Tax Gap Estimates for Tax Years 2008–2010

Overview

This overview presents estimates of the tax gap for the Tax Year (TY) 2008–2010 timeframe. The tax gap and associated concepts are a particular way of defining and analyzing compliance and noncompliance and are based on tax year liability. The tax gap provides a rough gauge of the level of overall noncompliance and voluntary compliance given all the events that occurred during the relevant tax periods and the Internal Revenue Code (IRC) provisions in effect at the time. Tax gap estimates provide the Internal Revenue Service (IRS) with periodic appraisals about the nature and extent of noncompliance for use in formulating tax administration strategies. The word “tax” in the phrase “tax gap” is used broadly to encompass both tax and refundable and non-refundable tax credits. The IRS last issued tax gap estimates covering TY 2006.

Unlike prior tax gap estimates that pertain to a single tax year, these estimates reflect an estimated average compliance rate and associated average annual tax gap for the TY 2008–2010 timeframe. This approach was motivated by the decision to pool multiple years of compliance data from the annual individual income tax reporting compliance component of the National Research Program (NRP) to provide greater reliability of individual income tax underreporting gap estimates by sources of noncompliance.

The estimates were prepared by the IRS and are based on original research and analysis conducted or sponsored by the IRS. Estimating the tax gap is inherently challenging and requires assessing the merits of alternative methods, assumptions, and data sources. There is no single approach for estimating all the components of the tax gap. Each approach is subject to non-sampling error; the component estimates that are based on samples are further subject to sampling error. The uncertainty of the estimates is not readily captured by standard errors that typically accompany estimates based on sample data. For that reason, standard errors, confidence intervals, and statistical comparisons across years are not reported. More detailed information about the underlying approaches and assumptions can be found in forthcoming papers.

The gross tax gap is the amount of true tax liability that is not paid voluntarily and timely. The estimated gross tax gap is $458 billion. The net tax gap is the gross tax gap less tax that will be subsequently collected, either paid voluntarily or as the result of IRS administrative and enforcement activities; it is the portion of the gross tax gap that will not be paid. It is estimated that $52 billion of the gross tax gap will eventually be collected resulting in a net tax gap of $406 billion. The voluntary compliance rate (VCR) is a ratio measure of relative compliance and is defined as the amount of tax paid voluntarily and timely divided by total true tax, expressed as a percentage. The VCR corresponds to the gross tax gap. The estimated VCR is 81.7 percent. The net compliance rate (NCR) is a ratio measure corresponding to the net tax gap. The NCR is defined as the sum of “tax paid voluntarily and timely” and “enforced and other late payments” divided by “total true tax”, expressed as a percentage. The estimated NCR is 83.7 percent. (See Attachment 1, Tax Gap Map.)

Many factors contribute to differences over time in both the gross tax gap and the VCR. These include factors such as the overall level of economic activity, changes in the composition of economic activity with shifts toward those with higher or lower compliance rates, changes in tax law and administration, updated data and improved methodologies, and changes in underlying compliance behavior on the part of taxpayers and preparers. Since the tax gap typically moves with the economy, the December 2007 through June 2009 recession and the weak recovery that followed contributed to the gross tax gap remaining substantially unchanged from the previously released TY 2006 estimate. As reported in the IRS Data Book, gross collections were $2.52 trillion in Fiscal Year (FY) 2006 and increased to $2.69 trillion in FY 2007 and $2.75 trillion in FY 2008. They declined to $2.35 trillion in FY 2009 and remained at that level in FY 2010.

The new estimates suggest that compliance is substantially unchanged since last estimated for TY 2006. Although the TY 2008–2010 gross and net tax gap estimates ($458 billion, $406 billion) are 1.8 percent and 5.5 percent higher, respectively, than the previously released TY 2006 estimates ($450 billion, $385 billion), those increases are driven by improvements in the accuracy and comprehensiveness of the estimates through updates in methods and the inclusion of new tax gap components. Had the improvements not been made, the TY 2008–2010 tax gap estimates would have been slightly lower than the previous TY 2006 estimates. (See Attachment 2, Table 1.)

The estimated VCR (81.7%) is lower than the previous TY 2006 estimate (83.1%). About half of the 1.4 percentage point difference is attributable to the updated methods. Given the challenges in estimating the tax gap and given the many factors that contribute to differences over time, the remaining 0.7 percentage point difference from the TY 2006 estimate does not support concluding that noncompliance has increased. (See Attachment 2, Table 1.)

