

Overview of the Federal Tax Gap

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 Internal Revenue Service
 NHQ Office of Research

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Tax Gap Concepts

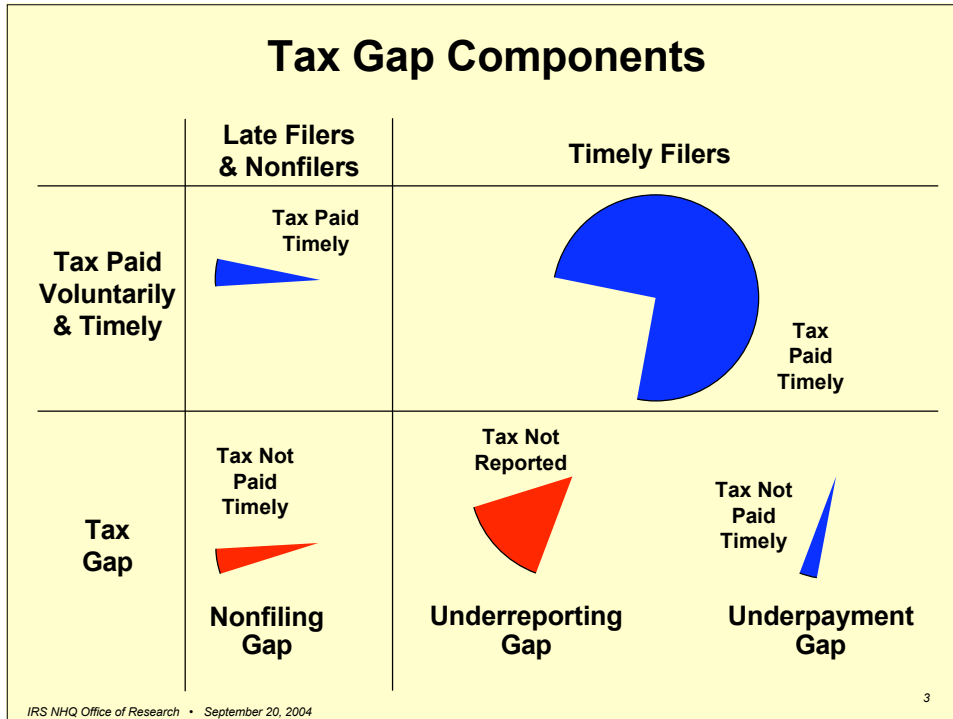
<i>For a given Tax Year:</i>	<u>TY2001*</u>
Total Tax Liability (Legal Sector)	\$2,078 B
— <u>Tax Paid Voluntarily & Timely</u>	- <u>1,767 B</u>
Gross Tax Gap	\$311 B
— <u>Late & Enforced Payments</u>	- <u>56 B</u>
Net Tax Gap	\$255 B

Color Key:
Mostly Observable
Unobservable

* Rough estimates for all types of tax

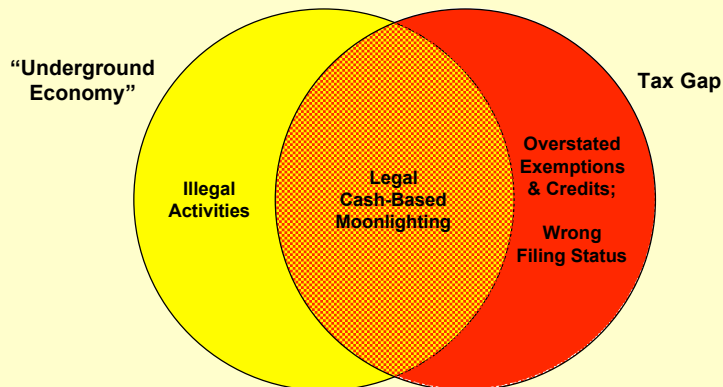
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Tax Gap Components



Scope of the Tax Gap Estimates

- **Legal-source** economic activity only
- **Not** synonymous with the “Underground Economy”



What is the Relationship Between the Tax Gap and ARDI?

The **Gross Tax Gap** is the amount of tax that is imposed by law for a given tax year, but is not paid voluntarily and timely.

The **Net Tax Gap** is the portion of the Gross Tax Gap that will not be collected after all IRS and taxpayer actions have been completed for a given tax year.

The **Accounts Receivable Dollar Inventory** (ARDI) is the sum of all accrued tax, penalties and interest that have been assessed, but not yet paid. These assessments are generally made by IRS as a result of its enforcement efforts, but they also include self-assessments that taxpayers report, but do not pay timely (the underpayment gap).

