WRITTEN TESTIMONY OF
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BEFORE
THE SENATE COMMITTEE ON FINANCE'S
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
ON
THE TAX GAP
JULY 26, 2006

Introduction

Chairman Kyl, Senator Jeffords, and Members of the Subcommittee, I am pleased to be here today to discuss the latest information we have on the tax gap. My name is Mark Mazur and I am the Director of Research, Analysis, and Statistics within the Internal Revenue Service. Because my office is not directly involved in either direct service to taxpayers or in direct compliance efforts, my remarks today will focus on the tax gap numbers themselves as well as the methodology we used to arrive at those numbers. I also would like to discuss the direction of future studies related to the tax gap.

Background:

The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

Commissioner Everson has stated repeatedly that the complexity of our current tax system is a significant reason for the tax gap and that fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions.

History of Estimating the Tax Gap

Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line by line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas.

However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988.

We conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, all of our subsequent estimates of the tax gap have been rough projections that basically assume no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program which we have used to estimate our most recent tax gap updates was born out of the desire to find a less intrusive means of measuring tax compliance. We used a focused statistical selection process that resulted in the selection of approximately 46,000 returns, somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time.

Like the compliance studies of the past, the NRP was designed to allow us to meet certain objectives: to estimate the overall extent of reporting compliance among individual income tax filers, and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The first NRP innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. The sources of the "case building" data included third-party information returns from payers of income (e.g., Forms W-2 and 1099) and prior-year returns filed by the taxpayers. Also, for the first time we added data on dependents from various government sources, as well as data from public records (e.g., current and prior addresses, real estate holdings, business registrations, and involvement with corporations). Together, these data reduced the need to ask taxpayers for information, with some of the selected taxpayers not needing to be contacted at all by the IRS. In effect, these data allowed us to focus our efforts where the return information could not otherwise be verified. This pioneering approach was so successful it is being expanded into our regular operational audit programs.

A second major NRP innovation was to introduce a "classification" process, whereby the randomly selected returns and associated case-building data were first reviewed by experienced auditors, referred to as classifiers, who identified not only what issues needed to be examined, but also the best way to handle each return in the sample. In this way, each return was either: (1) accepted as filed, without contacting the taxpayer at all (though sometimes with minor adjustments noted for research purposes); (2) selected for correspondence audit of up to three focused issues; or (3) selected for an in-person audit where there were numerous items that needed to be verified. In addition, the classifiers identified compliance issues that the auditors were required to evaluate, though the examiners had the ability to expand the audit to investigate other issues as warranted.

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including representatives of tax professional associations) in the design and implementation of the study. As mentioned earlier, the more focused selection process resulted in the NRP sample including around 46,000 returns—somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time. Clearly, the NRP approach was much less burdensome on taxpayers than the old TCMP audits, which examined every line item on every return. At the same time, the data collected through the NRP reporting compliance studies is about the same quality as that collected under TCMP.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among the major tax gap components since the most recent compliance data were compiled.(i.e.,1988 or earlier).

Distinguishing the Tax Gap From Related Concepts

The tax gap is not the same as the so-called “underground economy”, although there is some overlap (particularly in the legal-sector cash economy). For example, the tax gap does not include the illegal sector of the economy, which makes up a significant portion of the underground economy. Moreover, the underground economy does not include various forms of tax noncompliance such as overstated deductions or claiming an improper filing status or the wrong number of exemptions, that are characteristic of the tax gap.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, even though, at this point, we do not have sufficiently good data to clearly distinguish the amount of non-compliance that arises from willfulness, as opposed to unintentional mistakes. This is an area where we expect future research to improve our understanding.

Latest Numbers

The results of the NRP individual income tax reporting compliance study were rolled into our overall tax gap estimates and show that there is an overall gross tax gap of approximately $345 billion, corresponding to a noncompliance rate of 16.3 percent. The net tax gap or what is remaining after enforcement and other late payments is about $290 billion.

Noncompliance takes three forms: not filing required returns on time (nonfiling); not reporting one’s full tax liability when the return is filed on time (underreporting); and not paying by the due date the full amount of tax reported on a timely return (underpayment). We have separate tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes nearly 82 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes almost 8 percent and underpayment nearly 10 percent of the gross tax gap.

The individual income tax accounted for about half of all tax receipts in 2001. However, as shown on the chart below, *individual* income tax underreporting was approximately $197 billion, or about 57 percent of the overall tax gap. While a comparison with 1988 data would suggest a slight worsening of individual income tax reporting compliance, it is important to remember that the data tell us nothing about the years just before or just after Tax Year 2001 and, as such, cannot tell us whether compliance trends today are improving or getting worse. Moreover, many things are not comparable about the data and estimating methodologies used now relative to earlier studies.

