Tax Gap Estimates for Tax Years 2011–2013

Overview

This overview presents estimates of the tax gap for the tax year (TY) 2011–2013 timeframe. The tax gap and associated concepts are a particular way of defining and analyzing compliance and noncompliance and are based on tax year liability. The tax gap provides a rough gauge of the level of overall noncompliance and voluntary compliance given all the events that occurred during the relevant tax periods and the Internal Revenue Code (IRC) provisions in effect at the time. Tax gap estimates provide the Internal Revenue Service (IRS) with periodic appraisals about the nature and extent of noncompliance for use in formulating tax administration strategies. The word "tax" in the phrase "tax gap" is used broadly to encompass both tax and refundable and non-refundable tax credits. The IRS last issued tax gap estimates covering the TY 2008–2010 timeframe.

Like the TY 2008–2010 tax gap estimates, these new estimates reflect an estimated average compliance rate and associated average annual tax gap covering a timeframe of three tax years. This approach was motivated primarily by the decision to pool multiple years of compliance data from the annual individual income tax reporting compliance component of the National Research Program (NRP) to provide greater reliability of individual income tax underreporting tax gap estimates by sources of noncompliance.

The estimates were prepared by the IRS and are based on original research and analysis conducted or sponsored by the IRS. Estimating the tax gap is inherently challenging and requires assessing the merits of alternative methods, assumptions, and data sources. There is no single approach that can be used for estimating all the components of the tax gap, so multiple methods are used. Each approach is subject to non-sampling error; the component estimates that are based on samples are further subject to sampling error. The uncertainty of the estimates is not readily captured by standard errors that typically accompany estimates based on sample data. For that reason, standard errors, confidence intervals, and significance tests for statistical comparisons across years are not reported. When using these estimates and making comparisons across years, the user should be mindful of these limitations.

The gross tax gap is the amount of true tax liability that is not paid voluntarily and timely. The estimated gross tax gap is $441 billion. The net tax gap is the gross tax gap less tax that subsequently will be paid, either paid voluntarily but late or collected through IRS administrative and enforcement activities; it is the portion of the gross tax gap that will not be paid. It is estimated that $60 billion of the gross tax gap eventually will be paid resulting in a net tax gap of $381 billion. The voluntary compliance rate (VCR) is a ratio measure of relative compliance and is defined as the amount of "tax paid voluntarily and timely" divided by "total true tax", expressed as a percentage. The VCR corresponds to the gross tax gap. The estimated VCR is 83.6 percent. The net compliance rate (NCR) is a ratio measure corresponding to the net tax gap. The NCR is defined as the sum of "tax paid voluntarily and timely" and "enforced and other late payments" divided by "total true tax", expressed as a percentage. The estimated NCR is 85.8 percent. (See Attachment 1, Tax Gap Map.)

TY 2011–2013 Tax Gap Estimates

Gross Tax Gap: $441 B
Voluntary Compliance Rate: 83.6%
Net Tax Gap: $381 B
Net Compliance Rate: 85.8%

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Many factors contribute to differences over time in both the gross tax gap and the VCR. These include factors such as the overall level of economic activity, changes in the composition of economic activity with shifts toward those with higher or lower compliance rates, changes in tax law and administration, updated data and improved methodologies, and changes in underlying compliance behavior on the part of taxpayers and preparers.

The approaches used to estimate the various tax gap components for TY 2011–2013 generally follow the methods used for the previous TY 2008–2010 estimates. Newly available data, however, resulted in some modifications to the estimation approaches. The change that had the greatest impact was the way in which the analytical technique for adjusting for income undetected by audits (Detection Controlled Estimation, DCE) was applied in the development of the individual income tax underreporting tax gap estimates.

- *TY 2011–2013 Voluntary Compliance Rate (VCR) of 83.6% is virtually unchanged from the revised TY 2008–2010 estimate of 83.8%.*
- *Despite limitations due to differences in methods & data and general estimation challenges, voluntary compliance rate (VCR) estimates since TY 2001 suggest compliance is holding steady with estimates in the 82% to 84% range.*

Individual income tax underreporting tax gap estimates are based primarily on results from a statistical sample of individual income tax returns that were selected for audit. While these audits make every attempt to validate the accuracy of the return, it is inevitable that some unreported income will remain undetected. To account for these undetected amounts, the IRS has used DCE. For the TY 2011–2013 estimates, the availability and timing of new data allowed contemporaneous estimation of DCE, an improvement over the method used in the originally published TY 2008–2010 estimates.

