

# The Tax Gap

- The **difference between** the **tax** that **taxpayers should pay** and what they **actually pay** on a **timely basis**
- Includes three components:
  - **Nonfiling** (failure to file a tax return)
  - **Underreporting** (understating income, overstating deductions)
  - **Underpayment** (failure to fully pay reported taxes owed)
- An **understanding** of the **Tax Gap** and its components allows the legislative and executive branches of government to make **better decisions** about **tax policy** and the **allocation** of **resources** for **tax administration**

# National Research Program

- The IRS National Research Program (**NRP**) **measures noncompliance** that makes up the Tax Gap.
- **Detailed research** on taxpayer compliance was **last conducted** for **Tax Year 1988**.
- The **NRP** has now **completed** its **initial assessment of individual taxpayer compliance** for **Tax Year 2001**. The research sample covered 46,000 tax returns, including an oversampling of high income returns. The research provides a statistically valid representation of the overall population. **NRP has not updated the corporate Tax Gap**.
- Current **data are preliminary**, so **Tax Gap estimates are shown as ranges**. As refinements are made to the analysis, **some estimates may change**. It is unlikely, but possible, that the final estimates of the Tax Gap will fall outside the established range.

# Estimated TY2001 Federal Tax Gap

(in Billions of Dollars)

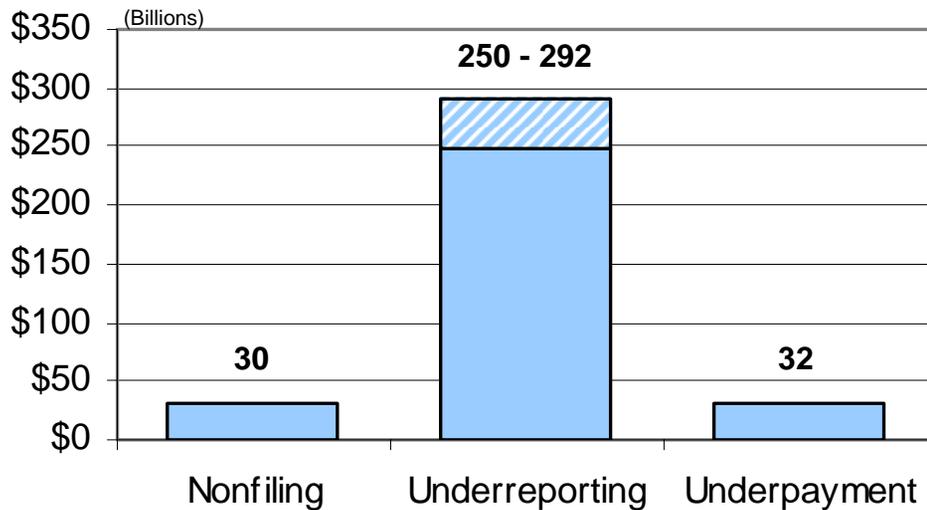
<b>Gross Tax Gap*</b>	<b>312 – 353</b>
<b>Enforced and Late Payments</b>	<b>(55)</b>
<b>Net Tax Gap</b>	<b>257 – 298</b>
<b>Noncompliance Rate</b>	<b>15.0% – 16.6%</b>

•Compares to \$311 billion estimate for 2001 using rules from 1988 and earlier studies.

# Two Views of the Tax Gap

- By Type of Noncompliance
  - Nonfiling
  - Underreporting
  - Underpayment
- By Type of Tax
  - Income
    - Individual
    - Corporation
  - Employment
    - Self-Employment
    - FICA and Unemployment
  - Estate
  - Excise
- The NRP for TY2001 addresses the underreporting of income and self-employment taxes by individual taxpayers.

