

Federal Tax Gap: New Estimates, New Approaches

Internal Revenue Service:

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National Research Program (NRP)

Compliance Measurement

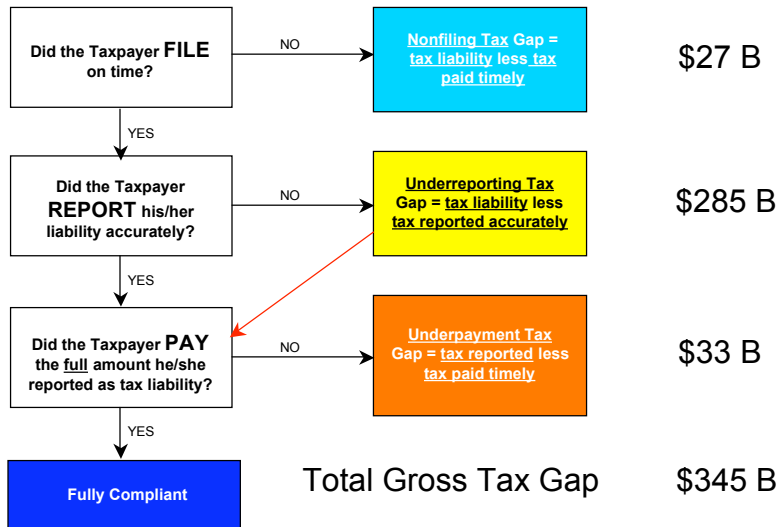
Complying with the U.S. Tax Code

- **Filing** requirements differ across taxpayer segments
 - The filing requirement for individual income taxpayers is primarily based on income and marital status
 - All businesses, charitable organizations (except certain religious organizations) and government entities must file
 - Most tax returns are filed annually, but some are more frequent
 - Taxpayers may request extensions for filing
- **Payments** are handled in a variety of ways
 - Most individual income taxes are collected via withholding
 - Most businesses and some individuals make estimated tax payments prior to the filing date
 - Taxpayers requesting extensions to file must pay by the original filing due date
- All filers must **accurately report** items on their returns, but these reporting compliance requirements are difficult to verify
 - IRS uses information documents to verify some individual income tax items
 - Wages & Salaries
 - Income tax withholding
 - Dividends & Interest
 - State/Local income tax refunds
 - Home mortgage interest
 - Most verification comes through examinations

NRP- A Comprehensive Effort

- NRP provides three compliance measures for different types of taxes and different groups of taxpayers
 - Filing Compliance: Percent of Returns Timely Filed
 - Payment Compliance: Percent of Reported Tax Liability Timely Paid
 - Reporting Compliance: Accuracy of Tax Timely Reported

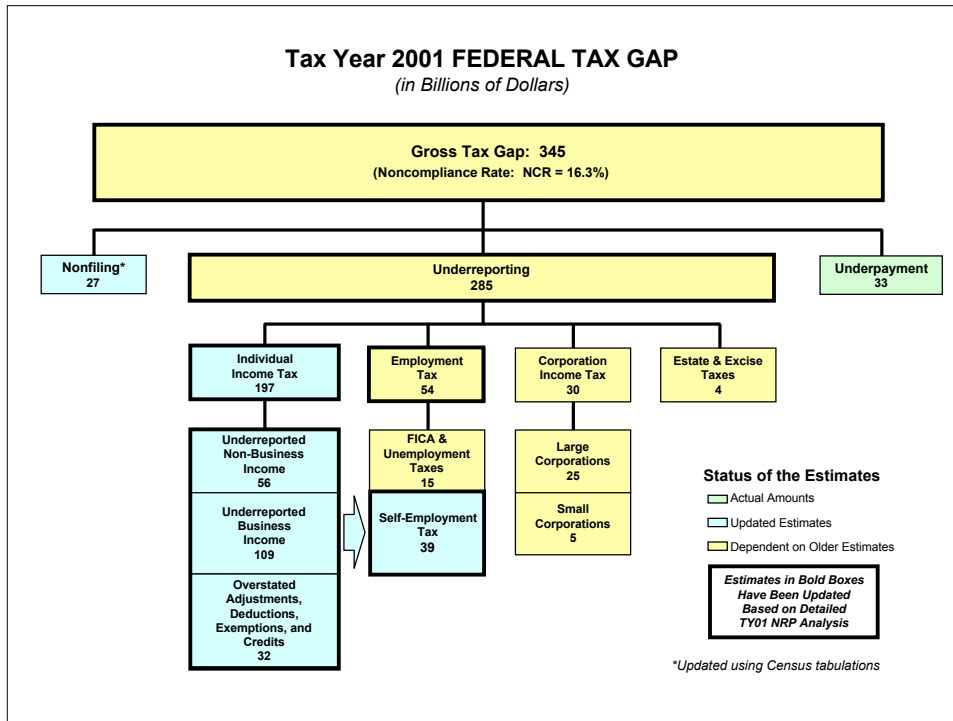
A Set of Measures Have Been Developed to Estimate Non-compliance and the Tax Gap



