TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections

April 2006

Reference Number: 2006-50-077

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Phone Number | 202-927-7037
Email Address | Bonnie.Heald@tigta.treas.gov
Web Site | http://www.tigta.gov

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

April 21, 2006

MEMORANDUM FOR DIRECTOR, OFFICE OF RESEARCH, ANALYSIS, AND STATISTICS

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections (Project # 200650001)

This report presents the results of our review of whether the Internal Revenue Service's (IRS) compliance efforts and strategies will enable it to achieve a 90 percent Voluntary Compliance Rate (VCR) by 2010.

Synopsis

In April 2004, the ranking member of the Senate Finance Committee, Senator Max Baucus, called for 90 percent voluntary tax compliance by 2010. Senator Baucus stated, in part, that "Today, I'm calling on the IRS to achieve a 90 percent voluntary compliance rate by the end of the decade, which would raise at least an additional $100 billion each year without raising taxes."[1] Perhaps the greatest challenge facing the IRS is finding ways to improve the VCR.

Using different terms, Senator Baucus challenged the IRS to reduce what is commonly known as the tax gap. The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. In February 2006, the IRS estimated the gross tax gap at $345 billion for Tax Year 2001.

To determine whether the IRS can achieve the VCR called for by Senator Baucus, we first evaluated the reliability of the IRS developed tax gap figures. We concluded the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance. The IRS has significant challenges in both obtaining complete and timely

[1] United States Senate Committee on Finance News Release, April 13, 2004

data and developing the methods for interpreting the data. However, it is important to tax administration and tax policy decision makers that an estimate be developed that is within tolerable parameters. Otherwise, inappropriate decisions can be made on how to address the tax gap. If one assumes that, in Tax Year 2010 the total tax liability is the same as it was in Tax Year 2001, noncompliant taxpayers would have to timely and voluntarily pay an additional $134 billion to achieve the Senator Baucus challenge to reach a 90 percent VCR by 2010.

Reliability of the Internal Revenue Service Developed Tax Gap Figure

Our analysis focused on whether there was sufficient, complete, and accurate information to determine whether the composite tax gap projections are reliable. We concluded that, despite the significant efforts undertaken in conducting the individual taxpayer National Research Program (NRP) for underreporting, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the VCR. Our primary concerns are described in the following areas of nonfiling, reporting compliance, and payments collected.

Nonfiling

In the pre-NRP tax gap map,[2] the IRS estimated the nonfiling gap to be $30.1 billion, which was comprised of $28.1 billion for individual income taxes and $2 billion for estate taxes. In February 2006, this estimate was updated to $25 billion for individuals. Supplementary data suggest that substantial amounts are not included in the estimates provided in the tax gap map projections. The maps described the nonfiling estimate as reasonable despite the missing segments of corporate income, employment, and excise taxes. These facts suggest the nonfiler estimate is incomplete and likely inaccurate.[3]

Reporting Compliance

The tax gap attributed to underreporting is by far the largest identified portion of the tax gap at an estimated $285 billion. Yet, this estimate may not be complete since there are at least four areas that suggest substantial amounts are not included in the tax gap map projections.

- The effect of the current NRP Subchapter S corporation study[4] on individual compliance could have a substantial impact on the individual taxpayer segment, as well as the employment tax segment.

---

[2] The tax gap map is an IRS developed chart that graphically depicts the tax gap along with its components and their relative sizes.
[3] There are no definite plans to update the estate tax segment or to estimate the corporate, employment, and excise tax nonfiler segment.
[4] This study is expected to take 2 years to 3 years to complete from its inception in October 2005.

- The $5 billion estimate for small corporations and the $25 billion estimate for large corporations date back to the 1980s and have a weak certainty status according to the IRS.
- The estimate for estate taxes was not updated during the current NRP, and no estimate has been made for excise taxes.
- The dated estimate for the Federal Insurance Contributions Act taxes and unemployment taxes are considered weak by the IRS.

Payments Collected

The payment information used to arrive at a net tax gap figure is shown as $55 billion in recoveries or enforced collections and other late payments.[5] This figure does not represent an actual amount but is an estimate based on formulas devised from historical analyses. However, the actual basis of these formulas seems to be very limited, as well as dated, since IRS officials stated they were developed "quite some time ago." Thus, these formulas most likely do not take into account changes in the IRS' ability to collect revenue. Furthermore, these collections have two basic parts: voluntary payments received by the IRS after the due date and payments received by the IRS as a result of some type of IRS intervention. The IRS does not currently correlate either type of payment to the applicable tax year and thus does not determine actual collections.

Comparing Tax Gap Estimates to Independent Observations Presents Difficult Challenges

In an effort to determine whether the tax gap projections developed by the IRS coincide with estimates developed by independent sources, we attempted to identify other estimates from independent sources. Although some outside studies exist, none provide sufficient information to allow close comparisons. However, one possible source of comparison is the annual Bureau of Economic Analysis estimate of the difference between its personal income figures and the IRS' measure of Adjusted Gross Income to derive what is called an Adjusted Gross Income Gap. IRS Office of Research officials suggested this is a narrow definition of tax noncompliance based, in part, on IRS estimates. For Tax Year 2001, the Bureau of Economic Analysis reported an Adjusted Gross Income Gap of $834.4 billion.[6]

The private sector has also developed some estimates of the tax gap. For example, in January 2005, financial analysts calculated the number of illegal immigrants in the United States

[5] According to one IRS representative, these collections can take up to 10 years because of appeals and court decisions.
[6] This number is an income gap rather than a tax gap. Thus, it would have to be multiplied by a tax rate to determine the associated tax gap. Similarly, the $35 billion stated in the following paragraph could be significantly smaller, depending on whether some of these workers have actual filing obligations.

at more than double the United States Census Bureau's estimated 9 million. These undocumented workers may hold as many as 15 million jobs, with perhaps 5 million collecting untaxed cash wages, costing the Federal Government an estimated $35 billion yearly.[7]

Learning From Previous Attempts to Reduce the Tax Gap and Increase Voluntary Compliance

In 1993, in concert with the Department of the Treasury and the Office of Management and Budget, the IRS formed a task group that performed an extensive review of the tax gap. The resulting report addressed major areas of the tax gap and provided recommendations that addressed multiple approaches to closing the tax gap. The recommendation that would have had the most impact included various legislative changes.

Conclusion

The IRS' ability to achieve 90 percent voluntary compliance by 2010 is a determination that cannot be made with the information currently available. Regardless of whether a 90 percent VCR can be achieved, the IRS faces formidable challenges in completely and accurately estimating the tax gap and finding effective ways to increase voluntary compliance. Overall strategies to decrease the tax gap, as well as major areas of noncompliance, were identified by the IRS more than a decade ago. Improvements can be realized; however, sufficient resources need to be provided to ensure tax administrators can effectively ensure compliance with the tax laws.