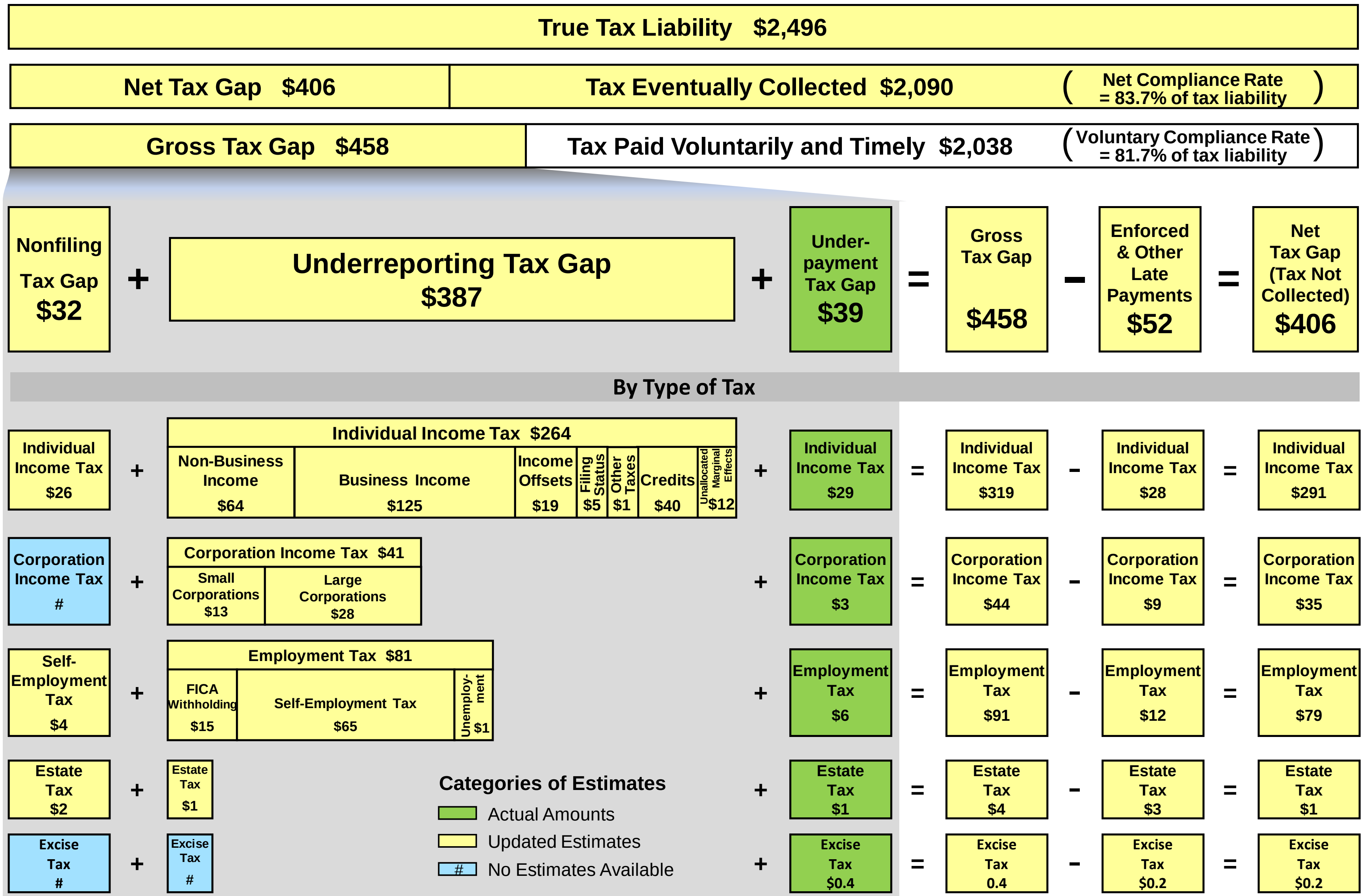
The gross tax gap is composed of three components: nonfiling, underreporting, and underpayment. The estimated gross tax gaps for these components are $32 billion, $387 billion, and $39 billion respectively. The gross tax gap estimates can also be grouped by type of tax. The estimated gross tax gap for individual income tax is $319 billion, for corporation income tax is $44 billion, for employment tax is $91 billion, and for estate and excise tax combined is $4 billion. (See Attachment 2, Table 2.)