Individual Reporting Compliance Study

- Processed approximately 46,000 tax year 2001 NRP cases (41,000 face-to-face, 2,000 correspondence, and 3,000 accepted as filed)
- 4,500 employees received NRP training
- Examinations began in October 2002 and continued through September, 2004
- NRP provided data from the study on December 30, 2004; use of the data started in January 2005

Tax Year 2001 FEDERAL TAX GAP (in Billions of Dollars)



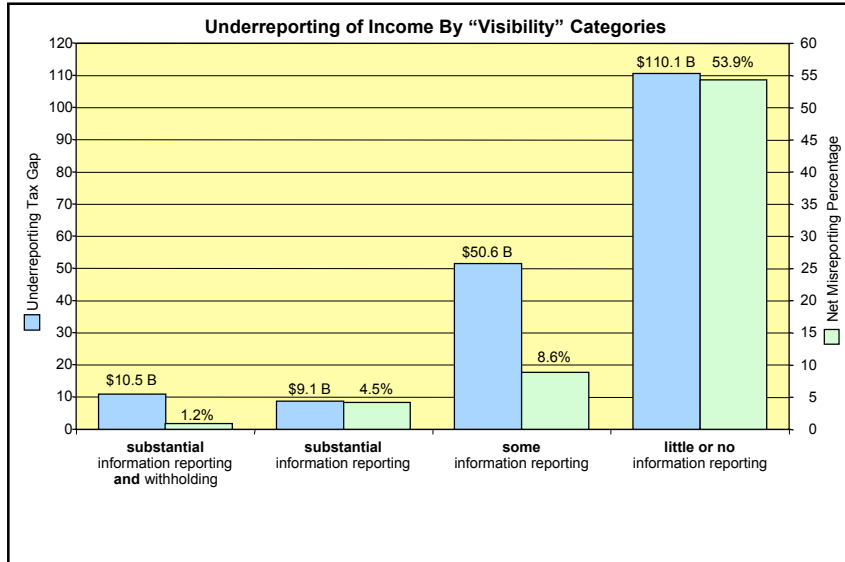
Individual Income Tax Underreporting Gap Estimates, Tax Year 2001

Type of Income or Offset	Tax Gap (\$B)	NMP †
Total Underreporting Gap	197	18%
Underreported Income	166	11%
Non-Business Income	56	4%
Wages, salaries, tips	10	1%
Interest income	2	4%
Dividend income	1	4%
State income tax refunds	1	12%
Alimony income	*	7%
Pensions & annuities	4	4%
Unemployment Compensation	*	11%
Social Security benefits	1	6%
Capital gains	11	12%
Form 4797 income	3	64%
Other income	23	64%
Business Income	109	43%
Nonfarm proprietor income	68	57%
Farm income	6	72%
Rents & royalties	13	51%
Partnership, S-Corp, Estate & Trust, etc.	22	18%
Overreported Offsets to Income	15	4%
Adjustments	-3	-21%
SE Tax deduction	-4	-51%
All other adjustments	1	6%
Deductions	14	5%
Exemptions	4	5%
Credits	17	26%
Net Math Errors (non-EITC)	*	

† NMP = Net Misreporting Percentage

* Less than \$0.5 billion.