Recommendations

The Commissioner should continue to conduct NRPs on a regular cycle for the major segments of the tax gap. To augment the direct measurement approach, the IRS should devise indirect measurement methods to assist in quantifying the tax gap. In addition, the Commissioner should consider establishing a tax gap advisory panel that includes tax and economic experts to identify ways to improve the methods to measure voluntary compliance.

Response

The IRS agreed with our first recommendation, subject to resource availability, and agreed with our second recommendation. The IRS will conduct reporting compliance studies consistent with resource constraints, with a goal of covering all major taxes and taxpayer groups. The IRS will also explore incorporating indirect measurement methods where these can improve the precision

[7] Bear Stearns, *The Underground Labor Force Is Rising To The Surface.*

of the resulting estimates. In addition, the IRS will look into establishing an advisory panel. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Director (Inspections and Evaluations), at (215) 516-2341.

Table of Contents

Background

The Federal income tax operates on a self-assessment basis. In general, taxpayers are responsible for determining their own tax liabilities. The success of the self-assessment system depends on the willingness of taxpayers to file tax returns when required, accurately report their tax liabilities, and timely pay their taxes.

The Internal Revenue Code system of self-assessment places three basic obligations on taxpayers. Generally, taxpayers are required to: (1) file annual tax returns, on which they (2) report the correct amount of tax that they owe, and (3) pay their tax on a timely pay-as-you-go basis. Tax noncompliance can therefore be categorized into three corresponding categories: nonfiling, underreporting, and underpayment. The total dollar value of noncompliance (for a given tax year) is called the gross tax gap. This is the estimated amount of tax that is owed but is not paid voluntarily and timely.

The three components of the tax gap are defined as follows:

- The nonfiling gap is the tax that is owed but is not paid voluntarily and timely by those who do not file required returns by their due date (April 15 for most individual taxpayers). In this definition, the nonfiling gap is net of any tax paid by or on behalf of these taxpayers before the due date of the return (e.g., through withholding).
- The underreporting gap is the amount of tax that is owed, but not paid voluntarily and timely, by those who file their returns timely but do not fully report their tax obligations. This can be intentional or unintentional.
- The underpayment gap is the amount of tax that is reported on timely filed returns but not paid voluntarily and timely.

Most of the gross tax gap is essentially an estimate by the Internal Revenue Service (IRS) and is never assessed or paid. However, some of it is paid late either through IRS enforcement efforts or through late payments that precede these efforts. The portion of the gross tax gap that is not eventually collected is called the net tax gap. The percentage of tax dollars paid by taxpayers who voluntarily and timely comply with their tax obligations is called the Voluntary Compliance Rate (VCR). The most recent IRS estimates of these various tax gap figures are for Tax Year (TY) 2001.

After a long period of inactivity,[1] the IRS reinstated comprehensive compliance measurement with the initiation of the National Research Program (NRP) for TY 2001 individual income tax returns. Data from the NRP have been used to update the 2001 tax gap figures.

In April 2004, the ranking member of the Senate Finance Committee, Senator Max Baucus, called for 90 percent voluntary tax compliance by 2010. Senator Baucus stated, in part, that "Today, I'm calling on the IRS to achieve a 90 percent voluntary compliance rate by the end of the decade, which would raise at least an additional $100 billion each year without raising taxes."[2] Perhaps the greatest challenge facing the IRS is finding ways to improve the VCR.

This evaluation was performed at the IRS Headquarters in Washington, D.C., in the Office of Research, Analysis, and Statistics during the period October 2004 through September 2005. Data in this report were subsequently updated to reflect revised information provided by the IRS in February 2006. The evaluation was performed in accordance with *Quality Standards for Inspections*. Detailed information on our evaluation objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[1] Prior to the National Research Program, tax gap estimates were based on the results of the IRS Taxpayer Compliance Measurement Program, which was a systematic program of tax return examinations conducted to facilitate the compilation of compliance data. The last Taxpayer Compliance Measurement Program processed involved TY 1988 individual income tax returns.
[2] United States Senate Committee on Finance News Release, April 13, 2004.

Results of Review

There is a critical issue the IRS needs to address before determining whether 90 percent voluntary compliance can be achieved. The IRS needs to ensure its estimates of the tax gap and the VCR are substantially complete and accurate.

Based upon the best information the IRS had available as of February 2006, the gross tax gap for TY 2001 was approximately $345 billion and the VCR was approximately 83.7 percent. Assuming, despite evidence to the contrary, the current IRS tax gap and VCR are complete and accurate, the compliance target set by Senator Baucus would present major challenges to tax administration. For example, if one assumes that, in TY 2010 the total tax liability is the same as it was in TY 2001, to reach a level of 90 percent voluntary compliance, noncompliant taxpayers would have to timely and voluntarily pay an additional $134 billion.[3]

The specific challenges confronting the IRS are discussed in the remainder of this report. Our analysis focused on whether there was sufficient, complete, and accurate information to determine whether the composite tax gap projections are reliable. Our purpose was not to be critical of the efforts the IRS took in reestablishing compliance measurement. On the contrary, we commend the IRS for restoring these critical measurements and for designing them to be much less burdensome to taxpayers than previous efforts. Our intent was to identify what the measurements included and excluded, what confidence can be ascribed to them, and what areas could be addressed to make the tax gap measurements more reliable and useful in determining an accurate VCR. Where appropriate, we have provided our recommendations for improvement.

The Reliability of Tax Gap Projections Are Affected by the Age, Completeness, and Accuracy of the Data

In any discussion about whether a specific VCR goal can be met, the logical starting point would be an assessment of the data reliability of the measurement. To explore the views of IRS managers not directly involved in estimating the tax gap, we conducted a survey in which over 1,000 IRS managers expressed their opinions on the importance and reliability of tax gap issues and related NRP data.[4] The following are selected responses to our questions. Additional and more detailed response information can be found in Appendix IV.

