# INTERNAL REVENUE SERVICE
# ADVISORY COUNCIL

# TAX GAP ANALYSIS
# SUBGROUP REPORT

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## INTRODUCTION/EXECUTIVE SUMMARY

The purpose of the Tax Gap Analysis Subgroup is to help the IRS improve its estimates of the tax gap. This is the report for 2008, which is year two in the three-year term of this subgroup.

In pursuing its mission the subgroup conducted three meetings with IRS staff this year -- a full-day face-to-face meeting in Washington, DC on January 31, 2008 and two telephone conference calls, on July 28, 2008 and September 12, 2008.

Most of the subgroup's deliberations during this year were centered on improving estimates of the corporate tax gap, but the subgroup also considered ways to apply new IRS estimates of underreporting by S-corporations to improve estimation of the individual income tax gap. At the January meeting, subgroup members were briefed on the history of IRS estimates of the corporate tax gap and then on a set of issues that IRS must address in estimating the tax gap, including:

- the extent to which estimates can be based on random audits or must rely on operational audits;
- the extent to which audits detect non-compliance;
- whether the measure of noncompliance should be an auditor's recommendations or the actual assessments after appeals;
- the way net operating losses are counted in the estimates; and
- the special challenge of integrating tax and fiscal year data.

A final presentation compared three alternative approaches for using operational audit data to estimate non-compliance. Later in the day, the subgroup met with staff members from the Large and Mid-Size Business Division (LMSB). Because yield curves have not provided sufficiently accurate estimates of non-compliance for LMSB firms, division staff members solicited suggestions for improving their methodology.

The July conference call was devoted to discussing a document prepared by staff of the Office of Research Analysis and Statistics (RAS), “Estimating the Corporate Income Tax Underreporting Gap Using Examination Yield Curves.” In the absence of studies under the National Research Program (NRP) that would estimate corporate noncompliance by looking at the results for firms *randomly* selected for audit, the IRS seeks to use the results of its operational audits to impute noncompliance in the corporate population at large. The document explained the available data, described the yield curve model and presented some preliminary results.

Two additional IRS staff documents were discussed during the September conference call, “Preliminary Methodology for Estimating the TY2004 Tax Gap Associated with S-Corporations” and “Preliminary Results of the 2003/2004 National Research Program S-Corporation Underreporting Study.” The first paper presented preliminary results from the NRP S-corporation study. The second paper updated prior NRP work on the individual tax gap for TY2001 to 2004 and discussed how the results of the NRP S-corporation study might be used to adjust the estimates from TY 2001 study (projected to 2004) of reporting compliance on individual income tax returns.

The Subgroup discussions over the course of the past year culminated in the following recommendations of actions IRS might wish to take, grouped into five categories.

**ISSUE ONE:**

**Recommendations**

General

1. In place of the current structure in which the Tax Gap subgroup is a part of the Internal Revenue Service Advisory Committee (IRSAC), establish outside of IRSAC, a permanent board of outside advisors, consisting of academics and practitioners, to review how IRS estimates the tax gap. This body would meet (in person or via conference call) to review and offer suggestions on IRS Research methodology papers, and, subsequently, drafts of tax gap studies. Towards promoting an efficient and fruitful interchange, the papers would be provided to board members in advance of their meetings. On their part, members of the board would funnel the latest academic research on tax compliance to the IRS. While the new board of advisors would be separate from the IRSAC, it would provide periodic reports of its findings and recommendations to the IRSAC and invite comments from other IRSAC members.
2. The IRS should release updated tax gap estimates at the end of 2008 that reflect: (a) new estimates of the corporate tax gap; (b) any revisions in the individual tax gap estimates that may flow from the S-corporation study (or an explanation why none were done); and (c) extrapolation of 2001 estimates to tax year 2004.
3. The IRS needs to do an updated study of employment tax compliance. The S-corporation NRP results regarding the compensation of officers could be one input into that study.

4. In the near future, the tax gap subgroup should provide suggestions for how IRS could develop better estimates of the international tax gap resulting from abusive transfer pricing transactions and other sources.