As in previous compliance studies, the NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated subtractions from income (i.e. statutory adjustments, deductions, and exemptions) and from overstated tax credits.

NRP-Based Tax Gap Estimates, Tax Year 2001

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**197**	**56%**
Understated non-business income	56	16%
Understated net business income	109	31%
Overstated adjustments, deductions, exemptions and credits	32	9%
Self-Employment tax underreporting gap	**39**	**11%**
All other components of the tax gap	**109**	**33%**
Total Tax Gap	**345**	
Note: Detail does not add due to rounding		

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self employment tax together, then, we see that individual underreporting contributes approximately two-thirds of the overall tax gap.

It appears that compliance rates for sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study for Tax Year 1988. The amounts least likely to be misreported on tax returns are subject to both third party information reporting and withholding and are, therefore, the most "visible" (e.g., wages and salaries). The net misreporting percentage for wages and salaries is only 1.2 percent.

Amounts subject to third-party information reporting, but not to withholding (such as interest and dividend income), exhibit a somewhat higher misreporting percentage. For example, there is about a 4.5 percent misreporting rate for interest and dividends.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage of 8.6 percent. As expected, amounts not subject to withholding or third party information reporting (e.g., sole proprietor income and the "other income" line on form 1040) are the least "visible" and, therefore, are most likely to be misreported. The net misreporting percentage for this group of line items is 53.9 percent.

With transactions that are less "visible" to the IRS, and with very low audit rates by historical standards, some sole proprietors may have become emboldened to cut corners on their taxes. Other small business owners may be swamped by the cost and complexity of meeting their tax obligations and their business requirements. Whatever the reason, it is easy to see that we have a serious problem with underreporting for those items not subject to withholding or third party information reporting.

Latest NRP Study

In viewing the strategic value of monitoring compliance trends, we now recognize the need to conduct reporting compliance studies more regularly. Each study will address a component of the overall tax gap. By measuring compliance for various types of taxes and taxpayers, we will be better able to target resources to encourage compliance, deter non-compliance and reduce the burden on taxpayers.

The most recent NRP reporting compliance study focuses on S corporations. Since 1985, S corporation return filings have increased dramatically. In that year there were 722,444 Form 1120 S returns filed. In 2002 that number had grown by four times to over 3.1 million. Compare that to other corporate returns which declined by approximately 450,000 over the same period.

By 1997, S corporations became the most common corporate entity. In 2003, nearly 3.4 million S corporations filed tax returns, accounting for over 58 percent of all corporate returns filed that year. The last time we conducted an S corporation study was 1984. As a result, we do not have reliable reporting compliance data for these entities.

The current NRP study of reporting compliance involves approximately 5,000 Form 1120S returns from a nationwide random sample. We used the asset size of the S corporation in the return selection process. This reporting compliance study involves Tax Years 2003 and 2004. This is the first time the IRS has conducted a reporting compliance study across tax years and it will require us to knit the data together to give a comprehensive picture. This study is underway and we expect it to continue through 2007.

Conclusion

On the whole, Mr. Chairman, our system of self-assessment of tax liabilities works well. Most countries would be thrilled to have a voluntary compliance rate of almost 84 percent.

However, we owe it to compliant taxpayers to do everything we can to make sure we collect from those who are noncompliant. Otherwise, honest taxpayers are asked to carry an unfair and unnecessary burden.

It is clear that consistent efforts to keep the complexity and unnecessary burden of the tax system to a minimum, to provide the level of service that the taxpaying public deserves, and to maintain a strong and well-targeted enforcement presence are necessary to improve compliance rates.

We intend to learn as much as we can about the extent of noncompliance and its causes so that we can devise cost-effective ways to increase compliance with our tax laws. In doing this our NRP office consults with stakeholders inside and outside the IRS throughout the development and refinement of the methodology for the studies and applies lessons learned from past compliance measurement efforts.

We are committed to applying our limited resources where they are of the most value in reducing noncompliance while ensuring fairness, observing taxpayer rights, and reducing the burden on taxpayers who comply. We do not have the resources to return to the high audit rates of the past, but we are using the NRP study results to manage our compliance programs more effectively and to design pre-filing activities that help taxpayers comply with the law.

Thank you for the opportunity to discuss the tax gap and our efforts to address it. I will be happy to take your questions.