Because of improvements in methods and data, estimates of the net tax gap by type of tax are available for the first time. The estimated net tax gap for individual income tax is $291 billion, for corporation income tax is $35 billion, for employment tax is $79 billion, and for estate and excise tax combined is $1 billion. (See Attachment 1, Tax Gap Map.)

Findings from earlier tax gap analyses that compliance is higher when amounts are subject to information reporting and even higher when also subject to withholding, continue to hold. The extent of coverage by information reporting and/or withholding is called “visibility” because incomes that are reported to the IRS are more “visible” to both the IRS and taxpayers. Misreporting of income amounts subject to substantial information reporting and withholding is 1 percent; of income amounts subject to substantial information reporting but not withholding, it is 7 percent; and of income amounts subject to little or no information reporting, such as nonfarm proprietor income, it is 63 percent. (See Attachment 3, Figure 1.)

Tax Gap Map

Tax Year 2008-2010 Annual Average ($ Billions)



Internal Revenue Service, April 2016

Detail may not add to total due to rounding . Not to scale.

Table 1. Comparison of Tax Gap Estimates for Tax Years 2006 and 2008-2010

[Money amounts are in billions of dollars]

Tax Gap Component	TY2006	TY2008-2010 [1]	Total Change	Change Due To: Updated Methods[2]	Change Due To: Other Factors[3]
Estimated Total True Liability	2,660	2,496	-164	14	-178
Gross Tax Gap	450	458	8	22	-14
Overall Voluntary Compliance Rate	83.1%	81.7%	-1.4%	-0.8%	-0.7%
Enforced and Other Late Payments	65	52	-13	-12	-1
Net Tax Gap [4]	385	406	21	34	-13
Overall Net Compliance Rate	85.5%	83.7%	-1.8%	-1.2%	-0.6%

[1] The estimates are the annual averages for the Tax Year 2008-2010 timeframe.

[2] Difference between the TY2006 and TY2008-2010 tax gap estimates accounted for by updated methods and new tax gap components.

[3] Difference between the TY2006 and TY2008-2010 tax gap estimates accounted for by changes in economic activity, changes in compliance behavior and statistical variability.

[4] The net tax gap is the gross tax gap reduced by the amount of enforced and other late payments that will eventually be collected.

Detail may not add to total due to rounding.

Table 2.Tax Year 2008–2010[1] Tax Gap Estimates

[Money amounts are in billions of dollars]

Tax Gap Component	TY 2008-2010[1]	Share of Gross Tax Gap
Estimated Total True Liability	**2,496**	
Gross Tax Gap	**458**	**100%**
Overall Voluntary Compliance Rate	**81.7%**	
Net Tax Gap	**406**	
Overall Net Compliance Rate	**83.7%**	
Nonfiling Gap	**32**	**7%**
Individual Income Tax	26	6%
Self-Employment Tax	4	1%
Estate Tax	2	[2]
Underreporting Gap	**387**	**85%**
Individual Income Tax	**264**	**58%**
Non-Business Income	64	14%
Business Income	125	27%
Income Offsets (Adjustments, Deductions, Exemptions)	19	4%
Filing Status	5	1%
Other Taxes	1	[2]
Unallocated Marginal Effects	12	3%
Credits	40	9%
Corporation Income Tax	**41**	**9%**
Small Corporations (assets under $10M)	13	3%
Large Corporations (assets of $10M or more)	28	6%
Employment Tax	**81**	**18%**
Self-Employment Tax	65	14%
FICA and Unemployment Tax	16	3%
Estate Tax	1	[2]
Underpayment Gap	**39**	**9%**
Individual Income Tax	29	6%
Corporation Income Tax	3	1%
Employment Tax	6	1%
Estate Tax	1	[2]
Excise Tax	[3]	[2]

