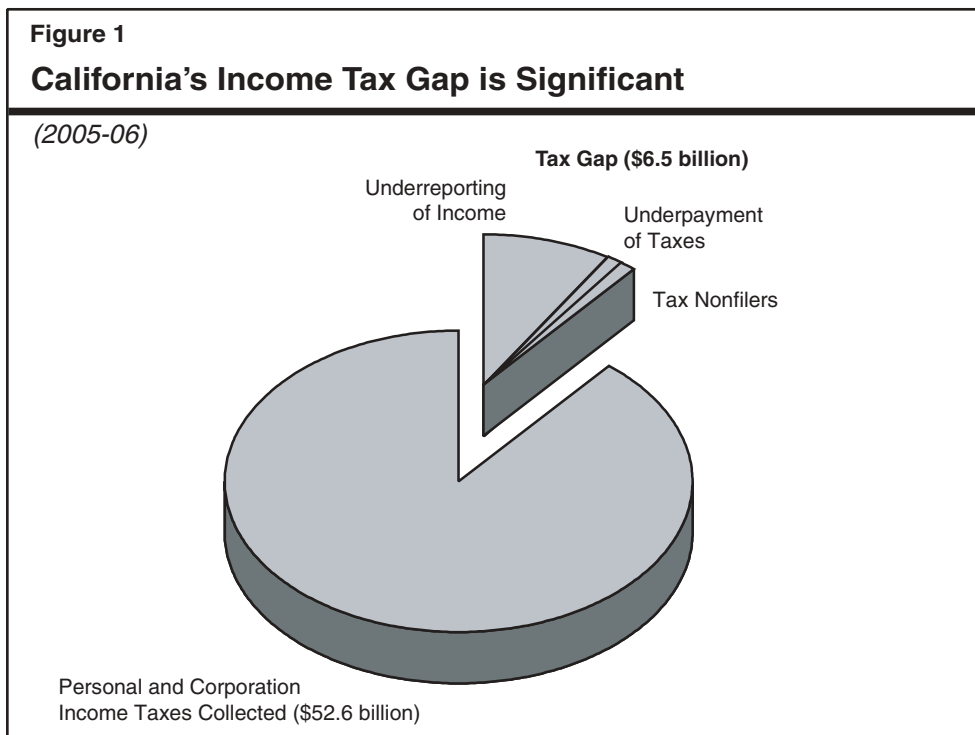
This tax gap estimate—while seemingly precise—is, in fact, based on an audit modeling process that was last conducted over a decade ago. This audit project, known as the Taxpayer Compliance Measurement Program, was discontinued in 1988. The tax gap estimate has been updated based on current demographics, but still incorporates the existing model’s assumptions regarding taxpayer behavior.

The assumptions regarding taxpayer behavior are likely to result in an understatement of the true current tax gap for the following reasons:

- The tax code has become increasingly complex, making it more difficult from a compliance perspective.
- There has been a proliferation of abusive tax shelter (ATS) activity, resulting in understated income.
- There has been an erosion in taxpayer attitudes regarding the acceptability of cheating, according to IRS surveys.
- There has been an increase in activities that may lend themselves to tax avoidance, such as cash and capital transactions.

The IRS has recently undertaken a new initiative to collect data that can be used for estimating the tax gap. This effort—entitled the National Research Program—is expected to be completed by January 2006. According to analysts, this effort is expected to show a sizeable increase in the federal income tax gap. The results should prove useful for both the federal and state governments in suggesting areas to focus information collection and tax compliance efforts.

California's Tax Gap. The FTB's estimate of the state's annual income tax gap is \$6.5 billion, and is based in part upon estimates of the federal gap. The figure for California represents a substantial increase from the \$2 billion annual figure estimated during the 1980s. This new amount constitutes about one-eighth of the total 2005-06 revenues generated by the PIT and the CT, as shown in Figure 1, and about 8 percent of the total General Fund.



Components of the Tax Gap

There are a number of different ways to measure the components of the income tax gap at the federal and state levels.

Types of Activities. In terms of the types of activity responsible for the existence of the gap, underreporting of income constitutes the largest share, representing about 80 percent of the tax gap. Common examples of underreporting income include hiding income through cash transactions, claiming excessive business deductions, and overstating personal charitable contributions. The other activity-based components of the tax gap—failure to file a tax return and underpayment of taxes owed—each represent about 10 percent of the total.

