

Tax Gap Presentation to Western States Association of Tax Administrators

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What is the Tax Gap?

The difference between the amount of tax that taxpayers *should* pay for a given year and the amount that *is* paid voluntarily and timely.

Components of the Tax Gap

- **Non-Filing**
 - Failure to file returns
- **Underpayment**
 - Failure to pay self-assessed amounts
- **Underreporting**
 - Failure to report all income
 - Overstated expenses, deductions, and credits

How Big is the Tax Gap?

- Total = **\$345 billion** (Tax Year 2001)

Nonfiling = \$27 billion

Underpayments = \$33 billion

Underreporting = \$285 billion

Total = \$345 billion

Estimating the Non-Filing Gap

- The Non-Filing Gap currently is estimated for individual income tax and for estate tax
- Basic approach - use a data set to estimate the tax liability of taxpayers with a filing obligation but who do not file timely
- Individual income tax estimates use Census data

Estimating the Underreporting Gap

- “Gold Standard” uses random sample of returns and subjects them to thorough examination
- IRS conducted Taxpayer Compliance Measurement Program from 1960s through 1980s, covering several types of taxpayers
- IRS created **National Research Program (NRP)** in 2001 and first NRP reporting compliance study covered individual taxpayers for TY 2001

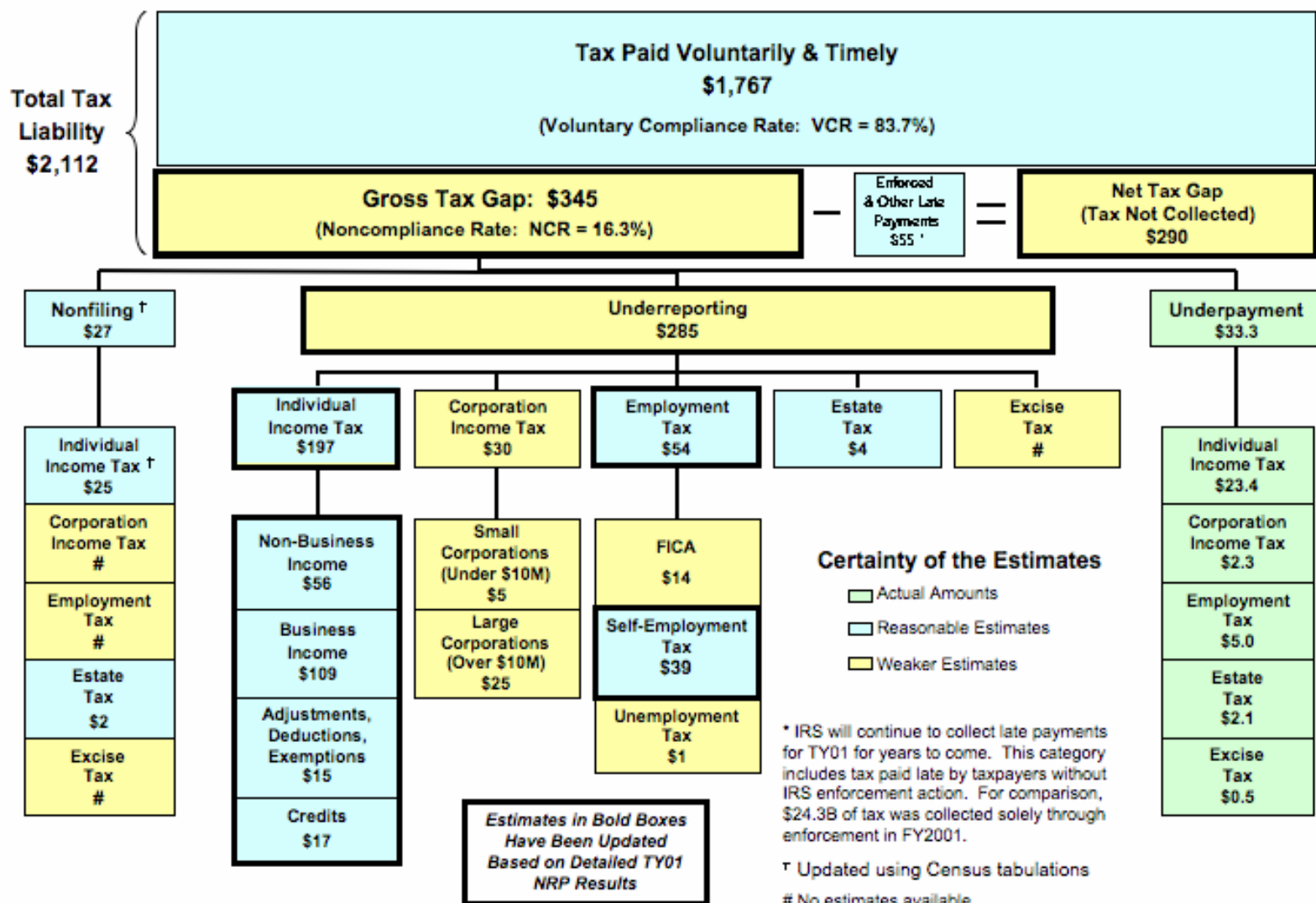
TY 2001 Reporting Compliance Study

- First NRP reporting compliance study
- Sample of 46,000 individual income tax returns from TY 2001
 - 3,000 returns accepted as filed
 - 2,000 correspondence exams
 - 41,000 face-to-face exams
- Exams proceeded over two years
 - October 2002 - September 2004
- Analysis of results continues

