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# IRS Tax Gap Studies: 1979, 1983, and 1988

- 1979 Study -- first attempt to estimate tax gap; focused on individual income

- 1983 Study -- more thorough; also included estimates for corporations and overstated deductions

- 1988 Study -- further refined the 1983 study

# GAO What is the Tax Gap ?

IRS defines the "tax gap" as the difference between the amount of income taxes voluntarily paid by individuals and businesses and the amount of income taxes that are owed.

As arranged with the Subcommittee, we did not obtain official comments on this briefing report from IRS. However, IRS officials were given an opportunity to comment on a draft and they suggested some clarifications that we considered in finalizing the briefing report. We are sending copies of this briefing report to the Commissioner of Internal Revenue and other interested parties and will make copies available to others upon request.

If you have any questions, please call Mr. Gerald Stankosky, on 272-7904.

Sincerely yours,

Jennie S. Stathis

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Associate Director

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GAO

Briefing Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

March 1988

# TAX ADMINISTRATION

# IRS' Tax Gap Studies

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Washington, D.C. 20548

General Government Division

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March 25, 1988

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

This briefing report responds to your February 8, 1988, request for a comparison of the various Internal Revenue Service (IRS) tax gap studies. The briefing report provides a series of charts and accompanying narrative to describe

-- IRS' definition of the tax gap;

-- IRS' 1979, 1983 and 1988 studies in which IRS estimated the size of the tax gap;

-- changes in the methodology and assumptions that IRS used in the 1988 tax gap study;

-- components of the tax gap and dollar estimates for each component in the 1988 tax gap study; and

-- trends in the size of the tax gap.

Our objective was to provide descriptive information in these areas. IRS has not made public the complete details of its assumptions, methodologies, and data used in deriving the latest estimates. As a result, our work consisted of interviewing officials from IRS' Research Division who are responsible for the 1988 study and comparing the 1988 study to IRS' 1979 and 1983 studies.

In sum, our analysis showed that IRS' 1988 study had major changes compared to the 1983 study. The 1988 study (1) excluded tax estimates for illegal source income and remittance problems, (2) changed the method for computing taxes on unreported income, and (3) assumed that compliance rates will remain constant. Our analysis of the 1988 study also showed the following trends: (1) the tax gap estimates were much higher in 1987 than in 1973, (2) the tax gap decreased from 1986 to 1987, and (3) the tax gap will continue to increase from 1987 through 1992. (See app.)

# CONTENTS



## ABBREVIATIONS

| | |
|---|---|
| IRS | Internal Revenue Service |
| SSA | Social Security Administration |
| SSN | Social Security Number |
| TCMP | Taxpayer Compliance Measurement Program |

## WHAT IS THE TAX GAP?

The Internal Revenue Service (IRS) defines the "tax gap" as the difference between the amount of income taxes voluntarily paid by individuals and businesses and the amount of income taxes that are owed. IRS' estimate of the size of the tax gap is affected by three key concepts.

First, the tax gap definition specifically focuses on taxes not voluntarily paid. Thus, all the amounts IRS subsequently collects through its various enforcement programs would be part of the tax gap, because they are taxes that have not been "voluntarily" paid. Therefore, IRS is already collecting a portion of what it considers the overall tax gap. If the definition recognized the amounts collected through enforcement programs, the tax gap would be lower.

Second, IRS' tax gap estimates are on the basis of taxes recommended rather than those that would actually be assessed. On an assessed basis, the tax gap would be lower.

Third, IRS makes little allowance for the collectibility of taxes that are owed but have not been paid. In its latest study, IRS recognized that it is difficult to tax income from illegal sources and subsequently to collect these taxes. However, for the most part, IRS has not factored in collectibility in estimating the other components of the tax gap. For example, IRS does not take into account the collectibility of taxes owed by businesses that have closed due to bankruptcy.