Types of Taxpayers. The IRS estimates that individual non-compliance represents about three-quarters of the tax gap and business activity representing the remaining one-quarter. Among individuals, wage earners report about 99 percent of their income,

self-employed individuals operating formal businesses report approximately 68 percent of their income, while self-employed “informal” suppliers report only 19 percent of their income. Among businesses, small corporations report their income at about the same rate as self-employed individuals operating formal businesses. Noncompliance among larger corporations tends to result from interpretation of existing tax laws which can result in excessive deductions or credits based on business activities.

Types of Occupations. The FTB, as well as independent researchers, have identified particular businesses and occupations that seem especially prone to underreporting income and other types of noncompliance that contribute to the tax gap. These activities appear to be concentrated in areas where cash payments are common and there are difficulties with information reporting. Some examples include: nannies, tutors, housekeepers, and landscapers, as well as other types of service businesses. In addition, professional or informal contractors who work for cash also seem to be susceptible to noncompliance, as do some waitresses and waiters, and professionals who trade or barter services.

Specific Examples of Noncompliance

There are several examples of noncompliance that serve to illustrate how taxpayers have avoided paying their fair share of the PIT or CT.

- **Required Forms Are Not Filed.** Businesses are required to file a Form 1099 with the state and federal tax agencies anytime an annual payment of more than \$600 is made to a nonemployee. This form is not always filed for individuals and is not required to be filed for payments to many businesses. This is a common way for many taxpayers in these situations to avoid paying taxes on nonwage income.
- **Accurate Information Is Not Provided.** Efforts on the part of businesses to collect accurate taxpayer information for Form 1099 may be thwarted by the provision of false identification or social security numbers. In this case, even if the Form 1099 is filed with federal and state tax officials, it is impossible to cross-check the payments to the taxpayer’s tax return, resulting in income going untaxed.
- **Payments Made in Cash.** Payments made for many obligations, such as rental payments, can be made in cash. Since there is no independent reporting of these cash transactions, noncompliant owners of property may avoid paying tax on some or all of cash income derived from this source. Similarly, a restaurant or other business that deals heavily in cash may not record receipts as revenue and thus avoid paying taxes on the resulting income.

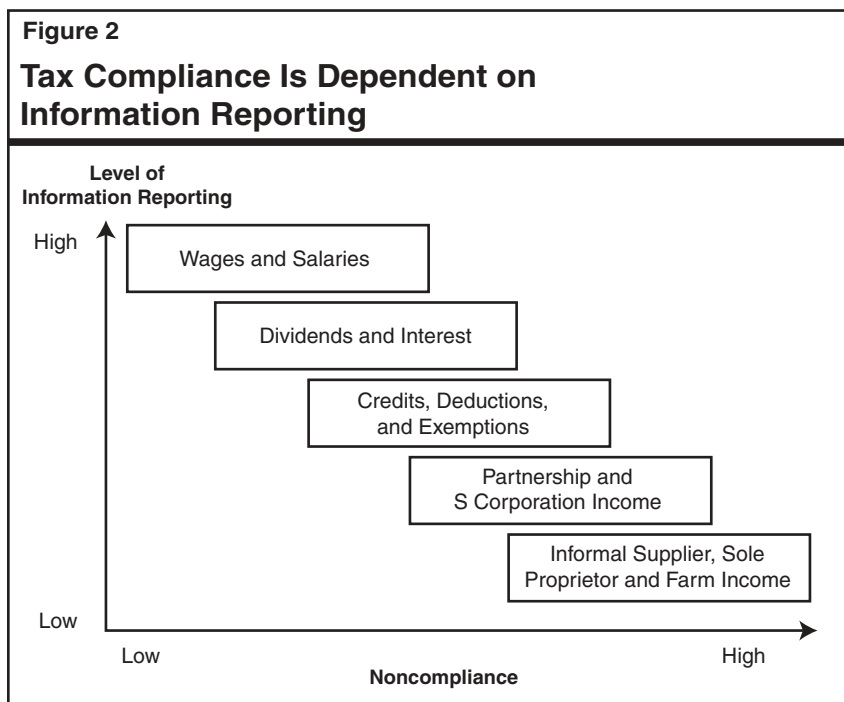
What Factors Contribute to the Tax Gap?