# Underreporting Noncompliance is the Largest Component of the Tax Gap

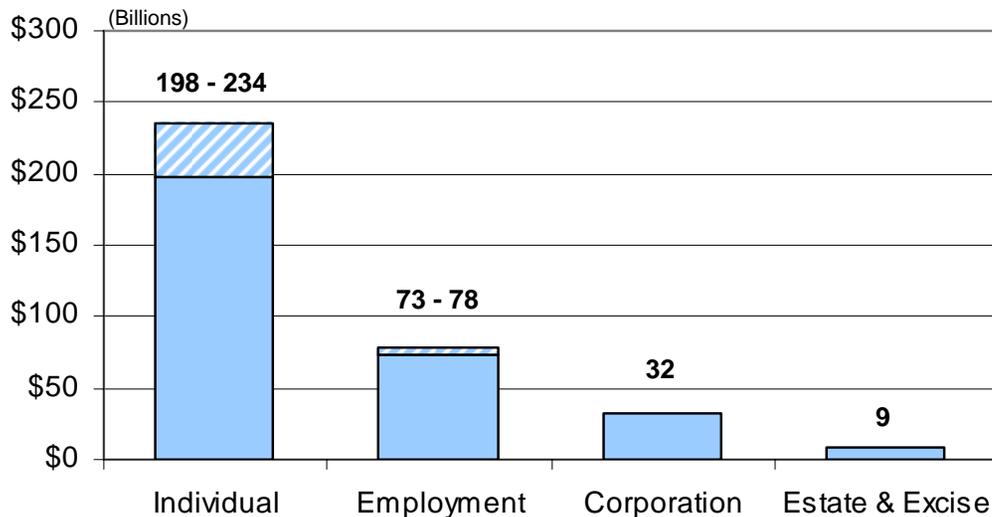


Underreporting sources:

- understated income
- improper deductions
- overstated expenses
- erroneously claimed credits

Preliminary estimates of noncompliance from **underreporting** account for **more than 80%** of the **Tax Gap**.

# Individual Income Tax is the Single Largest Source of the Annual Tax Gap

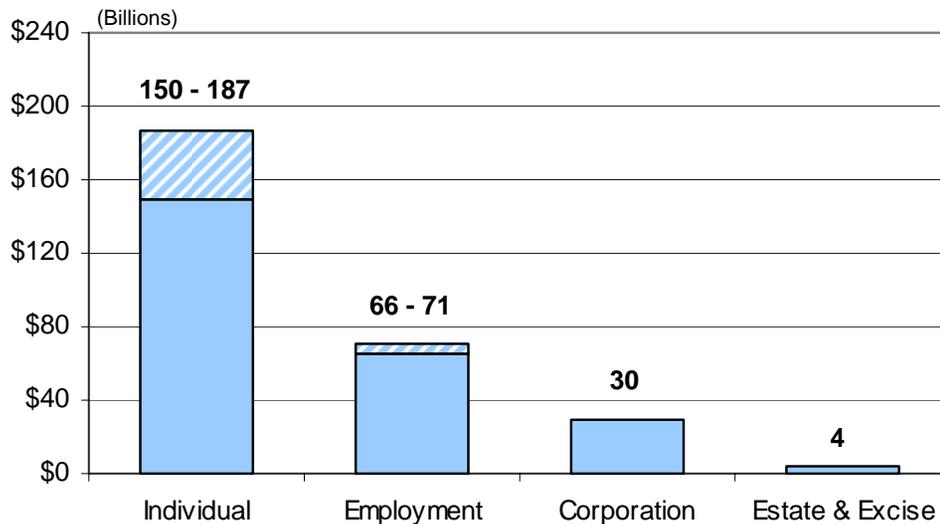


Individual Tax Gap includes:

- nonfiling
- underreporting
  - non-business income
  - business income
  - overstated deductions, credits, exemptions
- underpayment

Preliminary NRP results indicate that the **individual income tax** accounts for about **two-thirds** of the **Tax Gap**.

