Order Code RL33882

CRS Report for Congress

Tax Gap and Tax Enforcement

February 16, 2007

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Prepared for Members and
Committees of Congress

Congressional
Research
Service

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Summary

Recent and projected large federal budget deficits have generated congressional interest in the feasibility of raising revenue by reducing the tax gap. The Internal Revenue Service (IRS) defines the *gross* tax gap as "the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay voluntarily and timely for that year." "The *net* gap is the amount of the gross tax gap that remains unpaid after all enforced and other late payments are made for the tax year." For tax (calendar) year 2001, the IRS estimates a gross tax gap of $345 billion, equal to a noncompliance rate of 16.3%. For the same tax year, IRS enforcement activities, coupled with other late payments, recovered about $55 billion of the gross tax gap, resulting in a net tax gap of $290 billion.

The estimated gross tax gap of $345 billion consists of underreporting of tax liability ($285 billion), nonfiling of tax returns ($27 billion), and underpayment of taxes ($33 billion). (Taxes on illegal activities are excluded from these estimates.) The $285 billion of underreporting of tax liability has the following components: $197 billion of individual income tax, $54 billion in employment tax, $30 billion in corporate income tax, and $4 billion in estate taxes.

The IRS has replaced the Taxpayer Compliance Measurement Program — a systematic approach for estimating the tax gap — with the National Research Program (NRP). One of the guiding principles for the NRP is to minimize the compliance burden on those taxpayers selected in the NRP sample. The new methodology of the NRP was applied to the underreporting gap for the individual income tax for tax year 2001.

The estimates of the gross tax gap have been heavily publicized; perhaps as a result, some public officials have emphasized better enforcement of tax laws in order to raise revenue. Three factors limit the dollar amount that can be collected by increased enforcement. First, much of the gross tax gap for individual income tax filers is due to types of unreported income that are difficult to detect. Second, some of the detected tax liability cannot be easily collected, particularly from those taxpayers who are currently unable to pay. Third, many detected tax liabilities are so small relative to enforcement costs that it is not cost-effective to pursue collection.

From fiscal years 2001 to 2006, greater tax enforcement efforts by the IRS increased enforcement revenue from $33.8 billion to $48.7 billion. The IRS is attempting to reduce the gross tax gap by pursuing a strategy, which has seven components: reduce opportunities for evasion, make a multi-year commitment to research, continue improvements in information technology, improve compliance activities, enhance taxpayer service, reform and simplify the tax law, and coordinate with partners and stakeholders.

This report will be updated as issues develop or new legislation is introduced.

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Introduction

Recent and projected large federal budget deficits have generated congressional and executive branch interest in raising revenue by reducing the tax gap.[1] Other motivations for reducing the tax gap include adverse effects on (1) public trust in the fairness of the tax system, which may adversely affect voluntary compliance with tax laws, and (2) economic efficiency by providing an incentive for inputs of labor and capital to shift to those sectors of the economy with lower taxes. This report defines tax gap concepts, explains the methodology used to calculate the tax gap, examines the relationship between the tax gap and enforcement, and briefly discusses the Internal Revenue Service's (IRS's) strategy to reduce the gross tax gap.[2]

Tax Gap Concepts

The IRS defines the *gross* tax gap as "the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay *voluntarily* and timely for that year."[3] And it defines the *net* tax gap as "the amount of the gross tax gap that remains unpaid after all enforced and other late payments are made for the tax year."[4] Currently, these tax gap concepts exclude illegal activities because the IRS lacks adequate data on these activities.[5]

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[1] Kurt Ritterpusch, "Post-Election Action on Closing Tax Gap Deemed Common Ground Issue for Congress," *Daily Tax Report*, no. 208, Oct. 27, 2006, p. G1, and Drew Douglas, "Treasury 2008 Budget Plan to Include Renewed Focus on Compliance, Tax Gap," *Daily Tax Report*, no. 13, Jan. 22, 2007, pp. G1-G3.

[2] For a comprehensive review of the literature on tax compliance, see James Adreoni, Brian Erard, and Jonathan Feinstein, "Tax Compliance," *Journal of Economic Literature*, vol. 36, no. 2, June 1998, pp. 818-860.

[3] Alan Plumley, "Preliminary Update of the Tax Year 2001 Individual Income Tax Underreporting Gap Estimates," Internal Revenue Service, *SOI Tax Stats-Papers-2005 IRS Research Conference*, Washington, June 7-8, 2005, p. 15. Available at [http://www.irs.gov/taxstats/productsandpubs/article/0,,id=130103,00.html].

[4] Ibid.