Tax Year 2001 Individual Income Tax Underreporting Gap

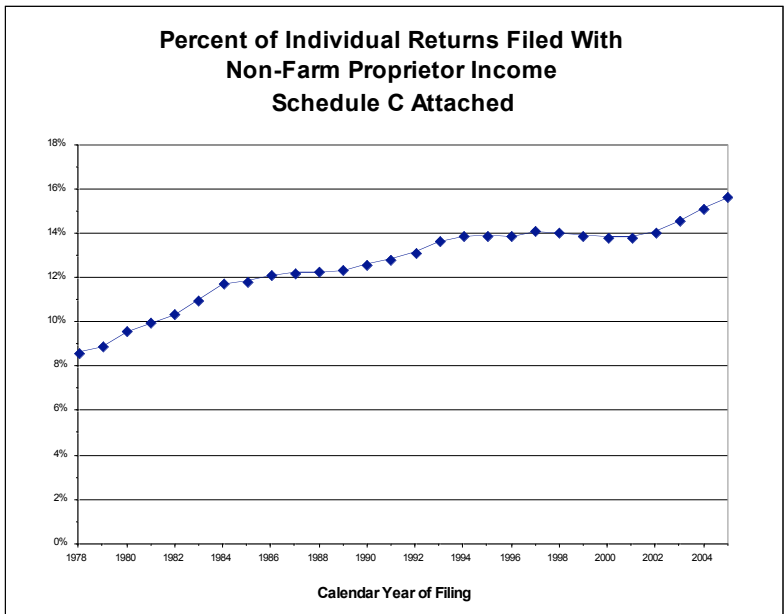


Based on updated estimates derived from the National Research Program underreporting compliance study.

Individual Income Tax Underreporting Gap Estimates for Tax Year 2001 Grouped by Visibility Category

Category	Tax Gap (\$ Billions)	Net Misreporting Percentage
Items Subject to Substantial Information Reporting and Withholding	10.5	1.2%
Wage Income	10.5	1.2%
Items Subject to Substantial Information Reporting	9.1	4.5%
Interest Income	1.6	3.6%
Dividends	1.1	3.7%
Pensions & Annuities	4.2	4.1%
Unemployment Compensation	0.5	11.1%
Social Security Benefits	1.1	5.8%
State Tax Refunds	0.6	11.6%
Items Subject to Some Information Reporting	50.6	8.6%
Partnership/SBC/E&G/etc.	22	17.8%
Alimony Income	*	7.2%
Capital gains	11	11.8%
Deductions	13.5	5.4%
Exemptions	4.2	5.4%
Items subject to Little or No Information Reporting	110.1	53.9%
Form 4797 Income	3.3	64.4%
Other Income	22.6	63.5%
Nonfarm Proprietor Income	68	57.1%
Farm Income	5.8	72.0%
Rents & Royalties	13.4	51.3%
Total Adjustments	-3	-21.1%
Not Shown on Visibility Chart	17.1	26.3%
Credits	17.1	26.3%
Total	197.4	18.0%

* Less than \$0.5 billion.



