An Examination of the 2001 IRS Tax Gap Estimates' Effects on Small Businesses

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I. INTRODUCTION

In 2006, the Internal Revenue Service (IRS) issued estimates of the "tax gap" for 2001. For any year, the tax gap is the difference between taxes owed and taxes actually paid in that year. The IRS estimated the 2001 tax-year gross tax gap at $345 billion. After considering late tax payments and amounts collected through IRS enforcement efforts, the estimated net tax gap was $290 billion.

The tax gap arises when taxpayers intentionally or inadvertently understate their income, fail to file a tax return, or fail to pay the amount of tax shown on their tax return. Estimates of the tax gap are important because they help assess the efficiency and fairness of the Federal tax system. If there is a high rate of noncompliance, those who pay their taxes subsidize the costs of government for those who do not pay their fair share.

The gross tax gap estimates correspond to a 16 percent noncompliance rate. While the U.S. rate of tax noncompliance is lower than in many countries, many people believe that this noncompliance rate is too high. The size of the 2001 tax gap estimates has led policymakers and the IRS to view the tax gap as a serious problem. The IRS has made tax compliance a high priority and there have been numerous Congressional hearings and legislative proposals to address the tax gap.

Because the tax gap estimates rely primarily on the results of the National Research Program (NRP), which focused on areas of noncompliance with respect to the individual income tax return, the estimates attribute a significant share of the tax gap to individual taxpayers and small business owners. The portion of the tax gap that the IRS attributes to large corporations relies on outdated information that predates significant changes in the techniques that large corporations use to minimize their Federal tax liability.

The relative size of the tax gap for various taxpayer segments (such as small businesses or large corporations) is important because the tax gap estimates drive IRS enforcement activities and motivate changes to the tax laws. If the tax gap estimates incorrectly skew the noncompliance picture toward a particular taxpayer segment, the IRS and policymakers are likely to focus their attentions on that segment. In order to provide more clarity on the 2001 tax gap estimates, this paper examines those estimates to explore: (1) the implications of the tax gap estimates for IRS enforcement and legislative activities, particularly with respect to small businesses, (2) the weaknesses of the tax gap estimates relating to large corporations and taxpayers involved in international transactions, and (3) the possible alternative approaches to tax compliance to reduce the burdens on small businesses.

II. EXECUTIVE SUMMARY

The IRS estimates that the tax gap, the difference between the amount of Federal taxes owed and the amount of Federal taxes actually paid, was $345 billion for 2001 before collection and enforcement activities and $290 billion after these activities. The rate of voluntary compliance in the United States is approximately 84 percent.

These tax gap estimates are important because the tax gap (1) is one measure of the efficiency of the Federal tax system, (2) contributes to the budget deficit and drives tax rates up, and (3) undermines confidence in the Federal tax system and contributes to further noncompliance. Further, the tax gap represents an equity issue, because taxpayers who report their income accurately subsidize taxpayers who do not.

The IRS tax gap estimates suggest that underreporting of income by small businesses is a significant problem representing $83-99 billion (nearly one-third) of the reported tax gap. However, there are problems with the tax gap estimates; the most significant of these problems is that the tax gap estimates fail to account sufficiently for the large corporation tax gap and the international tax gap. These problems are especially important because relying on IRS figures alone creates the impression that small businesses are the primary cause of the tax gap.

Therefore, the relevant issue is what portion of the tax gap should be attributed to small business. No one really knows the size of the corporate and international tax gaps. This lack of knowledge is due to inadequate data: the National Research Program (NRP) used to calculate the 2001 tax gap estimates did not include corporations and does not attempt to measure noncompliance from offshore activities. As a result, small businesses get a disproportionate focus. A better understanding of the limitations of existing tax gap estimates should lead to more efficient tax enforcement.

Understated estimates of the corporate and international tax gaps may convey the inaccurate impression that corporate tax noncompliance is benign and not worrisome. A better perspective on the relative noncompliance of large and small businesses will help inform the debate on future enforcement activity and tax legislation.

Large corporations have access to skilled tax professionals and employ sophisticated transactions involving multiple inter-related entities and foreign affiliates to manage their Federal tax liabilities. Over the last two decades, researchers and tax professionals have increasingly identified significant disparities between income reported on publicly filed shareholder reports and income reported to the IRS by large corporations[1] While there are legitimate and justifiable reasons that can explain many of these book-to-tax differences – many explicitly encouraged by the tax law – recent research suggests that these disparities arise, in part, by corporations taking increasingly aggressive tax positions. It is no secret that modern corporate tax departments are profit centers.[2]

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[1] Refer to Mills, Lillian, Leslie Robinson, and Richard Sansing, *FIN 48 and tax compliance*, March 2009.
[2] Refer to Section V. C. Underestimating the Size of the Corporate Tax Gap, for a more detailed discussion.

The tax gap estimates have led to increased audits of small businesses and to proposals to increase information reporting requirements. For example, the tax gap estimates have increased focus on improving third-party information reporting requirements, which have a disproportionate effect on small businesses. The health care legislation enacted in early 2010 included a new information-reporting requirement that requires businesses to report any payments of more than $600 during a year to corporate providers of goods and services.[3] The new requirement has generated widespread criticism, including concerns raised by the IRS Taxpayer Advocate's Office, which stated, "The Office of the Taxpayer Advocate is concerned that the new reporting burden, particularly as it falls on small businesses, may turn out to be disproportionate as compared with any resulting improvement in tax compliance.[4]

These increased audits and statutory changes increase further the burdens of an already burdensome system for small businesses. Complexity of the tax laws add to the disproportionate regulatory burden that small businesses already face.[5] Most small businesses are at a disadvantage when dealing with the IRS; small business owners often lack the resources and access to professional tax assistance to challenge the IRS. Small business owners are more likely than larger businesses to represent themselves (pro se representation) when challenging the IRS in court.[6] In a 2009 study of the most litigated cases involving trade or business deduction issues, approximately 71 percent involved pro se representation.[7]

However, most of the underreporting of income that occurs on individual income tax returns (where most small businesses report their income) is unintentional. IRS auditors conducting NRP examinations found that only one percent of all issues examined (three percent of issues resulting in a change in tax liability) resulted from deliberate or intentional failures to report income properly. [8] In addition, the IRS subsequently abates a significant percentage of penalties imposed on business owners, further suggesting that these taxpayers are making inadvertent errors, rather than deliberately trying to avoid their Federal tax liability.

Unlike large multi-national corporations that view their Federal income tax return as an opening bid in a long-running negotiation with the IRS and use sophisticated transactions to avoid detection, the small business tax gap arises because small business owners frequently feel overwhelmed by the amount and complexity of Federal tax requirements.[9] This suggests that the

[3] Internal Revenue Code 6041(h), as amended by the 2010 Health Care Act.
[4] U.S. Department of the Treasury, Internal Revenue Service, Taxpayer Advocate Service, *Report to Congress Fiscal Year 2011 Objectives*, June 30, 2010.
[5] Recent research has quantified the considerable regulatory burden facing small businesses. Refer to *The Impact of Regulatory Costs on Small Firms,* Crain and Crain, U.S. Small Business Administration, Office of Advocacy, 2010. http://www.sba.gov/advo/research/rs371tot.pdf.
[6] Pro se representation means self-representation. In other words, the individual chooses or cannot afford legal counsel to represent them in their case against the IRS.
[7] Nearly 75 percent of these cases involved trade or business expenses. Refer to page 442 in the National Taxpayer Advocate, 2009 report to Congress.
[8] U.S. Department of the Treasury, Internal Revenue Service, Taxpayer Advocate Service, *Written Statement of Nina E. Olson, National Taxpayer Advocate Before the Subcommittee on Financial Management, Government Information, and International Security of the Senate Committee on Homeland Security and Governmental Affairs, Hearing on the Tax Gap,* September 26, 2006.
[9] The GAO found that the IRS typically settles examinations with large corporations at the rate of 20 cents per dollar of the amount initially recommended during the examination. See Section V.C., below.

first step to reducing the tax gap for small business owners entails aggressive outreach and education efforts designed to help small businesses understand their tax filing obligations.

III. FEDERAL TAX GAP ESTIMATES AND THE EFFECT ON TAX COMPLIANCE AND ENFORCEMENT

A. Understanding the 2001 Tax Gap Estimates

1. Defining the Tax Gap[10]

The Internal Revenue Service (IRS) defines the "tax gap" as the difference between taxes owed and taxes paid to the Treasury. For fiscal year 2001, the IRS estimated that the gross tax gap was $345 billion; after enforced and other late payments, the IRS estimated the net tax gap to be $290 billion. This compares to an estimated $1.767 trillion dollars in Federal tax paid voluntarily and on time. The gross tax gap estimates translate to a voluntary compliance rate of around 84 percent, suggesting that the rate of noncompliance is about 16 percent. According to the IRS, the voluntary compliance rate has remained constant since 1985.[11]

In theory, no differences between taxes owed and taxes paid should exist. However, the U.S. Federal tax system is a voluntary system. As a result, uncollected revenue from noncompliance may arise from various sources. The IRS identifies the uncollected revenue or tax gap from three potential sources of noncompliance — ***non-filing, underpaying, and underreporting taxes***. ***Non-filing*** indicates that the taxpayer failed to file the proper tax returns and did not pay the amount of tax that taxpayers should have shown on the returns. ***Underpaying taxes*** indicates that the taxpayer identified their tax liability correctly, but failed to make the payment when filing the return. ***Underreporting*** indicates that the taxpayer filed the proper tax return, but either failed to report income items accurately or overstated certain deduction or expenses.

The tax gap derives from noncompliance from individuals and businesses participating in officially recorded economic activities, such as bricks and mortar businesses, and from participants in legal activities in the so-called underground economy. [12] The underground economy includes both legal and illegal activities. The legal activities, such as informal suppliers of services like yard work or housecleaning, are included in the tax gap estimates. Illegal activities, such as the income from drug sales, are not included in the tax gap estimates.[13]

The IRS has focused most of its tax gap studies on the individual income tax return, and more specifically, on the areas of the return that are not subject to withholding or third-party information reporting. As a result, the tax gap estimates place a heavy emphasis on business income reported on individual income tax returns. Because many small businesses report their

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[10] This section provides a brief overview of the methodology employed by the IRS to estimate the 2001 tax gap. A more thorough discussion of the IRS methodology is contained in Appendix A. In addition, a detailed breakdown of the components of the IRS tax gap is contained in Appendix B.

[11] The voluntary compliance was 83.6 percent in 1985, 84.6 percent in 1988, 84.3 percent in 1992, and 83.7 percent in 2001. See U.S. Department of Treasury, Internal Revenue Service, *I Will, IRS Strategic Plan, 2009-2013.* Accessed at http://www.irs.gov/pub/newsroom/long_term_measures.pdf.

[12] U.S. Department of the Treasury, Internal Revenue Service, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance*, August 2, 2007.

[13] The IRS does not include illegal activities in the tax gap estimates because (1) the government's goal should be to eliminate the illegal activity, not tax it, and (2) there are significant practical challenges in trying to measure it.

income and expenses on the individual income tax return, the IRS focus creates the general perception that the tax gap problem is predominantly one associated with individual income tax returns associated with business income of small businesses.

To calculate the 2001 tax gap estimates, the IRS conducted detailed examinations of 46,000 randomly selected individual income tax returns between October 2002 and September 2003. The IRS refers to these examinations as the NRP. The results of these examinations form the basis for many, but not all, of the IRS 2001 tax gap estimates.[14] As part of the NRP, the IRS used supplemental data to support information reported on the examined individual income tax returns, including third-party information returns and data from other government sources.[15] For purposes of the tax gap estimates, underreporting of income on individual income tax returns begins with the difference between amounts reported on the taxpayer's income tax return and amounts identified by IRS examiner during the NRP examination. This amount is then increased by an adjustment factor that accounts for the underreporting that the IRS assumes it did not find during the examination; the adjustment factors for "low visibility" sources of income (such as sole proprietor income not subject to third party reporting or withholding) range from 3.3 to 4.2.[16] These sources of income may be difficult to verify independently.[17]

Underreporting noncompliance is the largest component of the tax gap; the preliminary IRS estimates suggested that underreporting accounted for more than 80 percent of the tax gap in 2001.[18] Graph 1, below, shows the breakdown of the tax gap by the three major components – nonfiling, underreporting, and underpayment.

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[14] In fact, the portions of the tax gap estimates not based on individual income tax return filings examined as part of the NRP rely on estimates of taxpayer compliance that predate 1988. For example, the portion of the tax gap estimates attributable to corporations relies on operational audit data from the 1970's and 1980's. Portions of the estimates of the employment tax gap also date back to the 1980s and are similarly out of date.