[5] The IRS made tax gap studies for tax years 1979, 1983, and 1987. Each study used a different definition of the tax gap. For a discussion of the changes in the concept of the tax gap, see U.S. General Accounting Office, *Tax Administration: IRS' Tax Gap Studies*, Washington, March 1988, 23 p.

For tax year 2001, the IRS estimates a gross tax gap of $345 billion, equal to a noncompliance rate of 16.3%.[6] For the same year, IRS enforcement activities, coupled with other late payments, recovered about $55 billion of the gross tax gap, resulting in a net tax gap of $290 billion.[7]

The estimated gross tax gap of $345 billion consists of underreporting of tax liability ($285 billion), nonfiling of tax returns ($27 billion), and underpayment of taxes ($33 billion).[8] For 2001, the $285 billion of underreporting of tax liability has the following components: $197 billion of individual income tax, $54 billion in employment tax, $30 billion in corporate income tax, and $4 billion in estate taxes.[9] There are no estimates of the underreporting of excise taxes.[10] For 2001, the gross tax gap by type of tax was individual income tax ($245 billion), corporate income tax ($32 billion), employment taxes ($59 billion), and estate taxes ($6 billion).[11] IRS enforcement to reduce the gross tax gap has focused on the individual and corporate income components.

Methodology to Estimate the Tax Gap

The IRS has replaced the Taxpayer Compliance Measurement Program (TCMP) with the National Research Program (NRP) to estimate the gross income tax gap.

Taxpayer Compliance Measurement Program

Prior to tax year 1989, the IRS relied on data from the TCMP to estimate the gross tax gap for individual income taxpayers and small corporations (less than $10 million in assets). The IRS formulated upper- and lower-bound estimates of the gross income tax gap. The IRS completed "line-by-line examinations of several different types of tax returns."[12] The upper-bound estimates of the gross tax gap were calculated from the TCMP and regular audits of large corporations. For larger corporations ($10 million or more in assets), the IRS relied on regular operational

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[6] Internal Revenue Service, "IRS Updates Tax Gap Estimates," IR-2006-28, Feb. 14, 2006, p. 1. Available at [http://www.irs.gov/newsroom/article/0,,id=154496,00.html].

[7] Ibid.

[8] Ibid.

[9] Ibid.

[10] Internal Research Service, "Preliminary Update of the Tax Year 2001 Individual Income Tax Underreporting Gap Estimates," Nov. 17, 2005, p. 2.

[11] The most current estimates for components of the gross tax gap for tax year 2001 are listed in **Appendix A**.

[12] Internal Revenue Service, *Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates*, Washington, April 1990, p. 2.

audit of tax returns. If an audit showed an underpayment of taxes, the IRS examiner determined the tax deficiency.[13]

The lower-bound estimate of the gross tax gap was based on the amounts eventually assessed after the appeals and litigation process. Some of the tax deficiency found from audits was negated by taxpayers' appeals and court decisions leading to a lower estimate of taxes owed but unpaid.[14] "The eventual assessment may be considered to be the true 'legal' liability in the sense that IRS cannot attempt to assess more later, except in unusual cases."[15] The net tax gap differed depending on whether the upper- or lower-bound estimate of the gross tax gap was used.

National Research Program

The last TCMP was for tax year 1988. Several times in the 1990s, IRS officials attempted to conduct a new TCMP, but some Members of Congress objected because of the high cost to the IRS and the compliance burden placed on taxpayers who were selected in the TCMP sample. Consequently, IRS developed the National Research Program (NRP). According to the IRS,

> The goal of National Research Program (NRP) is to design and implement a successful strategy to collect data that will be used to measure payment, filing and reporting compliance and to deliver the data to the IRS Business Operation Division to meet a wide range of needs including support for the development of strategic plans and improvements in workload identification.[16]

A guiding principle for the NRP was to minimize compliance burden on taxpayers selected in the NRP sample.[17]

The NPR methodology was applied to the underreporting gap for the individual income tax for tax year 2001 and consisted of three major processes:

> (1) casebuilding — creating information files on returns selected for the NRP sample;
> (2) classification — using that information to classify the returns according to what, if any, items on the returns cannot be verified without additional information from the taxpayers; and
> (3) taxpayer audits limited to those items that cannot be independently verified.[18]

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[13] Ibid., p. 13.

[14] Ibid., pp. 13-14.

[15] Ibid., p. 14.

[16] Internal Revenue Service, "National Research Program (NRP), May 24, 2005, p. 1. Available at [http://www.irs.gov/privacy/article/0,,id=139179,00.html].

[17] Ibid.