## IRS STUDIES OF THE TAX GAP: 1979, 1983, AND 1988

IRS' initial attempt to estimate taxes owed but not paid was in its 1979 study.[1] However, this study did not attempt to focus on the entire tax gap. Instead, the study limited its estimates to unreported income by individuals, such as wages and dividends, and income from illegal activities. It did not attempt to address the corporate side or to estimate overstated deductions and other incorrect adjustments to income.

IRS' 1983 study[2] was wider in scope than the 1979 study in that it included estimates of unreported income and overstated deductions for individuals and corporations. For individuals who file annual returns, most of the estimates IRS used were derived from its Taxpayer Compliance Measurement Program (TCMP). In the TCMP, IRS subjects representative samples of returns to a thorough examination and keeps detailed records on the degree of compliance it finds with each of the items on the returns. The TCMP estimates of individual filers' noncompliance used in this study were from 1976 and earlier. In addition, IRS estimated the tax gap for individuals who did not file returns, but who should have filed. For the corporation tax gap, IRS derived its estimates for small corporations from TCMP examinations. This TCMP is similar to the program for individual filers. For large corporations, IRS used actual examination results, since its examination coverage of these entities is extensive. IRS also estimated the illegal source tax gap from illegal gambling, drug trafficking, and prostitution.

IRS' 1988 study[3] refined the methodology used in the 1983 study in several areas, such as unreported income. In some cases IRS used more recent data to estimate the various parts of the tax gap and in other cases used the same data as in the 1983 study. The major changes IRS made in the 1988 study in comparison to the 1983 study are further described in the following section.

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[1] Estimates of Income Unreported on Individual Income Tax Returns, Internal Revenue Service Publication 1104, September, 1979.

[2] Income Tax Compliance Research, Estimates for 1973-1981, Internal Revenue Service, July 1983.

[3] Income Tax Compliance Research: Gross Tax Gap Estimates for 1973-1992, Internal Revenue Service Publication 7285, March 1988.

## CHANGES IN THE 1988 STUDY

### Illegal income

In the 1983 study, IRS estimated the illegal source tax gap to be $9.0 billion for 1981.[4] The Chief of IRS' Compliance Analysis Group, who was responsible for the 1988 study, told us that the illegal source tax gap was excluded from the current study because of difficulties in agreeing on the levels of, and methods for estimating, illegal activities.

### Remittance problems

IRS excluded estimates for the tax gap due to certain remittance problems, such as employers who underdeposit employee income tax withheld from salaries. In the 1983 study, IRS estimated these remittance problems to be responsible for a $6.8 billion tax gap in 1981. IRS did not include an estimate in the current study primarily because IRS officials decided that estimates of remittance problems in previous studies were not sufficiently accurate. IRS hopes to correct this situation and plans to issue estimates of the remittance gap later.

### How tax on unreported income was computed

The major methodological change in the 1988 study that affected the size of the tax gap concerned how the taxes were computed on estimated unreported income. The 1983 study did not take into account the fact that some individuals might have more than one type of unreported income--e.g., unreported wages, interest, capital gains, etc.--and others might have no unreported income from any source. To account for these situations, IRS refined its analysis of the TCMP examination results used in the 1983 study to determine what types of individuals (income size, family size, etc.) had what types of unreported income. The Chief of the Compliance Analysis Group told us that this analysis led to a better estimate of the marginal tax rates that should be applied to unreported income and lowered the tax gap estimate for unreported income.

### Change in assumptions

The major change in overall assumptions involves the trend of compliance in future years. In the 1983 study, IRS assumed, for purposes of projecting its estimates to future years, that overall voluntary compliance would decline. In the 1988 study, IRS assumes that there will be no changes in the level of compliance across types of returns or types of income.