ARDI	Tax Gap
A cumulative cash flow concept that includes amounts related to many tax years (analogous to a balance sheet)	Estimated for a single tax year (analogous to an income statement)
Includes assessments of interest and penalties	Excludes interest and penalties
Only the small portion of the gross tax gap that is assessed becomes a part of Accounts Receivable.	Most of the tax gap is never assessed , and so never enters ARDI.
Of the portion of a given year's tax gap that <i>does</i> eventually pass through ARDI, only a fraction of this is likely to be in Accounts Receivable at any given time. The rest has already been collected, has not yet been assessed, or has been assessed and written off.	Estimates of the net tax gap take into account the degree to which assessments have historically been collected over time; any deviation from this experience would change the net tax gap, but not the gross tax gap. Recognizing that a portion of ARDI will not be collected does not change the net tax gap estimate if the non-collection is in line with recent experience.

Are The Underreporting Gap Estimates Based on Recommended Audit Adjustments or on Final Assessments?

Although some of our tax gap reports contain both types of estimates, all of the estimates in this presentation are based on audit **recommendations**. There are many reasons to prefer this basis alone for the estimates:

- **Not all noncompliance is detected or successfully assessed:** Using the recommended results compensates for this somewhat. This is particularly important for corporation income tax and employment tax, where our estimates do not account for noncompliance that is not detected.
- **Out-of-court settlements reduce assessments:** Increasing workloads, decreasing staff, the statute of limitations, and the "hazards" (uncertainties and costs) of litigation put pressure on both IRS and the taxpayer to settle out of court. Taxpayers are likely to anticipate higher net benefits from tax litigation than the IRS, putting downward pressure on the amount of any out-of-court settlements.
- **Appeals and Litigation are subject to self-selection bias:** Taxpayers whose recommended adjustment is too small tend not to appeal the adjustment.
- **Assessments are lower bounds:** Although neither the recommendations-based nor the assessment-based estimates perfectly represents true tax obligations, the recommendations-based estimates are the least likely to be biased. There are somewhat offsetting reasons why the recommendations-based estimates might be too high or too low, but the assessment-based estimates are certainly a lower bound on the true tax obligation.
- **Recommendations are not upper bounds:** Providing pairs of estimates (both recommendations-based and assessment-based) causes the reader to assume that the recommendations-based estimates are upper bounds on the true amount of noncompliance, but this is not the case.
- **Simplicity:** Providing pairs of estimates is also much more cumbersome and confusing than providing point estimates—both for tables and for discussions.

Is Employer Underdeposit of Withheld Income Tax Part of the Individual Income Tax Gap or the Employment Tax Gap?

It is more appropriately included with **individual income tax** for several reasons:

- **The tax gap is defined by type of tax**, rather than by who commits the noncompliance. An analogous example would be that of an individual who would likely misreport his income tax if his partnership reported the wrong income to him on Form K-1. The partner may not know that the amount is incorrect, but the underpaid individual income tax is still a part of the individual income tax gap.
- **Ultimate tax liability is individual income tax**: Ultimately, the tax liability that is being satisfied by employer deposits of withheld income tax is the individual's income tax liability.
- **Can't double-count tax liability**: When estimates of the tax gap, total tax liability, and noncompliance rates are combined across all types of tax, we need to be careful not to double-count the same tax liability as both individual income tax and employment tax liability; it needs to be associated with one or the other, and the logical place is with individual income tax.
- **Consistent with nonfiling gap**: Employer deposits of withheld income tax reduce the individual income tax nonfiling gap, so employer *underdeposits* of withheld income tax should *increase* the individual income tax underpayment gap.

Note: underdeposits of withheld FICA tax are clearly part of the employment tax underpayment gap.