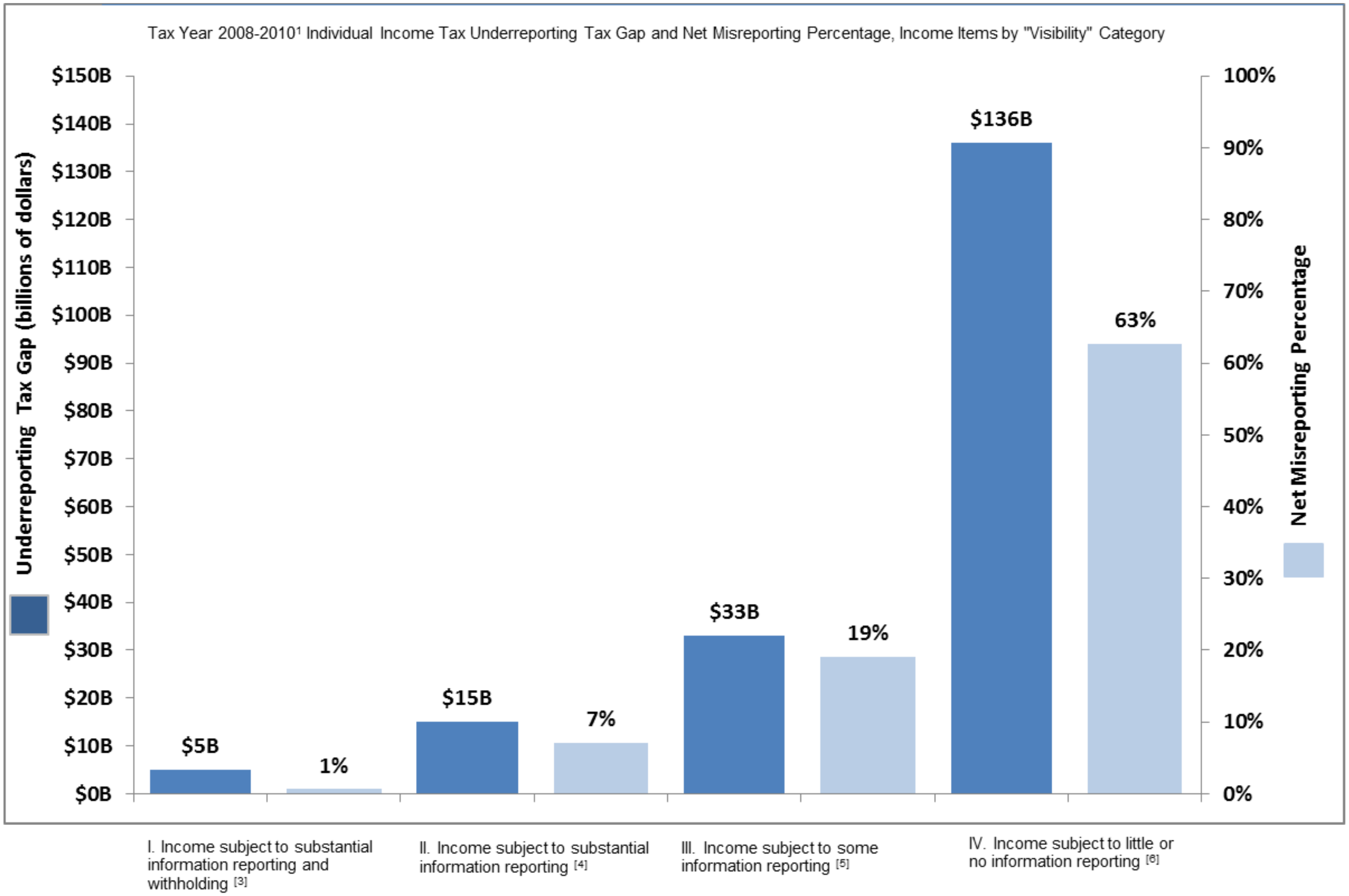
Detail may not add to total due to rounding.

[1] The estimates are the annual averages for the Tax Year 2008-2010 timeframe.

[2] Less than 0.5 percent.

[3] Less than $0.5 billion.

Figure 1. Effect of Information Reporting on Individual Income Tax Reporting Compliance, Tax Years 2008–2010



[1] The TY 2008 -- 2010 estimate is the annual average for the Tax Year 2008, 2009, and 2010 timeframe.
[2] The Net Misreporting Percentage is the net misreported amount as a ratio of the sum of the absolute values of the amounts that should have been reported expressed as a percentage. For the items included in this chart, the net misreported amount is understatements of income less overstatements of income. On net, income is understated.
[3] Includes wages & salaries.
[4] Includes pensions & annuities, unemployment compensation, dividend income, interest income, taxable Social Security benefits.
[5] Includes partnership/S corp. income, capital gains, alimony income. Prior definition also included deductions and exemptions.
[6] Includes nonfarm proprietor income, other income, rents and royalties, farm income, Form 4797 income. Prior definition also included adjustments to income .

Internal Revenue Service, April 2016