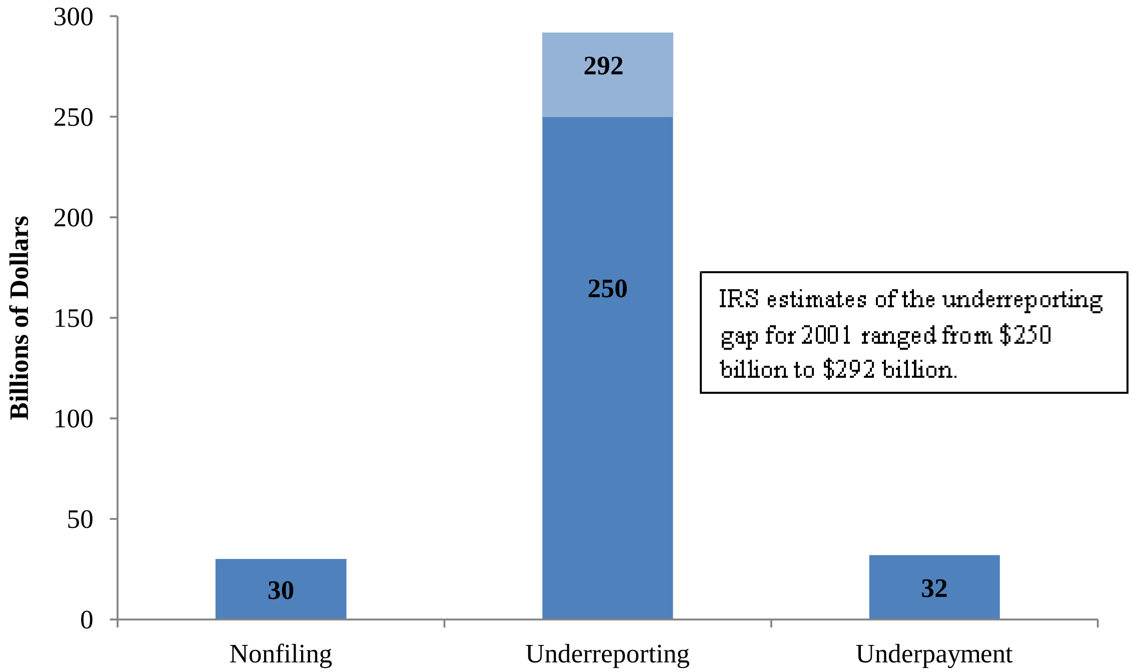
[15] The IRS began the NRP in 2002 and did not release the results of this study until 2006. As a result, at the release date, the estimates are already dated. However, while the IRS intends to update these estimates, doing so is costly and time consuming.

[16] Toder, Eric. *What is the Tax Gap?* Tax Notes, October 22, 2007

[17] Refer to Appendix B for the components of the 2001 IRS tax gap estimates.

[18] U.S. Department of the Treasury, Internal Revenue Service, *Tax Gap Facts and Figures* (March 2005). Accessed at http://www.irs.gov/newsroom/article/
0,,id=158619,00.html.

Graph 1 Components of the 2001 Gross Tax Gap
Source: IRS, *Tax Gap Facts and Figures (March 2005)*

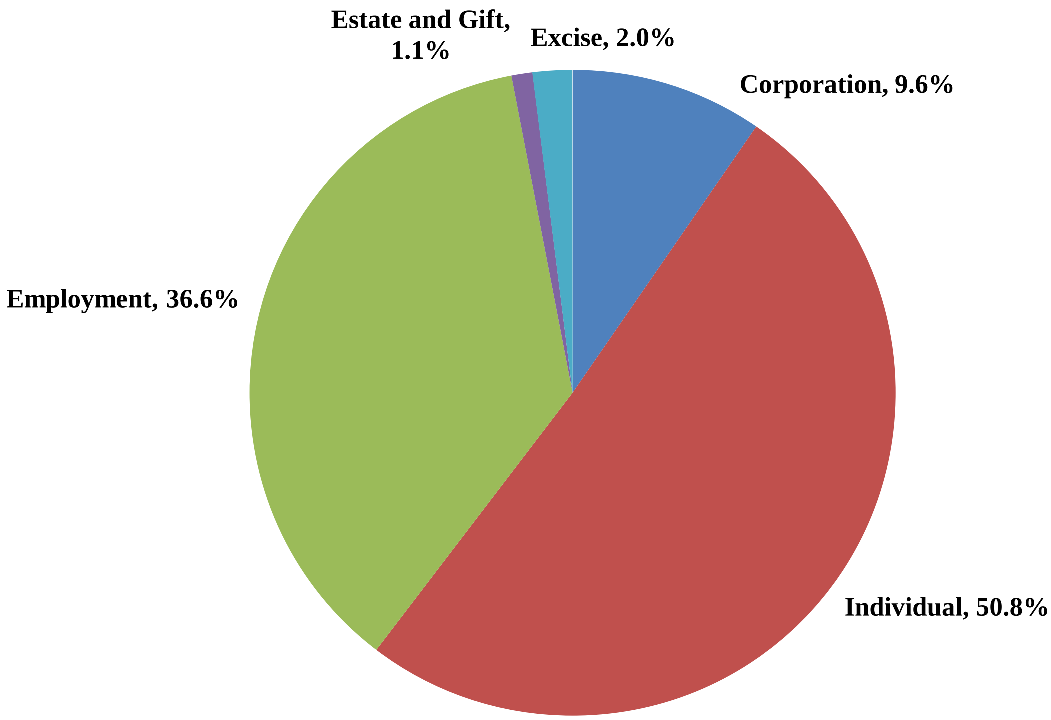


2. Small Business Tax Gap Estimates

The individual income tax is the area that has historically received the most scrutiny in the tax gap studies. One reason for this scrutiny is that the individual income tax and employment taxes are the largest component of Federal tax revenues. Together, individual income and employment taxes comprise approximately 87 percent of tax revenues, with individual income taxes alone comprising over 50 percent of tax revenues. Graph 2 shows the composition of tax revenues by type of tax for tax year 2009, showing the importance of individual and employment taxes to maintaining a strong tax base for collections. For tax year 2009, Federal tax revenues totaled $2.34 trillion. Individual income tax and employment taxes totaled $2.05 trillion.[19]

[19] Refer to the Internal Revenue Service Data Book, Internal Revenue Collections and Refunds, by Type of Tax & Fiscal Year, 2009.

Graph 2 Federal Tax Receipts by Type of Tax, Tax Year 2009
Source: IRS, SOI, Table 1. Internal Revenue Collections and Refunds, by Type of Tax, Fiscal Years 2008 and 2009



Small businesses frequently organize as sole proprietorships, partnerships, and S corporations. The income of these types of business entities are all reported on the individual income tax return of the business owner. Thus, individual income tax receipts include a significant component attributable to this business income.

The IRS estimates that $83-99 billion of the $150-187 billion individual income tax gap for 2001 was attributable to business income reported on the individual income tax return.[20] Of this $83-99 billion, the IRS attributes $59-65 billion to non-farm proprietor net income, $16-24 billion to partnership, S corporation, estate, and trust net income, $7-8 billion to rent and royalty net income and $2-3 billion to farm net income.

The IRS estimates that understated income (rather than overstated deductions) on individual income tax returns accounts for more than 80 percent of individual underreporting and the IRS estimates that business activities accounted for much of this underreporting.

[20] U.S. Department of the Treasury, Internal Revenue Service, *Tax Gap Facts and Figures (March 2005)*, accessed at www.irs.gov/newsroom/article/0,;id=158619,00.html.

3. Corporate Tax Gap Estimates

While the IRS derives the individual income tax gap estimates from the systematic examination of individual income tax returns, the 2001 corporate tax gap estimates relied on the results of operational audit data from the 1970s and 1980s, grown by the growth in corporate income tax receipts. Because the NRP looked only at individual income tax returns, the IRS did not update the corporate tax gap estimates to reflect current taxpayer behavior.

The IRS estimates the portion of the 2001 tax gap attributable to the corporation income tax was $30 billion, of which $5 billion was attributable to small corporations and $25 billion was attributable to large corporations. A 2006 Treasury Inspector General for Tax Administration (TIGTA) report raises concerns about the overall confidence in the IRS tax gap estimates due, in part, to the estimates of the size of the corporation income tax gap.[21] The TIGTA report notes, "for large corporate underreporting. . .these projections assume constant VCRs [Voluntary Compliance Rates], yet current experience suggests compliance may not be constant."[22]

B. Why the Tax Gap Estimates are Important

Widespread belief that the tax gap represents a serious problem creates long-term implications for U.S. tax administration and legislative policy. In a hearing before the Senate Committee on Finance in 2006, IRS Oversight Board Chairman Raymond Wagener articulated the reasons why the estimates of the size of the tax gap are important.[23] Mr. Wagner stated that the tax gap estimates represent a "serious problem" with the following consequences:

1. The tax gap represents an injustice because honest taxpayers must bear the financial burden by subsidizing those taxpayers who do not pay what they owe.
2. The tax gap deprives the Federal government of needed revenue.
3. The tax gap undermines confidence in the fairness of the tax system and contributes to further noncompliance.

The IRS 2001 tax gap estimates brought heightened attention to the issue of tax compliance. The IRS has made improving compliance a key goal in its long-term strategic plan.[24]

The tax gap estimates affect the allocation of IRS enforcement activities. A recent TIGTA report shows that, from fiscal year 2005 through fiscal year 2009, the examination coverage rate of individual income tax returns has increased, while the examination coverage rate for corporations with $10 million or more of assets has decreased by nearly 6 percentage points. Table 1 shows the trends in IRS examinations over this period.

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[21] U.S. Department of the Treasury, 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.
[22] Id at p. 8.
[23] *Written Testimony of IRS Oversight Board Chairman Raymond T. Wagner, Jr Before the Senate Committee on Finance Subcommittee on Taxation and Oversight on A Closer Look at the Size and Sources of the Tax Gap*, July 26, 2006.
[24] U.S. Department of the Treasury, Internal Revenue Service, *Strategic Plan, Fiscal Years 2009-2013.*

Table 1 – Numbers and Percentages of Individual and Business Tax Returns Examined					
	FY 2005	**FY 2006**	**FY 2007**	**FY 2008**	**FY 2009**
Individual Returns Examined					
Individuals (Form 1040)	1,199,035	1,283,950	1,384,563	1,391,581	1,425,888
Coverage Rate*	0.92%	0.97%	1.03%	1.01%	1.03%
Business Returns Examined					
Corporations <$10 million	17,858	17,849	20,020	20,580	18,298
Coverage Rate	0.79%	0.80%	0.92%	0.95%	0.85%
Corporations $10 million or more	10,829	10,578	9,644	9,406	9,536
Coverage Rate	20.02%	18.60%	16.81%	15.26%	14.55%
S Corporations (Form 1120S)	10,417	13,970	17,657	16,634	17,455
Coverage Rate	0.30%	0.38%	0.45%	0.40%	0.40%
Partnerships	8,489	9,752	12,195	13,203	12,855
Coverage Rate	0.33%	0.36%	0.42%	0.42%	0.38%

* The coverage rate is the percentage of returns filed that are subject to examination by the IRS.
Source: U.S. Department of the Treasury, Treasury Inspector General for Tax Administration, *Trends in Compliance Activities Through Fiscal Year 2009*, June 10, 2010, Reference Number: 2010-30-066.

As Table 1 shows, the examinations of large corporations declined from 20.02 percent in fiscal year 2005 to 14.55 percent in fiscal year 2009, while the examination coverage rate for individuals, small corporations, S corporations, and partnerships increased over the same period.

At the same time, the average recommended additional tax declined in all large corporation size categories except those corporations with $50-$100 million of assets.[25] For the largest corporations, the average recommended additional tax declined from $6.2 million in fiscal year 2005 to $4.3 million in fiscal year 2009. The IRS audit coverage statistics appear to support the notion that the IRS is redirecting its examination efforts away from large corporations and toward individuals and small businesses.

The IRS does not have unlimited resources to engage in enforcement activities. As a result, it must determine the most effective way to utilize its enforcement budget to encourage voluntary compliance and stop abusive noncompliance behavior. The tax gap estimates help the IRS prioritize its enforcement activities. Over fiscal years 2005 to 2009, the IRS reduced the audit coverage rate for large corporations and increased the audit coverage rate for individuals.

The issue of “closing the tax gap” has been the subject of numerous hearings on Capitol Hill following the release of the 2001 tax gap estimates. In a 2005 press release, Senator Kent Conrad, Chairman of the Senate Committee on the Budget, said, “the first step we should take to

[25] U.S. Department of the Treasury, Treasury Inspector General for Tax Administration, *Trends in Compliance Activities Through Fiscal Year 2009*, June 10, 2010, Reference Number 2010-30-066.

address the nation’s fiscal woes is to close the tax gap. . .closing the tax gap will lower the burden on the majority of Americans, who year after year pay their fair share.”[26]

[26] United States Senate, *Close the Tax Gap Now,* statement of Senator Kent Conrad, February 1, 2005.

IV. IMPACT OF THE TAX GAP ESTIMATES ON SMALL BUSINESSES

In September 2006, following release of their revised tax gap estimates, the Treasury Department Office of Tax Policy released a comprehensive strategy to reduce the tax gap.[27] In this report, the Treasury Department notes that the IRS estimates identify three key characteristics of the tax gap:

1. Over 70 percent of the gross tax gap is attributable to the individual income tax, which is the largest source of Federal receipts;
2. Over 80 percent of the gross tax gap relates to underreporting of tax with approximately half of this amount (40 percent of the gross tax gap) attributable to the underreporting of business income on individual income tax returns; and
3. Noncompliance is highest among taxpayers whose income is not subject to third-party information reporting or withholding requirements.

Because the tax gap estimates inform both tax enforcement and legislative activity, they have serious implications for small businesses. Many people believe that the best way to close the tax gap is to direct more enforcement money toward small businesses and to focus legislative proposals on greater recordkeeping and reporting with respect to small business transactions. Thus, the 2001 tax gap estimates have led to increased attention on closing the tax gap with respect to the underreporting of business income on individual income tax returns. This attention has significant implications for small business owners.