In order to devise ways to limit the growth in the tax gap—and begin to reduce its size—tax officials at the federal level and in California have attempted to identify the

characteristics of noncompliance in order to devise appropriate enforcement policies. They cite two key characteristics:

- **Absence of Withholding.** The lack of withholding for tax purposes in certain situations can lead to an increase in taxpayer noncompliance. Conversely, where taxes are actually withheld at the point of payment (such as with wages) the amount of noncompliance is quite small, and the chances quite good that the taxpayer will file a return with the amount of income accurately stated.
- **Little or Poor Information Reporting.** The second major characteristic of noncompliance occurs in situations where there is little or inaccurate information reporting. This is clearly the case in cash transactions, as well as in other areas where there is a lack of adequate independent reporting requirements. For example, when businesses do not accurately report payments to subcontractors, tax agencies have no way in which to verify the income.

Figure 2 below shows the inverse relationship of noncompliance and information reporting. As indicated, the contribution of each of the components to the tax gap increases as the amount of withholding and accurate information reporting decreases or is eliminated. In other words, the more “visible” a payment stream is, the more likely it is that the income will be fully reported. As indicated previously, the amount of wages and salary income that is understated is estimated to be less than 1 percent. In contrast, almost one-third of informal supplier income is understated. Not surprisingly, for those types of income on the far right of the figure, the role of cash transactions can be quite large. In general, tax research has shown that noncompliance has a close relationship to the ratio between cash and noncash income.



What Is Being Done About the Tax Gap?

Federal Efforts to Bridge the Gap

Because California “piggybacks” on many tax and administrative programs of the IRS, federal efforts to limit or reduce the tax gap have important implications for any steps the state might take. The IRS currently has plans to address the tax gap through the following actions:

- ***Refocus and Adjust Audit Process.*** It will reduce the audit cycle process for certain types of taxpayers as well as shift auditing resources to likely areas of tax noncompliance. It also plans improvements to measurement and detection of areas of tax noncompliance by leveraging the enforcement and information-gathering activities of other governmental agencies.
- ***Tighten Professional Tax Standards.*** The IRS plans to strengthen partnerships with professional organizations, and establish and communicate meaningful standards of conduct. As part of the initiative, the agency will establish a greater presence for its Office of Professional Responsibility and invoke sanctions and penalties for practitioners who violate professional standards.
- ***Detect and Deter Offshore Tax Evasion.*** Recently, numerous examples of tax evasion through offshore activity have been detected by the federal and some state governments. The IRS indicates it will strengthen efforts to detect this activity and pursue criminal action against taxpayers using such tactics. These efforts will focus on corporations and high-income individuals.
- ***Deter Abuse Within Tax Exempt and Governmental Entities.*** Tax exempt and governmental entities are not subject to federal income tax, but some ATS transactions have used such entities to accomplish the goal of tax evasion. The IRS indicates that it will target audits to particular areas of this sector in order to deter the use of such entities for noncompliance purposes.

FTB’s Current Tax Gap Efforts

Despite the proposed efforts noted above, the IRS is hampered by past reductions in resources, particularly in the audit area. While California can respond on its own to the tax gap problem, the state is somewhat limited in what it can do since some noncompliance involves questions of jurisdiction, such as overseas or interstate economic activity. In addition, some effective means of addressing noncompliance:

- Require federal involvement or support in reporting or information gathering.
- Potentially place California at a competitive disadvantage with respect to other states (for example, due to additional reporting requirements for business).

Nevertheless, the agency has long-established programs to address the general issue of tax compliance. In the audit area, for example, the FTB directs its auditing resources to: (1) areas of noncompliance that would result in the highest net return to the state, and (2) certain credits and deductions that seem susceptible to abuse—such as the refundable child and dependent care credit. The agency also has designed specific programs to detect areas where a tax gap might be present. For example, its Integrated Nonfiler Compliance (INC) project uses information from the IRS and various state sources to identify nonfilers in order to commence tax enforcement measures.

The state has also forged new approaches to tax compliance. For example, in 2004 the Legislature approved the FTB's Voluntary Compliance Initiative—a program designed to discourage participation in ATS. This initiative allowed investors in specific ATS transactions to come forth with payment for all taxes owed, in exchange for avoiding penalties for participating in such shelters. The program resulted in gross revenues to the state in excess of \$1 billion. The legislation also increased penalties in the future for engaging in ATS transactions.