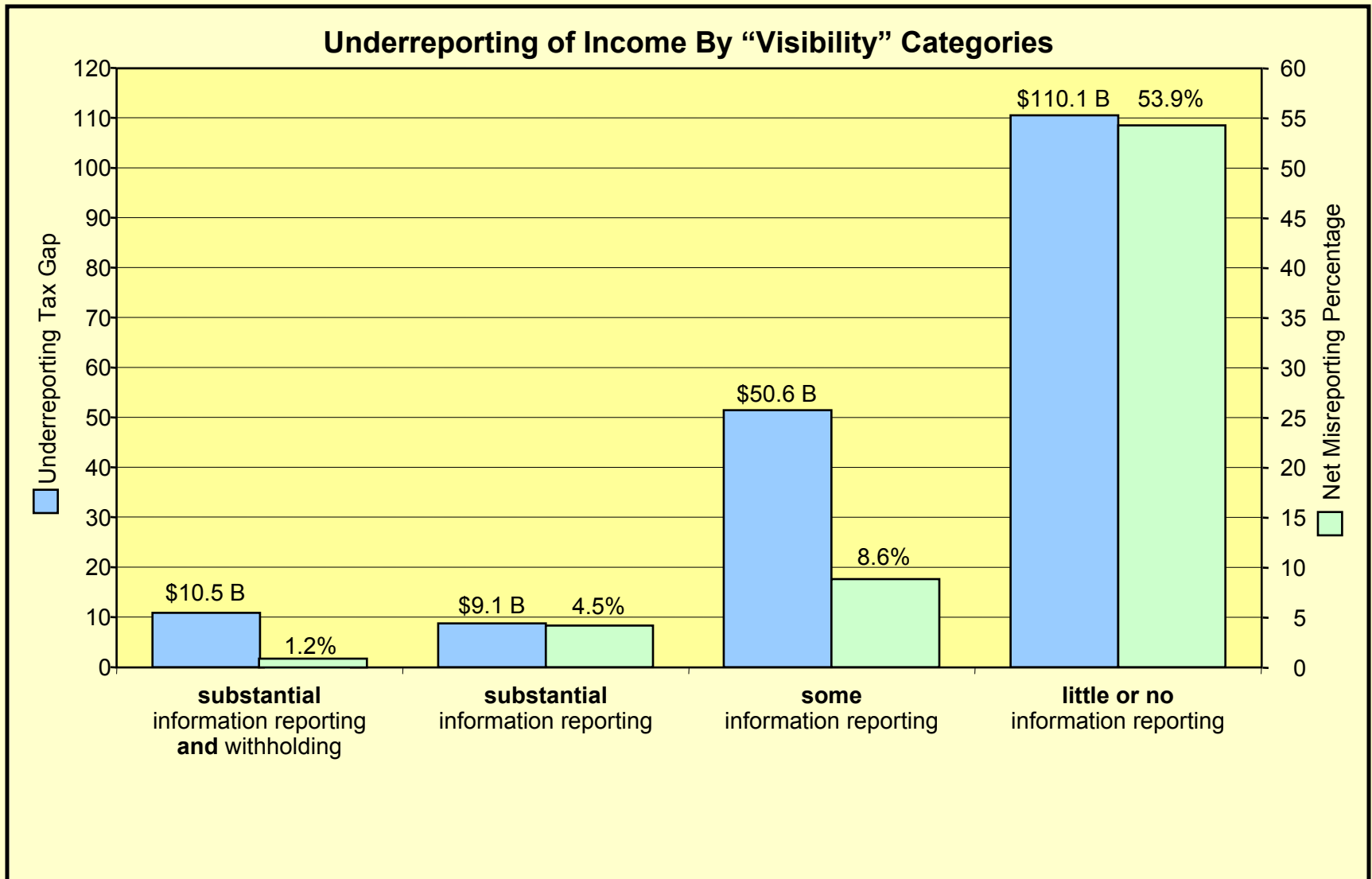
Measuring the Underpayment Gap

- Payment compliance measures are derived from IRS accounting data
- These cover all types of taxes and all types of taxpayers
- These can be computed for any tax period

TAX GAP MAP for Tax Year 2001 (in \$ Billions)



Tax Year 2001 Individual Income Tax Underreporting Gap



Based on updated estimates derived from the National Research Program underreporting compliance study.

Actions Resulting from TY 2001 Study

Data from the study was used to:

- Revise audit selection formulas
- Provide support for increased enforcement staffing and legislative proposals
- Support outreach and education initiatives

Effect of Federal Actions on States

- When the Federal Government increases revenue due to law changes or changes in enforcement, States may see significant increases in income tax revenue as well.
 - If the Federal Government requires increased information reporting and taxpayers report more income to the IRS, they are likely to report it to States as well.
- However, States have different tax bases from the Federal government and from each other, so the results are not uniform.

Administration's FY 2008 Proposals

- Expand Information Reporting:
 - Require 1099 reporting on payments to corporations
 - Require basis reporting on 1099 for security sales
 - Require 1099 reporting on sales through auction, consignment brokers
 - Require reporting of merchant payment card reimbursements
 - Increase penalty amounts for failure to file
 - Require TIN verification for non-employee service providers
 - Require 1099 reporting on certain federal procurement payments

Administration's FY 2008 Proposals

- Improve Compliance by Businesses:
 - Require e-filing by certain large businesses