Current Estimates of the Tax Gap

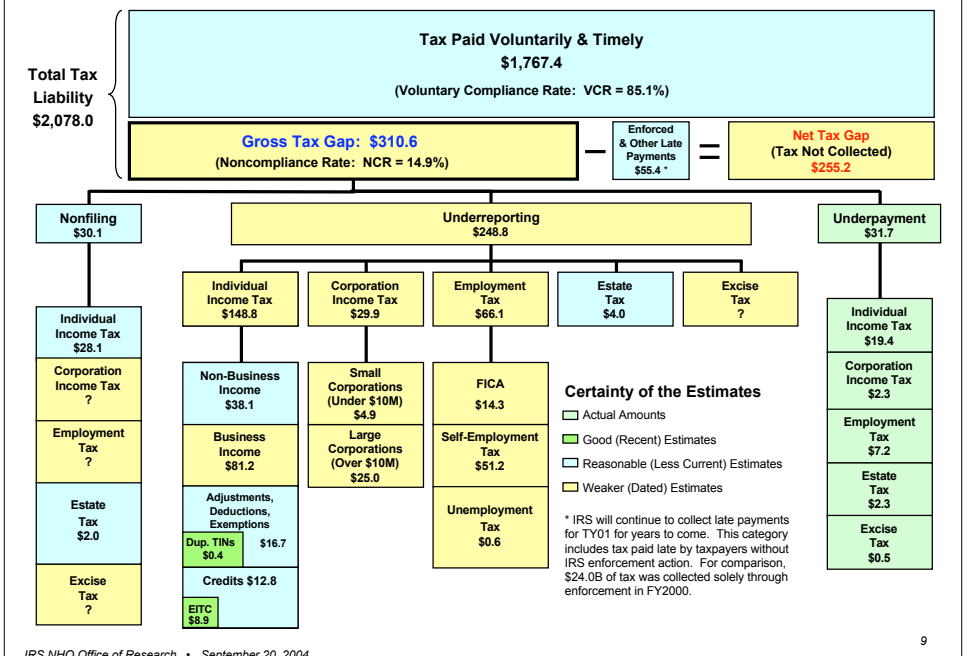
Sources of Data:

- **Nonfiling:**
 - TY88 study of individual nonfilers
- **Underreporting:**
 - Random samples of thorough audits (most recent was for TY88)
 - Regular (operational) audits
 - Special studies of specific components
- **Underpayment:**
 - Tabulations of actual underpayments

Projections to TY 2001:

- Based on very old compliance data
- Assume compliance rate constant in each major component
- Tied to growth in receipts

TAX GAP MAP for Tax Year 2001 (in \$ Billions)



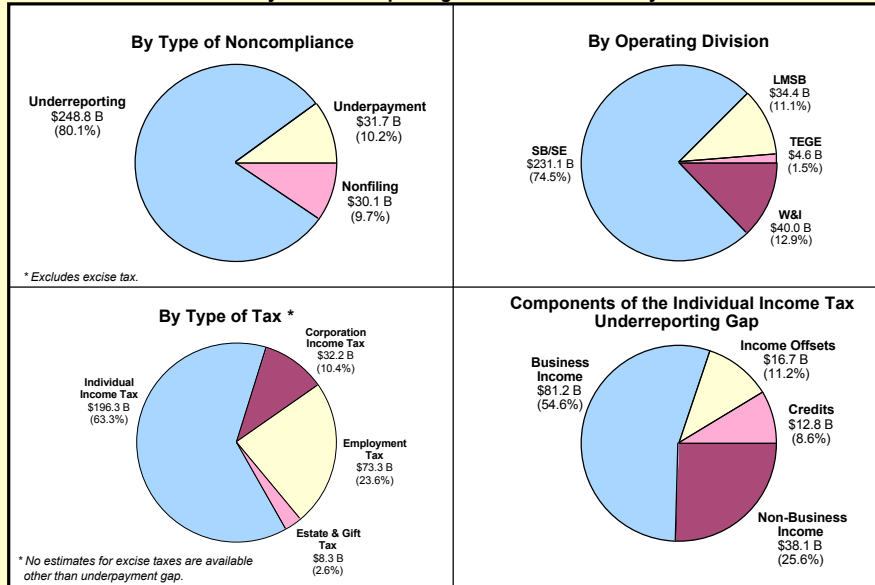
Certainty of the Estimates

The tax gap figures presented here range from actual amounts to very rough estimates. Our confidence in them depends on both the **quality of the original estimates** and **how many years they have been projected** beyond the original data.

Tax Gap Component	TY2001 Projection (\$B)	Confidence in Original Estimate		Age of the Compliance Data		Overall Confidence in Projection
Nonfiling						Reasonable
Individual income tax	28.1		Medium		Dated	Reasonable
Estate tax	2.0		Medium		Less current	Reasonable
Underreporting						Weaker
Individual income tax						Weaker
• Non-business income	38.1		Medium		Dated	Reasonable
• Business income	81.2	Low			Dated	Weaker
• Adjustments, deductions, exemptions	16.7		Medium		Dated	Reasonable
• Duplicate TINs			Medium			Recent
• Credits	12.8		Medium		Dated	Reasonable
• EITC			Medium			Recent
Corporation income tax						Weaker
• Small corporations	4.9	Low			Dated	Weaker
• Large corporations	25.0	Low			Dated	Weaker
Employment tax						Weaker
• FICA	14.3	Low			Dated	Weaker
• Self-employment tax (SECA)	51.2	Low			Dated	Weaker
• Unemployment tax (FUTA)	0.6	Low			Dated	Weaker
Estate tax						Reasonable
			Medium		Less current	
Underpayment	31.7			High		Recent
						Actual