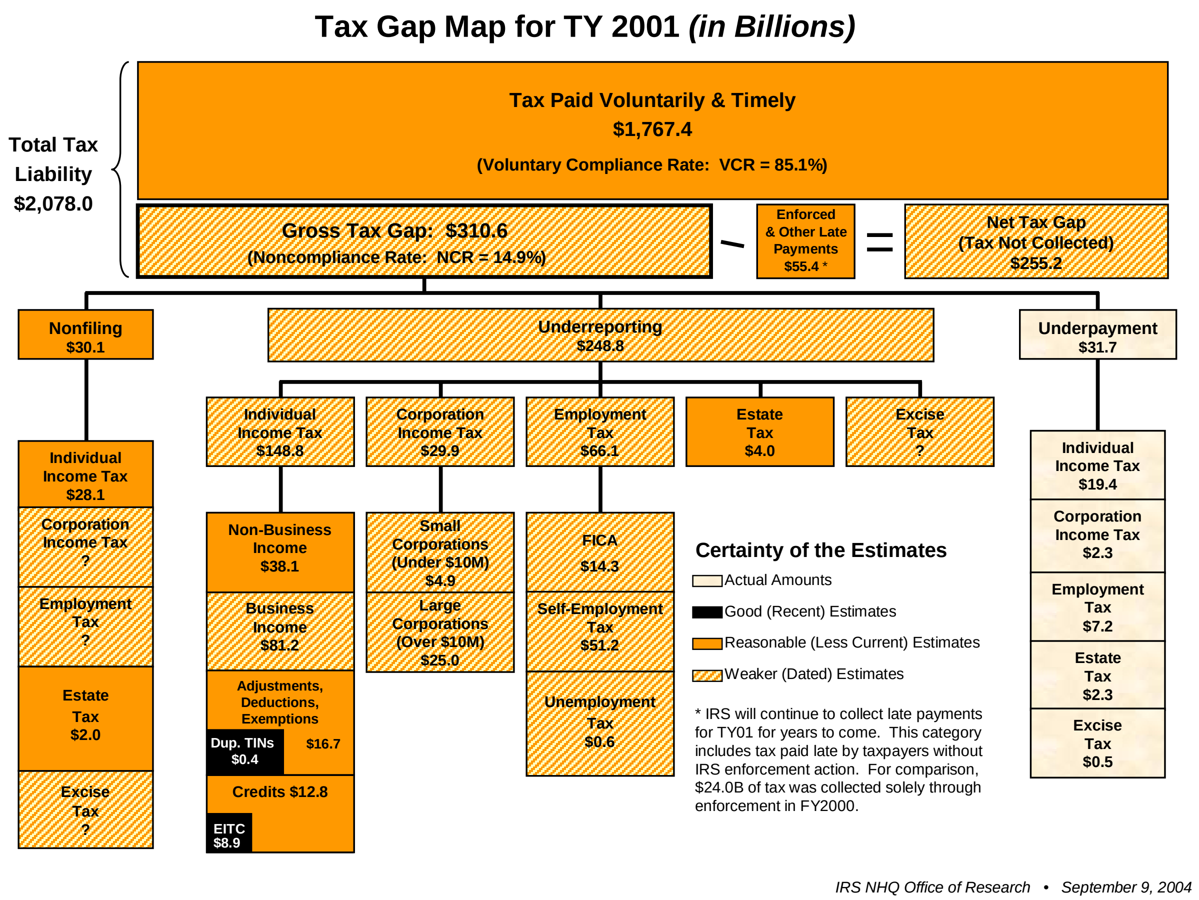
[3] The IRS goal in the 2007 budget is to reach an 85 percent VCR by 2009.
[4] There were 2,075 surveys sent to 2,689 managers and 16 executives. The IRS selected the managers in the Small Business/Self-Employed and Large and Mid-Size Business Divisions. We received 1,033 responses to the survey.

- Approximately 95 percent cited the level of voluntary compliance as a major problem facing tax administration, believed the IRS should accurately measure it, and agree it is important in developing strategies and programs.
- Almost one-third of these managers think the IRS has insufficient data on the reasons for noncompliance.
- Fewer than 60 percent believe the NRP will provide accurate compliance-level estimates.

These survey results further clarify the importance of voluntary compliance and the accuracy of the measures associated with it. Consequently, an analysis of the IRS tax gap projections was required to determine its accuracy and completeness.

The IRS developed a chart called the tax gap map to graphically depict the gross tax gap for TY 2001, its components, and their relative sizes. The first iteration of the map was completed prior to the first phase of the NRP and is shown in Figure 1.

Figure 1: IRS Tax Gap Map – Before the NRP



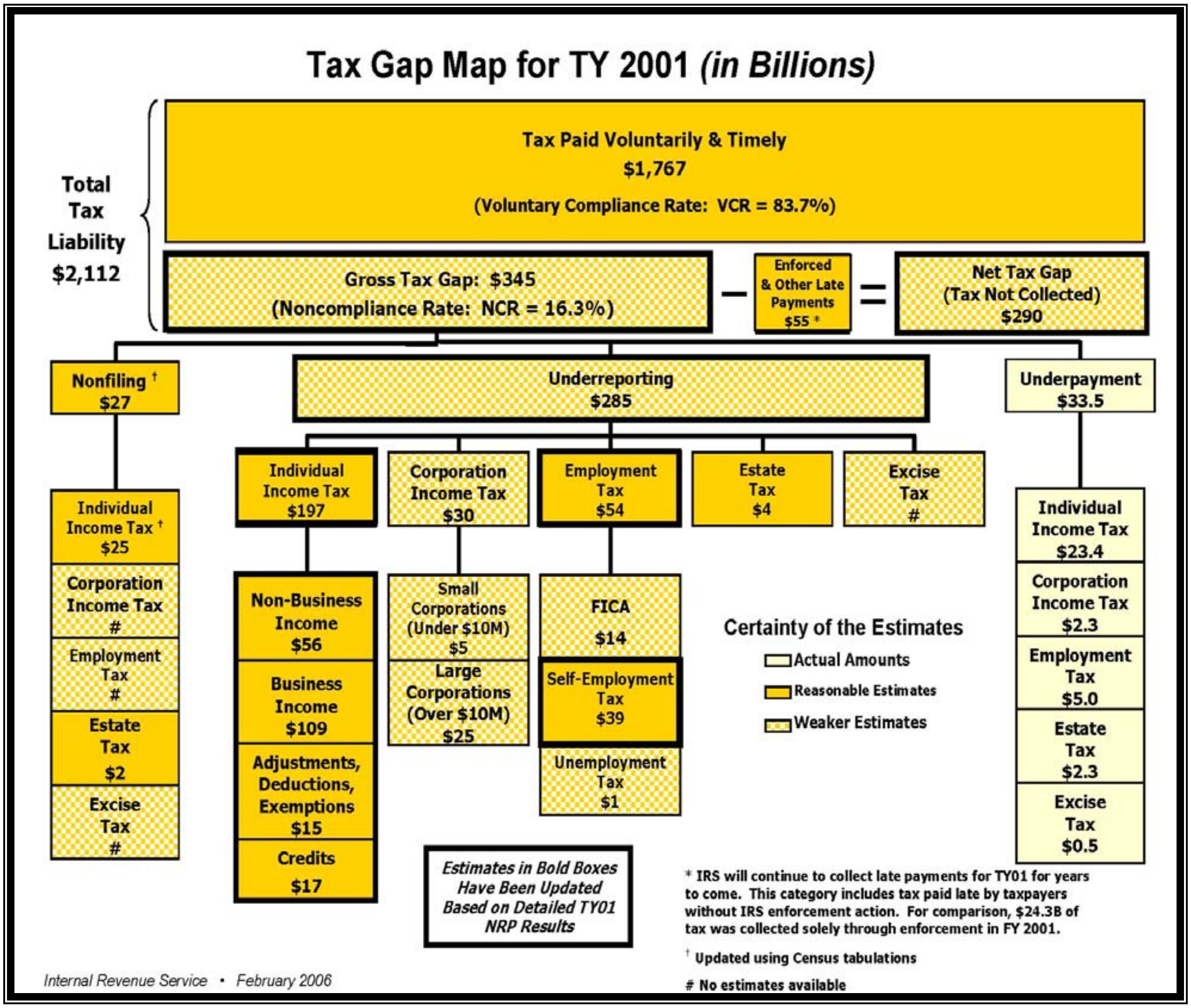
Legend: FICA is Federal Insurance Contributions Act
Dup TINs are Duplicate Taxpayer Identification Numbers
EITC is Earned Income Tax Credit
FY is Fiscal Year