 - Implement standards clarifying employee leasing company liability
 - Amend employment tax due process procedures - **ENACTED**
- Strengthen Tax Administration:
 - Provide IRS access to National Directory of New Hires database
 - Permit disclosure to prison officials of prisoner scams
 - Create criminal felony provision for aggravated failure to file

Administration's FY 2008 Proposals

- Actions Regarding Penalties:
 - Expand and increase signature requirements and related penalty provisions for preparers - **ENACTED**
 - Establish a specific penalty for failure to file electronically
 - Create a penalty for negligent or frivolous claims for refund - **ENACTED**

Treasury Strategy

- “Comprehensive Strategy for Reducing the Tax Gap” – released September 2006
- Seven components for reducing the tax gap:
 1. Reducing opportunities for evasion
 2. Making a multi-year commitment to research
 3. Continuing improvements in information technology
 4. Improving compliance activities
 5. Enhancing taxpayer service
 6. Reforming and simplifying the tax law
 7. Coordinating with partners and stakeholders

Recent IRS Report

- “Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance” – released August 2, 2007
- 100 page report outlining ongoing and future initiatives within each of the seven components outlined in the Treasury report
- Establishes milestones or timelines for each initiative

Future Steps to Reduce Tax Gap

- Finish NRP S-Corporation Reporting Compliance study (Tax Years 2003 and 2004) by end of 2007
- Begin next NRP individual reporting compliance study (TY 2006) in October 2007
- Implement and monitor initiatives and milestones established in IRS Tax Gap Report
- Develop additional approaches to addressing the tax gap