Tax Year 2001 Gross Tax Gap

Dominated By the Underreporting of Business Income by Individuals



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Noncompliance Rate

$$\text{NCR} = \frac{\text{Gross Tax Gap}}{\text{Total Tax Liability}} \times 100\% = \frac{\$311 \text{ B}}{\$2,078 \text{ B}} \times 100\% = 14.9\%$$

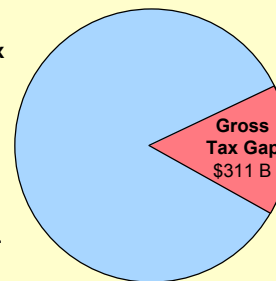
▪ **Overall** measure of noncompliance:

- Filing compliance
- Reporting compliance
- Payment compliance

▪ Must be **estimated**

▪ **Not** a percentage of taxpayers, but of tax dollars.

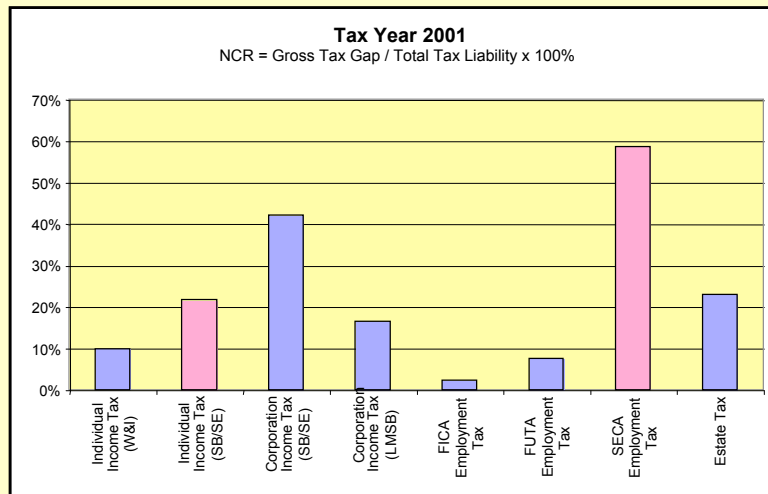
Total Tax Liability
\$2,078 B



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Noncompliance Rates for Major Categories



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Individual Income Tax Underreporting Gap

Four Main Components:

- Non-Business Income
- Business Income
- Offsets to Income (Adjustments, Deductions, Exemptions)
- Offsets to Tax (Credits)

- **Net Misreporting Percentage:** aggregate underreporting measure for each tax return line item

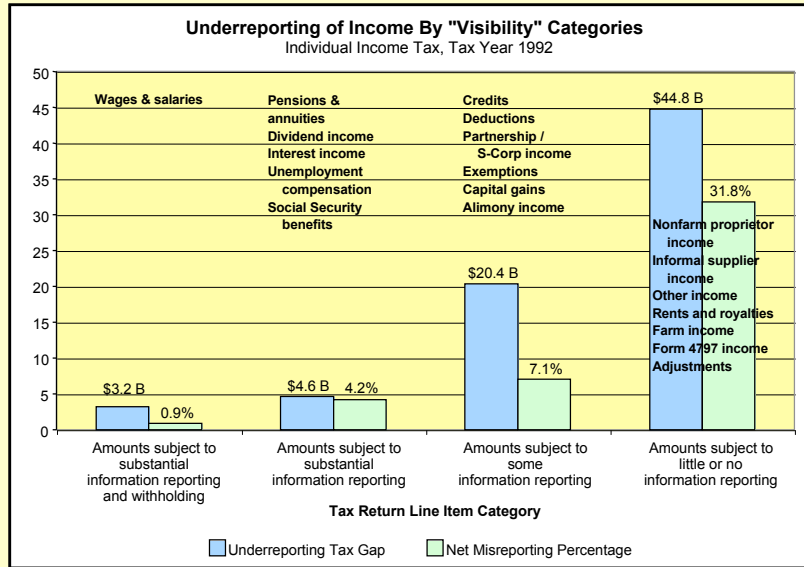
$$\text{NMP} = \frac{\sum \text{Net Misreported Amount}}{\sum |\text{Amount That Should Have Been Reported}|} \times 100\%$$

* Taking the absolute value of the correct amounts allows losses to be aggregated with gains.