[18] United States General Accounting Office, *Tax Administration: IRS Is Implementing the National Research Program as Planned*, GAO-03-614, June 2003, p. 4.

The IRS applied the NRP approach to about 46,000 randomly selected returns. It deliberately oversampled high income returns in order to draw conclusions about important sub-categories of taxpayers.[19]

Currently, the IRS is examining subchapter S corporations as part of the NRP. The IRS estimates that a large portion of the tax gap is attributable to small businesses including subchapter S corporations. The random sample consists of approximately 5,000 returns covering two tax years, 2003 and 2004. The case building and classification phases of the study are completed. The examination phase of the study began in October 2005 and is expected to be completed in approximately 36 months. The results are scheduled to be available in December 2008.[20]

Tax Enforcement

The estimates of the gross tax gap have been heavily publicized. Perhaps as a result, some public officials have emphasized better enforcement of tax laws to raise revenue. According to some, enforcement alone is likely to have a limited impact on the gross tax gap. Acting on this view, the IRS is implementing a comprehensive approach to reduce the gross tax gap.

Limitations to Increased Enforcement

Three factors are seen limiting the net revenue potential from increased enforcement. First, much of the gross tax gap for individual income tax filers is due to types of unreported income that are difficult to detect. Usually the income is not covered by third-party information returns (e.g., income earned by informal business proprietors who operate on a cash basis). Second, even when the unreported income is detected, some of the resulting tax liability cannot be easily collected, particularly from those taxpayers who are currently unable to pay. Third, many detected tax liabilities are so small relative to enforcement costs that it is not cost effective to pursue collection.

Tax Enforcement Efforts 2001-2006

Empirical data suggest that additional tax enforcement actions alone will have a limited effect on the gross tax gap. Between fiscal years 2001 and 2006, the IRS increased its enforcement efforts, and the enforcement revenue collected rose from $33.8 billion to $48.7 billion.[21] And, while $14.9 billion represents a 44% increase, it is only 4.3% of the estimated $345 billion gross tax gap in 2001. During the period FY2001-FY2006, staffing for key enforcement occupations rose from 20,203 to

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[19] Internal Revenue Service, "Understanding the Tax Gap," FS-2005-14, March 2005, p. 1. Available at [http://www.irs.gov/newsroom/article/0,,id=137246,00.html].

[20] Internal Revenue Service, "Federal Tax Gap: New Estimates, New Approaches," 2006, p. 8.

[21] Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results*, Nov. 20, 2006, p. 2.

21,185 (4.8%); examinations of individual tax returns increased from 731,756 (or 0.58% of returns) to 1,293,681 (or 0.98% of returns); examinations of business returns rose from 7,384,600 (or 0.55% of returns) to 8,722,410 (or 0.60% of returns); and examinations of tax-exempt-organization returns increased from 5,342 to 7,079 (preliminary estimate).[22] Rather than focusing only on enforcement, the Treasury Department and the Government Accountability Office (GAO)[23] argued that a comprehensive strategy is needed to reduce the tax gap.

In FY2003-FY2005, some of the most abusive domestic tax shelters were eliminated by the passage of legislation and expanded IRS enforcement.[24] Tax shelters are structured transactions with little or no clear business purpose. Further examination of tax shelters may occur in the 110th Congress.[25] Ms. Deborah Nolan, IRS Commissioner of the Large and Mid-Size Business Division, stated that in 2007 the IRS will focus particular attention on large taxpayers' international activities.[26]

Comprehensive Strategy for Reducing the Tax Gap

The Office of Tax Policy at the Treasury has developed what it considers a comprehensive strategy for reducing the tax gap, guided by the following four key principles:[27]

- Unintentional taxpayer errors and intentional taxpayer evasion should both be addressed.
- Sources of noncompliance should be targeted with specificity.

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[22] Ibid., pp. 2-7.

[23] U.S. Government Accountability Office, *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap*, Statement of Michael Brostek, Director, Tax Issues Strategic Issues Team, before the Senate Committee on the Budget, Jan. 23, 2007, 21 p.

[24] For an examination of tax shelters, see CRS Report RL32193, *Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals Considered in the 108th Congress*, by Jane G. Gravelle; and Joseph Bankman, "The Tax Shelter Battle," in *The Crisis in Tax Administration*, Henry J. Aaron and Joel Slemrod, editors, (Washington: Brookings Institution Press, 2004), pp. 9-28.

[25] The Joint Tax Committee published two reports concerning tax compliance. Some of the options examined in their first report were enacted into law. In the 110th Congress, some options in these reports may be proposed in legislation. See U.S. Congress, Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," Report no. JCS-02-05, 109th Congress, 1st sess., (Washington, Jan. 27, 2005), 430 p.; and U.S. Congress, Joint Committee on Taxation, "Additional Options to Improve Tax Compliance," 109th Congress, 2nd sess., (Washington, Aug. 3, 2006), 43 p.