# Individuals are the Dominant Source of the Underreporting Gap

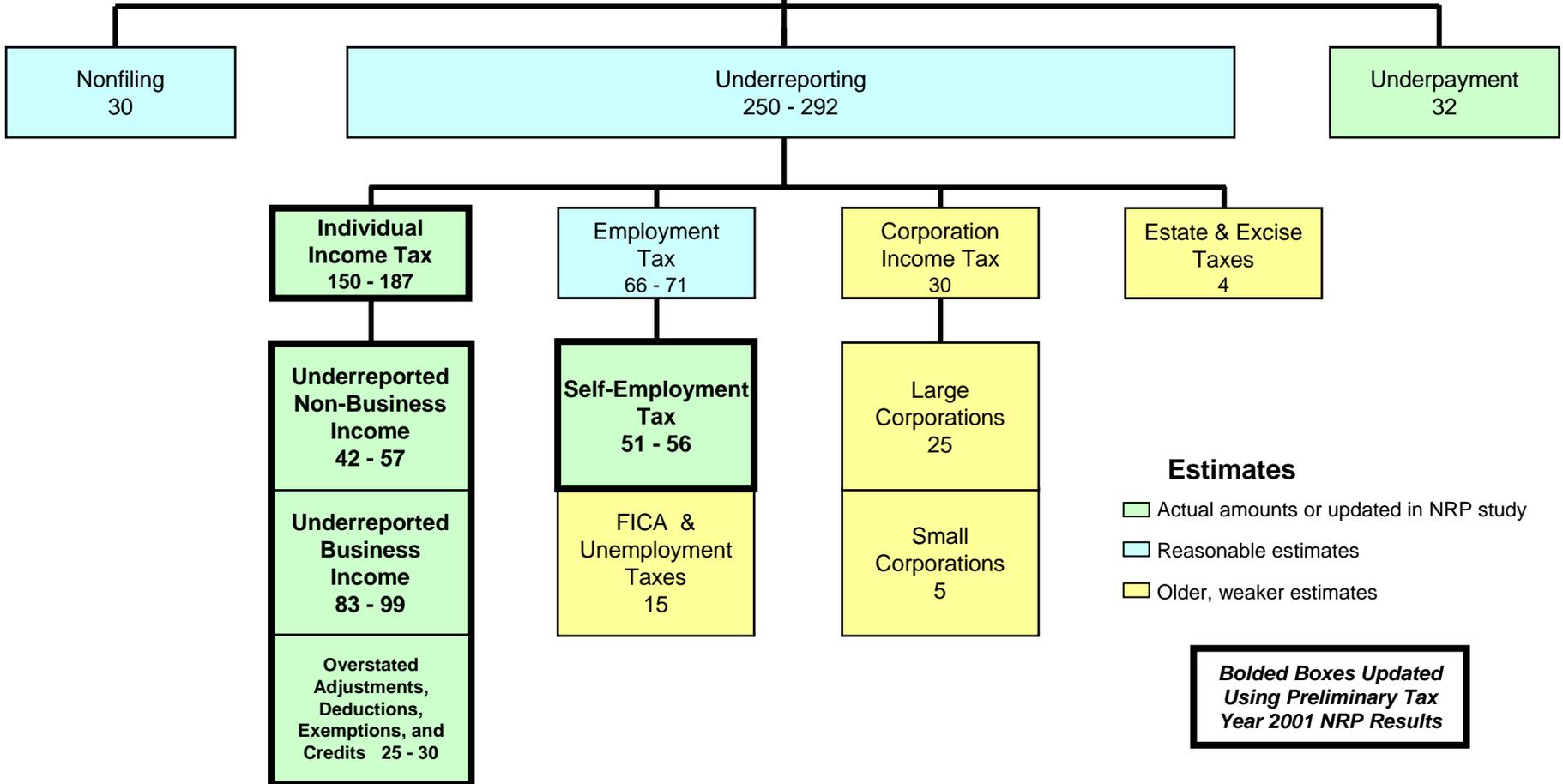


- **Understated income**, not overstated deductions, accounts for **over 80% of individual underreporting**.
- **Business activities**, not wages or investment income, account for **most of the understated individual income**.

# 2001 FEDERAL TAX GAP

(in Billions of Dollars)

**Gross Tax Gap**  
312 - 353



### Estimates

- Actual amounts or updated in NRP study
- Reasonable estimates
- Older, weaker estimates