The TY 2011–2013 estimates are not directly comparable to the previously published TY 2008–2010 estimates because of the effect of changes to the methodology. In order to compare the current estimates for TY 2011–2013 to the TY 2008–2010 time period, revised TY 2008–2010 estimates were developed using the same methods as used for the current estimates. A comparison with those revised estimates shows that the TY 2011–2013 VCR estimate of 83.6 percent is virtually unchanged from the estimate for the earlier period. The TY 2011–2013 gross and net tax gap estimates are higher than their respective revised TY 2008–2010 estimates by $47 billion (gross) and by $37 billion (net) because the estimated average annual true tax liability for the TY 2011–2013 timeframe is higher than the estimate for the TY 2008–2010 timeframe. (See Attachment 2, Table 1.)

Comparisons of the TY 2011–2013 estimates to the earlier TY 2001 and the TY 2006 tax gap estimates must be done with care because of differences in the estimation methods. Despite those limitations and recognizing the challenges in estimating the tax gap and the many factors that contribute to differences in estimates over time, the TY 2011–2013 estimates in conjunction with the tax gap estimates for TY 2001 and later years suggest that compliance is holding steady with the voluntary compliance rates estimated to be in the 82 percent to 84 percent range.

The gross tax gap is composed of three components: nonfiling, underreporting, and underpayment. The estimated gross tax gaps for these components are $39 billion, $352 billion, and $50 billion respectively. The gross tax gap estimates are also segmented by type of tax. The estimated gross tax gap for individual income tax is $314 billion; for corporation income tax it is $42 billion; for employment tax it is $81 billion, and for estate and excise tax combined it is $3 billion. (See Attachment 1, Tax Gap Map; Attachment 2, Table 2.)

The estimated net tax gap for individual income tax is $271 billion; for corporation income tax it is $32 billion, for employment tax it is $77 billion, and for estate and excise tax combined it is $1 billion. (See Attachment 1, Tax Gap Map.)

Findings from earlier tax gap analyses that compliance is higher when amounts are subject to information reporting and even higher when also subject to withholding, continue to hold. The extent of coverage by information reporting and/or withholding is called "visibility" because incomes that are reported to the IRS are more "visible" to both the IRS and taxpayers. Misreporting of income amounts subject to substantial information reporting and withholding is 1 percent; of income amounts subject to substantial information reporting but not withholding, it is 5 percent; and of income amounts subject to little or no information reporting, such as nonfarm proprietor income, it is 55 percent. (See Attachment 3, Figure 1.)

Compliance is higher

when there is

third- party information reporting

and withholding

Tax Gap Estimates for Tax Years 2011–2013

(Money amounts are in billions of dollars; estimates are annual average amounts.)

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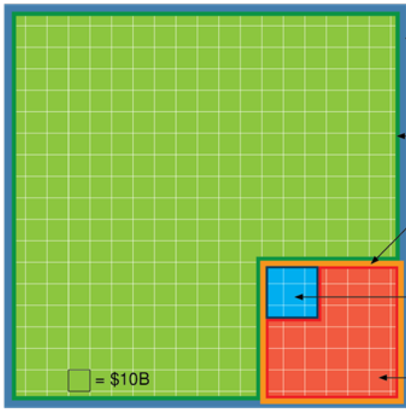

Estimated Total True Tax Liability*
$2,683B

Tax Paid Voluntarily & Timely
$2,242B 83.6% Voluntary Compliance Rate (VCR)

Gross Tax Gap
$441B

Enforced & Other Late Payments
$60B

Net Tax Gap (Tax Not Collected)
$381B 85.8% Net Compliance Rate (NCR)

Calculating the Net Tax Gap

Nonfiling
Underreporting
\+ Underpayment

Gross Tax Gap
− Enforced & Other Late Payments

Net Tax Gap

Total True Tax Liability	Tax Paid Voluntarily & Timely	Gross Tax Gap: Nonfiling	Underreporting	Underpayment	Gross Tax Gap	Enforced & Other Late Payments	Net Tax Gap (Tax Not Collected)
$2,683	$2,242	$39	+ $352	+ $50	= $441	− $60	= $381
By Type of Tax							
Individual Income Tax $1,398	Individual Income Tax $1,084	Individual Income Tax $31	Individual Income Tax + $245	Individual Income Tax + $38	Individual Income Tax = $314	Individual Income Tax − $43 (14%)	Individual Income Tax = $271
Corporation Income Tax $294	Corporation Income Tax $251	Corporation Income Tax #	Corporation Income Tax + $37	Corporation Income Tax + $5	Corporation Income Tax = $42	Corporation Income Tax − $10 (24%)	Corporation Income Tax = $32
Employment Tax $920	Employment Tax $839	Employment Tax [4] $6	Employment Tax + $69	Employment Tax + $6	Employment Tax = $81	Employment Tax − $5 (6%)	Employment Tax = $77
Estate Tax $16	Estate Tax $13	Estate Tax $2	Estate Tax + $1	Estate Tax + $<0.5	Estate Tax = $3	Estate Tax − $2 (55%)	Estate Tax = $1

Individual Income Tax underreporting:

Business Income	Non-Business Income	Credits	Income Offsets [1]	Filing Status	Other Taxes [2]	Unallocated Marginal Effects [3]
$110	$57	$42	$20	$5	$1	$10

Corporation Income Tax underreporting:

Large Corporations	Small Corporations
$26	$11

Employment Tax underreporting:

Self-Employment Tax	FICA & Uncollected FICA TAX	Unemployment
$45	$24	$1

NOTES:

* Totals include Excise Tax.