In an exploratory effort last year (as part of the 2004-05 budget), the Legislature directed FTB to conduct a study regarding the policy impacts and feasibility of imposing withholding requirements on payments to certain contractors. The resulting *Independent Contractor Withholding Report* indicates that while withholding would increase compliance among independent contractors, it would also have certain drawbacks. For example, even at very low withholding rates, some taxpayers with no liabilities would have taxes withheld. The refund of these withheld payments would only occur when the tax return was filed. In addition, such a withholding policy could also put the state at a competitive disadvantage with respect to other states.

Administration's Proposed Tax Gap Measures

For 2005-06, the administration has proposed a number of tax gap measures intended to directly target particular areas of tax noncompliance. In addition, the agency reports that the proposed measures were selected for their visibility to other taxpayers, in order to maximize indirect effects on taxpayer compliance. Each of the components is estimated to generate additional revenues in the budget year. The entire package is for an augmentation of \$8.6 million, which is expected to result in revenues of \$34 million in the budget year and \$44 million in 2006-07. The proposed FTB tax gap measures include:

- ***Enhanced Detection of Preparers Filing Fraudulent Returns.*** The board will seek to identify tax preparers who file fraudulent tax returns for taxpayers. Typically these returns involve fictitious or overstated credits and deductions. The program will also assess penalties and incorporate extensive audits of both preparers and taxpayers. The FTB anticipates a strong indirect effect on tax compliance due to the publicity element of this proposal.

- **Targeted Audit Staff Augmentation.** This proposal involves an augmentation to audit staff that would fund workload activities down to the 4 to 1 benefit-cost ratio. These resources will be focused on the underreporting of income, which has been identified as the single largest component of the tax gap. Although this particular proposal would result in benefit-cost ratio below the established 5 to 1 threshold, this would appear reasonable given the limited and targeted nature of this proposal.
- **Information Development for Nonfiler Detection.** The department expects that by developing new sources of information, it can identify thousands of nonfilers and add to the success of its existing INC project. The proposal would add six additional sources of income to the INC project and facilitate the discovery of additional tax liabilities. Additional revenue is expected to be generated from the component focused on real estate brokers and agents.
- **Informant Reward Program.** The informant reward program, modeled after a similar program at the IRS, would provide a mechanism by which citizens can earn rewards by bringing potential cases of taxpayer noncompliance to the attention of the tax agency. The focus of the initiative is to look at instances involving California taxes only, since FTB already receives referrals from an existing IRS program that involves federal and state taxes.
- **“Underground Economy” Criminal Investigations.** This component of the tax gap project involves adding resources for FTB’s investigations unit. Currently, the unit has a pilot project which has identified \$300 million in unreported income. The proposal would accelerate the disposition of existing criminal tax investigation cases as well as pursue additional cases.

What More Could FTB Do?

The administration’s tax gap proposals for FTB represent a targeted approach to various aspects of the noncompliance problem. However, there are other additional measures that the Legislature could consider as a means of addressing some of the most serious components of the tax gap. These measures have been identified from general discussions with the agency or are based on information presented in *The Independent Contractor Withholding Report*. As such, they do not represent proposals from the agency; however, if suitably developed, they could represent logical next steps in efforts to reduce the tax gap.

Focus on 1099 Filings. As suggested above, both federal and state officials have identified as a significant part of the tax gap the lack of compliance with Form 1099 filing requirements for independent contractors. A significant amount of revenue is lost because income taxes are frequently not remitted on such subcontractor payments—either because the Form 1099 is not filed or the information provided on the form is not accurate. The FTB’s *Independent Contractor Withholding Report* found a number of

shortcomings associated with withholding on *all* independent contractor payments. However, we think there are several other approaches the Legislature could consider relating to Form 1099 abuses and independent contractor payments, including:

- ***Impose Withholding With Modifications.*** In order to avoid overwithholding, the FTB could put in place a waiver program that would allow subcontractors to avoid such withholding if they could reasonably demonstrate the likelihood of a small or no tax liability. Alternatively, the state could maintain a list of “taxpayers in good standing,” who would be able to select their own level of withholding.
- ***Establish Taxpayer ID Verification System.*** One of the common issues associated with the Form 1099 occurs in situations where the tax identification number of the independent contractor is either not provided or is incorrect. This prevents the IRS and FTB from determining whether tax has been paid on the income received. A “real time” telephone or Internet-based verification system operated by the tax agency would limit this source of noncompliance by allowing employers to verify with the state the authenticity of identification presented by taxpayers. This particular option would require substantial resources to implement and administer, but would also provide substantial inroads into the noncompliance problem.