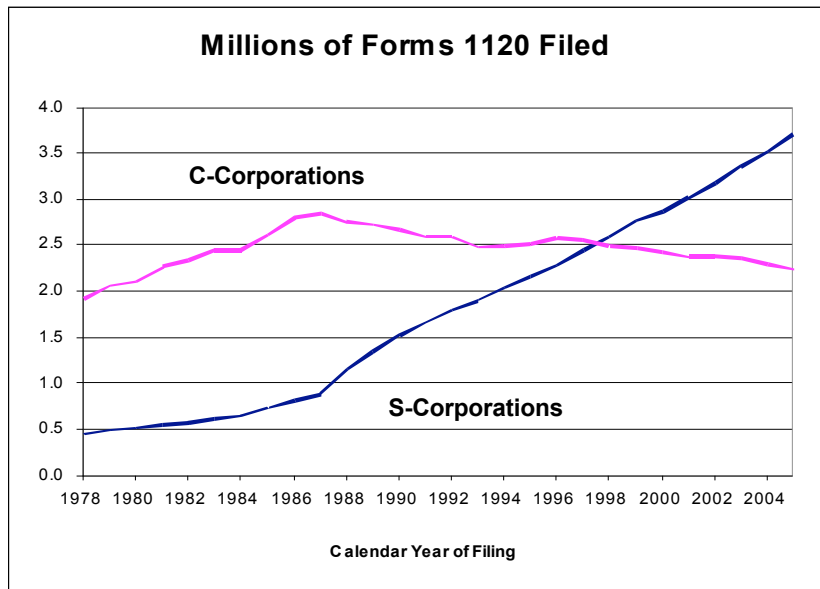
S Corp Study

Pilot Reporting Compliance Study on Flow-through Business Returns

- IRS started a pilot reporting compliance study of flow-through entities, subchapter S corporations (Form 1120-S) and partnerships (Form 1065), in November 2003
- The pilot included approximately 130 returns, divided evenly between the two form types
 - Pilot provided experiential data on procedures and logistics for larger studies
- The pilot examinations started in October 2004
 - Examiners have completed field work on more than 95% of the pilot cases
- Information from the pilot study led IRS to approve a larger reporting compliance study of subchapter S corporations

Why Study Subchapter S Returns?

- The last S corporation reporting compliance study occurred in 1984
- The population of S corporation returns has grown rapidly in the past 20 years
 - The number of S corporations in 1985 was 724,749; by 2002 that number had reached 3,154,377
 - Growth in the number of S corporations with more than \$10 million in assets has been even greater; from 2,305 in 1985 to 26,096 in 2002
- S corporations are now the most common corporate entity
 - In 2004, S corporation returns accounted for 58% of all corporate returns filed for that tax year
- IRS will use the results to more accurately gauge the extent to which the income, deductions and credits are properly reported on returns filed by S corporations and their shareholders
 - This study will complement the recently completed study of individual income tax reporting compliance



*Form 1120 "C" is a summation of the following corporate form types: Forms 1120/1120A/1120L/SF/FSC/REIT/RI/C

NRP Subchapter S Corporation Study Overview

- Random sample consists of approximately 5,000 returns from SB/SE and LMSB taxpayers covering two tax years, TY2003 and TY2004
- The study follows the standard NRP methodology:
 - IRS prepared "case built" files for key cases
 - IRS classified returns to identify specific issues that must be examined
 - Examiners have the ability to expand scope of the audit, if warranted
- The examination phase of the study will encompass approximately 36 months, beginning October 2005
 - Each tax year will have an examination cycle of approximately 24 months
- The case building and classification phases of the study are completed
 - The vast majority of 2003 returns are assigned to examiners and audits started
 - The 2004 returns are now in the field; taxpayer contacts started in April
- Expect study results by December 2008

NRP Reporting Compliance Studies – What's Next?

- The IRS is receiving a number of inquiries about future reporting compliance studies
 - When will we conduct the next 1040 study?
 - What is the schedule for upcoming studies?
- NRP has been considering how the next 1040 might look
 - Multiple tax years over multiple processing years; the first year might be TY2006, starting in October 2007
 - Smaller number of returns in each sample year
 - Look to incorporate results from operational audits
- The IRS needs to develop a long-term strategy for conducting reporting compliance studies
 - Which form types to study?
 - How to ensure trained workforce?
 - How to balance research needs against resource restrictions?