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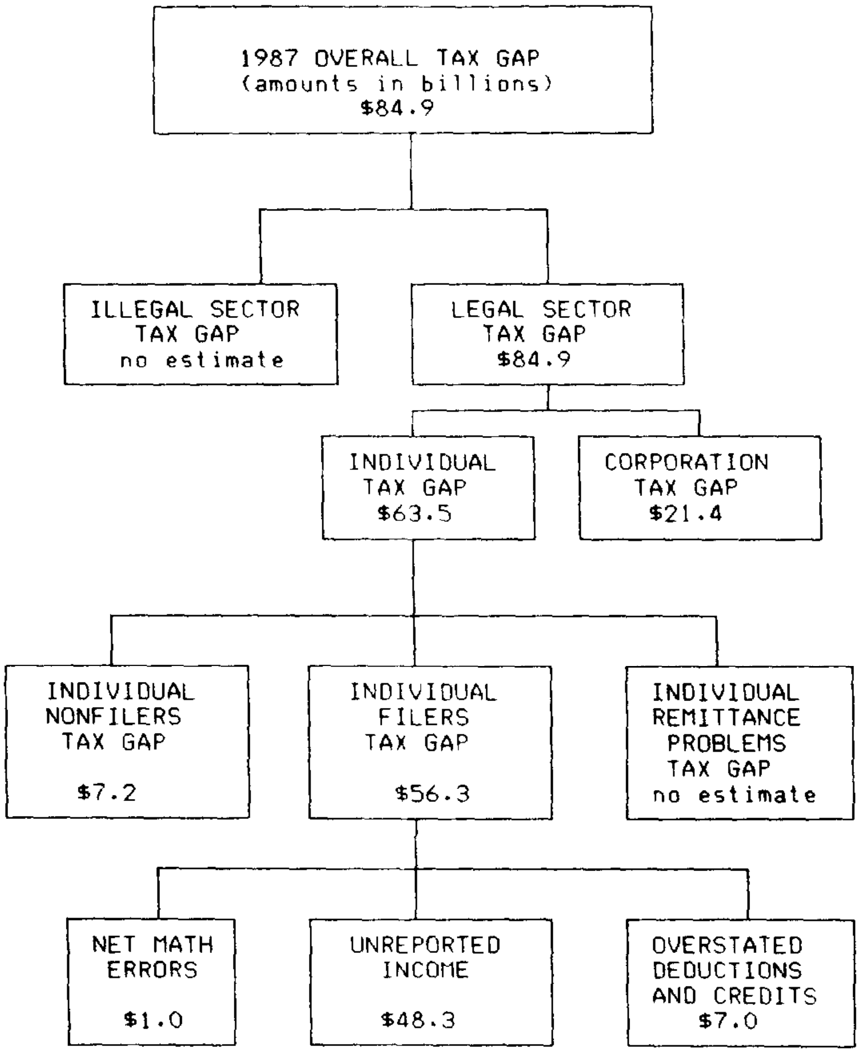
[4]The illegal source tax gap includes taxes owed but not voluntarily paid on illegal gambling, drug trafficking and prostitution.

## COMPONENTS OF THE TAX GAP

The overall tax gap is divided into two major components: the tax gap from legal source income and the tax gap from illegal source income. The legal source tax gap includes the tax gap from individuals and the tax gap from corporations. The illegal source tax gap consists of taxes owed but not voluntarily paid on such illegal activities as prostitution and drug trafficking. The following chart shows the various components of the tax gap and the corresponding amounts as reflected in IRS' latest estimates.

Figure I.1: Components of the Tax Gap and Estimated Amounts by Component for 1987



COMPONENTS OF THE TAX GAP: INDIVIDUALS

The individual nonfilers[5] tax gap estimate was $7.2 billion in 1987. To estimate this gap, income and demographic data obtained from individuals in 1972 and 1977 nationwide surveys were matched to Social Security Administration (SSA) and IRS records, primarily using social security numbers (SSNs) provided by the individuals surveyed. Earnings reported by the individuals and earnings in SSA records were reconciled, and IRS then used the earnings estimates to compute taxes owed but not paid on those earnings. The surveys were limited by the number of valid SSNs provided by individuals. About 92 percent of the SSNs in the 1972 survey and 66 percent in the 1977 survey were valid. Another potential limiting factor in the nonfiler estimates is that individuals who are not filing tax returns may be reluctant to provide accurate income information to an interviewer.

The tax gap estimate for tax remittance problems is not included in IRS' 1988 study. As discussed previously, IRS plans to issue a remittance tax gap estimate later.

