

March 2011

No. 377

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

by Quantria Strategies, LLC, Cheverly, MD 20785, 2011. [56] pages.

### Purpose

The tax gap is defined as the difference between taxes owed and taxes paid in the tax year for which the gap is calculated. Internal Revenue Service (IRS) estimates of the tax gap are based on data provided by the National Research Program (NRP). Data published by the NRP in 2006 gave an estimate for the tax gap for tax year 2001. The IRS calculated that the tax gap for 2001 was \$345 billion, or \$290 billion after late payments and amounts collected through enforcement efforts. Methodologically, the IRS focused its tax-gap study on individual income tax returns, and on returns not subject to withholding or third party reporting. Small businesses were deemed the culprits for the gap, as they are the most numerous users of such forms. To properly address the IRS's estimated and ensuing activities on the tax gap, it became apparent that research was needed to evaluate these effects on small business. The estimates of the tax gap vary widely. The reliability of the estimates should be understood if legislative action is considered.

This study examines the estimates to explore (1) the implications of the tax-gap estimates for IRS enforcement and legislative activities with respect to small businesses; (2) the weakness of the estimates relating to large corporations and taxpayers involved in international transactions; (3) possible alternative approaches to tax compliance to reduce the burden on small businesses.

### Overall Findings

- The gross tax-gap estimate translates to a voluntary compliance rate (VCR) of 84 percent. The IRS suggests that the VCR has remained constant since 1985.

- Most of the underreporting of income that occurs on individual income tax returns is unintentional. IRS auditors conducting NRP examinations found that 1 percent of all issues examined resulted from deliberate or intentional failures to report income properly.
- Seventy-one percent of the small businesses involved in litigated cases (involving trade or business deduction issues) were in pro se representations (small businesses representing themselves).
- The corporate tax gap estimates in the 2001 NRP are based on data from the 1970s and 1980s. The IRS did not update them for the analysis published in 2006.

### Highlights

- For fiscal years 2005-2009, the examination coverage rate of individual income tax returns has increased, while the examination coverage rate for large corporations with \$10 million or more in assets has decreased.
- The amount of money the IRS collects per auditor hour is significantly different for small businesses compared with large corporations. The IRS collects an average of \$9,354 per auditor hour for large corporations, while it collects only \$1,034 per auditor hour for small to mid-sized businesses.
- For fiscal years 2005-2009, the amount of time the IRS spent auditing the tax returns of large corporations went down by 13 percent.
- In measuring the underreporting of business income (on individual tax returns), the IRS applied a multiplier (adjustment factor) to account for the amount of underreported income

not visible to the examiner during the examination. The IRS has consistently used a multiplier ranging from 3.3 to 4.2.

- Unlike large corporations, small businesses lack the resources and expertise to enter into negotiations with the IRS. They are overwhelmed by the complexity of the tax code. Only aggressive outreach and education designed to help small businesses understand their tax filing obligations will significantly reduce the tax gap attributable to them.

### Scope and Methodology

The authors evaluated the literature and decomposed the 2001 NRP estimate to understand the weaknesses in the estimate.

This report was peer reviewed consistent with Advocacy's data quality guidelines. More information on this process can be obtained by contacting the director of Economic Research at [advocacy@sba.gov](mailto:advocacy@sba.gov) or (202) 205-6533.

### Ordering Information

The full text of this report and summaries of other studies performed under contract with the U.S. Small Business Administration's Office of Advocacy are available on the Internet at [www.sba.gov/advo/](http://www.sba.gov/advo/). Copies are available for purchase from:

National Technical Information Service  
5285 Port Royal Road  
Springfield, VA 22161  
(800) 553-6847 or (703) 605-6000  
TDD: (703) 487-4639

[www.ntis.gov](http://www.ntis.gov)

Order Number: PB2011- PB2011-105089

Paper A05 (\$48.00)

Microfiche A05 (\$33.00)

CD-ROM A00 (\$30.00)

Download A00 (\$15.00)

For email delivery of Advocacy's newsletter, press, regulatory news, and research, visit <http://web.sba.gov/list>. For RSS feeds, visit [www.sba.gov/advo](http://www.sba.gov/advo).