A. Increased Recordkeeping and Reporting Burdens

A 2007 hearing in the House Committee on Small Business focused on the closing the tax gap without creating burdens for small businesses. Chairwoman Nydia Velazquez noted that the Administration's fiscal year 2008 budget included $100 million for IRS enforcement initiatives and that 75 percent of that amount was directed toward small business.[28] Ranking Member Steve Chabot stated, "already struggling under the weight of massive paperwork burdens and high taxes, many of the ideas put forth by the IRS would only make it more difficult for small businesses to keep their head above water."[29]

The regulatory burdens of the Federal tax system for small businesses and the effect of tax compliance initiatives on this regulatory burden has become a point of focus for the IRS Taxpayer Advocate's Office. The Taxpayer Advocate, Nina Olson, stated in 2006 testimony "I am also concerned with the compliance burdens placed upon small businesses. . .every penny that they earned went back into the business and it was very difficult for them to save and make

[27] U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap*, September 26, 2006.
[28] United States House of Representatives, Committee on Small Business, *Full Committee Hearing on Closing the Tax Gap Without Creating Burdens For Small Businesses*, *Opening Statement of Chairwoman Velazquez*, April 26, 2007.
[29] Opening Statement of Mr. Chabot, supra.

estimated tax payments. When the IRS came calling. . .it was too late to help – the sheer weight of the tax debt caused the business to go under."[30]

The Office of Advocacy updated the regulatory burden of federal regulations on small business in a 2010 study, "The Impact of regulatory Costs on Small Firms."[31] The research finds that the total costs of federal regulations have further increased from the levels established in previous studies, as have the costs per employee.[32] More specifically, the total cost of federal regulations has increased to $1.75 trillion, while the updated cost per employee for firms with fewer than 20 employees is now $10,585 (a 36 percent difference between the costs incurred by small firms when compared with their larger counterparts). With respect to the burden imposed by tax regulations, the study finds that the cost of tax compliance is 206 percent higher in small firms than the cost in large firms. The study found that in a firm with less than 20 employees, the cost per employee of tax compliance was $1,584 compared with $760 for firms with 20-499 employees, and $520 for firms with 500 employees or more (Table 16, Page 54).

The tax gap estimates have increased focus on improving third-party information reporting requirements, which have a disproportionate effect on small businesses. The health care legislation enacted in early 2010 included a new information-reporting requirement that requires businesses to report any payments of more than $600 during a year to corporate providers of goods and services.[33] The new requirement has generated widespread criticism, including concerns raised by the IRS Taxpayer Advocate's Office, which stated, "The Office of the Taxpayer Advocate is concerned that the new reporting burden, particularly as it falls on small businesses, may turn out to be disproportionate as compared with any resulting improvement in tax compliance."[34]

A related problem is the fact that increased recordkeeping and reporting burdens increase the complexity of an already overly complex system for small businesses.

Tax complexity creates two general types of costs – overhead costs and opportunity costs.[35] Overhead costs are the costs associated with tax planning, compliance, and litigation. Opportunity costs are the costs of economic opportunities lost because of taxpayer uncertainty. The costs of tax complexity fall disproportionately on small businesses. As an example, small corporations with assets less than $1 million spent 27 times more on compliance as a percentage of assets in 1996 compared to large corporations with assets of at least $10 million.[36]

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[30] U. S. Department of the Treasury, Internal Revenue Service, Office of the Taxpayer Advocate, *Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the Committee on Small Business, U.S. House of Representatives, Hearing on The Effects of Tax Compliance Initiatives on Small Business*, April 5, 2006.

[31] *The Impact of Regulatory Costs on Small Firms*, Crain and Crain, U.S. Small Business Administration, Office of Advocacy, 2010. http://www.sba.gov/advo/research/rs371tot.pdf.

[32] For previous Advocacy studies addressing the cost of regulations, please see http://www.sba.gov/advo/research/regulation.html.

[33] Internal Revenue Code 6041(h), as amended by the 2010 Health Care Act.

[34] U.S. Department of the Treasury, Taxpayer Advocate Service, *Report to Congress Fiscal Year 2011 Objectives, June 30, 2010.*

[35] Moody, J. Scott. *The Impact of Tax Complexity on Small Businesses, Testimony Before the Subcommittee on Tax, Finance, and Exports of the House Small Business Committee.* Tax Foundation, Special Brief, September 2000.

[36] Id.

Small business taxpayers face daunting challenges in their dealings with the Federal tax system. Some portion of the tax gap occurs because taxpayers have a lack of knowledge about how to comply with the Federal tax laws.[37] For example, consider the example of a small business owner, such as a plumber or electrician without a college degree and a growing customer base. If the small business owner hires an employee, a variety of additional regulatory requirements come into play, including the requirement to withhold and pay employment taxes with respect to the employee. The IRS Taxpayer Advocate notes, "for most taxpayers, these requirements would seem daunting or even impenetrable, and some taxpayers inevitably do not comply simply because they have no idea where to begin."[38]

The tax gap estimates do not distinguish between intentional and unintentional noncompliance. The majority of taxpayer errors are due to inadvertent mistakes rather than intentional noncompliance.[39] In conducting the NRP examinations, IRS auditors characterized, for each problem they found, the reason for noncompliance. According to the IRS auditors, 31 percent of all issues (67 percent of issues that resulted in a change in tax liability) were the result of inadvertence or a mistake. Twelve percent of all issues (27 percent of issues that resulted in a change in tax liability) were the result of an automatic or computational error. Only one percent of all issues (three percent of issues resulting in a change in tax liability) resulted from deliberate or intentional failures to report income properly.[40]

The Taxpayer Advocate noted that, even if the margin of error was quite large in this characterization, "the designation by IRS's own auditors of only 3 percent of identified misreporting issues as intentional raises fundamental questions about the wisdom of the IRS's current objective of ramping up enforcement activities more than outreach and education."[41]

B. Increased Audit Activity for Small Businesses

As part of the increased focus on enforcement activities as a way of improving compliance with the Federal tax laws, the audit rates with respect to individual income tax returns and small businesses have gone up over the last five years.

In its 2009 annual report to the Congress, the Taxpayer Advocate raised concerns about the IRS examination program. In this report, the Taxpayer Advocate's Office stated, "we note that the IRS often fails to design its exam initiatives to maximize voluntary compliance and instead takes a one-off approach that creates burden on taxpayers and uses IRS resources ineffectively. Of particular concern is the IRS's penchant for correspondence exams, which constitute 77 percent of all individual exams conducted by the IRS in FY 2009. This is so despite clear evidence that

[37] Id.
[38] Id, at p. 4.
[39] U.S. Department of the Treasury, Internal Revenue Service, Taxpayer Advocate Service, *Written Statement of Nina E. Olson, National Taxpayer Advocate Before the Subcommittee on Financial Management, Government Information, and International Security of the Senate Committee on Homeland Security and Governmental Affairs, Hearing on the Tax Gap,* September 26, 2006.
[40] Id.
[41] Id.

correspondence-based audits negatively impacts the results for certain groups of taxpayers."[42] The Taxpayer Advocate further noted that the IRS collection practices might harm long-term taxpayer compliance. As the Taxpayer Advocate stated in Congressional testimony, "I am concerned that the IRS does not have sufficient information and research to determine how best to allocate its resources between examination, collection, and taxpayer service. . .Because business taxpayers have frequent dealings with the IRS, IRS' focus will significantly impact these taxpayers."[43]

A 2010 Business Week article discusses the ramp up in IRS examination activity of small businesses with respect to the classification of workers as independent contractors. The article cites Dean Zerbe, a former Congressional staff member and currently managing director of Alliantgroup, who stated that the IRS believes smaller businesses are more likely to evade taxes and "it's also easier and quicker to audit smaller businesses."[44] Compared to the examination of a large corporation, which employs sophisticated tax professionals and typically settles disputes for cents on the dollar, small businesses are more likely to settle their claims with the IRS quickly and without negotiation.

A small business owner contacted by the IRS often does not have access to sophisticated tax advice to help him or her deal with the issues the IRS has raised. Small business owners are more likely than larger businesses to represent themselves (pro se representation) when challenging the IRS in court.[45] In a 2009 study of the most litigated cases involving trade or business deduction issues, approximately 71 percent involved pro se representation.[46] The small business owner is much more likely to accept the IRS claims without regard to whether they are correct or not compared to a large corporation. Further, the small business owner is more likely to settle for the amount that the IRS has assessed compared to a large corporation. Because of this, the audit of a small business owner may represent "low-hanging fruit" for the IRS.

During fiscal years 2005 through 2009, the amount of time the IRS spent auditing the tax returns of the largest corporations (corporations with assets of at least $250 million) declined by 33 percent.[47] During fiscal year 2005, the IRS audited 43 out of every 100 returns in this size category; by fiscal year 2009, the audit rate had declined to 25 out of every 100 returns. At the same time, the amount of money the IRS collects per auditor hour is significantly greater for these large corporations than for small to midsize businesses. The IRS collects an average of $9,354 per auditor hour for the largest corporations, compared to $1,034 for the small to mid-size businesses.

[42] Refer to the National Taxpayer Advocate, 2009 Report to Congress.

[43] Nina Olson Testimony, 2005, supra.

[44] Field, Anne. *The IRS Targets Independent Contractors,* Bloomberg Businessweek, April 22, 2010. Accessed at http://www.businessweek.com/smallbiz/content/april2010/sb20100421_463331.htm.

[45] Pro se representation means self-representation. In other words, the individual chooses or cannot afford legal counsel to represent them in their case against the IRS.

[46] Nearly 75 percent of these cases involved trade or business expenses. Refer to page 442 in the National Taxpayer Advocate, 2009 report to Congress.

[47] Transactional Records Access Clearinghouse (TRAC), Syracuse University, Despite Rising Deficits, IRS Audits of the Largest and Richest Corporations Decline, April 12, 2010, accessed September 15, 2010 at http://trac.syr.edu/tracirs/newfindings/v15/

C. Are There Better Approaches to Addressing the Federal Tax Gap With Respect to Small Businesses?

Addressing the problem of the tax gap with respect to small businesses needs a multi-pronged approach. Broad-brushed enforcement activities, such as the extensive use of intrusive audits and expanding burdensome recordkeeping and reporting requirements that apply to all small businesses whether they are compliant or not, should be used only to the extent necessary. A variety of other approaches to the issue of tax compliance of small businesses can improve compliance without overly burdening taxpayers, including:

1. Improving education and outreach to small businesses to help them become compliant;
2. Providing small businesses with a representative to help them earlier in the audit process;
3. Reviewing the way that penalties are assessed and abated with respect to small businesses to try to reduce the assessment of needless penalties; and
4. Improving the quality of third-party return preparers frequently used by small businesses.

In a 2007 report, the GAO stated that no single approach is likely to cost-effectively reduce the tax gap relating to sole proprietors and that various options should be considered as part of an overall strategy, including enhancing assistance to taxpayers, making information return submission more important, requiring more information reporting, and increasing IRS enforcement.[48]

One approach that may improve taxpayer compliance, while minimizing the burdens on small businesses, would expand the role of the IRS Taxpayer Advocate Service. The IRS Taxpayer Advocate Service is an independent organization within the IRS designed to help taxpayers resolve problems with the IRS and propose changes to prevent these problems; in this role, the Taxpayer Advocate Service has been a strong advocate on behalf of small business owners. The Taxpayer Advocate Service helps taxpayers who have tried to resolve problems through normal IRS channels and failed, and helps taxpayers whose problems are causing financial difficulty or significant cost, including the cost of professional representation.

The IRS Taxpayer Advocate has proposed a number of strategies to improve compliance while minimizing the burdens on small businesses. The Taxpayer Advocate suggests that the IRS could achieve improvements in voluntary compliance through improved education and outreach efforts, combined with better IRS customer service and access. In addition, the Taxpayer Advocate believes that requiring due diligence on the part of third-party preparers could improve the voluntary compliance rates for small businesses as well.[49] The Taxpayer Advocate notes that small business taxpayers cannot always afford sophisticated professional tax advice and that these taxpayers need help from the IRS in understanding and complying with their tax obligations.[50] The Taxpayer Advocate has consistently argued for greater allocation of IRS funding for taxpayer service and education activities.

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[48] U.S. Government Accountability Office, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014, July 2007.
[49] Refer to pages 57 and 64 in the National Taxpayer Advocate, 2009 Report to Congress.
[50] Nina Olson Testimony, 2005, supra.

When the IRS does audit a small business, the Taxpayer Advocate's office gets involved later in the audit process when the small business has difficulty resolving its issue with the IRS. However, if the Taxpayer Advocate's office were involved at an earlier stage in the process, there would be a greater possibility of taxpayer outreach and education and a greater possibility that the small business owner would come to an acceptable compromise with the IRS that minimizes the disruptions on the small business. For example, if the Taxpayer Advocate's office were to act as a small business representative available whenever the IRS contacts a small business, it is more likely that any compliance issues would be resolved quickly and fairly and the imposition of penalties and interest would be fair and manageable for the small business.

The assessment and abatement of penalties is just one example of how contact with the IRS can disrupt small business operations. The reporting of wages and payment of employment taxes represent a significant part of the tax burden for small businesses and they frequently make mistakes. The IRS assesses Federal Tax Deposit (FTD) filing penalties against one out of 16 employment tax returns, but later abates more than 60 percent of the total amount originally assessed.[51] Similarly, the IRS in fiscal year 2004 assessed more than 91,000 combined annual wage reporting reconciliation penalties, but later abated 31 percent of the total assessments and 64 percent of the total dollars assessed for a total amount abated of nearly $1.4 billion.[52] The Taxpayer Advocated has stated, "the frequent abatement of penalties indicates a serious problem with the administration of this program that adversely and unnecessarily affects small businesses."[53] In addition to the disruptions in small business operations, these assessments often create lasting hardships. Such hardships include damage to the credit report of small businesses, deleterious effect on the ability to obtain credit, and the possible negative impact on the ability to continue business relationships.[54]

In addition to assistance throughout the audit and collection processes, changes in the requirements of third-party preparers would greatly improve the compliance of small businesses. Studies of chain preparers indicated a significant error rate in tax return preparation.[55] Many small businesses are unable to afford a private accountant and as a result rely on chain preparers to file their income tax returns.