There are several other tax gap initiatives that we think the Legislature should consider that have potential for improving overall tax compliance, including:

- ***Fund More Discovery Audits.*** Discovery audits provide valuable information to the tax agency regarding new areas of tax abuse and noncompliance. In order to provide adequate resources for the ATS initiative as well as direct audit resources to high return activities, most discovery audit staff have shifted to other areas. In 1999-00, FTB logged 23,000 hours on discovery audits; for 2004-05, only 5,000 hours will be spent on such activity. Such discovery activities do not generally reach the accepted benefit-cost threshold, but provide crucial information that ensures effective deployment of audit resources and would help close the tax gap in the medium and long term.
- ***Develop More Information Sources.*** As part of the tax gap initiative proposed by the administration, the FTB proposes to select and develop new sources of information on nonfilers. Some other opportunities for finding noncompliance involve using information from diesel fuel fee returns to identify self-employed truckers, community care licensing information to identify self-employed individuals in this sector, or using other licensing or registration information to identify other self-employed individuals.
- ***Establish Misdemeanor Program.*** Currently, the FTB pursues tax cases in the event that a felony is believed to have occurred. Misdemeanor cases are generally not pursued. The fundamental difference between the two categories is that

in a felony case, it must be shown that the taxpayer *intended* to evade taxes, while in misdemeanor cases, only a *failure to comply* need be demonstrated. A successful misdemeanor program cannot only have a direct revenue impact but also put noncompliant taxpayers on notice, thus increasing overall compliance. The program could also make in-roads into the underground and cash economy. The FTB indicates that additional resources of slightly over \$1 million for its investigations unit for misdemeanor cases would result in \$4 million of additional resources.

- **Maximize Audit Links to BOE and EDD.** Given the existence of and the potential growth in the tax gap, it is beneficial for the state’s three major tax agencies to cooperate in compliance and enforcement activities. While the links between FTB and the Employment Development Department (EDD) are established, additional attention could be paid to setting up and maintaining links between BOE and FTB. For example, taxable sales reported to BOE could be matched to gross revenue reported to FTB in order to further compliance efforts.

The options discussed above are preliminary outlines of additional steps the Legislature may want to consider in the tax gap area. They have not been fully developed in terms of policy implications, budgetary costs, or revenue impacts. Some may warrant a “pilot” effort or some other type of limited deployment, while others may require additional development. The Legislature may want FTB staff to respond at hearings regarding the feasibility of these potential compliance activities.

THE SALES TAX GAP

For the most part, the tax-gap-related focus of state and federal governments has been on income taxes rather than on consumption taxes. States tend to have income tax systems that are similar to and share information with the federal system, and thus directly benefit from any tax gap initiative taken at the federal level. In contrast, states are largely left to their own resources with respect to consumption tax issues. Nevertheless, there is evidence from various sources that a significant SUT gap exists in other states, and California is likely to have one too.

Components of the Sales Tax Gap

Like the income tax gap, that SUT tax gap is defined as the difference between the tax that is owed by consumers and businesses and the amount actually paid. In California the sales tax is actually comprised of the *sales tax*—levied on tangible goods purchased in the state—and the *use tax*—levied on the use of tangible goods purchased outside of California but used in this state. The factors contributing to the existence of a tax gap are very different for each of these components.

Sales Tax Component Gap. Since not as much attention has been paid to the sales tax gap, less is known about its specific components than about the income tax gap. However, since the tax is levied on final sales and remitted by the seller of the goods,

efforts to evade the tax generally relate to understating the amount of taxable sales actually made. For example, a seller may not obtain the required sellers permit or simply not file a sales tax return as specified. In other cases, a seller may understate actual sales in the event of a cash transaction. Whether the tax is actually collected but not remitted (to the benefit of the seller) or not collected at all (to the benefit of the purchaser) is irrelevant from a revenue collection point of view. In still other situations, a business may seek to obtain a fraudulent “reseller” certificate and purchase items for its own use on a tax-free basis.