The tax gap estimate for individual filers represents the amount of taxes owed but not voluntarily paid by individuals who file annual returns. This part includes estimates of net math errors, overstated deductions and credits, and unreported income, which at $48.3 billion in 1987 was the largest single part of the overall tax gap. Most, but not all, of the estimates that make up the individual filers tax gap are from TCMP examinations of individual returns. IRS believes that TCMP estimates are more accurate in disclosing overstated deductions than in measuring unreported income. This is because to disallow deductions, the examiner need only note the lack of adequate proof for the offsets to income. To assess tax on unreported income, however, the examiner must develop evidence that the income has been received. TCMP estimates of unreported income, therefore, may be understated. IRS has attempted to compensate for this potential understatement, as described on page 15. Figure I.2 illustrates the various types of unreported income.

[5]Throughout this briefing report, the term "nonfilers" refers to individuals who should file returns but do not. Nonfilers who are not required to file returns are not included in this group.

COMPONENTS OF THE TAX GAP: UNREPORTED INCOME

At $48.3 billion in 1987, unreported income is the largest single component of the overall tax gap. The largest portions of unreported income are from sole proprietorships, informal supplier income, and capital gains.

As stated previously, because discovering unreported income during the examination process is more difficult than disallowing overstated deductions, IRS has attempted to compensate for undiscovered unreported income in its tax gap estimates. Thus, the estimates of unreported income are derived from raw estimates of unreported income multiplied by 3.28. IRS calculated this multiplier from an analysis of 1976 TCMP data, which showed that without access to information returns, the examinations only discovered about $1 for every $3.28 in unreported income. In IRS' 1983 study, a 3.50 multiplier was applied, with some adjustments, to all categories of unreported income. The 1988 study made several refinements to both the multiplier and its application to the various types of unreported income. A second methodological change, discussed previously, was in the method of computing the tax on the unreported income. In order to more precisely calculate the tax rates that should be used, IRS further analyzed the same 1976 TCMP data to determine what individuals had what types of unreported income. Finally, the 1988 study made several other refinements to better reflect the interaction of unreported income with other tax form items, such as tax credits. Many tax credits are limited to certain percentages of adjusted gross income. If adjusted gross income rises because of the discovery of unreported income, the amount of specific tax credits that the individual can take may correspondingly change, thereby affecting the amount of taxes owed on the unreported income. The analysis in the 1988 study adjusts for such changes.

Informal supplier income is one part of unreported income that is not estimated from TCMP data. Instead, it is based on survey results for a 1-year period covering parts of 1984 and 1985. In this survey, individuals were asked specific questions about the extent to which they purchased various items or services from street vendors or others on a cash basis. From this survey information, IRS attempted to estimate the amount of unreported informal supplier income, making various assumptions about the applicable tax rates, deductions, etc. of the individuals receiving this income.

## COMPONENTS OF THE TAX GAP: CORPORATIONS

The $21.4 billion 1987 corporation tax gap consists primarily of an estimate of the taxes not paid but owed by corporations. This total consists of an estimated $5.2 billion tax gap for small corporations (those with assets under $10 million), and an estimated $15.9 billion tax gap for medium and large corporations (those with assets over $10 million). In addition, the corporation gap includes an estimated $0.3 billion for taxes owed but not paid by exempt organizations on business income unrelated to their exempt purposes and taxes owed but not paid by fiduciaries.

The corporation tax gap estimate is derived from three sources. First, for small corporations, IRS used 1981 small corporation TCMP data. Second, for medium-size corporations, IRS calculated the gap by estimating how much tax revenue is generated if IRS examined all these corporations' tax returns. Finally, for large corporations, because IRS examines a high percentage of large corporations, examination results were used in total as estimates of the tax gap for these corporations.

The 1988 study methodology differed from that of the 1983 study in that the multiplier (3.28) for unreported income was applied just for unreported income of small corporations to arrive at the 1988 estimate. The multiplier was not used for corporations in the 1983 study.