Source: IRS Office of Research.

The map attributes various certainties to the tax gap estimates representing the IRS' confidence in the figures based on the quality and age of the estimates. We discuss the reasonableness of the certainty categorization in our evaluation of the estimates later in this report.

Subsequent to the NRP, the map was updated with preliminary figures in March 2005. After refinement of the NRP data, a third iteration was issued in February 2006. Figure 2 shows the most recent version of the tax gap map.

Figure 2: IRS Tax Gap Map – After the NRP



Source: IRS Office of Research.

As shown in the preceding tax gap maps, the IRS' preliminary TY 2001 gross tax gap estimate for individual, employment, corporate, and other taxes was $310.6 billion with a VCR of 85.1 percent. However, the most recent gross tax gap estimate is $345 billion with a VCR of 83.7 percent based on updates using the NRP data.

In all three compliance areas across the major tax gap segments, there are concerns about whether the tax gap projections are complete and accurate. Our primary concerns are described in the areas of nonfiling, underreporting, and estimated payments that result in the difference between the gross and net tax gaps.

Nonfiling

In the pre-NRP tax gap map, the IRS estimated the nonfiling gap to be $30.1 billion, which was comprised of $28.1 billion for individual income tax and $2 billion for estate tax. In February 2006, this estimate was updated to $25 billion for individual income tax. The individual estimate was based on data provided by the United States Census Bureau. However, there are supplemental data that suggest substantial amounts are not included in the estimates provided in the tax gap map projections. The maps described the nonfiling estimate as reasonable despite the missing segments of corporate income, employment, and excise taxes. There are no definite plans to update the estate tax segment or to estimate the corporate, employment, and excise tax nonfiler segments. These facts suggest the nonfiler estimate is incomplete and likely inaccurate.

The IRS has shown concerns about the significance of nonfiling in the corporate segment. Although Headquarters Office of Research officials stated their belief that corporate nonfiling was not a significant issue because of corporate visibility, in July 2004, researchers in the Small Business/Self-Employed Division issued a report on business nonfilers recommending an enhanced system for creating and selecting inventory be designed and implemented. Subsequently, the Small Business/Self-Employed Division Research office developed a prototype that matched $4.6 trillion in transactions to over one-half of the business nonfilers for TY 2002, detecting approximately $1 trillion of apparent taxable income. This fact alone brings the $27 billion into question and demonstrates the need for more research to better estimate nonfiling for all tax segments.

Underreporting

The tax gap attributed to underreporting is by far the largest identified portion of the tax gap at an estimated $285 billion. Yet, this estimate may not be complete since there are at least four areas that suggest substantial amounts are not included in the tax gap map projections. First, the business income portion of the individual underreporting tax gap estimate is incomplete without information from another NRP study that the IRS is undertaking on flowthrough returns[5] of Subchapter S corporations.[6] The study will take 2 years to 3 years to complete from its inception in October 2005, which means information from these audits was not available for the February 2006 updated TY 2001 tax gap estimates. Over 2.9 million Subchapter S Corporation

[5] These include partnerships and Subchapter S corporations through which individual partners and shareholders, respectively, derive tax information from those entities. The flowthrough study covers only Subchapter S corporations and not partnerships. In 1958, Congress established Subchapter S of the Internal Revenue Code that enables small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders. Subsequently, the Code was revised to allow as many as 100 shareholders. Electing this form of business organization, commonly referred to as an S corporation, exempts the profits from corporate taxation and allows the profits to "pass through" to the shareholders who are then responsible for individual income taxes on the profits.
[6] The study began in October 2005 with audits of TY 2003 returns.

returns were filed in TY 2001 with over 5.3 million shareholders reporting $187.7 billion in net income.

Second, the revised tax gap map lists the underreporting gap at $5 billion for small corporations and $25 billion for large corporations. These amounts are essentially carryovers from the previous estimate, including their weaker certainty status, since no new information was developed. For small corporations, the estimate is based on the 1980 TCMP survey. For large corporate underreporting, the previous estimates were not based on random TCMP audits but on operational audit coverage from the mid-1980s. These projections assume constant VCRs, yet current experience suggests compliance may not be constant. For example, in 2003, a contractor estimated the yearly tax gap arising from abusive corporate tax shelters alone was between $11.6 billion and $15.1 billion.[7]

Third, the revised map similarly categorized as reasonable a $4 billion figure for estate taxes and provided no estimate for excise taxes, yet the estate tax estimate was not updated during the current NRP. In addition, there are no firm plans for further studies or updates of these components.

Finally, in the employment tax component, the weaker combined $15 billion Federal Insurance Contributions Act and unemployment tax gap figure was also carried over and will not be further studied. Most of the employment tax component consists of self-employment tax. Yet, like the business income portion of the individual income tax gap, this too is incomplete without the flowthrough data.

Payments collected

The IRS' tax gap maps, both before and after the NRP, list $55 billion as recoveries or enforced collections and other late payments.[8] This figure does not represent an actual amount but is an estimate projected from historical information and formulas based on what is known about the amount of collections on accounts over time. However, the actual basis of these formulas seems to be very limited, as well as dated, since IRS officials stated they were developed "quite some time ago." Thus, these formulas most likely do not take into account changes in the IRS' ability to collect revenue.