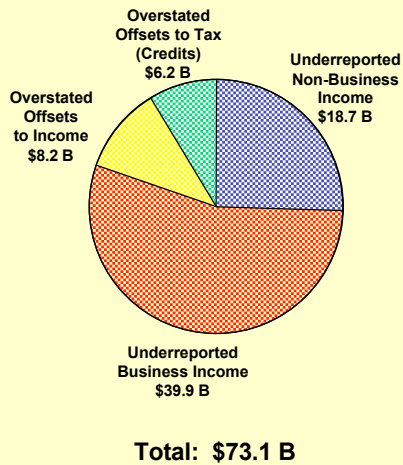
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Individual Income Tax Underreporting Gap



Tax Year 1992* Individual Income Tax Underreporting Gap and NMP Detail



Largest Components

Component	Tax Gap (\$B)	NMP (%)
Non-Farm Proprietor Income	16.9	32.3
Informal Supplier Income	12.3	81.4
Other Income	7.6	24.9
Credits	6.2	40.2
Deductions	5.1	4.4
Rent & Royalty Income	3.7	17.2
Partnership, S-Corp. Income	3.6	7.5
Farm Income	3.4	32.2
Wage Income	3.2	0.9
Exemptions	2.9	4.5
Capital Gains	2.5	7.2

* Tax Year 1992 is the last year for which line-item compliance measures have been published.

Underreporting of Self-Employment Income

■ Sole Proprietors:

- Generally not subject to information reporting by third-parties
- Easy to treat personal expenses as business expenses

■ Informal Suppliers:

- Proprietors who operate in an informal business style:
 - Poor (or nonexistent) books and records
 - Often cash-based transactions
 - Often no identifiable place of business
 - Often anonymous to customers
- Examples:
 - Street vending
 - Moonlighting
 - Roadside stands

Plans For Updating These Estimates

Data are being compiled to facilitate several updates in the near future.

■ Individual Income Tax Underreporting Gap:

- NRP compliance data available for analysis by the end of 2004
- Supplemental data and analyses (informal suppliers, detection-controlled estimation, microsimulation model)
- New tax gap estimates for TY2001 by the end of 2005

■ Individual Income Tax Nonfiling Gap: Aggregate tabulations from the Census Bureau's Exact Match study for TY1999 and TY2001

■ Flow-Through Entities and Arrangements:

- Next NRP study will focus on partnerships and S-corporations
- Introductory pilot study scheduled to begin later in 2004

■ Other Components of the Tax Gap

- Based on regular (operational) enforcement data
- Some combination of operational and random data
- Estimate aggregate excise tax liabilities using external data?

More Detailed Information

■ Published Tax Gap Reports:

1. **2002 EITC Report:** Internal Revenue Service, "Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns," February 28, 2002.
2. **1996 Individual Report:** Internal Revenue Service, "Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992," Publication 1415 (Rev. 4-96).
3. **Employment Tax Report:** Internal Revenue Service, "Federal Tax Compliance Research: Gross and Net Employment Tax Gap Estimates for 1984-1997," Publication 1415-E (Rev. 10-93).
4. **Net Tax Gap Report:** Internal Revenue Service, "Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates (Supplement to Publication 7285)," Publication 1415 (Rev. 4-90).
5. **1988 Gross Tax Gap Report:** Internal Revenue Service, "Income Tax Compliance Research: Gross Tax Gap Estimates and Projections for 1973-1992," Publication 7285 (Rev. 3-88).
6. **1988 Appendices:** Internal Revenue Service, "Income Tax Compliance Research: Supporting Appendices to Publication 7285," Publication 1415 (Rev. 7-88).

Report	Individual Income Tax	Corporation Income Tax	Employment Tax	Nonfiling	Under-reporting	Under-payment	Net Tax Gap
1. 2002 EITC Report *	■				■		■
2. 1996 Individual Report *	■			■	■	■	■
3. Employment Tax Report *			■		■	■	■
4. Net Tax Gap Report *	■	■		■	■	■	■
5. 1988 Gross Tax Gap Report	■	■		■	■		
6. 1988 Appendices	■	■		■	■		

* Available online at: <http://www.irs.gov/taxstats/article/0,,id=129014,00.html>

More Detailed Information

■ Interactive Tax Gap Map

A PowerPoint slideshow containing:

- Detailed definitions, description of methodologies, etc.
- Estimates broken out in additional ways
- FAQs
- Hyperlinks, allowing the user to navigate topics in any order

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