The GAO suggested two remedies for this problem: (1) due diligence requirements for the paid preparer and (2) questions that both educate and prompt for information.[56] With respect to improving paid preparer's due diligence, requiring the preparer to certify that they sought and verified certain information will improve the accuracy of the services provided. Achieving this goal would occur through modifications to the filing process. Prior to submitting the return, the preparer would have to file a separate report certifying their due diligence.

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51 Nina Olson Testimony, 2005 supra.
52 Id.
53 Id.
54 Refer to pages 322 to 323 in the National Taxpayer Advocate, 2009 Report to Congress.
55 The Taxpayer Advocate refers to a GAO study in which auditors posed as individuals seeking to have their tax return prepared at a chain preparer. (Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study*, *Chain Preparers Made Serious Errors* 2, Apr. 4, 2006) The error rate approached 100 percent. Refer to page 57 in the National Taxpayer Advocate, 2009 Report to Congress.
56 Id.

V. Problems With the 2001 Tax Gap Estimates

Most people accept the IRS tax gap estimates at face value. As a result, the estimate of a $290 billion net tax gap for 2001 is widely reported as a legitimate estimate of the size of the overall annual tax gap. However, the IRS acknowledges the weakness in some of the tax gap estimates; the tax gap map contained in Appendix B shows the components of the IRS tax gap estimates along with a key to the reliability of the estimates.[57] The Treasury Inspector General identified a number of issues with the tax gap estimates. In Congressional testimony, the Inspector General makes the following statement about the IRS tax gap estimates:

> "In summary, much of the information remains dated, the new information is incomplete in several respects, and methodology differences create challenges. Considering this, a somewhat different picture of the tax gap emerges. My staff 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 [Voluntary Compliance Rate]. . .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. . . both the underreporting tax gap and the nonfiling gap will indefinitely leave an unfinished picture of the overall tax gap and compliance."[58]

Toder (2007) also questioned the reliability of the IRS tax gap estimates.[59] He notes,

> "Nonetheless, a large amount of uncertainty must be assigned to the current tax gap estimate. There are both technical and conceptual issues in determining the correct measure of the tax gap. Some of the more serious issues. . .are: adjustments for failure to detect underreporting on individual income tax returns, underreporting of income through flow-through entities, measurement of overreporting of individual income tax liability, timeliness of data, conceptual issues in measuring the corporate tax gap, and special problems in estimating the portion of the tax gap due to sophisticated tax avoidance techniques."[60]

No one knows with certainty the true size of the tax gap in the United States. The 2001 IRS tax gap estimates are just that – estimates. The only portion of the IRS tax gap estimate known with certainty is the underpayment gap (the difference between the amount reported (correctly) and the amount actually remitted to the IRS). The reliability of the other components of the tax gap estimates depends upon both the validity of the assumptions underlying the estimates and the ability to verify these assumptions. Because the tax gap estimates are widely accepted and

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[57] *Tax Gap Facts and Figures*, supra.

[58] U.S. Department of the Treasury, Treasury Inspector General for Tax Administration. *Statement of The Honorable J. Russell George, Treasury Inspector General for Tax Administration, Hearing Before the U.S. Senate Committee on Finance Subcommittee on Taxation and IRS Oversight, "A Closer Look at the Size and Sources of the Tax Gap,"* July 26, 2006, p. 8.

[59] Toder, supra.

[60] Id.

disseminated, it is important to understand the problems that reduce the reliability of the estimates.

A. Measuring the Underreporting of Business Income on Individual Income Tax Returns

The IRS estimates that $109 billion of the 2001 tax gap (31 percent of the gross tax gap) represents the underreporting of business income on individual income tax returns.[61] The IRS estimates that the net misreporting percentage (NMP) is as high as 53.9 percent for income (primarily business income) with little or no information reporting.[62] These numbers suggest that the problem with the underreporting of business income is pervasive. However, it is important to understand both how these estimates are calculated and what they represent.

First, the estimates of the underreporting gap do not rely upon what IRS examiners found during their examinations of 2001 individual income tax returns. Rather, these estimates rely on assumptions about what the IRS examiners did NOT find on examination. The IRS assumed that its examiners would not find all unreported income when they audited individual income tax returns. In addition, the IRS assumed that their examiners had varying abilities to identify unreported income. Therefore, the IRS applied an adjustment factor (multiplier) to the income adjustments that its examiners made to adjust these numbers up to what the IRS thinks represents the amount of unreported income. The IRS has not published the assumptions (multipliers) that have been applied to different sources of income making it difficult to know how much of the tax gap estimates are based on what examiners actually found and what is assumed to exist based on the multiplier. In the case of some business income that is not subject to withholding or information reporting, the IRS uses an adjustment factor (multiplier) ranging between 3.3 and 4.2.[63]

To put this in perspective, if IRS examiners found $25 billion of unreported income on examination of individual income tax returns, the multiplier could have the effect of increasing that number to $120 billion for the tax gap estimate. Thus, a significant percentage of the underreporting gap occurs because of the application of the multipliers to income found on examination.

The multipliers, by design, help estimate the income that goes unreported through the "underground economy." A portion of the underground economy includes people engaged in legal business activities, who fail to report their business income for Federal income tax purposes. These "informal suppliers" can take different forms. For example, they may include individuals who:

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[61] The IRS estimates that the underreporting gap ranges from $250-292 billion (Graph 1 above), suggesting that the underreporting of business income represents approximately 40 percent of the underreporting gap.
[62] U.S. Department of the Treasury, Internal Revenue Service, "*Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance,*" August 2, 2007. Appendix C contains the net misreporting percentage estimates for a variety of items on the individual income tax return.
[63] Toder, 2007, supra.

1) Report none of their income for tax purposes,
2) Report only some of their business income, but not all of it,
3) Report income from a primary job, but not from an after-hours casual job, or
4) May be individuals who do not understand their income reporting requirements, such as teenagers who make money performing odd jobs in their neighborhoods, but who do not report the income for tax purposes.

In many cases, the IRS bases these estimates on small studies that compare State sales tax receipts and Federal income tax receipts. One study of Iowa businesses found 2,607 instances over a three-year period where the gross sales reported to the state exceeded the gross receipts reported to IRS by $100,000 or more and 304 cases where the difference was greater than $1 million.[64] This study included sole proprietors, partnerships, and both S and C corporations. The IRS study does not differentiate by the size of the business or the legal formation.

However, it is important to note that a GAO study found that 10 percent of sole proprietors who understate their tax liability represent 61 percent of the total understated tax liability for sole proprietors.[65] This suggests that a minority of small business returns account for the majority of the tax compliance problems.

A second problem is that the IRS tax gap estimates fail to differentiate between underreporting of income by traditional brick and mortar businesses and the underreporting that occurs as part of the "underground economy." As Toder (2007) notes, "the inclusion of informal supplier income makes the underreporting rate for schedule C income for 2001 returns look much higher than the estimate reported for 1988 returns. . .but that apparent increase in Schedule C noncompliance mostly reflects a change in presentation."[66]

This change in presentation lumps all business income on the individual income tax return into one broad category and leads to a conclusion that the underreporting of income by small businesses is both pervasive and widespread. However, if the IRS stated separately the portion of the tax gap attributable to the underground economy, the noncompliance rate with respect to other small businesses would be much smaller.

While the IRS adjusts the tax gap estimates for underreporting not found by its examiners, it does not make any corresponding adjustment for overreporting of income that may have occurred.[67] IRS examiners are unlikely to be diligent in exploring possible overstatements of income or missed deductions when examining individual income tax returns. This potential bias could overstate the tax gap with respect to individual income tax returns. Studies have shown that taxpayers do fail to take advantage of tax benefits that are available to them. For example, Koenig and Harvey (2005) found that, in the first year that taxpayers were eligible to claim a

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[64] U.S. Department of the Treasury, Internal Revenue Service, Small Business/Self-Employed Division (SB/SE) Research, Project No. BKN0048, *Matching State of Iowa Sales Tax Data Against Gross Receipts Reported to IRS* (Feb. 2007).
[65] Refer to The National Taxpayer Advocate, 2009 Report to Congress, page 185 and GAO-07-1014, July 2007.
[66] Toder, 2007, supra.
[67] Toder, 2007, supra.

new retirement savings tax credit, 34 percent of all eligible taxpayers (2.7 million taxpayers) failed to claim nearly $500 million of credits.[68]

B. Underestimating (or Failing to Estimate) the Size of the International Tax Gap

A 2009 TIGTA report noted that the IRS has not developed an estimate of the international tax gap, which TIGTA defines as the taxes owed, but not collected on time, from a U.S. person or foreign person whose cross border income is subject to U.S. taxation.[69] TIGTA stated that

> "While there might be overlap between the IRS tax gap estimate and the international tax gap, it is doubtful that the $345 billion estimate includes the entire international tax gap. The primary reason for this conclusion is that identifying hidden income within international activity is very difficult and time-consuming. Furthermore, the IRS did not measure for the international tax component in the . . .NRP estimate for the 2001 tax gap. Therefore, it is unlikely that hidden offshore income is comprehensively included in the IRS tax gap estimates."[70]

TIGTA further noted that determining the size of the international tax gap is an important issue for U.S. tax administration. International business and investment in the United States grew significantly over the last 30 years, from $188 billion in 1976 to $14.5 trillion in 2007 and U.S. investment outside the United States grew from $368 billion to $15 trillion over the same period.[71] The number of multinational enterprises increased from 3,000 in 1990 to more than 63,000 in 2007. Between 2002 and 2007, the number of corporation income tax returns filed with international features increased 87 percent. [72]

In July 2008, the Senate Permanent Subcommittee on Investigations released a report on tax haven banks and U.S. tax compliance.[73] The Subcommittee report estimated that the United States loses $100 billion per year in tax revenues due to offshore tax abuses. The report notes that offshore tax havens hold trillions of dollars of assets of U.S. taxpayers.

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68 Koenig, Gary and Havey, Robert. *Utilization of the Saver's Credit: An Analysis of the First Year.* National Tax Journal, Vol. LVIII, No. 4, December 2005.

69 U.S. Department of the Treasury, Treasury Inspector General for Tax Administration, *A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap,* January 27, 2009, Reference Number: 2009-IE-R001.

70 Id.

71 Id.

72 *U.S. Department of the Treasury, Treasury Inspector General for Tax Administration. A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap. 2009-IE-R001, January 27, 2009*.

73 U.S. Senate, Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations. *Staff Report on Tax Haven Banks and U.S. Tax Compliance.* July 17, 2008.

Having the ability to locate operations in other jurisdictions allows corporations to reduce U.S. tax liability by shifting operations and profits to low-tax countries that afford favorable tax treatment to foreign corporations. Over the last 15 years, large U.S. corporations have aggressively used their international tax operations to assist in minimizing U.S. Federal income tax liability. By establishing operations in countries with low tax rates (or no tax) on corporate income, U.S. corporations can reduce their U.S. tax liability. In a 2009 press release, the Treasury Department stated that the "tax code is rife with opportunities to evade and avoid taxes through offshore tax havens."[74] The press release noted that, in 2004, U.S. multinational corporations paid $16 billion of Federal tax on $700 billion of foreign active earnings, for an effective U.S. Federal tax rate of 2.3 percent. According to Treasury, of the 100 largest U.S. corporations, 83 had subsidiaries in tax haven countries in 2009. In the Cayman Islands alone, one building is the official address for 18,857 corporations, very few of which have a presence in the country.[75]

A second way U.S. corporations can avoid paying tax is by letting profits remain in low-tax jurisdictions. Under U.S. tax law, profits earned in other countries are not subject to tax until the profits return to the United States in the form of inter-corporate dividends. A large and profitable method of corporate tax planning involves exploiting this "deferral" of tax liability. While there are rules in place to limit the usefulness of deferral, they are rarely effective.

Multinational corporations also use transfer pricing (a form of income shifting) to reduce U.S. tax liability. In the simple case, a company would set up manufacturing operations through a foreign subsidiary in a low-tax jurisdiction. Usually, sales would occur in a high-tax jurisdiction and profits from those sales are subject to tax at the higher rate. Transfer pricing involves setting the price that the manufacturer in the low-tax country charges the parent corporation for goods and materials at a level that effectively shifts taxable income to the low-tax jurisdiction.

One area where transfer pricing is especially profitable for the corporation is in the tax treatment of intangible assets such as patents and trademarks, product development, marketing and customer relationships. The corporation usually performs these activities in the United States, but they transfer the incomes generated from these activities to affiliates in a low-tax jurisdiction.

The transfer pricing rules require that prices charged by one affiliate of a corporation to another in an intercompany transfer of goods, services, or intangible assets yield results that would occur if the parties were unrelated. However, in order to minimize U.S. tax liability, U.S. corporations artificially lower the cost of goods and services sold to subsidiaries in low tax countries and artificially inflate the costs of goods and services returned to the United States.

Pak and Zdanowicz studied U.S. export and import records for 2001 to try to identify the extent to which imports were over-invoiced and exports were under-invoiced in order to shift income

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[74] U.S. Department of the Treasury. *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas.* TG-119, May 4, 2009.

[75] U.S. Government Accountability Office, *"Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist,"* GAO-08-778, July 2008.

outside the United States to avoid U.S. tax.[76] Pak and Zdanowicz estimated that, in 2001, the U.S. Federal tax loss from abusive transfer pricing amounted to $53.1 billion. The numbers represent an increase from prior years of $35.7 billion in 1998, $42.7 billion in 1999, and $44.6 billion in 2000.[77] The authors believe that this was a conservative estimate because they only analyzed quantifiable commodities that had a specific unit of measure and, if a similar proportion applied to all goods, the estimated tax loss would be substantially higher. In addition, Pak and Zdanowicz did not examine transfer-pricing abuses with respect to services and intangible assets, which also would increase the estimate.