To determine the validity of the potential $55 billion in collections, we requested data on actual collections to date for TY 2001 by year of collection. These collections have two basic components: voluntary payments received by the IRS after the due date and payments received by the IRS as a result of some type of IRS intervention. The IRS responded it does not currently correlate either type of payment to the applicable tax year. Consequently, the IRS has no means of determining whether the $55 billion is ever collected. While the IRS is currently working on

[7] The IRS has not developed a new estimate of this figure.
[8] According to one IRS representative, these collections can take up to 10 years because of appeals and court decisions.

developing a table that will separate collections resulting from enforcement actions into the related tax years, no similar data are being developed for voluntary late payments. Unless the latter data are categorized, the IRS will be unable to determine actual collections or an accurate net tax gap.

The methodology can significantly affect the accuracy of the projection

Beyond the concerns about the completeness and accuracy of the current tax gap estimates, there are additional concerns about the samples and adjustments made to the estimates. Both sampling and adjustments can have a significant effect on the confidence that can be placed in the estimates.

The first concern about sampling for the NRP studies is whether the sample sizes would affect the usefulness, or perhaps accuracy, of the data. Performing the studies depends on limited audit resources. Office of Research officials described the problem as acute for the current flowthrough study. The most recent TCMP survey of partnerships, for example, involved a sample size that was significantly larger than the present normal, or operational, audit coverage of partnership returns. That sample size was sustainable at the time of the TCMP survey, when the operational audit program was much larger, but is not feasible now. The same thing was true of the last TCMP survey of Subchapter S corporation returns. The NRP Office proposed much smaller sample sizes for its current surveys of flowthroughs, not because the same sample sizes are no longer needed but because the resources necessary to sustain the required number of random audits are not available.

Although the IRS Office of Research stated the sample size was not an issue for the individual income tax study, the size of the calibration sample[9] for the individual study was constrained by fewer resources than what would have been preferred. A consultant's evaluation of the NRP's sample design expressed concern that using the calibration audits to adjust the NRP could introduce considerable error into the adjusted estimates. An expert we consulted believed the appropriate size of the original NRP sample was an open question that needs addressing for future work. Furthermore, as a result of software issues and anomalies in the data, only about 37,000 of the original 46,000 cases in the original sample were used in the most recent tax gap estimate.

The second factor that affects the tax gap estimates is the use of the multipliers.[10] Using multipliers complicates the confidence in, and precision of, the estimates.

---

[9] Without the intensive audits that characterized the TCMP, the NRP may obtain less complete information, possibly resulting in misstatement of tax liabilities. To address this potential bias, the NRP conducted more comprehensive line-by-line audits of a small calibration sample of 1,683 returns to provide a means of evaluating and, if necessary, correcting the full sample for this bias. The IRS Office of Research believes the quality level of the NRP is about the same as that for the TCMP.

[10] Multipliers are essentially methods used to estimate undetected additional taxable income.

In summary, considering that much of the information remains dated, the new information is incomplete in several respects, and methodology differences create challenges, a somewhat different picture of the tax gap map emerges. We concluded that, despite the significant efforts undertaken in conducting the individual taxpayer NRP, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the VCR. Although having new information about TY 2001 individual taxpayers is better when compared to the much older TY 1988 information from the last TCMP survey, some individual compliance information remains unknown. Additionally, although individuals comprise the largest segment of taxpayers and were justifiably studied first, no new information about employment, small corporate, large corporate, and other compliance segments is available. With no firm plans for further studies or updates in many areas of the tax gap, both the underreporting tax gap and the nonfiling gap will indefinitely leave an unfinished picture of the overall tax gap and compliance.

Comparing Tax Gap Estimates to Independent Observations Presents Difficult Challenges

In an effort to determine whether the tax gap projections developed by the IRS coincide with estimates developed by independent sources, we attempted to identify other estimates from such sources. Although some outside studies exist, none provide sufficient information to allow close comparisons. A few States do a type of tax gap analysis, but most simply compare State taxes to the IRS' numbers and use a ratio. A paper by the Organization for Economic Co-operation and Development[11] looked at compliance studies by other countries, but the data were limited to small and mid-size businesses. The United States is probably the only country in the world that does an NRP-type study.

One possible source of comparison is the annual Bureau of Economic Analysis estimate of the difference between its personal income figures and the IRS' measure of Adjusted Gross Income (AGI) to derive what is called an AGI Gap. Although the IRS has used this measure in the past to provide an independent validity check on its unreported income estimates, IRS Office of Research officials suggested this is a narrow definition of tax noncompliance based, in part, on IRS estimates. Nonetheless, difficulties in reconciling personal income and AGI components make the AGI Gap a starting point for further analysis.[12] For TY 2001, the Bureau of Economic Analysis reported an AGI Gap of $834.4 billion.[13]

---

[11] Organization for Economic Co-operation and Development *Information Note: Compliance Risk Management – Use of Random Audit Programs, September 2004.*

[12] Edgar Feige, *Defining And Estimating Underground And Informal Economies: The New Institutional Economics Approach.*

[13] This number is an income gap rather than a tax gap. Thus, it would have to be multiplied by a tax rate to determine the associated tax gap. Similarly, the $35 billion stated in the following paragraph could be significantly smaller, depending on whether some of these workers have actual filing obligations.

The private sector has also developed some estimates of the tax gap. For example, in January 2005, financial analysts calculated the number of illegal immigrants in the United States at more than double the United States Census Bureau's estimated 9 million. These undocumented workers may hold as many as 15 million jobs, with perhaps 5 million collecting untaxed cash wages, costing the Federal Government an estimated $35 billion yearly.[14]