Use Tax Gap. According to various studies, the bulk of the SUT tax gap occurs in the use tax component. Tax noncompliance occurs in three principal areas:

- **Use Tax Remittance by California Business Consumers.** Business purchasers of equipment and supplies are required to pay sales tax on in-state purchases and the use tax on out-of-state purchases. The lack of payment of the use tax can often occur due to ignorance of the tax law, a misunderstanding of the obligations to remit such a tax, or intentional noncompliance. This type of noncompliance occurs most frequently among businesses that are not registered sellers in California, such as professional offices.
- **Use Tax Remittance by California Household Consumers.** This area represents another large component of the use tax gap. Noncompliance in this area is largely due to ignorance of the requirement to remit the use tax on out-of-state purchases. It also relates to the fact that, due to the inability to enforce the collection of the tax without creating onerous compliance burdens, consumers may not remit the tax since they believe that very few other consumers will.
- **Use Tax Collection By Non-California Sellers.** The last main area of use tax noncompliance relates to businesses located outside of California that should be collecting the use tax for California, but are not doing so. Their obligation to collect the tax is based on the state’s determination that they have nexus—or presence—in California. Determination of nexus could be based on any number of factors, including (1) a warehouse in the state, (2) California-based employees, or (3) an agent based in California. Noncompliance by these businesses may be due to lack of awareness of the requirements of the law, a misapplication of the law, or intentional efforts to avoid collecting the sales tax in order to lower the effective consumer price and increase sales.

Size of the Sales Tax Gap

Evidence compiled by the Multistate Tax Commission (MTC)—of which California is a member—suggests that there is nationwide SUT tax gap in the tens of billions of dollars. In addition, two states that rely on the sales tax for a significant portion of general revenues, have undertaken or commissioned studies to examine the size of their respective state’s tax gap.

Minnesota Study. A 2002 Minnesota study estimated a state SUT gap of about \$570 million in 2004, representing about 15 percent of SUT revenue received by Minnesota. Of this amount, about two-thirds was estimated to be the result of underreporting taxable sales and the remainder due to nonfiling of tax returns.

Washington Study. A Washington study of that state's SUT estimated a 2003 tax gap of \$145 million, representing about 3 percent of SUT revenues. It determined that use tax noncompliance resulted in a tax gap of \$79 million, and that sales tax noncompliance resulted in an additional tax gap of \$66 million.

California's SUT Gap. The BOE estimates that the SUT tax gap is probably around \$1.5 billion or almost 4 percent of revenues from the tax. This is consistent with results of the two state studies, which suggest that California's tax gap is somewhere in the range of \$1 billion to \$3 billion.

BOE's Current Tax Gap Efforts

The BOE has established and continues to administer a rather limited number of programs intended to address particular aspects of the tax gap. Most noteworthy are those programs designed to address the gap caused by use tax noncompliance by businesses who are required to collect the tax because of nexus in California. These programs include:

- **MTC Nexus Program.** This program sends MTC member states leads from other states regarding firms who may have nexus in more than one state. The BOE reports that the program has been only marginally successful in generating high quality leads that result in generating additional revenue.
- **Form 1032 Nexus Program.** This program provides leads (through audits of California businesses) on out-of-state businesses that should be collecting the use tax because they have nexus in California. The BOE reports that the program cost is about \$0.5 million and generated over \$13 million in 2003-04.
- Other minor programs are focused on noncompliance by sellers, including the Border States Caucus (focuses on cigarette and fuel excise taxes), Truck Stop Enforcement (focuses on fuel and large shipments), and Christmas Tree Program (focuses on enforcing sellers permit requirement). Together these programs generate less than \$1 million annually.

Some of the other programs initiated by BOE address the type and quality of audits that are conducted. To the extent that these programs are successful, they generate additional income from both the sales tax and use tax. It should be noted that although these program do address components of the tax gap, they also are standard activities of any tax compliance operation. Components of the program include:

- ***Specified Audits.*** Under current BOE regulations (adopted pursuant to Section 6596 of the California Revenue and Taxation Code) taxpayers are not held accountable for tax liabilities arising from situations where they relied on written information or audit results of the BOE. Thus, if an audit does not find discrepancies in a particular area (even if it does not specifically examine that area), and discrepancies are later found to exist, the taxpayer is not responsible for resulting liabilities. To address this problem, BOE now specifies in its audit regarding which areas of the taxpayer’s records have been examined and which areas have specifically *not* been examined. Through this process, it seeks to avoid taxpayers relying on an audit omission as a means of using Section 6596 protection.
- ***Improved Audit Selection.*** Typically, most BOE audits have been selected and carried out at the department’s field offices. However, the BOE has begun to incorporate additional information from the IRS and FTB into its audit selection process that require a more centralized and less “ad hoc” approach to audit selection activities. The process involves much more of what is referred to as “data mining” which, combined with matching of accounts and records, leads to improved selection of the most productive accounts.
- ***Participation in Streamlined Sales Tax Project.*** Currently, out-of-state sellers are not required to collect the tax if they do not have nexus in California. In order to deal with this issue, California and other states that levy SUTs participate in the Streamlined Sales Tax Project, an effort to coordinate the state-based tax systems and make it less burdensome for out-of-state companies to collect the tax on behalf of states. States hope to demonstrate to Congress that collection of the tax by sellers is no longer burdensome and the power to require its collection by sellers should be granted to states.

