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IRS Updates Tax Gap Estimates

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WASHINGTON — Internal Revenue Service officials announced today that they have updated their estimates of the Tax Year 2001 tax gap based on the National Research Program (NRP).

The updated estimate of the overall gross tax gap for Tax Year 2001 – the difference between what taxpayers should have paid and what they actually paid on a timely basis – comes to $345 billion. This figure falls at the high end of the range of $312 billion to $353 billion per year, an estimate released last March.

IRS enforcement activities, coupled with other late payments, recover about $55 billion of the tax gap, leaving a *net* tax gap of $290 billion for Tax Year 2001.

"The vast majority of Americans pay their taxes accurately and are shortchanged by those who don't pay their fair share," said IRS Commissioner Mark W. Everson. "The magnitude of the tax gap highlights the critical role of enforcement in keeping our system of tax administration healthy."

The complexity of the tax law is also a significant factor in causing the tax gap, which can be seriously addressed only in the context of fundamental tax reform and simplification.

While no tax system can ever achieve 100 percent compliance, the IRS is committed to taking all reasonable steps to improve compliance through increased and better targeted enforcement and through increased taxpayer service and outreach efforts.

"Helping taxpayers better understand their obligations under the current tax law will facilitate compliance, but simplifying the tax code would have a big impact on reducing the tax gap" said Everson.

One important administrative step already taken to improve compliance has been the updating of the audit selection system with the NRP information. The newer statistics enable the IRS to audit more efficiently and improve the detection of underreported income and overstated deductions, credits, etc.

To gain an estimate of taxpayer compliance, the IRS launched the NRP, a three-year study of tax year 2001 returns of individuals. The study involved the review and examination of about 46,000 randomly selected returns. These audits were completed by the fall of 2005. To gather statistically valid data, the return selection process for the NRP included an over-sampling of high income returns. This enabled IRS researchers to draw valid conclusions about important sub-categories of taxpayers.

As with prior estimates, the updated estimate of the tax gap shows that the largest component of this gap, more than 80 percent, comes from underreported taxes. Underreported income tax is the largest component of this (see attached Tax Gap Map for Tax Year 2001). Nonfiling and underpayment of tax comprise the rest of the tax gap.

The updated NRP estimates also include estimates of the Net Misreporting Percentage (NMP) for each major line item on individual income tax returns. The NMP is the net amount that was misreported on a given line item expressed as a percentage of the total amount that should have been reported on that line item (see attached table, Individual Income Tax Underreporting Estimates, Tax Year 2001).

Though the net misreporting percentage varies by category of income, the rates reflect that compliance is highest where there is third-party reporting or withholding.

“Simply stated, compliance is highest where there is third-party reporting,” Everson said.

For example, one percent of all wage, salary, and tip income is misreported, contributing an estimated $10 billion to the tax gap. In contrast, nonfarm sole proprietor income, which is reported on a Schedule C and is subject to little third-party reporting or withholding, has a net misreporting percentage of 57 percent, contributing about $68 billion to the tax gap.

Since 2001, the year covered by the study, the IRS has taken a number of steps to bolster enforcement and reduce the tax gap. The IRS increased its enforcement revenues by nearly 40 percent from $33.8 billion in 2001 to $47.3 billion in 2005. Audits of high-income taxpayers — those earning $100,000 or more — topped 221,000 in fiscal year 2005, the highest number in the past 10 years. Total audits of all taxpayers topped 1.2 million last year —a 20 percent jump from the prior year.

Proposals to Begin Addressing the Tax Gap

The President’s FY 2007 budget proposal contains five legislative changes aimed at narrowing the tax gap. These proposals include:

- Expanding third-party information reporting to include certain Government payments for property and services;
- Expanding third-party information reporting on debt and credit card reimbursements paid to certain merchants;
- Clarifying liability for employment taxes for employee leasing companies and their clients;
- Expanding beyond income taxes the requirement that paid return preparers sign returns, and imposing a penalty when they fail to do so; and
- Authorizing the IRS to issue levies to collect employment tax debts prior to collection due process proceedings.