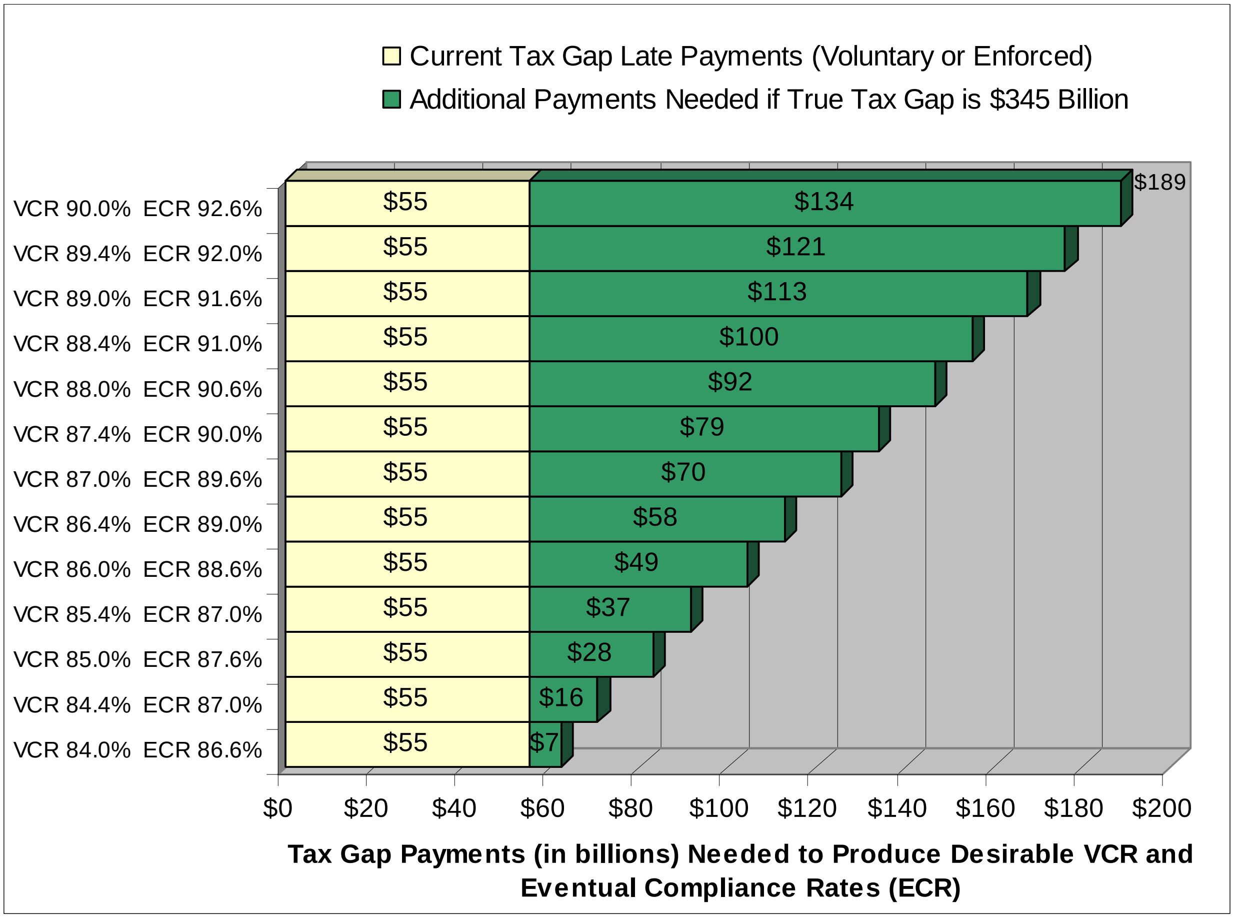
While these estimates may not be precisely comparable to the IRS tax gap estimate, they employ indirect methods of economic measurement. If these estimates are closer to the actual tax gap than the lower IRS developed estimates, this could have a significant effect on tax policy and tax administration.

The Range of Additional Collections That Would Be Required to Achieve Targeted Voluntary Compliance Goals

While we have concerns about the overall reliability of the tax gap projections, the annual amounts collected that reduce the net tax gap, and the VCR, it is instructive to analyze what additional amounts the IRS would have had to collect to reach 90 percent voluntary compliance at different estimated intervals for TY 2001. Figure 3 shows what the range would have been for TY 2001 based upon the total tax liability for TY 2001 as estimated in February 2006. The IRS has proposed in the Fiscal Year (FY) 2007 budget that the VCR will be raised from 83.7 percent to 85 percent by 2009. Accordingly, if the total tax liability remained constant, the IRS would have to collect, on a voluntary and timely basis, $28 billion more in TY 2009, thus reducing the gross tax gap to $317 billion. To reach 90 percent voluntary compliance by TY 2010,[15] the amount voluntarily and timely collected for TY 2010 would be an additional $134 billion, thus reducing the gross tax gap to $211 billion if the total tax liability remained constant.

[14] Bear Stearns, *The Underground Labor Force Is Rising To The Surface.*
[15] This is the amount previously described in this report that was called for by Senator Baucus.

Figure 3: Additional Voluntary and Timely Payments Required to Reach Specified VCR Levels[16]



Source: Treasury Inspector General for Tax Administration.

The Barriers Caused by Budget and Taxpayer Burden Concerns Hamper Compliance Research

Performing a compliance measurement program is expensive and time consuming. The estimated cost for performing the TY 2001 individual taxpayer NRP was approximately $150 million. The IRS Office of Research staff explained that resource constraints are a major

[16] Payment of the $55 billion estimated by the IRS as late or enforced payments does not affect the VCR. However, it does affect the total amount collected by the IRS. Therefore, we developed the Eventual Compliance Rate term that shows the effect of these payments when coupled with additional voluntary and timely payments that do affect the VCR.

driver in NRP studies and will affect how often the NRP is updated. From FYs 1995 through 2004, the revenue agent workforce declined by nearly 30 percent while the number of returns filed grew by over 9 percent. Additionally, operational priorities must be balanced against research needs. This shortfall in examiner resources makes conducting large-scale research studies problematic.

The IRS' budget submission to the Department of the Treasury for FY 2007 requests funding to support ongoing NRP reporting compliance studies. It requests funding for 268 Full-Time Equivalents[17] and $45.9 million that will include 26 analytical and technical positions to estimate reporting compliance for new segments of taxpayers (such as S corporations, partnerships, and other business entities) and to update estimates of reporting compliance for other segments. It also requests 510 additional revenue agents to conduct reporting compliance research examinations. The initiative seeks to provide a foundation for conducting compliance studies and to limit the diversion of resources to research audits from operational priorities. The IRS Oversight Board[18] supports ongoing dedicated funding for compliance research. Unfortunately, funding for those resources in previous fiscal years did not materialize. It bears repeating that, without a resource commitment to continually update the studies, the information will continue to be stale and less useful in improving voluntary compliance.

Learning From Previous Attempts to Reduce the Tax Gap and Increase Voluntary Compliance

In June 1993, IRS executives met with Department of the Treasury and Office of Management and Budget officials to discuss key issues for the FY 1995 budget. The issues facing the Federal Government were similar to the current issues: severe financial constraints and the desire for good tax administration. Consequently, both the Department of the Treasury and Office of Management and Budget agreed to work with the IRS on a comprehensive plan to reduce the tax gap.

The IRS formed a task group that performed an extensive review of the tax gap. The resulting task force report addressed the major areas of the tax gap and provided recommendations that addressed multiple approaches to close the tax gap. The report concluded:

- Enforcement is the most costly option and delivers only limited revenue.

---

[17] A measure of labor hours in which 1 Full-Time Equivalent is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2005, 1 Full-Time Equivalent was equal to 2,088 hours.
[18] According to the IRS Oversight Board web site (irsoversightboard.treas.gov), it is an "independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction."

- Methods to increase voluntary compliance are less costly but more burdensome to taxpayers.
- Legislative changes are needed as the primary means to increase compliance levels.
- The TCMP surveys can be used to develop the types of noncompliance but not the causes.
- The IRS needs to reevaluate its media and taxpayer education efforts.
- The tax gap needs to be treated as a multibillion dollar market, and efforts need to be made to capture as much of that market as possible.
- The IRS needs to consider making a high-level official responsible for overseeing efforts to close all components of the tax gap.
- The IRS Strategic Plan needs to be modified to more closely align with the tax gap components.