What More Could BOE Do?

Although the BOE has initiated some programs to deal with the tax gap in the SUT area, there are additional steps that could be taken to reduce the tax gap problem. These potential activities and programs have been identified through discussions with the agency, but do not represent their proposals. In most cases, these initiatives would need to be more fully developed. The Legislature could consider the following:

- ***Conversion to NAICS.*** Currently BOE classifies industries and businesses within the state according to its own system. This limits its ability to cross-match various records and link taxpayers records with other state systems. The agency has begun a process of converting to the North American Industry Classification System (NAICS) but advises that it has not completed this process due to a lack of resources. Through their technology systems based on NAICS, both EDD and FTB are able to cross-match similar data and documents. The FTB indicates that it was able to complete this conversion for less than \$50,000 with ongoing annual

costs of about \$10,000. If BOE were to carry out a similar conversion, it would have much greater access to data and documentation for audit and other compliance purposes.

- **Revive Customs Program.** In 2001, the BOE had in place a pilot program that involved receiving referrals from the U.S. Customs Service. Data tapes were provided to the department with information on incoming cargo and its destination. These tapes were then reviewed in order to determine whether use tax would likely be owed on such purchases. The pilot program was quite successful in terms of the benefit-cost ratio and could be expanded or put in place on a permanent basis. The board recently submitted a proposal to the administration to reestablish this program with funding of \$66,000, which in turn would generate estimated revenues of \$1 million in 2005-06 and \$2 million in 2006-07.
- **Target Service Industry Use Tax.** Service businesses, such as professional offices and consulting services, have been identified by the agency as the source of considerable use tax noncompliance. There are two areas the Legislature could consider for expansion to address this problem. First, it could weigh the benefits of a focused audit and education initiative that targets professional offices. For example, many professional offices use equipment or furniture from out of state but do not pay use tax on such items. Second, it could modify the filing requirements for Form 571, which is used by businesses to report personal property to county assessors. Since sales taxes paid on equipment represent a portion of the property tax base, these are incorporated in the form. The reporting requirement could be expanded to include use taxes paid, evidence of such payment, and a signed statement by the taxpayer. The department indicates that it is currently reviewing Form 571 filing requirements.
- **Improve Audit Selection.** As discussed above, FTB has had auditors who engage in so-called discovery audits in order to get a better sense of potential areas of taxpayer noncompliance. The BOE could better focus its audit efforts by engaging in limited discovery audits. Unlike other states with large SUT programs, BOE devotes few resources to audit selection to help determine the highest return audits. In contrast, Arizona, with a smaller population, has five staff specifically devoted to audit selection. One option here would be for the agency to reallocate existing resources in order to improve the quality of its audit selection methodology. Alternatively, a discovery audit component could result in the detection of new areas of tax noncompliance.

As with the FTB tax gap alternatives, the options presented with respect to BOE represent preliminary ideas for legislative consideration. Should the Legislature wish to pursue some of these options, it could request that the BOE report at hearings and provide additional details regarding these measures, including their estimated costs, savings, and policy implications.

CONCLUSIONS

The persistence of a large tax gap in California, and the likelihood that this gap will expand in the future absent corrective action, poses a significant challenge for the state. The tax gap not only results in tax rates that are higher than would otherwise be necessary but also undermines the legitimacy and fairness of the tax collection system itself. There are a number of steps that the state can take on its own initiative to address this issue. Some of these have been proposed by the administration.

There are also additional steps that the Legislature could consider. We recommend that the Legislature request the tax agencies to develop various additional tax gap measures such as those identified above. In weighing the relative merits of these proposals, the Legislature should consider the additional benefits to the state—and the taxpayers—of various programs, both in terms of revenues and tax fairness. These benefits can then be compared to the additional costs that such proposals would impose on taxpayers.



This report was prepared by Mark A. Ibele and reviewed by Mac Taylor. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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