Some examples of the abuses in transfer pricing that Pak and Zdanowicz found included the following:

1. Abnormally low export prices – live bovine animals exported to Mexico valued at $20.65, bulldozers exported to Colombia valued at $1,741.92, and missile and rocket launchers exported to Israel valued at $52.03; and
2. Abnormally high import prices – briefs and panties imported from Hungary valued at $739.25 per dozen, plastic buckets imported from the Czech Republic valued at $972.09, and battery-operated smoke detectors imported from Germany valued at $3,500.

C. Underestimating the Size of the Corporate Tax Gap

The estimates of the size of the corporate tax gap are widely accepted as out of date.[78] The NRP, which looked at individual income tax returns, cannot be used to estimate the size of the corporate tax gap. In its 2001 tax gap estimates, the IRS included an estimate that large corporations (those corporations with assets exceeding $10 million) underreported $25 billion of Federal income taxes.

When considering the large corporation tax gap estimates, it is important to consider three points. First, the tax gap estimates for large corporations rely upon operational audit coverage from the mid-1980s. Second, the estimates assume that large corporation compliance has remained constant since that time. Third, the IRS acknowledges that these estimates are considerably weaker than other tax gap estimates. In fact, the IRS 2001 tax gap estimates for large corporations ($25 billion) are lower than the estimates for tax year 1998 ($32.7 billion).[79]

Operational audit data from the 1980s fails to capture significant changes in the way that large corporations have approached Federal income tax liability beginning in the 1990s. The growth in the economy during the 1990s fueled increased interest in ways for corporations to minimize their Federal tax liability. Sophisticated tax planners competing for corporate business began to

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[76] Pak, Simon J. and John S. Zdanowicz. *U.S. Trade with the World, An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports.* October 31, 2002.
[77] *Pricing Schemes Reduce Corporate Taxes by Billions.* Knowledge@W.P. Carey, August 31, 2005.
[78] Toder, supra. U.S. Department of the Treasury, 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.
[79] See Brown, Robert E. and Mark J. Mazur, *IRS's Comprehensive Approach to Compliance Measurement,* U.S. Department of the Treasury, Internal Revenue Service, June 2003.

develop transactions that would reduce Federal tax liability and increase corporate earnings for financial reporting purposes, making corporations' bottom lines look even better.

In a 2006 testimony, the GAO criticized the IRS tax gap estimates for corporations. The testimony noted, "…the available tax gap estimates are highly uncertain and incomplete. IRS has not systematically measured the level of compliance for large corporations. . .IRS's level of certainty with respect to the accuracy of the corporate tax gap estimate is low for reasons such as use of incomplete and old data, interpretation of complex laws, and resource constraints."[80]

Beginning in the 1990s, large corporations began increasingly to utilize a variety of transactions to help minimize Federal tax liability and maximize financial accounting income to inflate corporate profits. Professor Dan Shaviro's 2004 paper on corporate tax shelters discusses what drove changes in corporate behavior in the 1990s.[81] He notes in his paper:

> "On the demand side, companies that were increasingly aggressive about managing, say, their inventory costs came to think of tax costs as no different and of their tax departments as in effect profit centers. On the supply side, financial innovation increased the available tools for creative paper shuffling and the rise of tax consulting work. . .may have mattered as well. When the big accounting firms began to get more involved in tax planning, they increased competitive pressures and brought a new entrepreneurial spirit to the marketplace for tax services."

The corporate tax minimizing transactions that began in the 1990s included (1) transactions that could survive IRS scrutiny, (2) transactions that exploited "gray areas" of the law that might or might not be upheld upon closer inspection, and (3) transactions that clearly would be overturned if discovered by the IRS. Large corporations are often under long-term audit by the IRS, which suggests that the IRS could more easily identify and disallow questionable transactions. However, in reality, large corporation tax returns are extraordinarily complex and even the best IRS agents will have difficulty identifying transactions that a corporation does not disclose. Large corporations frequently use affiliated entities to create a complex web of transactions that lack transparency.[82] As an example, for the period 1997-2000, the number of Federal tax returns Enron prepared each year with respect to its affiliated and related entities increased from 1,002 to 2,486.

GAO's 2006 testimony addressed the problem with underreporting of income on large corporation income tax returns.[83] GAO notes that tax avoidance is such a problem that corporate tax departments have become corporation profit centers. This was the case with Enron, the large corporation that filed for bankruptcy in 2001 amid allegations of corporate executive wrongdoing. In Enron's case, the tax department prepared an annual report that measured the

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[80] *Id.*

[81] Shaviro, Daniel N. *Corporate Tax Shelters in a Global Economy. Why They Are a Problem and What We Can Do About Them.* The AEI Press: Washington, DC, 2004.

[82] U.S. Government Accountability Office, *Tax Gap: IRS Can Improve Efforts to Address Tax Evasion by Networks of Businesses and Related Entities*, GAO-10-968, September 2010.

[83] U.S. Government Accountability Office, "*Testimony Before the Senate Committee on Finance, Tax Compliance, Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting,"* GAO-06-851T, June 13, 2006.

total tax savings generated by the department prior to the approval of annual employee bonuses. As the Joint Committee stated in its report "in essence, Enron's tax department was given a new responsibility – to contribute to Enron's bottom line earnings, much like Enron's operating business units."[84]

GAO went on to state in its 2006 testimony, "some have postulated that major corporations' tax returns are actually just the opening bid in an extended negotiation with IRS to determine a corporation's tax liability."[85] The GAO found that the IRS typically settles examinations with large corporations at the rate of 20 cents per dollar of the amount initially recommended during the examination.[86] These amounts are also often not even collected after review in the IRS appeals process or proceeding through the legal system in the courts. Protracted negotiations can drag out the resolution of large corporation audit issues for years.

Conceptual Issues Measuring the Corporate Tax Gap

Corporate tax planning strategies often span a continuum from 'perfectly legal' to 'clearly illegal.' In between these two extremes lie areas subject to interpretation and disputes by both parties. The IRS handles these interpretations and disputes very differently for individuals and corporations. Individuals and small businesses rarely challenge an IRS examiner's recommendation for an adjustment as part of a tax audit. If the taxpayer challenges the adjustment, the court usually upholds the IRS decision.[87]

When large corporations undergo an audit, it is a much different situation. Many refer to corporate tax filings as a strategic interaction between the IRS and the company. Some tax professionals routinely refer to the initial return filed by a corporation as the "opening bid" in a complex and protracted negotiating strategy.[88] Large, multi-national corporations have the resources to engage in this strategy, while most small businesses do not.

A related issue in measuring the corporate tax gap relates to complexity of the corporate tax return. Unlike an individual return (most small businesses file an individual income tax return) that represents the income and deductions of one taxpayer, the business owner, the tax return of a large corporation may represent the business activities of many companies and tax entities that may also be other corporations. The ability of the IRS examiner to detect complex transactions between inter-connected and multi-tiered entities creates a difference in the tax enforcement outcomes of large and small businesses. Often, these other tax entities serve no economic purpose and just allow the corporation to shift income to a low-tax or tax-indifferent partner. For example, in recent years, corporations have formed partnerships with not-for-profit quasi-government entities (e.g., public transportation providers) to swap depreciation deductions for lower costs for machinery and equipment (e.g., railroad cars). In a simple transaction, the

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[84] See, Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, Volume I Report*, JCS-3-03, February 2003.
[85] U.S. Government Accountability Office, "*Testimony Before the Senate Committee on Finance, Tax Compliance, Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting,"* GAO-06-851T, June 13, 2006.
[86] Id.
[87] Toder, 2007, supra.
[88] GAO-06-851T, supra.

corporation buys the equipment, claiming deductions and credits that are of no use to the tax-indifferent partner. In return, the not-for-profit entity receives capital investment at a price reduced by the tax benefit to the taxable corporation (less administrative costs).

Detecting Corporate Tax Noncompliance

In addition to the use of international operations to minimize U.S. tax liability, researchers and tax professionals have identified other areas of tax law that contribute to, or relate directly to, corporate tax compliance. For the most part, these aspects of the tax law are not relevant to small businesses that, by design, never encounter most of this complexity and therefore do not have the same opportunities.

Tiered Entities

Many corporations use tiered entities to hide transactions flowing through a complex network of inter-locking relationships. Tiered entities consist of partnerships whose partners may be other partnerships the partners of which may be other corporations or foreign subsidiaries. Often, tiered entities serve no economic purpose other than to hide or obscure tax-minimizing strategies that exploit complex and vague tax provisions. The IRS has tried to develop sophisticated tools to detect and analyze the patterns of flows between entities that could signal the existence of tax evasive strategies to auditors.[89]

Tax Shelters

The rise in corporate tax planning activities in the 1990s led to increased use of so-called "corporate tax shelters." The Joint Committee on Taxation describes tax shelters as "transactions that may comply with the literal language of a specific tax provision yet yield tax results that are unwarranted, unintended or inconsistent with the underlying policy of the provision."[90] Abusive tax shelters involve exploiting the complexity of the tax law to obscure transactions that would otherwise be deemed illegal. Many corporations conceal tax shelter transactions among legitimate transactions on the corporate tax return making detections difficult.[91] GAO notes, "because these transactions are often composed of many pieces located in several parts of a complex tax return, they are essentially hidden from plain sight, which contributes to the difficulty of determining the scope of the abusive shelter problem."[92]

Tax shelter transactions usually have no economic substance: corporations construct tax shelters solely to reduce tax liability and often involve pass-through entities (e.g., partnerships) to disguise further their character. Tax professionals, who take aggressive tax positions that may or may not hold up under scrutiny, often market tax shelters. Sometimes the individual pieces of

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[89] Toder, 2007, and GAO-10-968, supra.

[90] Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters, Scheduled for a Public Hearing Before the Senate Committee on Finance,* JCX-19-02, March 19, 2002.

[91] U.S. Government Accountability Office, *Testimony Before the Senate Committee on Finance, Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting,* GAO-06-851T, July 7, 2006.

[92] U.S. General Accountability Office 2006 testimony, supra, at p. 11.

the transaction are perfectly legal, but taken together can be considered an abusive tax shelter.[93] Presently, the IRS has identified 34 tax shelters (e.g., "listed transactions") considered abusive transactions.[94]

GAO previously explored the possible size of the corporate tax gap related to abusive tax shelters. A 2003 GAO report discusses one estimate that suggested an average annual tax gap from tax shelters of approximately $12 billion to $15 billion.[95]

Empirical Estimates of the Corporate Tax Gap

Until recently, most of the research into measuring the corporate tax gap relied on making inferences about its size by examining differences in the net income that companies report to the IRS and what they report to their shareholders. Companies have a strong incentive to show robust income growth to shareholders while at the same time minimizing taxes paid to the IRS. While there are numerous reasons that book income can diverge from taxable income that have nothing to do with tax evasion, most tax professionals believe that a large book-to-tax differential can suggest aggressive tax planning.

The SEC recently adopted new reporting requirements that many believe can lend insight into the "tax aggressiveness" of corporations as well as provide the IRS with a new and effective tool in fighting corporate noncompliance.

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93 Toder, 2007, supra.

94 U.S. Department of the Treasury, Internal Revenue Service, *Listed Transactions – LB&I Tier I Issues*, accessed at http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html.

95 U.S. General Accountability Office, *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters,* GAO-04-104T, October 21, 2003.

VI. CONCLUSIONS

The IRS tax gap estimates suggest that underreporting of income by small businesses is a significant problem representing nearly one-third of the reported tax gap.

The tax gap estimates have led to increased audits of small businesses and to proposals to increase information reporting requirements. These actions increase the burdens of an already burdensome system for small businesses.

Most of the underreporting of income that occurs on individual income tax returns (where most small businesses report their income) is unintentional. IRS auditors conducting NRP examinations found that one percent of all issues examined (three percent of issues resulting in a change in tax liability) resulted from deliberate or intentional failures to report income properly. In addition, the IRS subsequently abates a significant percentage of penalties imposed on small business owners, further suggesting that these taxpayers are making inadvertent errors, rather than deliberately trying to avoid their Federal tax liability.

The international and corporate tax gaps are missing from the 2001 NRP estimates. Should the IRS revise the tax gap estimates to reflect more accurately the *true* size of the tax gap in the United States, the portion of the tax gap attributable to small businesses would be much smaller.

Unlike large multi-national corporations that view their Federal income tax return as an opening bid in a long-running negotiation with the IRS, small business owners enter into negotiations with the IRS at an obvious disadvantage; they lack the resources and access to sophisticated tax assistance to challenge IRS findings. Small business owners frequently feel overwhelmed by the amount and complexity of Federal tax requirements. In light of the data presented here, the first step to reducing the tax gap for small business owners entails aggressive outreach and education efforts designed to help small businesses understand their tax filing obligations.

APPENDIX A: HOW THE TAX GAP IS CALCULATED

A. Overview of the Tax Gap Estimating Process

Over the past 50 years, the IRS has undertaken a number of compliance studies and surveys of completed tax returns. These studies focused on all aspects of the tax gap (underpayment, non-filing, and underreporting). However, studies of individual income tax return studies provided the primary focus of the underreporting component of the tax gap.

The IRS studies focus their attention on the tax gap that results from legal sources of noncompliance.[96] The IRS employs two methods to identify the sources of noncompliance — direct computation and estimation.

The IRS uses direct computation to determine the underpayment of tax. In this case, the IRS compares the administrative records and the actual tax return information to identify any mathematical errors or tax underpayments. The estimated methods support the underreporting and rely on detailed studies of tax return data.

Generally, individual income tax returns are the only return type receiving consistent scrutiny for underreporting in any detail. The other return types are subject to less scrutiny and most of the IRS effort focuses on the underpayment taxes or non-filing of tax returns.