***Bolded Boxes Updated  
Using Preliminary Tax  
Year 2001 NRP Results***

Net tax gap after recoveries of 55 = 257 - 298



# 2001 Individual Income Tax Gap

Major Contributors Ranked by Dollars

Form 1040 Line	Preliminary Estimate* (\$ Billions)
<b>Total</b>	<b>150 – 187</b>
<b>Non-Business Income</b>	<b>42 – 57</b>
Other income (gambling winnings, awards, etc.)	14 – 18
Wages, salaries, tips, etc.	13 – 15
Net capital gains, distributions, other gains	6 – 9
Taxable pension, annuities, IRA distributions	4 – 8
Taxable interest and dividend income	3 – 5
Miscellaneous	< 3
<b>Business Income</b>	<b>83 – 99</b>
Non-farm proprietor net income	59 – 65
Partnership, S-Corp, estate and trust net income	16 – 24
Rent, royalty net income	7 – 8
Farm net income	2 – 3
<b>Offsets to Income or to Tax</b>	<b>25 – 30</b>
Deductions	15 – 18
Credits	11 – 14
Exemptions	5
Adjustments: All Other	≤ 1
Adjustments: 1/2 of Self-Employment Tax	-6 to -7

\* Line item **estimates subject to significant changes**; detailed analyses to be completed by the end of 2005.

# 2001 Individual Income Tax Gap

## Major Contributors Ranked by Misreporting Percentage

Form 1040 Line	Tax Gap (\$ Billions)	Preliminary Misreporting %*
<b>Non-Business Income</b>		
Alimony income	< 1	21.0 – 23.8
Unemployment compensation	≤ 1	8.3 – 15.3
State income tax refunds	< 1	5.9 – 6.5
Taxable pension, annuities, IRA distributions	4 – 8	4.1 – 7.4
Taxable interest and dividend income	3 – 5	3.9 – 5.7
Taxable Social Security benefits	1	3.9 – 4.0
Wages, salaries, tips, etc	13 – 15	1.2 – 1.4
Net capital gains, distributions, other gains	6 – 9	n/a
Other income (gambling winnings, awards, etc.)	14 – 18	n/a
<b>Business Income</b>		
Non-farm proprietor net income	59 – 65	n/a
Partnership, S-Corp, estate and trust net income	16 – 24	n/a
Rent, royalty net income	7 – 8	n/a
Farm net income	2 – 3	n/a
<b>Offsets to Income or to Tax</b>		
Credits	11 – 14	17.1 – 22.5
Deductions	15 – 18	5.2 – 6.0
Exemptions	5	4.8 – 5.0
Adjustments: All Other	≤ 1	n/a
Adjustments: 1/2 of Self-Employment Tax	-6 to -7	n/a