#—No estimate.

Detail may not add to totals due to rounding.

[1] Includes adjustments, deductions, and exemptions.

[2] Includes the Alternative Minimum Tax and taxes reported in the "Other Taxes" section of the Form 1040 except for self-employment tax and unreported social security and Medicare tax (which are included in the employment tax gap estimates).

[3] Is the difference between (1) the estimate of the individual income tax underreporting tax gap where underreported tax is calculated based on all misreporting combined and (2) the estimate of the individual income tax underreporting tax gap based on the sum of the tax gaps associated with each line item where the line item tax gap is calculated based on the misreporting of that item only. There may be differences if the marginal tax rates are different in these two situations.

[4] Self-employment tax only.

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Table 1. Comparison of Tax Gap Estimates for Tax Years 2008-2010 and 2011-2013

[Money amounts are in billions of dollars]

Tax Gap Component	TY 2008-2010 Prior Published [1]	TY 2008-2010 Revised [1]	TY 2011-2013 [1]
Estimated Total True Tax	**$2,496**	**$2,431**	**$2,683**
Gross Tax Gap	**$458**	**$394**	**$441**
Nonfiling Gap	$32	$31	$39
Underreporting Gap	$387	$325	$352
Underpayment Gap	$39	$39	$50
Voluntary Compliance Rate	**81.7%**	**83.8%**	**83.6%**
Enforced and Other Late Payments	**$52**	**$50**	**$60**
Net Tax Gap [2]	**$406**	**$344**	**$381**
Net Compliance Rate	**83.7%**	**85.8%**	**85.8%**

[1] The estimates are the annual averages for the covered timeframe.

[2] The net tax gap is the gross tax gap reduced by the amount of enforced and other late payments that will eventually be paid.

Detail may not add to total due to rounding.

Table 2. Tax Year 2011–2013[1] Tax Gap Estimates

[Money amounts are in billions of dollars]

Tax Gap Component	TY 2011-2013[1]	Share of Gross Tax Gap
Estimated Total True Tax	**$2,683**	
Gross Tax Gap	**$441**	**100%**
Voluntary Compliance Rate	***83.6%***	
Enforced and Other Late Payments	**$60**	
Net Tax Gap	**$381**	
Net Compliance Rate	***85.8%***	
Nonfiling Gap	**$39**	**9%**
Individual Income Tax	$31	7%
Self-Employment Tax	$6	1%
Estate Tax	$2	[2]
Underreporting Gap	**$352**	**80%**
Individual Income Tax	**$245**	**56%**
Non-Business Income	$57	13%
Business Income	$110	25%
Adjustments, Deductions, Exemptions	$20	4%
Filing Status	$5	1%
Other Taxes [4]	$1	[2]
Unallocated Marginal Effects [5]	$10	2%
Credits	$42	10%
Corporation Income Tax	**$37**	**8%**
Small Corporations (assets under $10M)	$11	2%
Large Corporations (assets of $10M or more)	$26	6%
Employment Tax	**$69**	**16%**
Self-Employment Tax	$45	10%
Uncollected Social Security and Medicare Tax	$1	[2]
FICA and Unemployment Tax	$24	5%
Estate Tax	**$1**	**[2]**
Underpayment Gap	**$50**	**11%**
Individual Income Tax	$38	9%
Corporation Income Tax	$5	1%
Employment Tax	$6	1%
Estate Tax	[3]	[2]
Excise Tax	[3]	[2]

[1] The estimates are the annual averages for the Tax Year 2011-2013 timeframe.