## COMPONENTS OF THE TAX GAP: ILLEGAL SOURCE

As stated previously, IRS makes no estimates of the illegal source income tax gap for the 1988 study. In its 1983 study, IRS estimated the size of the illegal source tax gap to be $9.0 billion, based on 1981 tax year data. In estimating this tax gap, IRS included unreported income from drug trafficking, illegal gambling, and prostitution. It should be noted that income from other illegal activities, such as theft, was not included in this estimate.

The 1983 estimate for drug trafficking included income from marijuana, heroin, and cocaine. IRS prepared its estimates of income from the sale of illegal drugs by using data from the Drug Enforcement Administration and others. IRS adjusted its estimates for, among other things, payments to foreigners; certain legal business expenses that might have been incurred; and the fact that some illegal income is reported, in disguised form, on individual tax returns. The estimate for illegal gambling activities relied on data collected in a 1974 University of Michigan survey of American gambling. To estimate the extent of unreported income from prostitution, IRS relied in part on statistics of arrests for prostitution.

TRENDS IN THE TAX GAP

IRS' 1988 study of the tax gap shows three major trends: (1) the tax gap estimates were much higher in 1987 than in 1973, (2) the tax gap decreased from 1986 to 1987, and (3) the tax gap will continue to increase through 1992.

IRS' 1988 study shows that the tax gap was about three times higher in 1987 than in 1973. IRS estimated that the tax gap for 1973 was $28.4 billion compared to $84.9 billion for 1987. Also, the individual tax gap was $19.7 billion for 1973 compared to $63.5 billion for 1987, and the corporation tax gaps for these years were $8.8 billion and $21.4 billion, respectively. IRS attributes this growth in the tax gap largely to the increase of income tax liabilities through real expansion of the economy and through inflation. Using the gross national product implicit price deflator, the 1973 tax gap would be about $66 billion in 1986. Although IRS' estimates show that the tax gap is much higher in 1987 than in 1973, the 1987 tax gap is lower than IRS had previously projected. A prior IRS study projected a $115.2 billion gap for 1987, whereas the 1988 IRS study now estimates the gap to be $84.9 billion. IRS partially attributes this decrease to the changes in the data, methodology, and assumptions that IRS used in the 1988 study.

From 1986 to 1987, IRS estimates that the tax gap dropped from $95.0 billion to $84.9 billion because of changes in the economy and the effects of the Tax Reform Act of 1986 on individuals. The individual tax gap dropped from $79.3 billion to $63.5 billion while the corporation gap rose from $15.6 billion to $21.4 billion. For individuals, tax reform lowered marginal tax rates and repealed or limited many deductions from taxable income. As a result, the likelihood of miscomputing tax liability or intentionally understating income or overstating deductions lessened. However, IRS believes tax reform had the opposite effect on the corporate tax gap. Tax law changes, like repealing the investment tax credit, in combination with growing corporate profits, resulted in increased corporate tax liabilities that, in turn, created increased opportunities for the tax gap to grow.

Nonetheless, IRS' 1988 study projects continued growth in the tax gap. While the study did not provide reasons for the growth, IRS projects the individual gap will be $82.6 billion and the corporation gap will be $31.1 billion by 1992, resulting in a tax gap of $113.7 billion for 1992.

Figure I.3 and table I.1 more fully depict the trends in the tax gap from 1973 to 1992.

Table I.1: IRS' Tax Gap Estimates: The 1988 Study[1]

(Numbers in billions)