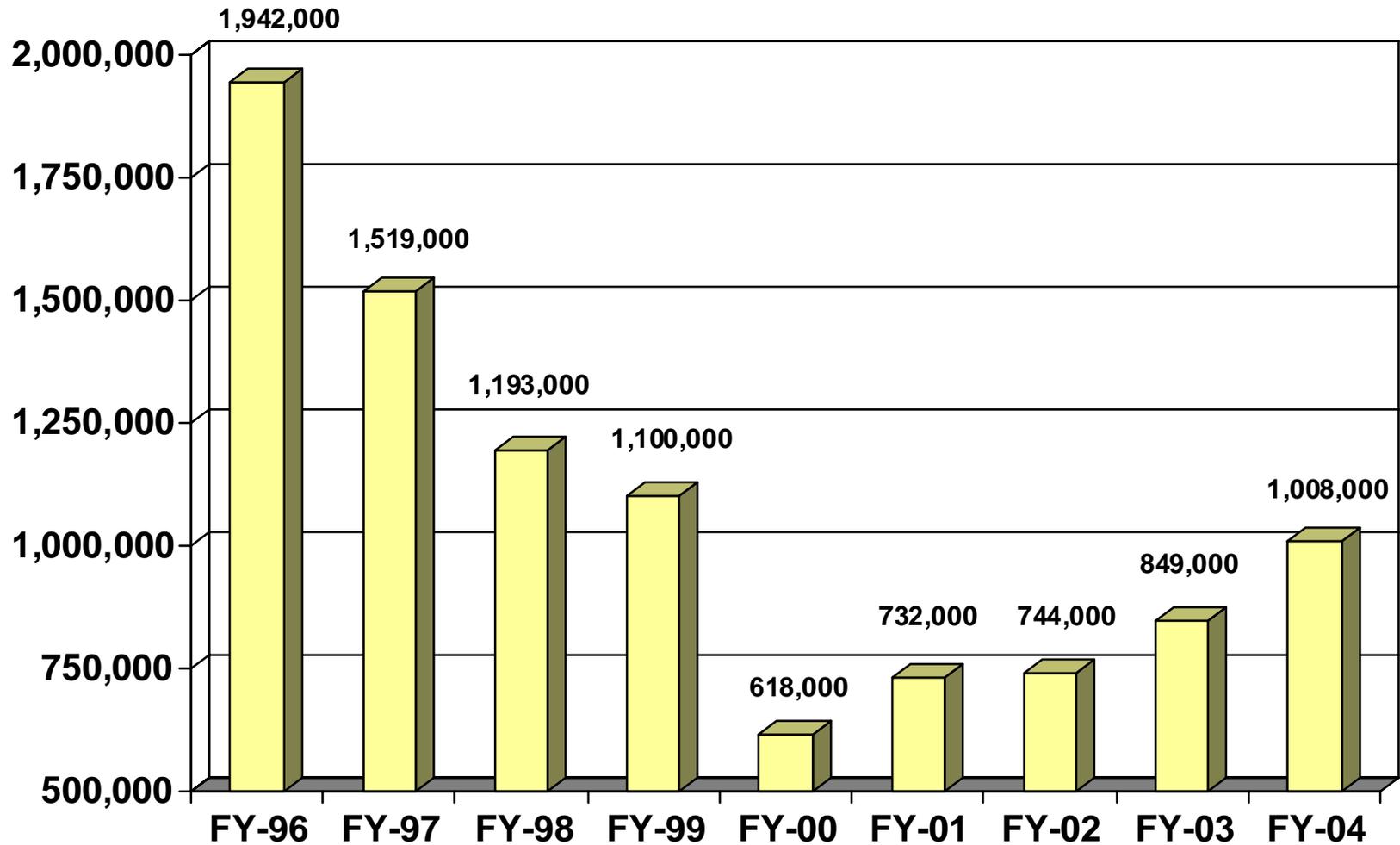
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n/a – not available

