Major New IRS Study Of The "Tax Gap" Signals Increased Audits For S Corporations, Partnerships And High-Income Taxpayers

A recently-completed IRS National Research Program examined 46,000 tax returns to measure individual taxpayer reporting compliance. The study revealed a "tax gap" of over $300 billion consisting of:

1. Underreporting.
2. Underpayment.
3. Non-filing by individual taxpayers.

A major result of the study will be updated statistical formulas that the IRS uses in selecting returns for audit. Initial implications of the report suggest that audits may increase for flow-through entities (S corporations and partnerships), high-income taxpayers, and schedule C sole proprietors. A related result will be the likelihood that those with accurate tax returns will receive a lower level of scrutiny.

New IRS Study Provides Preliminary Tax Gap Estimate

The Internal Revenue Service released preliminary results from a major research project assessing compliance with the tax laws. The study reveals the vast majority of American taxpayers pay their taxes timely and accurately, but the nation still has a significant tax gap.

The preliminary findings show the gross tax gap — which is the difference between what taxpayers should pay and what they actually pay on a timely basis — exceeds $300 billion per year. The results indicate the nation's tax gap increased to between $312 billion and $353 billion in tax year 2001. This compares to the old tax gap estimate for 2001 of $311 billion based on earlier studies.

Net Tax Gap Tops Quarter-Trillion Dollars

IRS enforcement activities, coupled with late payments, recover about $55 billion of the tax gap, leaving a net tax gap between $257 billion and $298 billion.

"This research confirms that the vast majority of Americans pay their taxes honestly and accurately," IRS Commissioner Mark W. Everson said. "Even after IRS enforcement efforts and late payments, the government is being shortchanged by over a quarter-trillion dollars by those who pay less than their fair share. People who aren't paying their taxes shift the burden to the rest of us."

Since 2001, the year covered by the study, the agency has taken a number of steps to bolster enforcement. The IRS increased its enforcement revenues by nearly 28% from $33.8 billion in 2001 to $43.1 billion in 2004. Audits of high-income taxpayers — those earning $100,000 or more — topped 195,000 in fiscal year 2004, which is more than double those conducted in 2001. Total audits of all taxpayers topped 1 million last year — a 37% jump from 2001.

"We are ramping up our audits on high-income taxpayers and corporations, focusing more attention on abusive shelters and launching more criminal investigations," Everson said. He noted that the IRS announced last week it had collected $3.2 billion in the settlement initiative for Son of Boss, a particularly abusive tax shelter.

"Our enforcement efforts are designed to increase compliance and reduce the tax gap," Everson said.

The initial tax gap findings come from a three-year study called the National Research Program (NRP), which audited 46,000 individual income tax returns for 2001. The preliminary results determined a range for the tax gap, which will be refined into final, more detailed estimates by year-end 2005. It is unlikely but possible that the final estimates of the total tax gap will fall outside the established range.

The tax gap has three components: underreporting of income, underpayment of taxes and non-filing of returns.

The new study shows modest deterioration in tax compliance

Understanding The Tax Gap

The Internal Revenue Service developed the concept of the tax gap as a way to gauge taxpayers' compliance with their federal tax obligations. The tax gap measures the extent to which taxpayers do not file their tax returns and pay the correct tax on time.

Understanding the tax gap and what its components are allows the legislative and executive branches of government to make better decisions about tax policy and the allocation of resources for tax administration.

Components of the Tax Gap

The tax gap can be divided into three components: non-filing, underreporting and underpayment. Non-filing occurs when taxpayers who are required to file a return do not do so on time. Underreporting of tax occurs when taxpayers either understate their income or overstate their deductions, exemptions and credits on timely filed returns. Underpayment occurs when taxpayers file their return but fail to remit the amount due by the payment due date.

Of these three components, underreporting of income tax, employment taxes and other taxes represents about 80% of the tax gap. The single largest sub-component of underreporting involves individuals understating their incomes, taking improper deductions, overstating business expenses and erroneously claiming credits. Individual underreporting represents about half of the total tax gap. Individual income tax also accounts for about half of all tax liabilities.

The National Research Program

Previous estimates of the tax gap relied on detailed research that was conducted for tax years 1988 and earlier. To update this research and reflect a changing economy, revisions to the tax code and more subtle shifts in individual behavior, the IRS launched the National Research Program (NRP) in 2001.

The NRP was designed to measure individual taxpayer reporting compliance for tax year 2001. Over the course of the next three years, the IRS randomly selected about 46,000 returns for review and examination. These audits were largely completed by the fall of 2004. To gather statistically valid data, the return selection process for the NRP included an oversampling of high income returns. This enables IRS researchers to draw valid conclusions about important sub-categories of taxpayers.