| | 1973 | 1976 | 1979 | 1982 | 1985 | 1986 | 1987 | 1988 | 1992 |
|---|---|---|---|---|---|---|---|---|---|
| Legal Sector Tax Gap -- total 2 | $28.4 | $40.7 | $61.7 | $62.6 | $87.8 | $95.0 | $84.9 | $87.1 | $113.7 |
| Individual tax gap | $19.7 | $29.6 | $46.8 | $51.9 | $73.3 | $79.3 | $63.5 | $64.3 | $82.6 |
| Individual filers tax gap | $17.9 | $26.8 | $42.3 | $46.2 | $65.5 | $71.2 | $56.3 | $56.9 | $72.4 |
| Unreported income | $15.4 | $24.6 | $36.4 | $38.1 | $54.6 | $60.0 | $48.3 | $45.5 | $62.8 |
| Overstated deductions and credits | $2.3 | $1.7 | $5.3 | $7.4 | $9.8 | $10.2 | $6.9 | $7.2 | $8.1 |
| Net math errors | $0.2 | $0.2 | $0.5 | $0.7 | $1.0 | $1.0 | $1.0 | $1.1 | $1.5 |
| Individual nonfilers tax gap | $1.8 | $2.8 | $4.5 | $5.7 | $7.8 | $8.1 | $7.2 | $7.3 | $10.2 |
| Individual remittance gap 3 | | | | | | | | | |
| Corporation tax gap 4 | $8.8 | $11.1 | $15.0 | $10.7 | $14.4 | $15.6 | $21.4 | $22.8 | $31.1 |
| Illegal sector tax gap 3 | | | | | | | | | |

1 Individual tax gap and corporation tax gap numbers may not add to legal sector tax gap total due to rounding errors.

2 Estimates differ from those reflected in earlier IRS studies of the tax gap due to (1) use of new data, (2) changes in methodology and assumptions, and (3) changes as a result of the Tax Reform Act of 1986.

3 These items are not included in IRS' 1988 tax gap study. They were included in the 1983 study.

4 The corporation tax gap includes estimated tax gaps for corporate nonfilers, exempt organization unrelated business income and fiduciaries.



APPENDIX

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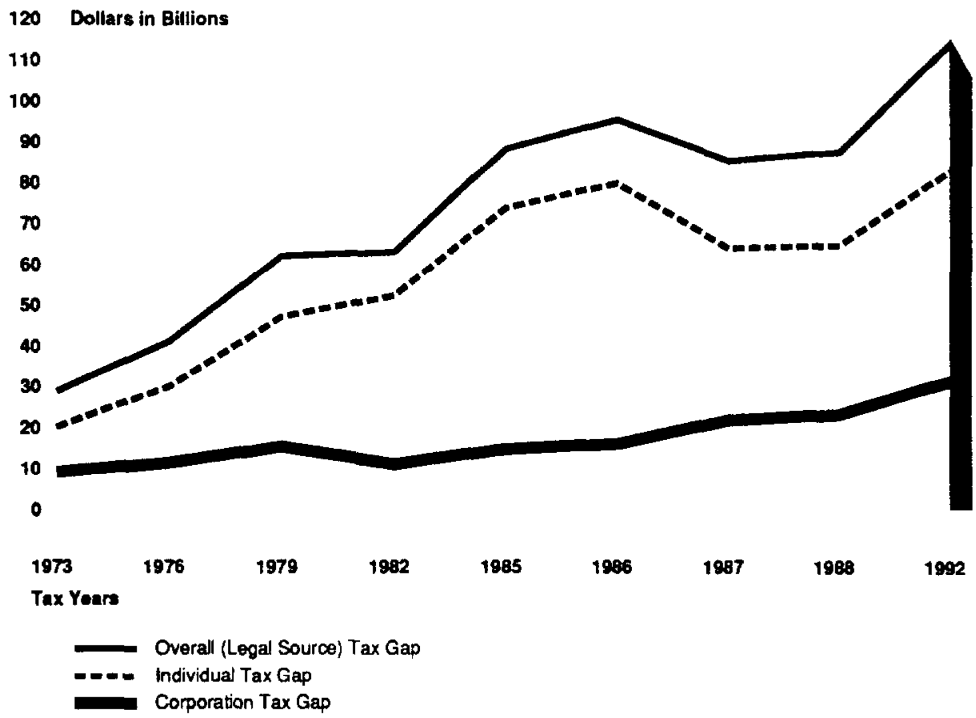
Figure I.3: Trends in the Tax Gap, 1973 to 1992




Source: Income Tax Compliance Research: Gross Tax Gap Estimates and Projections for 1973-1992, Internal Revenue Service, March 1988.