[26] Stephen Joyce, "IRS to Continue Tax Compliance Push; Effect on Audits, Planning Uncertain," *Daily Tax Report*, Report Supplement: Tax Administration, no. 9, Jan. 16, 2007, p. 7.

[27] This section of the report consists of excerpts from U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap,* Sept. 26, 2006, 12 p.

- Enforcement activities should be combined with a commitment to taxpayer service.
- Policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.[28]

The resulting strategy developed by the Treasury (a strategy they term "comprehensive, integrated and multi-year") includes the following seven components:

- *Reduce Opportunities for Evasion*. The Administration's FY2007 budget included five legislative proposals to reduce evasion opportunities and improve the efficiency of the IRS. The Treasury Department's Office of Tax Policy is working with the IRS to develop additional legislative proposals for consideration as part of the FY2008 budget process.

- *Make a Multi-Year Commitment to Research*. Research is essential to identify sources of noncompliance so that IRS resources can be properly targeted. Regularly updating compliance research ensures that the IRS is aware of vulnerabilities as they emerge.

- *Continue Improvements in Information Technology*. Continued improvements to technology would provide the IRS with better tools to improve compliance through early detection, better case selection, and better case management.

- *Improve Compliance Activities*. By improving document matching, examination, and collection activities, the IRS would be better able to prevent, detect, and remedy noncompliance.

- *Enhance Taxpayer Service*. Service is especially important to help taxpayers avoid unintentional errors. Given the increasing complexity of the tax code, providing taxpayers with assistance and clear and accurate information before they file their tax returns reduces unnecessary contacts afterwards, allowing the IRS to focus enforcement resources on taxpayers who intentionally evade their tax obligations.

- *Reform and Simplify the Tax Law*. Simplifying the tax law would reduce unintentional errors caused by a lack of understanding. Simplification would also reduce the opportunities for intentional evasion and make it easier for the IRS to administer the tax laws.

- *Coordinate with Partners and Stakeholders*. Closer coordination is needed between the IRS and state and foreign governments to share information and compliance strategies. Closer coordination is also

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[28] Ibid., pp. 1-2.

needed with practitioner organizations, including bar and accounting associations, to maintain and improve mechanisms to ensure that advisors provide appropriate tax advice.[29]

[29] Ibid., pp. 2-3.

Appendix A: Gross Tax Gap Data for 2001

Table A1. Estimated Gross Tax Gap by Type of Tax

Type of Tax	Gross Tax Gap ($ Billions)	Share of Gross Tax Gap
Individual Income	245	71%
Corporate Income	32	9%
Employment	59	17%
Estate	6	2%
Excise	Not Available	
Total[a]	**345**	**100%**

Note: Totals may not add up to 100% due to rounding. Taxes on illegal activities are excluded from these estimates.

Table A2. Estimated Gross Tax Gap by Type of Error

Type of Error	Component of Error	Gross Tax Gap ($Billions)	Share of Gross Tax Gap
Underreporting[a]	**Individual Income Tax**		
	Non-Business Income	56	16%
	Business Income	109	32%
	Overstated, Adjustments, Deductions, Exemptions, and Credits	32	9%
	Total	**197**	**57%**
	Corporation Income Tax	**30**	**9%**
	Employment Tax		
	FICA	15	4%
	Self-Employment Income Tax	39	11%
	Total	**54**	**16%**
	Estate Tax	**4**	**1%**
	Total Underreporting	**285**	**83%**
Underpayments[b]	Individual Income Tax	23	7%
	Employment Tax	5	1.5%
	Other	5	1.5%
	Total Underpayments	**33**	**10%**
Nonfiling[c]	Individual Income Tax	25	7%
	Estate	2	1%
	Total Nonfiling	**27**	**8%**
Grand Total		**345**	**100%**

Source: Adapted by CRS from Internal Revenue Service, "IRS Updates Tax Gap Estimates," IR-2006-28, Feb.14, 2006, p. 1, (Tax gap figures link), available at [http://www.irs.gov/newsroom/article/0,,id=154496,00.html], and U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap*, Sept. 26, 2006, pp. 3-4.

Notes:

a. Information regarding underreporting of excise taxes is not available. Taxes on illegal activities are excluded from these estimates.

b. Underpayments include employer failures to deposit withheld income and employment taxes.

c. Information regarding the nonfiling gap associated with corporate income taxes, employment taxes, or excise taxes is not available.