<u>LMSB Issues</u>

1. Until U.S.-specific data are available, the IRS should develop reasonable methods to convert the publicly-disclosed aggregate liability balances contained in FIN 48 disclosures to an annual gap related to U.S. tax uncertainty.  Because FIN 48 disclosures provide information about whether the liability relates to permanent or temporary tax positions, analysis of FIN 48 data should assist the IRS in evaluating how much of the tax gap is permanent.
2. Congress should provide the IRS with summary data from the Permanent Subcommittee on Investigations' detailed analysis of approximately 40 firms' FIN48 disclosures.  Specifically, knowing how much of the FIN 48 liability relates to U.S., international, or multistate tax uncertainty could inform IRS' estimates relating aggregate FIN 48 liability to the U.S. tax gap for other taxpayers.
3. The IRS Research should consider whether it is possible to report separately non-compliance from domestic and international transactions and, if not, what additional data capture from NRP audits or regular audits would be necessary to do this.  Separate reporting of domestic and international based non-compliance could be done for both corporate and individual taxpayers.

Corporate Tax Gap – Yield Curves

1. The IRS should address the fundamental problem of selection bias in inferring noncompliance for the population of corporate taxpayers from that detected in corporations it selects for operational audits.
    a. One approach to this problem would be to infer population noncompliance from audits conducted on a randomly selected sample of corporations, as in the NRP audits.
    b. An alternative would be to introduce a correction to the operational audit estimates that explicitly models the process the IRS uses to select corporations for audit. A selection bias model would include all of the factors available on corporate returns that are associated with choosing entities for audit. A selection bias model should further account for:
        i. Listed transactions. IRS should estimate models that predict whether a firm has a listed transaction, based on data reported on tax returns and data from financial statements. Doing so should help determine whether these firms get audited more in general, either because they are on the list or for other reasons.
        ii. The Compliance Assurance Program (CAP). Participating firms may or may not have characteristics that make them more likely to be compliant, based on current scoring methods.
        iii. Financial statement data. The model should include appropriate variables from financial statements to determine whether they are useful in developing compliance-scoring methods.

2. The IRS Research should more clearly articulate the consequences of excluding the effects of subsequent taxpayer claims that might be presented during an examination or in an amended return (such as carry-backs and new deductions) from tax gap estimates. To the extent that claims offset deficiencies, clear communication is necessary to avoid Congress believing the current definition of the tax gap represents easily accessible government receipts.
3. For large corporations, the IRS should model the probability that specific issues get examined during an audit. Even if there were 100 percent audit coverage for these firms, there would still be the issue of extrapolating total non-compliance because only a subset of issues get examined and the content of that subset is likely to differ across firms.
4. The IRS should include as independent variables in yield curve functions variables that are available both for audited and unaudited firms. That is, the auditors' recommended change should depend not only on items that typically arise during an operational audit but also on items that characterize all firms.

<u>National Research Project (NRP) Individual and S-Corp Studies</u>

1. The IRS should incorporate operational audits more comprehensively into its NRP work. To enable this to be done, IRS examiners should be encouraged to capture more data from operational audits than is currently done in a form that facilitates use in subsequent research. IRS researchers, with assistance from the new board of advisors, would then need to develop further methodologies for combining random and operational audit data in tax gap estimation. If

operational audits were used to supplement random audits, fewer random audits could be conducted, reducing costs and/or making more frequent tax gap estimates possible.

2. There are sampling issues in the S-corporation study that deserve further attention.

    a. The IRS should vary the sampling rates across return classes in order to ensure a fully representative sample. For example, while most S-corporations have only one or two shareholders, a small number have 75 or more. Stratifying the sample on the number of shareholders, S-corporations with many shareholders should be oversampled, relative to those with few shareholders.

    b. The IRS should consider pooling tax years, with every S-corporation given a weight that is the inverse of the sampling likelihood.

3. The IRS should pursue the following additional issues in the NRP program.

    a. The self-employment aspect of S-corporations is a very common planning issue, likely to be associated with noncompliance.

    b. Entity conversions. The IRS should look at entity conversion cases to see to what extent either the election was incorrect or the examiner converted an S-corporation to Schedule C. This could happen either if the taxpayer failed to file Form 2553 *Election by a Small Business Corporation* or if the taxpayer filed the form, but nevertheless did not meet the requirements to be a subchapter S-corporation.

c. The IRS should display estimates of non-compliance of S-corporations for separate asset classes and then compare the observed non-compliance rate for the smallest S-corporation asset class to the observed noncompliance (excluding the adjustment for non-detection) for Schedule C income in the 2001 NRP individual taxpayer compliance study.

4. In the NRP S-corporation study, the IRS should adjust for inflation between 2003 and 2004.

<u>Beyond Measuring the Tax Gap</u>

1. IRS Research should think systematically about the potential returns to marginal dollars spent on alternative enforcement and service activities, with a view towards developing an evidence-based strategy for efficiently reducing the gap.