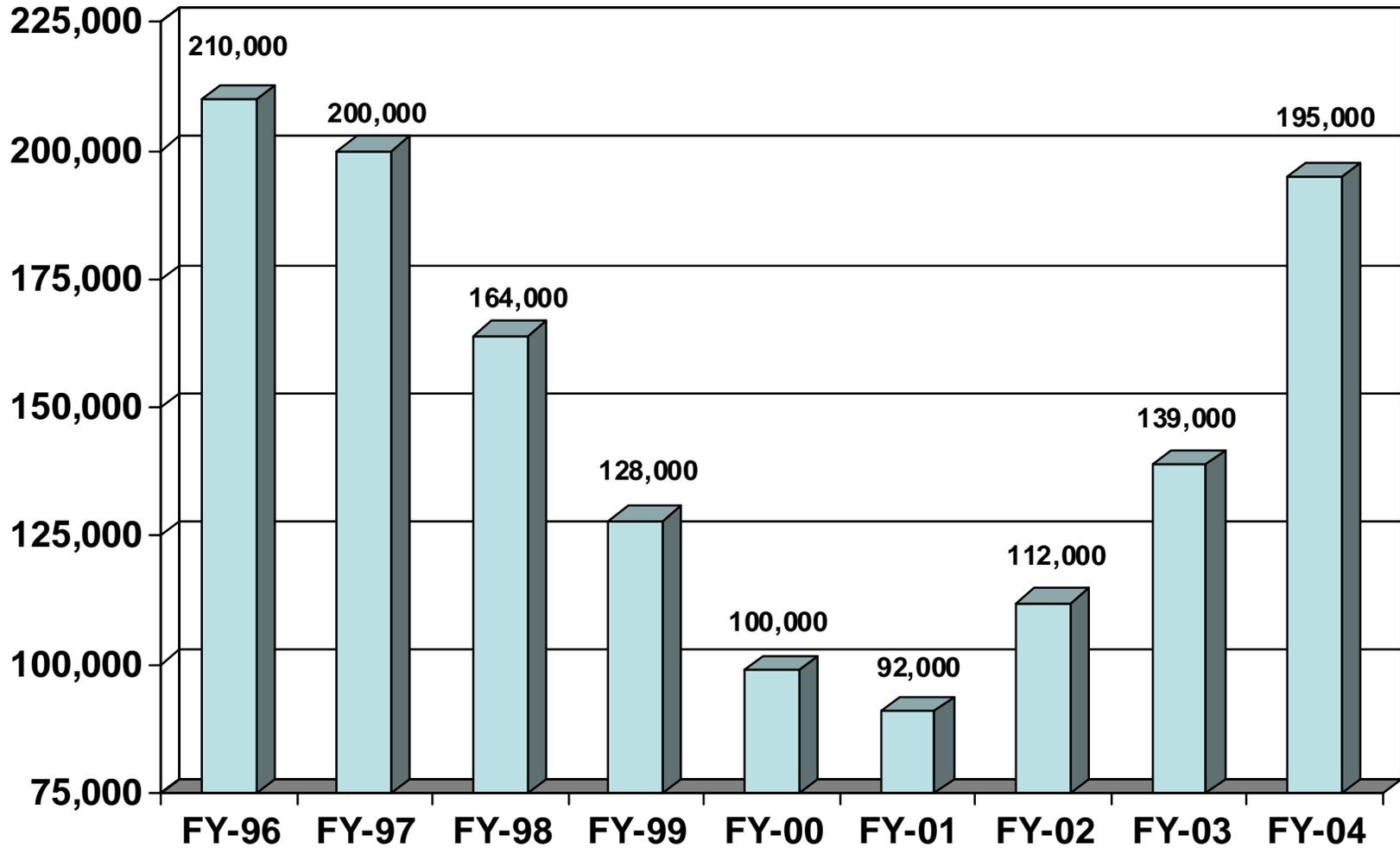
# Next Steps

- **Refine estimates** from the individual taxpayer study to further update Tax Gap estimates. Comprehensive estimates should be **completed by the end of 2005**.
- **Update estimates** for **other areas** of the Tax Gap—first area to be addressed is reporting compliance study of **flow-through entities** (S-Corporations and partnerships).
- Use data from the individual taxpayer study to **build new audit models** and develop **other ways to address noncompliance**.