# GAO Trends in the Tax Gap

- Gap in 1973: $28.4 billion
  Gap in 1987: $84.9 billion

- Tax gap decreased from 1986 to 1987

- Tax gap is expected to increase after 1987 through 1992

# GAO Components of the Tax Gap: Illegal Source

- Not estimated in IRS' 1988 study

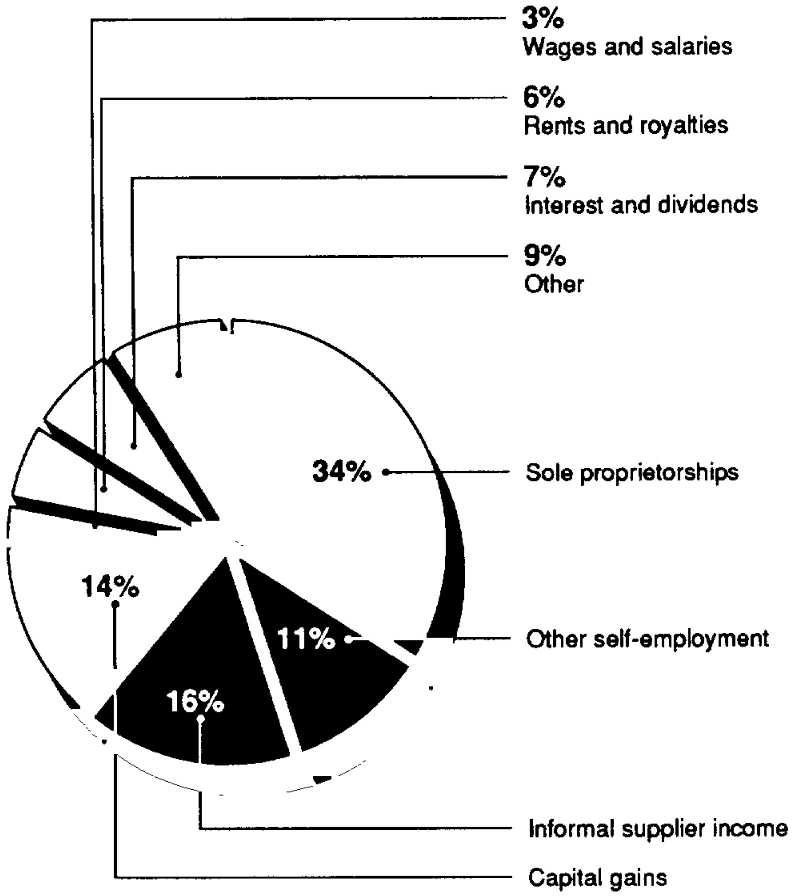
- 1983 study estimate was $9.0 billion from:

  - drug trafficking
  - prostitution
  - illegal gambling

# GAO Components of the Tax Gap: Corporations

- Corporation tax gap was $21.4 billion in 1987
- Corporation tax gap includes estimated tax gaps for:
  - corporations
  - fiduciaries
  - tax-exempt organizations' unrelated business income tax

Figure I.2: Unreported Income--the Largest Portion of the 1987 Tax Gap ($48.3 Billion)




Note 1: Other income includes pensions and annuities, estate and trust income, state income tax refunds, alimony, and other unspecified income.

Note 2: Other self-employment income includes partnership, small corporation, and farm income.

Note 3: Informal supplier income is cash income received by individuals through informal arrangements, such as those for home repair or day care. It is also referred to as "off the books" income.

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# Components of the Tax Gap: Individuals

- Individual nonfilers: estimated from survey data
- Individual remittance problems: not included
- Individual filers: made up of math errors, overstated deductions and credits, and unreported income

# GAO Components of the Tax Gap

- Legal source income:
  - Individuals
  - Corporations
- Illegal source income

# GAO Changes in the 1988 Study

- No estimate of illegal source tax gap
- Excluded estimate of tax gap due to remittance problems
- Taxes are computed differently on unreported income
- Study assumes future compliance rates will remain constant