For instance, slightly more than 6% of individual taxpayers filed Schedule C as sole proprietors in 2001. These taxpayers reflect a wide range of economic activity. To draw valid conclusions on Schedule C filers, the NRP examined about 21,000 individuals who filed a Schedule C, slightly less than 46% of the total sample.

The current data from the NRP are preliminary, so the results are shown as ranges. As refinements are made to the tax gap analysis, some of these estimates may change. It is unlikely, but possible, that the final estimates of the tax gap will fall outside of the established range.

The tax gap figure does not include taxes that among individual taxpayers since the last study was conducted in 1988. Preliminary findings include:

- Underreporting noncompliance is the largest component of the tax gap. Preliminary estimates show underreporting accounts for more then 80% of the total tax gap, with non-filing and underpayment at about 10% each.
- Individual income tax is the single largest source of the annual tax gap, accounting for about two-thirds of the total.
- For individual underreporting, more than 80% comes from understated income, not overstated deductions.
- Most understated income comes from business activities, not wages or investment income.

"People who aren't paying their taxes shift the burden to the rest of us."

should have been paid on income from the illegal sector of the economy.

Preliminary Findings on the Tax Gap

For tax year 2001, all taxpayers paid $1.767 trillion on time, a figure that represents from 83.4% to 85% of the total amount due. The 2001 tax gap, the difference between taxes owed and taxes paid on time, is from $312 billion to $353 billion for all types of taxes.

Overall, the noncompliance rate is from 15% to 16.6% of the true tax liability. The old estimate, derived from compliance data for tax year 1988 and earlier, was 14.9%.

Late payments and other IRS enforcement and compliance efforts, including taxpayer audits and collection activities (payment arrangements, liens, levies and other legal actions) recover some of the tax gap. For tax year 2001, the IRS expects eventually to collect an additional $55 billion of the tax gap, reducing the net amount of the tax gap to between $257 billion and $298 billion.

Among the areas where taxpayer compliance appears to have worsened are:

- Reporting of net income from flow-through entities, such as partnerships and S corporations.
- Reporting of proprietor income and expenses, such as gross receipts, bad debts and vehicle expenses.
- Reporting of various types of deductions.

Among the areas where compliance seems to have improved is the reporting of farm income.

Overall, compliance is highest where there is third-party reporting and/or withholding. For example, most wages, salaries and tip compensation are reported by employers to the IRS through Form W-2. Preliminary findings from the NRP indicate that less than 1.5% of this type of income is misreported on individual returns.

IRS researchers anticipate identifying other specific areas of deterioration and improvement in the coming months as they complete the detailed analysis of the study's data.

Benefits of This Research

More than establishing the overall extent of individual underreporting, the NRP study also offers IRS officials specific insight into the types of income reporting that have the greatest compliance problems. For example, the NRP data will not only provide the misreporting rates associated with individual lines of the tax return, but will also be the basis for updating the statistical formulas that assist IRS employees in selecting returns for audit.

When these updated formulas become available for use, IRS employees will be better positioned to select returns for examination that have the greatest likelihood of underreporting. Using such an approach better ensures that IRS audits are focused on the returns most in need of examination. This not only improves IRS efficiency, but it also assures taxpayers that others are paying their fair share. It also lessens the likelihood that those with accurate tax returns will receive the same degree of scrutiny.

• Compliance rates are highest where there is third-party reporting or withholding. Preliminary findings show less than 1.5% of wages and salaries are misreported.

The NRP study includes updated research only on individuals, not corporations.

Preliminary Findings Support Enforcement Efforts, Tax Reform

Everson said the study confirms two key points involving tax enforcement and simplification.

"The IRS needs to enforce the law so that when Americans pay their taxes, they are confident that neighbors and business competitors are doing the same," Everson said. "At the same time, this research underscores the President's call for tax reform. Complexity obscures understanding. Complexity in the tax code compromises both the service and enforcement missions of the IRS. Those who try to follow the law but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say 'why bother.' Meanwhile, individuals who seek to pay less than what they owe often hide behind the tax code's complexity in order to escape detection by the IRS and pay less than their fair share."

The President has called for a nearly 8% increase for enforcement activities in the administration's 2006 IRS budget request. The additional funding will increase audits of corporations and high-income individuals as well as expand collection and criminal investigation efforts.

Everson noted that the United States tax administration system remains one of self-assessment and has a high compliance rate.

"We're moving aggressively to reduce the tax gap," Everson said. "With proper funding, over a number of years we will be able to close a significant portion of the gap. But no one should think we can totally eliminate the gap. That would take Draconian measures and make the government too intrusive. We have to strike the right balance."

The next stage of the NRP will be to finish the data analysis and refine the tax gap data in late 2005. The IRS will also use the data to update its statistical tools used to select individual returns for audit, an important step in strengthening compliance with the tax system.

The IRS also plans to update estimates for other areas of the tax gap. The first part of this process will study reporting compliance of flow-through entities (S corporations and partnerships).