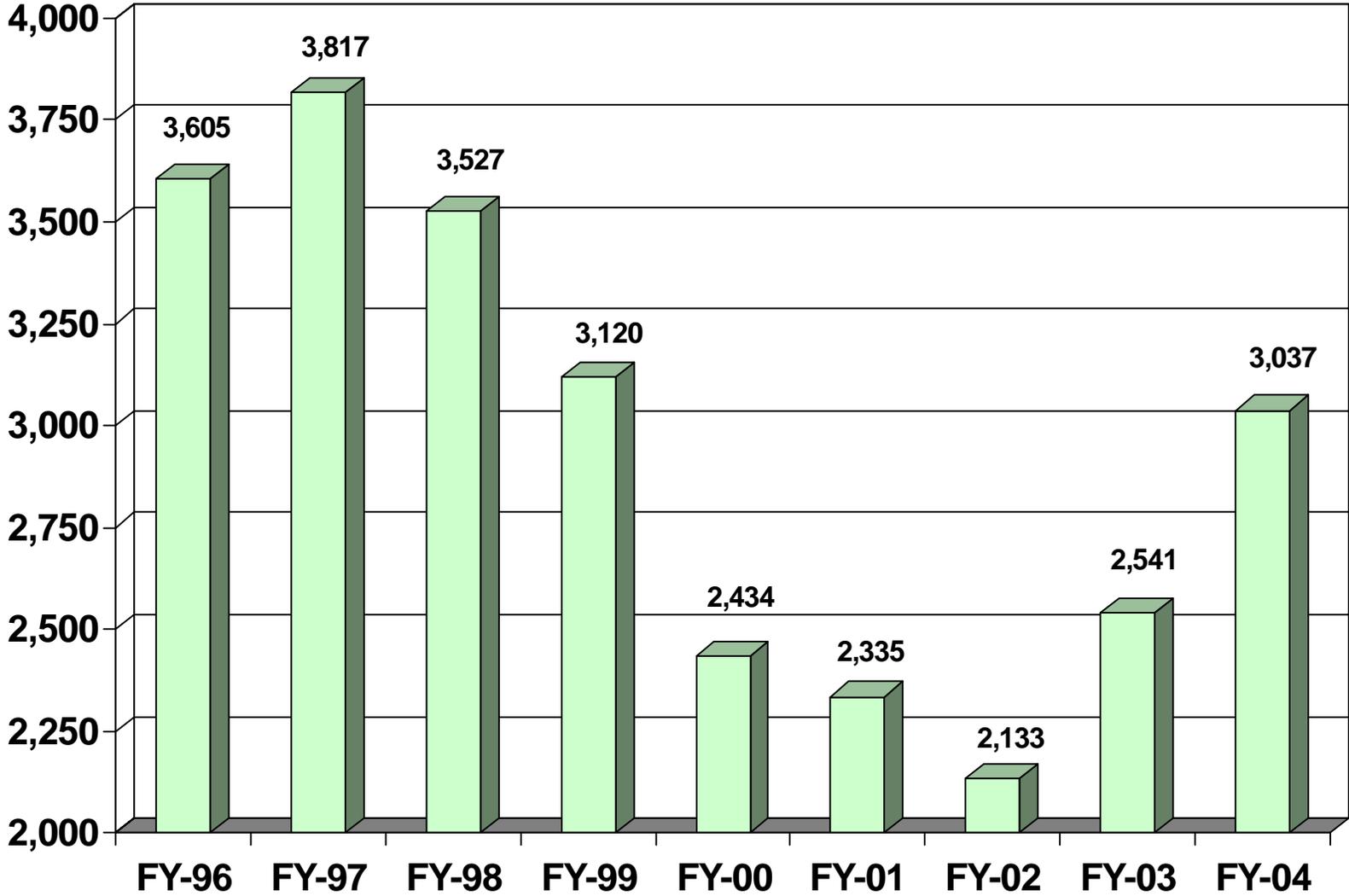
# Individual Audits



# High Income Audits

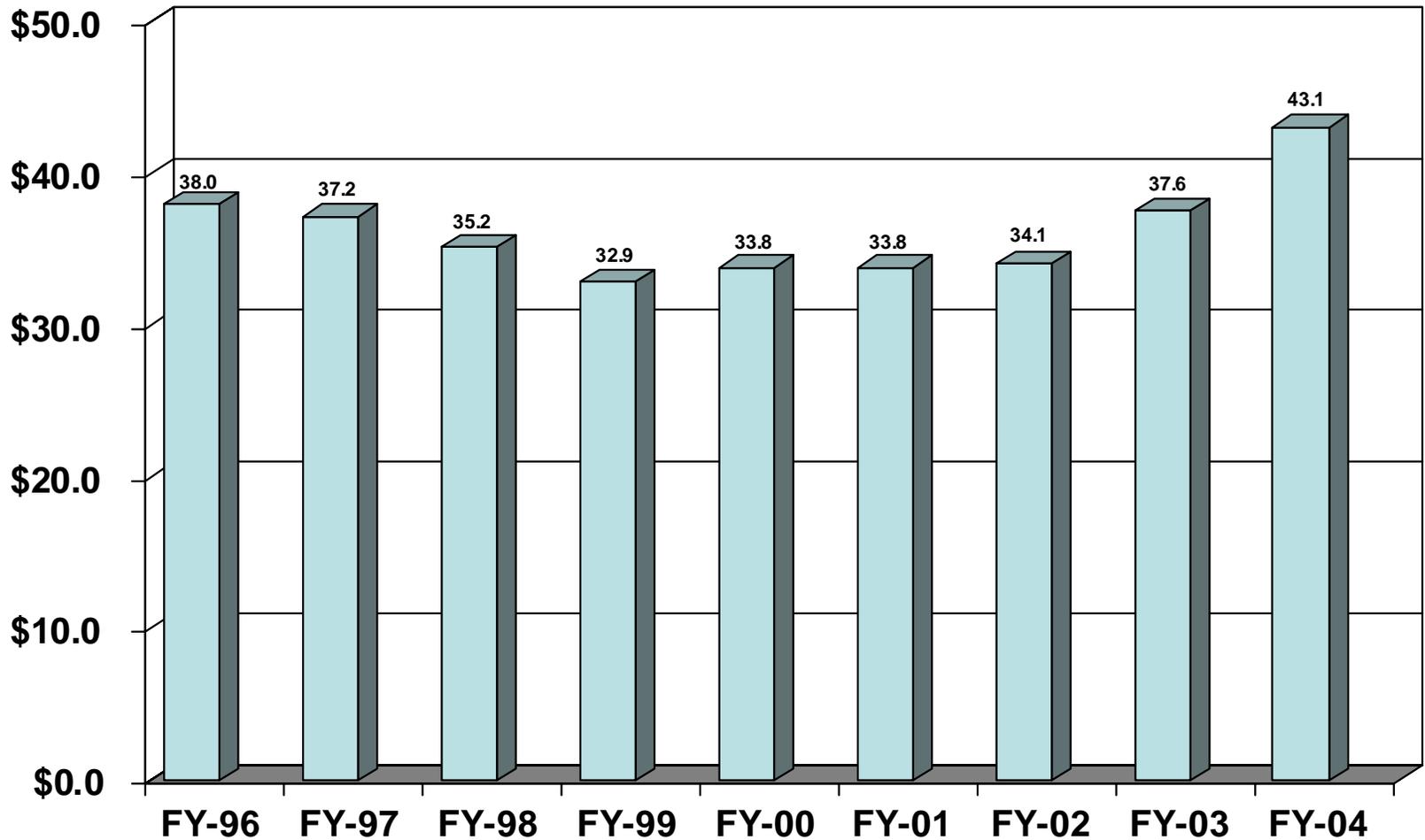


# Criminal Prosecutions Recommended



# IRS Enforcement Revenue

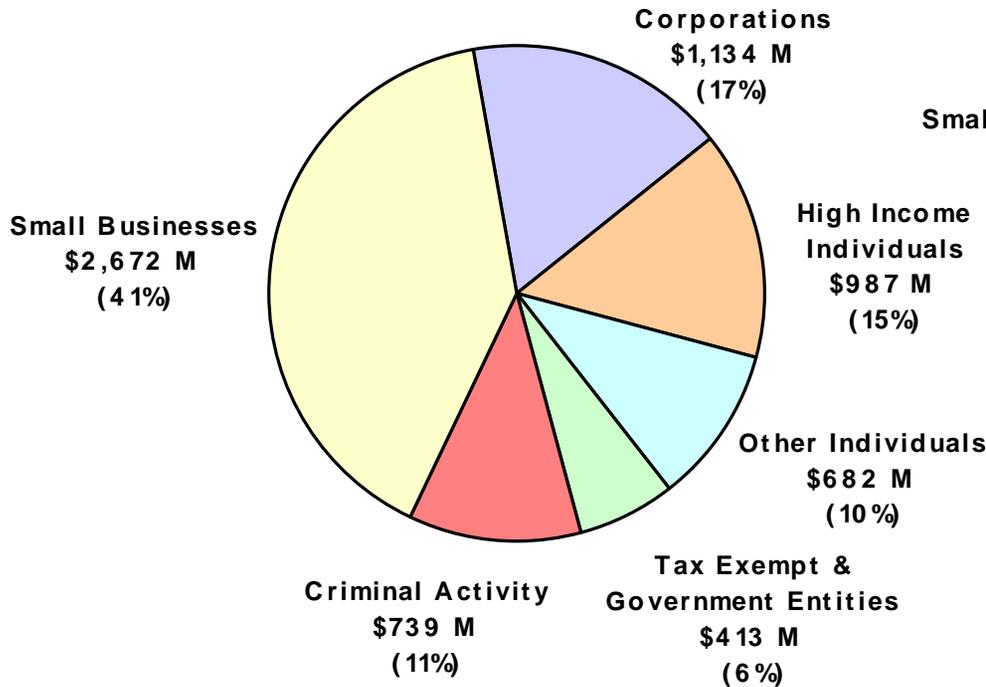
Dollars in Billions



# Allocation of Enforcement Resources

Dollars in Millions

**Base Enforcement Resources**  
Total = \$6,628 M



**2006 Initiatives**  
Total = \$ 265 M