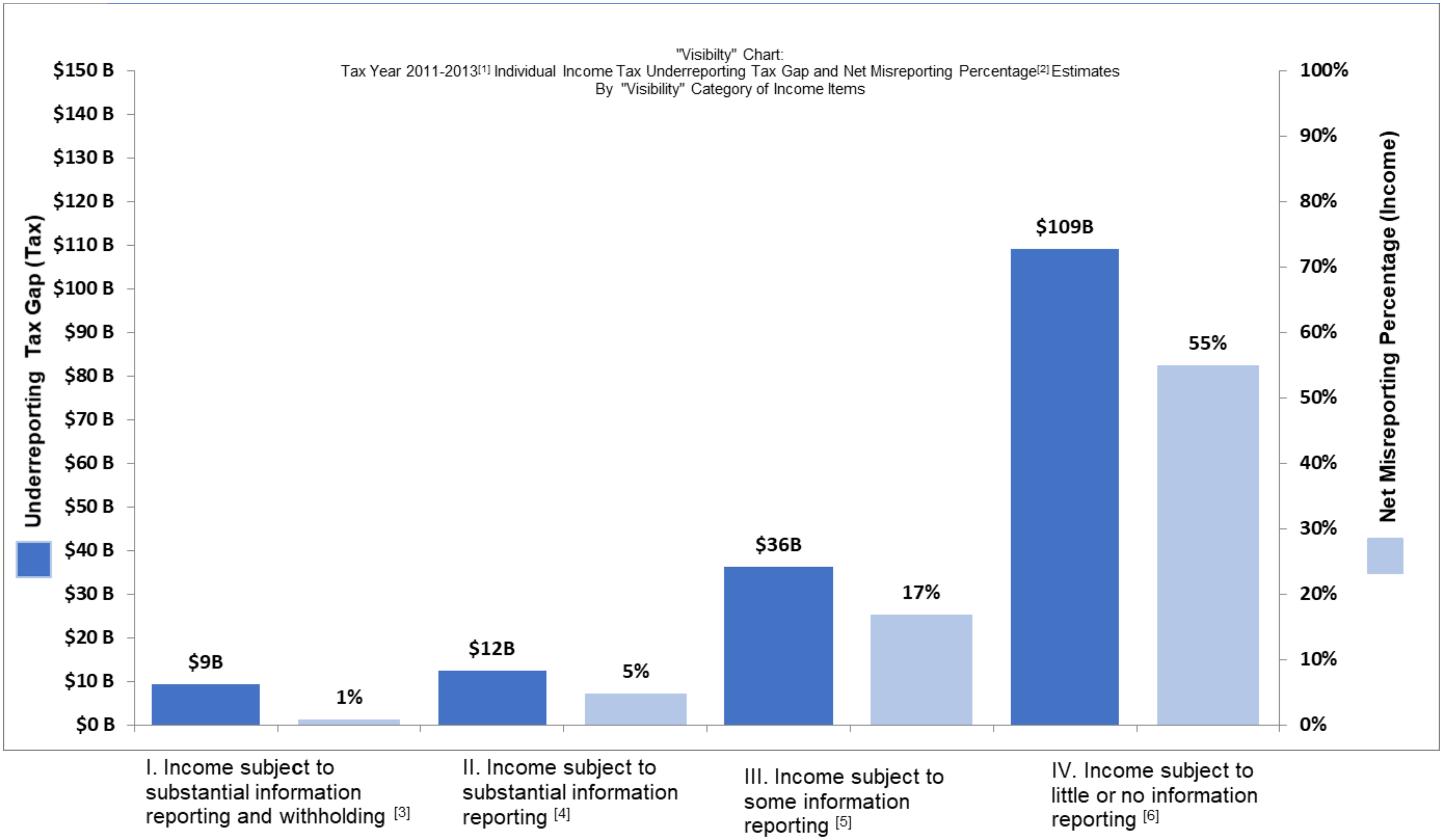
[2] Less than 0.5 percent.

[3] Less than $0.5 billion.

[4] Other taxes include the Alternative Minimum Tax and taxes reported in the "Other Taxes" section of the Form 1040 except for self-employment tax and unreported social security and Medicare tax (which are included in the employment tax gap estimates).

[5] Unallocated marginal effects is the difference between (1) the estimate of the individual income tax underreporting tax gap where underreported tax is calculated based on all misreporting combined and (2) the estimate of the individual income tax underreporting tax gap based on the sum of the tax gaps associated with each line item where the line item tax gap is calculated based on the misreporting of that item only. There may be a difference whenever more than one line item has been misreported on the same return and the combined misreporting results in a higher marginal tax rate than when the tax on the misreported amounts is calculated separately.

Detail may not add to total due to rounding.



[1] The TY 2011--2013 estimate is the annual average for the TY 2011, 2012, and 2013 timeframe. This chart displays the tax gap attributable to the underreported income category and the rate at which that income is misreported as measured by the Net Misreporting Percentage.
[2] The Net Misreporting Percentage is the ratio of the net misreported amount to the sum of the absolute values of the amounts that should have been reported, expressed as a percentage. For categories I - IV, the net misreported amount is understatements of income less overstatements of income. On net, income is understated for these categories.
[3] Includes wages & salaries.
[4] Includes pensions & annuities, unemployment compensation, dividend income, interest income, taxable Social Security benefits.
[5] Includes partnership/S corp. income, capital gains, alimony income.
[6] Includes nonfarm proprietor income, other income, rents and royalties, farm income, Form 4797 income.

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