Due to the cost and complexity of such studies, the IRS identifies one segment of the taxpaying population for each study. Over the past 50 years, the vast majority of IRS studies of tax gap estimates focused on individual income tax returns with the most recent estimates based on the 2001 tax year. The IRS refers to the study of 2001 individual income tax returns as the NRP. The NRP examined approximately 46,000 randomly selected individual income tax returns from October 2002 through September 2003. The IRS released the estimates produced by this comprehensive study in February 2006.[97]

All return types, other than individual income tax returns, rely on estimates based on studies of taxpayer compliance for periods prior to 1988.[98] With the exception of the individual income tax gap, the estimates released in 2006 relied on data from these prior studies projected to the 2001

[96] An important point to establish about the IRS tax gap studies is that they exclude unpaid taxes that arise from illegal activities. This exclusion is for both philosophical and practical reasons. The government's role is to eliminate illegal activities, rather than to collect tax revenue on that activity. From a practical perspective, generally the illegal activity remains outside the traditional systems and is less visible. In other words, the income arising from illegal activities is not subject to third party reporting, is often a cash transaction, or may involve complex transactions that are difficult to discern or identify the illegality. In its 2007 report, the IRS notes" although tax is due on income from whatever source, legal or illegal, the tax attributable to illegal activities is extremely difficult to estimate. Moreover, the government's interest in pursuing this type of noncompliance is, ultimately, to stop the illegal activity, not merely to tax it."

[97] Refer to "Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance," U.S. Department of the Treasury, July 8, 2009.

[98] Refer to Brown, Robert E. and Mazur, Mark J., "IRS's Comprehensive Approach to Compliance Measurement," Internal Revenue Service, June 2003.

tax year. In the case of the corporation income tax, the tax gap estimates rely on operational audit data dating to the 1970's and 1980's.

Table 2 below provides a summary of the studies of voluntary compliance undertaken by the IRS since 1963. The individual income tax has been the subject of eleven comprehensive surveys in the past 47 years. However, it is important to note a significant omission from the table — large corporations. Due to the complexity of the corporation return and the ongoing audit practices, large corporations have not been subject to the same tax gap review as individual income taxpayers, which include the vast majority of small businesses.

The only other area that received considerable attention is the study of delinquent returns and delinquent accounts. The IRS relies on administrative records to analyze these returns. The IRS identifies easily the delinquent account, since generally, the taxpayer files the return on a timely basis, but the payment of taxes has not yet occurred.[99]

[99] Internal Revenue Service, Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992, Publication 1415 (Rev. 4-96), 1996.

Table 2 – IRS Studies of Measures of Voluntary Compliance by Return Type and Return Year										
Tax Year	**Number of Returns in Sample, by Return Type**									
	Individual Income Tax	**Small Corporations**	**Estate Tax Returns**	**Exempt Organizations**	**Fiduciary Returns**	**Employee Plan Returns**	**Partnership Return**	**S Corp Return**	**Delinquent Returns Non-Farm Business and Individuals**	**Surveys of Delinquent Accounts**
1963	92,000								27,000	178,000
1964										166,000
1965	50,000									
1966									114,000	
1969	53,000	16,000							70,000	1,800,000
1970										1,800,000
1971	26,000		4,600							1,800,000
1973	55,000	20,000								
1974				11,400						
1975					8,900					
1976	50,000									
1978		33,000								
1979	55,000			20,000					25,000	
1981		19,000								1,800,000
1982	50,000					18,000	27,000			
1984										1,800,000
1985	50,000							10,000		
1986										
1987										
1988	54,000			3,000					25,000	
2001	46,000									

Source: U.S. Government Accountability Office, *"Tax Compliance Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753, July, 2005

Methodology

1. Individual Income Tax

As mentioned above, individual income tax is the area that receives the most scrutiny in the tax gap studies. One reason for this scrutiny is that the individual income tax and employment taxes are the largest component of Federal tax revenues. Together, individual income and employment taxes comprise approximately 87 percent of tax revenues, with individual income taxes alone comprising over 50 percent of tax revenues. For tax year 2009, Federal tax revenues totaled $2.34 trillion. Individual income tax and employment taxes totaled $2.05 trillion.[100]

The most recent individual income tax gap measures rely on data collected through the NRP. Like past compliance studies, the IRS designed the NRP to allow for estimates of the overall extent of reporting compliance among individual income tax filers and to update audit-selection formulas.

One important objective of the NRP was to find a less intrusive means of measuring tax compliance. It introduced several innovations designed to reduce the burden imposed on taxpayers with returns selected for the study.

The first NRP innovation was to use supplemental data to support information reported on the returns. Most line items on the individual income tax return have third-party information returns from payers of income (for example, Form W-2 and Form 1099). In addition, the IRS assembled prior year returns filed by the selected taxpayers to provide corroborating information. The IRS referred to these additional sources as "case building" data.

In addition, the IRS obtained data on dependents from other government sources, as well as data obtained from public records (e.g., current and prior addresses, real estate holdings, business registrations, and involvement with corporations).

The use of third-party data means that taxpayers would no longer have the need to produce detailed information. In some cases, the IRS did not need to contact selected taxpayers. This allowed the IRS to focus on line items of the individual income tax return not supported by third-party information.

A second NRP innovation was to introduce a "classification" process, whereby an experienced auditor (who identified not only which issues to examine, but also the approach for each return in the sample) reviewed the randomly selected returns and third-party data.[101] The auditors classified the return into one of three categories: (1) accepted as filed, without contacting the taxpayer at all; (2) selected for correspondence audit of up to three focused issues; or (3) selected for an in-person audit to verify numerous tax items. In addition, the classifiers identified

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[100] Refer to the Internal Revenue Service Data Book, Internal Revenue Collections and Refunds, by Type of Tax & Fiscal Year, 2009.

[101] The IRS also refers to experienced auditors as classifiers. Generally, the classifier identified returns for the individual conducting the in-person audit.

compliance issues that the auditor was required to evaluate, although the examiners had the ability to expand the audit to investigate other issues as warranted.

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including representatives of tax professional associations) in the design and implementation of the study. The NRP approach was much less burdensome on taxpayers than the old TCMP audits, which examined every line item on every return selected.

The NRP study began with three questions: (1) did the person file a tax return; (2) did the appropriate payment accompany the tax return; and (3) did the taxpayer report accurately their income and expenses to determine their tax liability.[102] This progression of questions provides the basis of the three tax gap measures. In addition, the IRS considers interactions between the three forms of tax compliance. Understanding the interactions allows the IRS to develop methods that encourage timely filing, payment, and reporting of income taxes. The NRP provides information for developing strategic and operating methods for improving taxpayer compliance.

Brown and Mazur present an example of the importance of the interactions between the three forms of tax compliance.[103] This example, shown below in Table 3, assumes there are ten taxpayers, each with a $1,000 tax liability. One taxpayer fails to file a return on a timely basis. Two taxpayers underreport their tax liability. Three taxpayers fail to remit the full amount of their tax liability. As shown below, considered separately, the individual compliance rates are all 90 percent or greater. However, collectively, the effect of the three compliance rates generates a collection rate of 82.5 percent.

The example of only ten taxpayers demonstrates two things: (1) the importance of the interactions of the various compliance rates and (2) the potential for Treasury collections to deteriorate.

[102] Refer to Brown and Mazur, 2003.
[103] Brown and Mazur, supra.

Table 3 – Interaction of IRS Compliance Measures and Impacts on the Tax Gap					
	Baseline	**Filing Compliance**	**Reporting Compliance**	**Payment Compliance**	**Cumulative Effects**
Compliance Case	Each taxpayer files and pays in a timely manner, and reports accurately	One taxpayer fails to file	Taxpayer 1 underreports liability by $150; Taxpayer 2 underreports by $300	Three taxpayers pay only $900 of their $1,000 liability	One non-filer, two under reporters, three under payments
Filing Rate	10/10 = 100 percent	9/10 = 90 percent	10/10 = 100 percent	10/10 = 100 percent	9/10 = 90 percent
Voluntary Reporting Rate	$10,000 reported/$10,000 liability = 100 percent	$9,000 reported/$9,000 liability = 100 percent	$9,550 reported/$10,000 liability = 95.5 percent	$10,000 reported/$10,000 liability = 100 percent	$8,550 reported/$9,000 liability = 95.0 percent
Voluntary Payment Compliance Rate	$10,000 paid of the $10,000 owed = 100 percent	$9,000 paid of the $9,000 owed = 100 percent	$9,550 paid of the $9,550 owed = 100 percent	$9,700 paid of the $10,000 owed = 97 percent	$8,250/$8,550 = 96.7 percent
Treasury Collection Rate	$10,000/$10,000 = 100 percent	$9,000/$10,000 = 90 percent	$9,550/$10,000 = 95.5 percent	$9,700/$10,000 = 97 percent	$8,250/$10,000 = 82.5 percent
Tax Gap Amount	**$0**	**$1,000**	**$450**	**$300**	**Total = $1,750**
Source: Brown, Robert E. and Mazur, Mark, "IRS's Comprehensive Approach to Compliance Measurement, Internal Revenue Service, June 2003, page 10					

The following sections detail the approaches used by the IRS to assess individual taxpayer compliance in each of the three areas.

a. Filing Compliance

The IRS estimates the filing compliance rate and the tax gap associated with non-filers. The two concepts are interrelated, because the proportion of taxpayers that voluntarily file a tax return requires knowing the anticipated total returns for each tax year.

The estimated total number of returns includes those returns filed (both returns filed on a timely basis) as well as a measure of those returns that were not filed, but should have been. From this second class of returns (those not filed), the IRS estimates the *net* tax gap associated with non-filers.[104]

[104] The tax gap for non-filers is the net tax gap, as many taxpayers have had income taxes withheld from their paycheck, but fail to file a tax return. The IRS devotes some of its resources to understanding the reasons behind non-filers and attempts to identify whether the non-filing is intentional or unintentional.

Estimates of filing compliance are only for individual income tax returns.[105] The IRS does not identify separate classes of individual income tax non-filers, because there is inadequate data to classify further the non-filers. For instance, if an individual filed a return with Schedule C (business) income in the previous tax year, it does not necessarily suggest that the individual will have business income in a subsequent year. Other examples include complex family structures that may change from year-to-year or a low-income taxpayer who falls below the filing threshold for a given year.

In order to estimate filing compliance, the IRS relies on the Current Population Survey (CPS) from the Census Bureau and their internal databases. The IRS uses the CPS to estimate the denominator (total returns for the current tax year). The IRS internal database provides the numerator (the actual number of returns filed). This ratio represents the filing compliance rate, which they estimated at approximately 91 percent in 2001.[106] While the filing compliance rate seems quite high, it corresponds to an estimated 11 million taxpayers who did not file an income tax return for tax year 2001.

This method involves constructing individual income tax returns from Census data. The IRS creates tax-filing units from the household units of the CPS. This process relies on family income and characteristics reported to the CPS. The IRS tabulates the estimated number of individual tax units that, based on the CPS, would have a requirement to file a return.[107]

After determining the total tax units with a requirement to file, the IRS compares the number of returns filed to the total to determine the rate of compliance. Alternatively, the rate of non-filing is the ratio of the tax units that did not file (expressed as the difference between the total number of tax units estimated to have a filing requirement minus the total number of returns filed) divided by the total estimated tax units (based on CPS).

Toder indicates that the IRS relied on a 2003 exact match file from the Census. To obtain an exact match, the IRS provided limited information from individual income tax returns to the Census. In turn, Census matched these IRS records with information collected by the CPS. The Census used the results of this exact match to estimate aggregate income and tax liability for tax year 2003. The IRS projected backward to tax year 2001 to obtain the amount of the non-filing liability for the NPR. While this methodology has some technical issues (e.g. incorrect social security numbers on the Census file), the results are comparable to those obtained by the IRS based solely on tax data.

Previous Measures of Non-filers – Prior to the NRP, the IRS conducted a separate study within its Taxpayer Compliance Measurement Program (TCMP) that focused exclusively on non-filers. The non-filer study relied on income tax returns for tax year 1988.[108]

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[105] The IRS has virtually no way to determine the number of business returns that taxpayers should file each year. Businesses often reorganize (with a name and EIN change), merge with other businesses, or cease operations. Further, there are no comprehensive business data sources to facilitate an estimate of business non-filers.
[106] Refer to Eric Toder, *"What is the Tax Gap?"* Tax Notes, October 22, 2007.
[107] Ibid. Toder, page 2.
[108] Refer to IRS Publication 1415 (Rev. 4-96).

The TCMP relied on an intensive matching program of Social Security records, income tax returns, and third-party information returns to estimate the non-filing tax gap. This matching program generated approximately 88 thousand potential non-filer leads.[109] The IRS selected a stratified sample of approximately 23,000 returns from the leads.

The TCMP non-filer study had two segments – collections and examinations. The collection segment sought to locate the potential non-filer and secure or collect the tax return. Then, for a subset of these located potential non-filers, the IRS made an effort to assess the accuracy of the delinquent returns filed by the located non-filer.

The IRS was able to locate approximately 80 percent of the sample (18,689 returns). Of those located, 75 percent were not required to file an income tax return (13,929 returns), resulting in about 25 percent of the original sample as delinquent filers (4,760 returns). Approximately 74 percent of the located delinquent returns submitted a tax return (3,546 returns).[110] The IRS examined a sample of approximately 2,200 delinquent returns.

The IRS applied weights to the results from the examinations to reflect the universe of non-filers. Net misreported amounts (NMAs) from previous TCMP studies of individual income tax returns provided the basis of the non-filer tax gap estimates.

