

# IRS Compliance Research and Tax Gap Estimates

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## Defining the Tax Gap

- The tax gap is the difference between the tax imposed by the Tax Code and what taxpayers actually pay on a timely basis
- The tax gap, in principle, covers all taxes and all taxpayers

## Tax Gap vs. Non-Observed Economy

- **Illegal source income not included in tax gap estimates**
  - Difficult to measure and government would prefer to either eliminate these activities or move them into the legal sector
- **Tax gap includes items unique to tax law**
  - Overstated dependent exemptions/credits
  - Incorrect filing status
- **Tax gap does not include some legal tax avoidance items**
  - Do-it-yourself work; neighbor help; some employment-related fringe benefits

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## Three Components of the Tax Gap

- **Non-filing gap** – tax not paid on time by taxpayers who filed late or not at all
- **Under-reporting gap** – mis-statement of tax on timely-filed returns (e.g., understated income or over-stated deductions or credits)
- **Underpayment gap** – failure to pay on time all of the reported tax liability

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## Estimating the Non-Filing Gap

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

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## Estimating the Under-Reporting Gap

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

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## NRP TY 01 Reporting Compliance Study

- First NRP reporting compliance study
- Sample was 46,000 individual income tax returns
- 3,000 returns accepted as filed
- 2,000 correspondence exams
- 41,000 face-to-face exams
- Exams proceeded over 2 years  
(October 2002 through September 2004)

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## Measuring the Under-Payment Gap

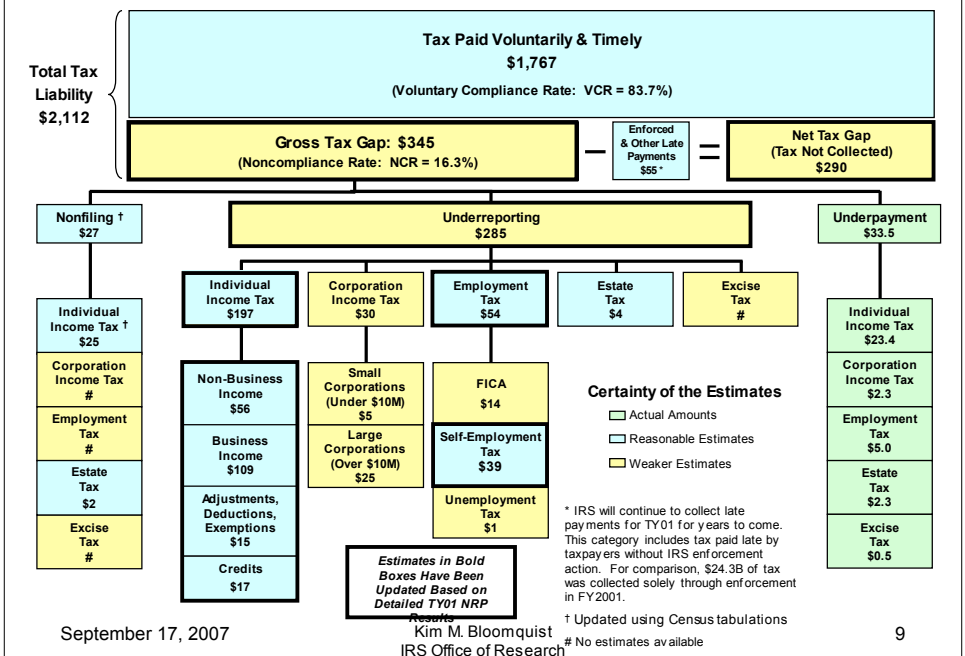
- Payment compliance measures are derived from IRS accounting data
- These cover all types of taxes and all types of taxpayers
- These can be computed for any tax period