We found it difficult to trace what became of the recommendations in the report. While it is likely that some of the recommendations were implemented, not all were. From the information we could obtain, the IRS did receive funding for about 5,000 additional compliance employees in the FY 1995 budget; however, there was a cut for about the same amount in the following year.

There are likely to be more task groups and studies of the tax gap, although the overall strategies to reduce the tax gap are already known. The largest areas of noncompliance are also known. The changes needed could be difficult and add to taxpayer burden. However, 90 percent voluntary compliance and a significant reduction in the $345 billion annual gross tax gap will not be achieved without a multifaceted approach that includes the aforementioned conclusions and recommendations.

Conclusion

The IRS' ability to achieve 90 percent voluntary compliance by 2010 is a determination that cannot be made with current information. However, as illustrated in Figure 3 of this report, it is unlikely that such a massive change in voluntary and timely compliance can be achieved without significant changes to the entire system of tax administration. Regardless of whether a 90 percent VCR can be achieved, the IRS faces formidable challenges in completely and accurately estimating the tax gap and finding effective ways to increase voluntary compliance. Consequently, it is important to tax administration and tax policy decision makers that an estimate be developed that is within tolerable parameters. Otherwise, inappropriate decisions can be made on how to address the tax gap. Overall strategies to decrease the tax gap as well as major areas of noncompliance were identified by the IRS more than a decade ago. Improvements can be realized; however, sufficient resources need to be provided to ensure tax administration can effectively ensure compliance with the tax laws.

Recommendations

Recommendation 1: The Commissioner should continue to conduct NRPs on a regular cycle for the major segments of the tax gap. To augment the direct measurement approach, the IRS should devise indirect measurement methods to assist in quantifying the tax gap.

> ***Management's Response:*** The IRS agreed with our recommendation and, subject to available resources, will conduct reporting compliance studies on a regular basis for the foreseeable future. Management's goal is to cover all major taxes and taxpayer groups over a period of years. Initially, they will focus on the most valuable and productive studies and will depend on the IRS Enforcement Committee to prioritize these efforts. As one step in estimating the tax gap, they use indirect methods as a check on their analytical work. They will continue to do so in the future and will explore the viability of incorporating indirect measurement methods where these can improve the precision of the resulting estimates. However, this may require an improvement in the quality and reliability of indirect methods.

Recommendation 2: The Commissioner should consider establishing a tax gap advisory panel that includes tax and economic experts to identify ways to better measure voluntary compliance.

> ***Management's Response:*** The IRS agreed with this recommendation. IRS management will look into establishing such an advisory group with the intent of using it to validate and improve their estimation methods.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the Internal Revenue Service's (IRS) compliance efforts and strategies will enable it to achieve a 90 percent Voluntary Compliance Rate by 2010. To accomplish our objective, we:

I. Evaluated voluntary compliance and the tax gap to establish the parameters and premises of the challenge to achieve a 90 percent Voluntary Compliance Rate by 2010.

   A. Determined the IRS' meanings for Voluntary Compliance Rate and tax gap.

   B. Determined and analyzed the relationships between specific tax gap components and their impact on the gross and net tax gaps and assessed the reliability of the IRS' Voluntary Compliance Rate and tax gap estimates.

   C. Determined the potential effect of the National Research Program on improving voluntary compliance.

   D. Reviewed IRS and other historical information to determine the continuing challenges to improving voluntary compliance.

II. Determined whether the IRS developed and communicated a viable strategy for improving voluntary compliance and reducing the gross tax gap.

   A. Surveyed IRS compliance function executives and managers to determine their knowledge and opinions about the tax gap, the IRS' strategic planning, and the IRS' compliance efforts and to solicit their ideas for ways to reduce the tax gap and improve voluntary compliance.

Appendix II

Major Contributors to This Report

Philip Shropshire, Acting Director, Inspections and Evaluations
Preston Benoit, Audit Manager
Cynthia Dozier, Senior Auditor
Richard Hayes, Senior Auditor
Theodore Lierl, Senior Auditor
Larry Madsen, Senior Auditor
Bill Russell, Senior Auditor
Karen Stafford, Senior Auditor
Robert Weiss, Senior Auditor

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaisons:
- Director, Office of Research, Analysis, and Statistics RAS
- Commissioner, Small Business/Self-Employed Division SE:S

Appendix IV

Survey Results

This appendix presents detailed information on the results of a survey of 1,033 Internal Revenue Service (IRS) managers conducted to solicit the views of managers who work closely with the most significant components of the IRS tax gap. Of the 1,033 managers, 838 identified themselves as first-line managers, 175 as second-line managers or above, and 20 as executives. Counting the 1,033 managers by IRS operating divisions, 249 were from the Large and Mid-Size Business Division and 784 were from the Small Business/Self-Employed Division. Counting the 1,033 managers by IRS function, 642 were involved with the Examination function, 288 were involved with the Collection function, and 103 listed their function as "other."

	Agree or Tend to Agree	Disagree or Tend to Disagree	Don't Know
The current level of voluntary compliance is a major problem facing tax administration.	983	50	
Current compliance efforts are having an effect on increasing the Voluntary Compliance Rate (VCR).	707	326	
I am confident that changes can be made to significantly improve the VCR.	800	233	
IRS procedural changes could significantly improve the VCR.	759	274	
IRS regulatory changes could significantly improve the VCR.	856	177	
Tax law changes could significantly improve the VCR.	878	155	
The IRS should have an accurate measure and/or estimate of the VCR.	995	38	
The National Research Program (NRP) will provide an accurate estimate of the VCR.	600	433	
The IRS successfully measures the effect of compliance programs on voluntary compliance.	454	579	
The IRS has sufficient data to determine the major reasons for noncompliance.	704	329	
The IRS accurately measures the items most important to achieving its mission.	523	510	
The IRS mission statement should include the concept of the VCR.	623	410	
The VCR is important when developing IRS compliance strategies and programs.	979	54	
The IRS should develop methods other than the NRP to measure the VCR.	903	130	
The IRS needs to fully understand the reasons for noncompliance.	958	75	
IRS research study results are used in my function to direct efforts at increasing the VCR.	641	392	
There are research areas/topics not ongoing or planned that would better identify noncompliance.	737	296	
The strategic planning process enables the IRS to achieve its mission.	614	262	157
The IRS Strategic Plan for 2005-2009 provides the means and strategies for the IRS to increase voluntary compliance.	497	302	234
The Strategic Plan provides a clear roadmap for IRS operations for the 5-year period.	595	215	223
Elements of the Strategic Plan are included in my performance standards.	772	73	188
I am knowledgeable about the goals and objectives of the Strategic Plan.	836	197	
My work decisions are driven by the goals and objectives in the Strategic Plan.	811	222	
My input was requested during the strategic planning process.	287	746	
I received a copy of the IRS Strategic Plan for 2005-2009.	804	229	
The Strategic Plan was discussed with me in manager's meetings.	721	312	