The current methodology improves upon the previous non-filer study in a number of ways. First, the NRP provides a way to measure the number of potential tax returns. By comparing this to the actual number of returns submitted in a tax year, it produces a reasonable estimate of the filing compliance rate.

b. Payment Compliance

Compared to other estimates of taxpayer compliance, payment compliance is a relatively straightforward concept. Simply stated, for those taxpayers filing a timely return, payment compliance measures the amount of tax liability actually paid compared to the total tax liability amount. Payment compliance relies exclusively on IRS internal data.

The IRS developed two payment compliance measures – the voluntary payment compliance rate (VPCR) and the cumulative payment compliance rate (CPCR). The VPCR is the initial measure representing the rate of payment compliance at the filing deadline. The CPCR is the subsequent measure representing the rate of payment compliance another (later) date.

The CPCR provides an indication of the success of collection processes, enforcement efforts, and taxpayer delinquent (voluntary) payments. For example, in tax year 1999, the VPCR was 98.4 percent (approximately $36 billion in unpaid taxes). After one year, the CPCR was 99.4 percent

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[109] It is important to note that the matching program may have been more successful in identifying information that did not correspond to a return, as opposed to identifying 88 million potential non-filers. The potential non-filers included delinquent filers as well as individuals who were not required to file a return. However, the analysis excludes non-residents and individuals without a valid social security number.

[110] According to IRS Publication 1415 (Rev. 4-96), in many cases, those located delinquent non-filers that did not produce an income tax return were referred for further collection or legal action.

(additional collections of $22 billion). After two years, the CPCR was still 99.4 percent (with an additional collection of only $0.9 billion). Clearly, the ability to collect unpaid tax liabilities declines over time. The 1999 example indicates that approximately 38 percent of the original unpaid taxes remain unpaid after two years.

c. Reporting Compliance

Reporting compliance for individual taxpayers is a measure of how accurately a taxpayer reports income and expense items on the tax return. In the NRP, the IRS studied individual taxpayers to measure the rate of voluntary compliance reporting (VCR). The VCR is the ratio of tax liability accurately reported on timely filed returns over the total tax liability. From the VCR, the IRS estimates the underreporting tax gap.

The underreporting tax gap, above all other estimates, receives the most attention. As mentioned previously, this is due partly to the magnitude of the estimated tax gap associated with reporting noncompliance. However, another reason is that this measure focuses on the accuracy of returns filed in a timely manner. The suggestion, when the IRS identifies an income tax return that contains inaccurate information, is that there is some intent to underreport deliberately.[111]

Further, the IRS focuses their study of reporting compliance on those areas of the individual return that have 'low visibility.' In other words, low visibility refers to those line items on a form or schedule that rely solely on taxpayer input as opposed to those line items with third-party information reporting. Past studies identified certain line items that demonstrated a pattern of amounts reported incorrectly.[112] Such items included capital gains, farm income, informal supplier income, nonfarm sole proprietor income, partnership income, rents & royalties, and other income.[113] Of these tax line items, the IRS estimates that nonfarm sole proprietor income is the largest component of the underreporting tax gap.

The NRP marked departure from past tax gap measures, introducing many improvements and enhanced techniques to estimate the tax gap compared to past measures. Because of the attention paid to the individual underreporting tax gap estimate and the contribution of nonfarm sole proprietorship income to this estimate, understanding the new methodology is critical to understanding the tax gap estimate.

As mentioned previously, the NRP used supplemental data to support information reported on the returns. Where available, the NRP used supporting third-party information returns (e.g., Form W-2 and Form 1099) from the payer of income to support reporting of line items on the individual income tax return. In addition, the IRS assembled prior year returns filed by the

[111] In fact, this is not always the case. Many line items require extensive recordkeeping to support the expense or income. Often, taxpayers do not maintain the necessary records to substantiate the reported amounts, which would result in a disallowance of the amount reported. This inability to substantiate the amount does not necessarily mean that the reported amount is incorrect, but rather that it is unsubstantiated.
[112] Refer to IRS Publication 1415 (Rev. 4-96).
[113] However, it is important to note that, over time, modifications to tax laws require more third-party reporting for many of these items.

selected taxpayers to provide corroborating information. The IRS referred to these additional sources as "case building" data.[114]

In addition, the IRS obtained data on dependents from other government sources, as well as data obtained from public records (e.g., current and prior addresses, real estate holdings, business registrations, and involvement with corporations). Using third party verification offers the opportunity to reduce taxpayer burdens, while improving the quality of the data collected by the NRP.

However, in some situations, it was necessary to perform an audit of the return. The study conducted many of the audits through mail contacts, with others conducted through face-to-face meetings.

Past TCMP studies found that face-to-face audits often detected lower amounts of unreported income than third party information reporting. The auditors detected these discrepancies in a subsample of the tax year 1976 TCMP survey. This subsample produced results indicating that for every dollar of unreported income detected by an auditor (without the use of information reporting documents), the auditor did not detect another $2.28.[115] Therefore, the IRS increased all unreported income (detected by the auditor without the aid of information reporting documents) by a 'multiplier.' A multiplier is, as the name implies, a parameter that the IRS uses to increase the estimate of unreported income. Generally, the multiplier was $3.28, but the IRS modified the multiplier for selected income line items as shown in Table 4 below. As shown in Table 4, all but two of the understated income items rely on the $3.28 adjustment, with non-farm sole proprietor and farm incomes relying on a lower multiplier of $2.40.

The purpose of the multiplier is to reflect the inability of the auditor or examiner to identify completely income reported improperly on the tax return. Through the 1976 TCMP study, the IRS documented that there was systematic bias in detecting underreported income.

The NRP replaced 'multipliers' with 'detection-controlled estimation.' Detection-controlled estimation is a statistical technique to enhance the multiplier concept. The concept behind detection-controlled estimation is the recognition that an individual auditor will perform consistently, detecting comparable results for all accounts examined. However, the detection-controlled estimation also recognizes that across auditors, there will be greater inconsistency reflecting differences in experience or abilities. The new measure creates a "composite best examiner" and applies this ability to detect underreported income to all of the face-to-face audits.[116]

[114] Use of these third-party sources requires a considerable amount of data2.27 cleaning and verification. While this improved the quality of the data and the estimates, it created a time lag between data collection and release of the tax gap estimates. Refer to Mazur and Plumley, "Understanding the Tax Gap," National Tax Journal, Vol. LX, No. 3, September 2008.

[115] Refer to Internal Revenue Service, "Federal Tax Compliance Research, Individual Income Tax Gap Estimates for 1985, 1988, and 1992," Publication 1415, (Rev. 4-96), 1996.

[116] Mazur and Plumley, page 573.

Table 4 Tax Year 1988 Multiplier-Expanded Underreported Income Estimates, Understated Income Items					
Income Item	**Detected through:**		**Effective Multiplier**	**Non-Information Reporting Income Estimates [(2)x(3)]=**	**Total Under-reported Income (1)+(4)=**
	Information Reporting Document	**Non-Information Reporting Documents**			
	(1)	**(2)**	**(3)**	**(4)**	**(5)**
Wage Income	1,801	1,970	3.28	6,462	8,263
Interest Income	1,963	663	3.28	2,175	4,138
Alimony	4,218	565	3.28	1,853	6,071
Capital Gains	5,188	33	3.28	108	5,296
Pensions & Annuities	1,236	1,564	3.28	5,130	6,366
Farm Income	254	1,936	2.40	4,646	4,900
Non-Farm Sole Proprietor Income	1,234	17,735	2.40	42,564	43,798
Partnership & SBC Income	48	3,104	3.28	10,181	10,229
Rents and Royalties	345	1,433	3.28	4,700	5,045
Other Income	4337	4,246	3.28	13,927	18,264
Unemployment Compensation	809	14	3.28	46	855
Source: IRS Publication 1415 (Rev. 4-96), Table B3, page 48					

Mazur and Plumley indicate that the IRS applied the detection-controlled estimation to selected taxpayer classes due to data limitations. The IRS applied the adjustments to four taxpayer classes including high- and low-income and high- and low-visibility taxpayers. In these taxpayer classes, high- and low-income is self-explanatory. High- and low-visibility taxpayers refer to the degree of third party reporting that is available for the return. Generally, the degree of compliance increases as the degree of income visibility or third party information reporting increases. Past IRS studies indicate that income subject to third-party information reporting and withholding has 99 percent reporting compliance.

The IRS constructed an estimate (detection-controlled estimation multiplier) of the total amount of income that taxpayers should have reported for each of the four-taxpayer classes. Like the TCMP estimates, the new multipliers include both the amounts identified directly through information reporting and amounts not identified through the audit process.[117] This approach is similar to the approach shown in Table 5 above, but the IRS applied the rates to selected taxpayer classes and only those taxpayers classes with information not verified through third party information reporting.

[117] The IRS also supplemented the estimates of underreported income with an estimate of unreported tip income.

These estimates of underreporting of income and overstating expenses are inherently difficult to produce. In essence, as with non-filing, the measure involves quantifying something not observed (and in many cases, not possible to observe). Further, the estimates of underreporting of income (and overstating expenses) rely on assumptions that assume certain taxpayer behavior has not changed over time.[118]

However, several factors that might influence behavior have changed. One such factor is the amount of third party information reporting and backup withholding that is required. One example is pension and annuity income. In addition to the detailed information reporting requirements, financial institutions are required to withhold income taxes at the time of the pension or annuity distribution.

Another factor that remains difficult to measure or quantify is the perception of the potential 'audit threat' a taxpayer may or may not feel when filing an income tax return. Many personal use software programs (for self-prepared individual income taxes) provide an indication of the potential risk of an audit with the return in its current form. This indicator provides an opportunity for the taxpayer to revise or reconsider any reporting that may lack supporting documentation.

In any event, the use of a multiplier to estimate underreported income for individual returns remains somewhat questionable. This is particularly true, because as discussed below, the same system does not apply to large or medium-sized corporation returns.

2. Corporate Taxes

***Overview* –** The corporation tax gap estimates rely on operational audit data from the 1970's and 1980's. The IRS projected these previous estimates to tax year 2001. The projections grew in conjunction with the corresponding growth in corporate receipts. However, these estimates assume that reporting compliance rates remained constant for the past twenty years.[119] These earlier studies focused on two classes of corporations – the largest U.S. corporations with $250 million or more in assets and mid-sized corporations those corporations with more than $10 million and less than $100 million in assets.[120]

During the 1980's, audit coverage for the largest U.S. corporations approached 100 percent each year. In other words, nearly every large corporation with assets greater than $250 million is subject to audit on an ongoing basis. However, the audits focus on a major component of the tax return, because large corporate returns may easily include thousands of pages of tax return forms

[118] Mazur and Plumley indicate that this is one of the motivations for developing the new multipliers. However, the current GAO studies indicate that the IRS has not made an effort to understand the reasons for noncompliance. Therefore, as a result, the estimates suggest somewhat static assumptions about behavior. Refer to GAO-05-753.
[119] A number of sources, including the IRS and the GAO question the validity of this assumption, given the many changes in tax laws affecting corporations. Refer to Mazur and Plumley (2007) and GAO-05-753.
[120] Corporations with $10 million or less in assets were included in the TCMP program

and schedules. One reason for this coverage rate is that corporations with $250 million in assets paid approximately 86 percent of all corporate taxes, nearly $290 billion in 2007.[121]

The tax gap estimates for corporations with more than $10 million and less than $250 million in assets rely on results from operational audits – referred to as large corporation audits. Currently, the IRS refers to this program as an Industry Case (IC). The IC is a taxpayer with a relatively simple corporate tax return.

The largest corporations were part of another program referred to as the coordinated exam program (CEP), which the IRS refers to as the Coordinated Industry Cases (CIC) program. A CIC includes the more complex corporate returns of the largest corporations and their effectively controlled entities. These taxpayer returns meets a point criteria established by the IRS, who assigns a tax return a certain number of points based upon such factors as gross receipts, gross assets, and number operating entities. Once the Division assigns 12 or more points to the return, the IRS considers the return a CIC and assigns a team of examiners to review the return.

Currently, the Large and Mid-Size Business Division is responsible for compliance activities on all business returns with assets exceeding $10 million.

Corporation Audits – Chart 1 below, provides a picture of the audit process experienced by the largest corporations. Generally, the audit process for the larger corporations is a process of negotiations for a variety of reasons explained below.[122]

After reviewing the tax corporate return, the IRS begins generally with a recommended tax increase. The IRS assesses the tax only after the:

- Corporation agrees to the recommendation;
- Corporation fails to respond to the IRS's deficiency notice; or
- Courts rule on the recommendation.

The GAO estimates that between 80 and 90 percent of all corporations contest the recommended tax increase and they do so through the IRS Office of Appeals or the court system.

Through the Appeals process, the corporation and the IRS will agree to lower the recommended tax to an assessed tax. This assessment is generally a fraction of the recommended tax (22 percent for CIC corporations and 27 percent for IC corporations).

Generally, in time, the corporation pays the assessed amount, so there is very little difference between taxes assessed and collected through these audit programs. However, audit collections represent only a fraction of the potential tax gap associated with large corporations.

[121] Refer to the IRS, Statistics of Income Corporate Source Book, 2007, Table 1.
[122] As a rule, this negotiation process is not available to small corporations and sole proprietors. The primary reason is that the larger and largest corporations have access to resources that most small businesses do not have. For instance, larger corporations retain tax staff with specialized skills.