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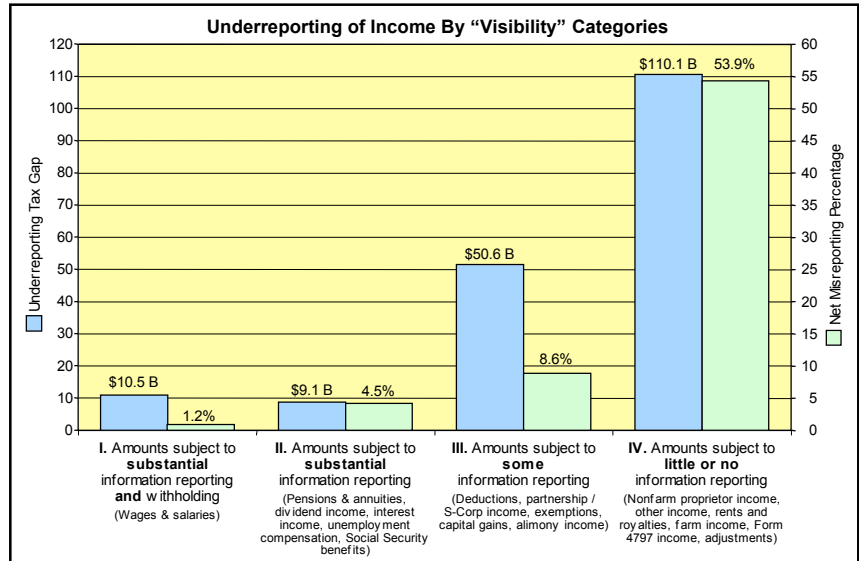
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### TAX GAP MAP for Tax Year 2001 (in \$ Billions)



### Tax Year 2001 Individual Income Tax Underreporting Gap



Based on updated estimates derived from the National Research Program underreporting compliance study. 8 February 2006  
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## Impact of Tax Gap Study on Tax Administration and Tax Policy

- Renewed interest by Congress on finding ways to reduce the tax gap
- However, in the past Congress has shown reluctance to significantly increase IRS funding for enforcement
- Therefore, need to find ways to increase the visibility of different sources of income

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## Selected Exam Coverage Rates for Individuals – FY 2006

Estate Tax with Gross Estate > \$5M	23.5%
Individual Business with Schedule C	3.1%
Individual with EITC	2.3%
Individual High Income (> \$100K)	1.7%
Individual Non-business	0.8%
Individual Business with Schedule F	0.5%

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## Administration's FY08 Proposals

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

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## Administration's FY08 Proposals

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

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## Administration's FY08 Proposals

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

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## Legislative Proposals

- Solicited from:
  - Employees
  - Tax professionals
  - State tax officials
- More than 1,200 suggestions received

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## Next Steps

- Continued educational efforts
- Continued enforcement efforts
- S-Corporation NRP study in process
- Corporation tax gap update
- Methodology to provide annual updates for individual tax gap

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## S-Corporation Study

- Second NRP reporting compliance study
- Choice of study reflects growth in S-Corporation filing
- Sample is 5,000 returns covering TY03 & TY04
- Study is underway and should be complete by June 2008
- Data will help update individual tax gap figures and identify compliance issues

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## Corporation Tax Gap

- Revised estimates to rely on operational audit data
- Some aspects unique to corporation tax gap estimation
  - Large differences in exam coverage levels
  - Concentration of audit results among corporations with assets > \$250 Million
  - How to treat net operating losses

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## Form 1120 Corporation Exam Coverage Rates– CY 2006

Corporations with Assets > \$250M	45.4%
Corporations with Assets > \$10M	21.2%
Corporations with Assets > \$5M	14.3%
Corporations with Assets > \$1M	5.2%
Corporations with Assets > \$0.25M	2.7%
All Corporations	1.4%

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## Form 1120 Percentage AIMS Audit Results: CY 2006

Asset Category	Percent of Total Recommended Amount
Corporations with Assets > \$250M	57.0%
Corporations with Assets > \$10M	91.2%
Corporations with Assets > \$5M	93.7%
Corporations with Assets > \$1M	95.9%
Corporations with Assets > \$0.25M	99.1%
All Corporations	100.0%

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## Annual Updates

- IRS has a goal of achieving a voluntary compliance rate of 86 percent by 2006, so annual tax gap estimates needed
- Individual NRP will change to smaller annual samples (13,000 cases) for the indefinite future
- Data will provide information on compliance behavior for new groups of taxpayers
- But, delivery of TY2006 individual NRP data due in 2009. Need to develop an alternative methodology to “bridge” from 2001 to 2006 and perhaps beyond until 2008 NRP are available in 2011.

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## For More Information

- Joint IRS/Treasury report on Reducing the Federal Tax Gap, August 2, 2007
  - [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf)
- Forthcoming IRS report on the tax gap estimation methodology including line item NRP estimates of individual taxpayer reporting compliance

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