From my experience and observations, the top 5 reasons for noncompliance, in the order of frequency, are: (please select 5 reasons from the list of 13 common reasons given for noncompliance).						
	Percent of Respondents					
Importance Ranking:	1	2	3	4	5	Not One of the Top 5 Reasons
Negligence - Willingness to chance some underreporting	23%	17%	12%	9%	7%	33%
Inability to pay causes taxpayer to not file, underreport, or overstate deductions or credits	20%	10%	8%	10%	10%	42%
Tax law complexity - aware of requirement, but misapplies to tax situation	10%	9%	11%	9%	10%	51%
Income Sheltering - primary motivation is to move assets/income from the ability of courts to locate for liability purposes	9%	10%	11%	9%	7%	55%
Fraud - intention to evade	9%	9%	7%	5%	8%	63%
Form of protest - conscious willingness to not comply because of disagreement over government policies or actions such as war, social programs, or similar	6%	6%	6%	7%	9%	66%
Perception of unfairness of tax laws - taxpayer believes others do not pay fair share, so chooses to be noncompliant	5%	9%	8%	11%	11%	56%
Disagrees with the IRS position on laws and regulations - aware of all requirements, simply applies in a position contrary to IRS position	5%	5%	7%	8%	5%	70%
Reliance on practitioners - relied on others' advice without question	4%	8%	10%	8%	8%	62%
Fear of consequences - taxpayer aware of noncompliance but fears the consequences of becoming compliant	2%	4%	5%	6%	6%	77%
Ignorance of requirements - error or omission based on ignorance of law or regulation	2%	9%	6%	8%	8%	68%
Accounting errors - due to omissions, math errors, or lack of records	2%	3%	6%	5%	4%	80%
Illness or tragedy - sickness, disaster, or death of taxpayer or immediate family member	1%	2%	3%	5%	5%	83%

Details may not add to totals due to rounding.

In order of significance, with 1 being the most and 8 the least, please rank the effect of the following factors on the Voluntary Compliance Rate (use each number only once).								
	Percent of Respondents							
Importance Ranking:	1	2	3	4	5	6	7	8
Lack of IRS resources to properly enforce compliance	30%	22%	16%	11%	8%	6%	6%	3%
Intentional taxpayer underreporting	26%	17%	18%	12%	10%	8%	5%	4%
Complexity of the tax system	18%	16%	13%	17%	16%	11%	7%	4%
IRS compliance efforts	11%	15%	18%	19%	13%	11%	8%	3%
Lack of additional tax laws to help address compliance	6%	12%	11%	12%	10%	11%	13%	25%
Fairness of the tax system	5%	8%	12%	11%	18%	22%	16%	9%
Economy	3%	7%	8%	12%	14%	17%	21%	18%
IRS customer service	2%	3%	4%	8%	11%	14%	23%	35%

Details may not add to totals due to rounding.

Appendix V

Management's Response to the Draft Report

APR. 17. 2006 10:02AM RAS NO. 173 P. 2

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
APR 14 2006

APR 14 2006

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mark J. Mazur
Director, Office of Research, Analysis, and Statistics

SUBJECT: Draft Audit Report – Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections (Audit # 200530003)

This memorandum provides comments from the Internal Revenue Service (IRS) concerning the draft audit report on the IRS's tax gap estimates. The IRS appreciates the time and effort that auditors from the Office of the Treasury Inspector General for Tax Administration (TIGTA) devoted to understanding our tax gap estimation methodology. We appreciate TIGTA's endorsement of our basic approach by undertaking studies, for example the National Research Program (NRP) Individual Reporting Compliance Study and the ongoing reporting compliance study of S-Corporations. We intend to build on the foundation of these reporting compliance studies, but in an environment characterized by increasingly tight resource constraints, it is difficult to commit to a multi-year schedule for future studies. Instead, we intend to continue this process by conducting the most valuable and productive studies in the near future.

We are aware that the level of confidence in our tax gap estimates is paramount in maintaining our credibility and for using these estimates to direct resource allocation and audit selection. We intend to continuously improve our methodologies and to regularly collect high-quality data on reporting, filing, and payment compliance. We believe that building on our successes to date is the most effective way to develop support for future efforts in this area. We consider the insights offered by TIGTA and other oversight and stakeholder bodies as valuable inputs to help us improve our data collection and analytical procedures.

In summary, we welcome TIGTA's recommendations and appreciate the recognition that IRS was able to successfully design a methodology to produce high quality compliance measurements that is much less burdensome to taxpayers than previous efforts. We hope to build on our efforts in this area in future years and are confident that we can continue to count on TIGTA's support. If you have any questions, please contact me at (202) 874-0100.

Our comments related to the report's specific recommendations follow.

RECOMMENDATION 1
Continue to conduct NRP studies on a regular cycle for the major segments of the tax gap. To augment the direct measurement approach, the IRS should devise indirect measurement methods to assist in quantifying the tax gap.

CORRECTIVE ACTION
We generally agree with this recommendation. Consistent with resource constraints, we will conduct reporting compliance studies on a regular basis for the foreseeable future. Our goal is to cover all major taxes and taxpayer groups over a period of years. Initially, we will focus on the most valuable and productive studies, and will depend on the IRS Enforcement Committee to prioritize these efforts. As one step in estimating the tax gap, we use indirect methods as a check on our analytical work. We will continue to do so in the future and will explore the viability of incorporating indirect measurement methods, where these can improve the precision of the resulting estimates. However, this may require an improvement in the quality and reliability of indirect methods.

IMPLEMENTATION DATE
Ongoing.

RESPONSIBLE OFFICIAL
Director, Research, Analysis, and Statistics

CORRECTIVE ACTION MONITORING PLAN
This corrective action will be monitored as part of our quarterly Business Performance Review (BPR) process.

RECOMMENDATION 2
The Commissioner should consider establishing a tax gap advisory panel that includes tax and economic experts to identify ways to improve the methods to measure voluntary compliance.

CORRECTIVE ACTION
We agree with this recommendation. We will look into establishing such an advisory group with the intent of using it to validate and improve our estimation methods.

IMPLEMENTATION DATE
April 2007.

RESPONSIBLE OFFICIAL
Director, Research, Analysis, and Statistics

CORRECTIVE ACTION MONITORING PLAN
This corrective action will be monitored as part of our quarterly BPR process.