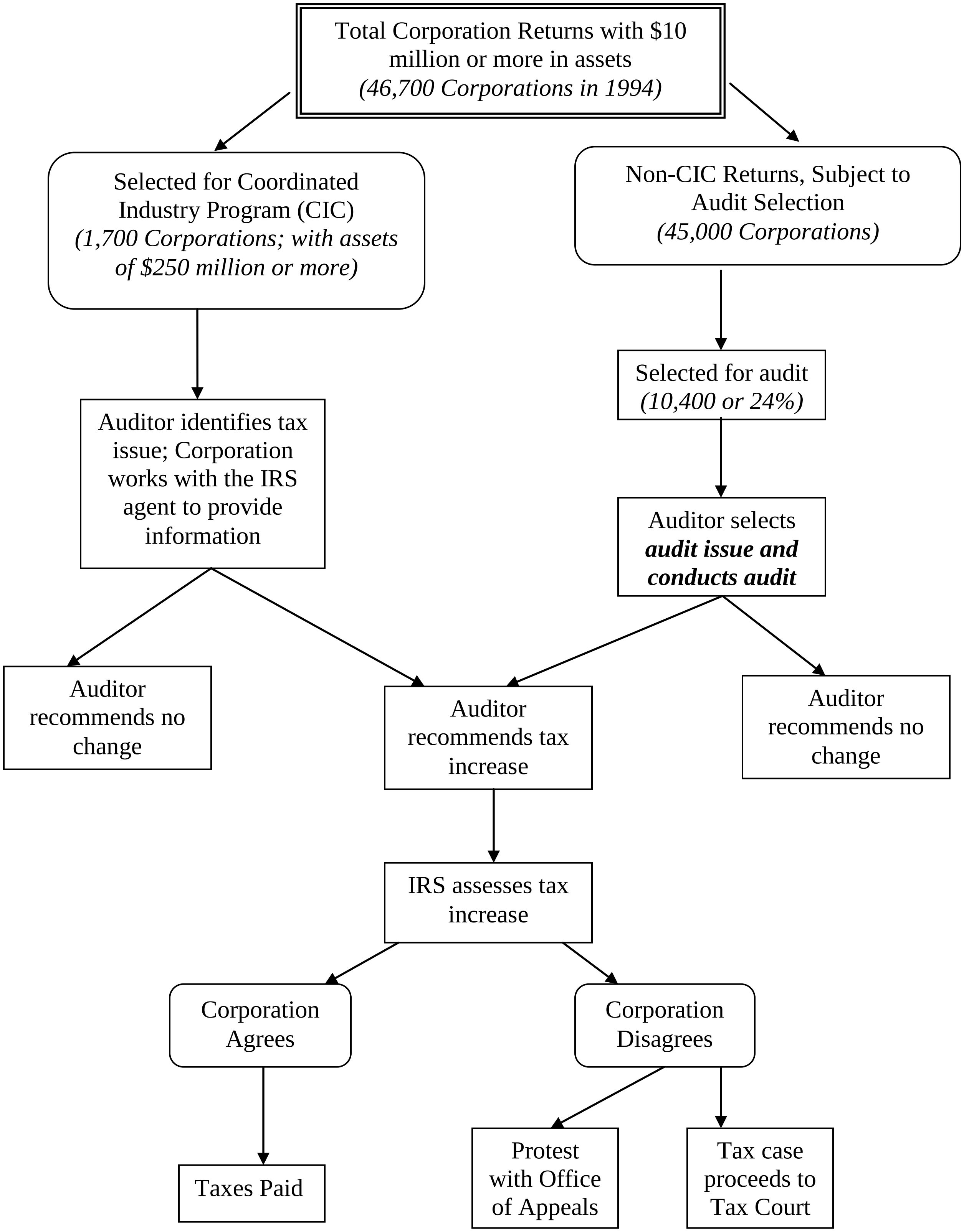
Coordinated Industry Case (formerly Coordinated Exam Program) **–** The CIC includes the largest U.S. Corporations in an ongoing examination program; thus, the largest corporations are subject to annual examinations. However, these examinations identify specific tax issues to review. In other words, the complexity of the return makes it difficult for IRS agents to conduct a complete examination of the corporation's return and, instead, identifies specific issues for audit. Therefore, the examiners select a section of the return that corresponds to the code sections most identified with tax problems.[123] Once the examiner identifies the tax issue and concludes the examination, the IRS recommends either no change to the return or an increase (or decrease) to the tax liability. After the IRS identifies a recommended tax increase, the CIC-corporation typically challenges the recommended tax increase. As mentioned above, the process of addressing the recommended tax increase typically involves the Office of Appeals. The IRS resolves approximately 90 percent of all these cases through Appeals. (The remaining cases proceed through the court system.) However, as mentioned, the appeals process involves a reduction in the recommended amount to the assessed amount.

There are a number of reasons that the IRS has difficulty collecting the recommended taxes. The GAO mentions the complexity of the tax code as a primary reason for this difficulty. The complexity creates the potential for multiple interpretations of the tax law. In many cases, the interpretation creates legitimate differences, which places the burden on the IRS to substantiate further their recommended tax amounts. The GAO indicates that this perpetuates a situation where there are recurring tax issues with ongoing disputes. It often takes a number of years to resolve these debates and agree to an assessed tax amount.

[123] The GAO indicates that 14 IRC sections comprise 45 percent of all tax problems and 57 percent of all collections for large corporations in the appeals process. Refer to GAO-GGD-94-70, page 4.

Chart 1 – Corporation Audit Process

(Refer to GAO/GGD-97-62 and GAO/GGD-98-128. The IRS case management has changed moreover, these represent the latest numbers under this system.)



Another problem in collecting recommended taxes is that in many cases, the CIC audit does not begin until several years after the corporation filed the return. Further, the examination of the return may take several years before the auditor makes a determination. This time delay generates a tension between the IRS and the corporation about collecting information to substantiate or refute the recommended tax amount. In many cases, the corporations do not respond to the request for additional information creating further delays in resolving the disputed recommended tax amounts.

Industry Case, Formerly known as the Large Corporation Audits – As mentioned above, the large corporation audits include those corporations with assets of more than $10 million but less than $250 million (includes those corporations not included in the CIC). These corporations pay approximately 7.4 percent of all corporation taxes, approximately $24 billion in 2007.[124]

The GAO conducted several studies of the IRS large corporation audit procedures.[125] The GAO indicates that the IRS audits approximately 24 percent of large corporations (not included in the CIC).

A similar process occurs for the large corporation audit as for the CIC audits. The IRS auditor identifies a tax issue to examine and conducts the audit based on this selection. Just as with the CIC, the IRS recommends a tax change (between 80 to 90 percent of all large corporation returns). However, the corporation must agree to this amount. If they do not agree, the large corporation proceeds with the appeals process. This process generates an assessed amount, which is considerably lower than the recommended amount.

The GAO identifies four primary reasons for the low collection rates: complexity of the tax code, ability of recommendations to survive the Appeals process, different goals for the Examination and Appeals offices, and difficulties in information sharing between Examination and Appeals.

As mentioned previously, the complexity of the tax code creates an opportunity for legitimate differing interpretations of tax law. This complexity puts additional pressure on the IRS examiner to recommend amounts that would survive the appeals process. This creates a burden on the IRS to recommend those amounts that they believe they can substantiate through the appeals process.

Yet, the conflicting pressures facing the Examination and Appeals staff present additional difficulties. Both offices focus on the time and staff resources as a measure of their performance. However, the Office of Appeals focuses on settling disputes and closing cases while the Examination Office focuses on the dollars for recommended tax changes. The disparity between the respective focuses places opposite pressure on the tax amounts. The examiners attempt to characterize the true tax liability (for the single tax issue) and the Appeals process attempts to reach an agreement between the IRS and large corporation.

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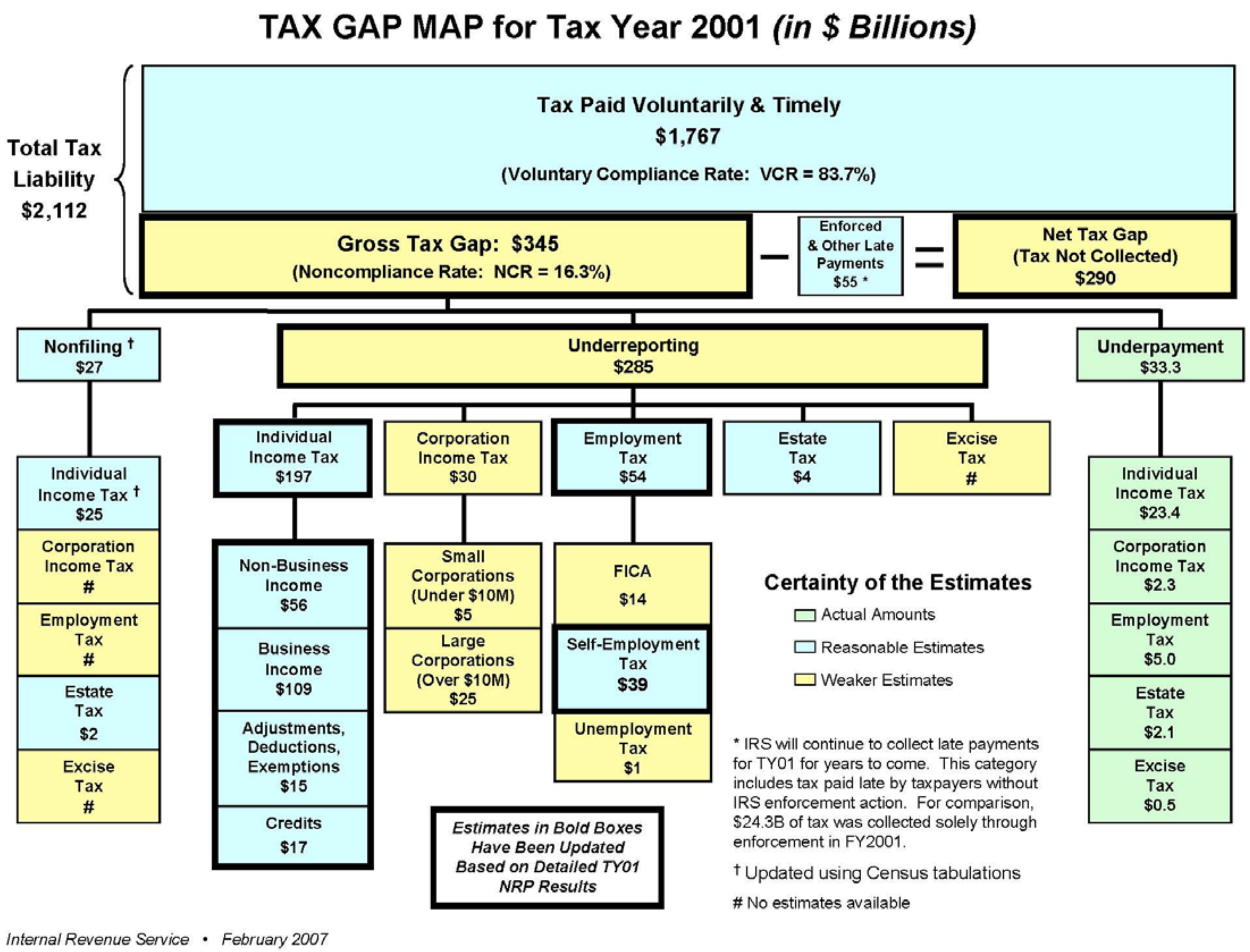
[124] Supra, Corporation Source Book, 2007. Small businesses organized as a C corporation remit approximately 5 percent of all corporation taxes, about $19 billion in 2007.
[125] Information contained in this section relies on multiple GAO studies of the corporation audit system. These reports include: GAO/GGD-94-70, GAO/GGD-96-6, GAO/GGD-97-62, and GAO/GGC-98-128
.

Generally, the amounts assessed through Appeals are a fraction of the amounts recommended (27 percent as mentioned above). However, the GAO identifies a further tension between the two offices – information sharing.

The GAO indicates that the Office of Appeals rarely shares information collected during the appeals process with the examiners. This means that the examiners often do not receive the benefit of a complete explanation or the rationale supporting a lower assessed amount. Over time, the examiner continues to recommend tax amounts and the appeals process continues to negotiate lower assessments.

This process of contesting recommended tax increases is available to small businesses. However, small business owners rarely have the resources and technical expertise at their disposal to do so. This suggests that when the IRS recommends a tax increase to the small business, they are at a distinct disadvantage relative to their larger counterparts.

APPENDIX B – Components of the 2001 IRS Tax Estimates



APPENDIX C – IRS Estimates of Net Misreporting Percentages (NMP) for Income Items on Individual Income Tax Returns

Individual Income Tax Underreporting Gap Estimates, Tax Year 2001

Category	*Tax Gap ($B)*	*NMP †*
Items Subject to Substantial Information Reporting and Withholding	**10.5**	**1.2%**
Wages, salaries, tips	10.5	1.2%
Items Subject to Substantial Information Reporting	**9.1**	**4.5%**
Interest income	1.6	3.6%
Dividend income	1.1	3.7%
State income tax refunds	0.6	11.6%
Pensions & annuities	4.2	4.1%
Unemployment Compensation	*	11.1%
Social Security benefits	1.1	5.8%
Items Subject to Some Information Reporting	**50.6**	**8.6%**
Partnership, S-Corp, Estate & Trust, etc.	22.0	17.8%
Alimony income	*	7.2%
Capital gains	11.0	11.8%
Deductions	13.5	5.4%
Exemptions	4.2	5.4%
Items Subject to Little or No Information Reporting	**110.1**	**53.9%**
Form 4797 income	3.3	64.4%
Other income	22.6	63.5%
Nonfarm proprietor income	68.0	57.1%
Farm income	5.8	72.0%
Rents & royalties	13.4	51.3%
Total Statutory Adjustments	-3.0	-21.1%
Not Shown on Visibility Chart	**17.1**	**26.3%**
Credits	17.1	26.3%
Total	**197.4**	**18.0%**

† NMP = Net Misreporting Percentage, the net amount of income or offset misreported divided by the amount that should have been reported.

* Less than $0.5 billion.

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