Tax Gap for Tax Year 2006

Overview

Jan. 6, 2012

The current tax gap estimate was published in 2006, based on tax year 2001 liabilities. An update, including re-estimation of all components using more recent data and improved methodologies, has been completed. The update is based on tax year 2006 liabilities. The increase in the gap since 2001, for which the gap estimate is $345 billion, is due almost entirely to the increase in total tax liabilities over the intervening period and does not reflect any significant change in compliance rates

The gross tax gap is defined as the amount of true tax liability faced by taxpayers that is not paid on time. For 2006 it is estimated to be $450 billion. (Years are tax years unless otherwise defined.) The voluntary compliance rate (VCR) for 2006 remained essentially unchanged at 83.1%, which is within the range of error of the previous estimate of 83.7% for 2001. (The VCR is defined as 1 minus the ratio of the gross tax gap to total liabilities.)

The net tax gap is defined as the amount of true tax liability that is not paid on time and is not collected subsequently, either voluntarily or as the result of enforcement activities. Thus, the net tax gap represents the amount of tax liability that is never paid.

The net tax gap for 2006 is estimated to be $385 billion, which is $95 billion higher than the $290 billion net tax gap previously estimated for 2001. The estimated net compliance rate (NCR) for 2006 is 85.5% which is within the range of error of the previous estimate of 86.3% for 2001. (The NCR is defined as 1 minus the ratio of the net tax gap to total liabilities.) The 85.5% NCR means that 14.5% of the estimated total tax liability for 2006 will never be paid. (See Table 1.)

The difference between the net and gross tax gap estimates for 2006 is $65 billion, which represents the amount of the gross tax gap that will eventually be collected, leaving the net tax gap at $385 billion. Late tax payments and IRS enforcement efforts reduced the 2006 gross tax gap by $65 billion compared to $55 billion in 2001. Late payments and enforcement recoveries do not include payments of interest and penalties. Additionally, enforcement and late payments related to 2006 were likely lower than they otherwise might have been because of the reduced ability of taxpayers to pay these past-due liabilities during the recession of 2008 and 2009. Enforcement and late payments are typically received in years subsequent to the tax year in which the liability arose (in other words, those related to tax year 2006 would typically be received in 2007 and beyond.)

The growth in the tax gap over the five years was concentrated in the underreporting and underpayment forms of noncompliance, which jointly account for more than nine out of ten tax gap dollars. The nonfiling portion of the gap hardly changed. The underreporting gap grew by 32%; the underpayment gap grew by 38%; and the nonfiling gap grew by 4%. The overall gap grew by 30%, slightly more than the growth in overall tax liabilities.

More than a third of the growth in the underreporting gap was attributable to corporate income taxes. The 2001 estimate of this portion of the tax gap was estimated based on old empirical data and was likely understated. The new methodology relies on more recent data and is significantly improved. In addition, between 2001 and 2006, corporation income tax liabilities more than doubled, while the individual income taxes grew by only 15 percent.

The finding established with the 2001 tax gap that compliance is far higher when reported amounts are subject to information reporting and, more so, when subject to withholding, holds unchanged with the 2006 tax gap. For example, the net misreporting percentage, or NMP, (defined as the net misreported amount as a ratio of the true amount) for amounts subject to substantial information reporting and withholding is 1%; for amounts subject to substantial information reporting but no withholding, it is 8%;

and for amounts subject to little or no information reporting, such as business income, it is 56%. (See Chart 1.)

The basic finding of the tax gap update is that the change in the estimated VCR, to 83.1% in 2006 from 83.7% in 2001, is sufficiently small that it is statistically unchanged.

IRS:RAS

Table 1: Tax Gap Statistic, Tax Year 2006 Compared to Tax Year 2001

[Money amounts are in billions of dollars]

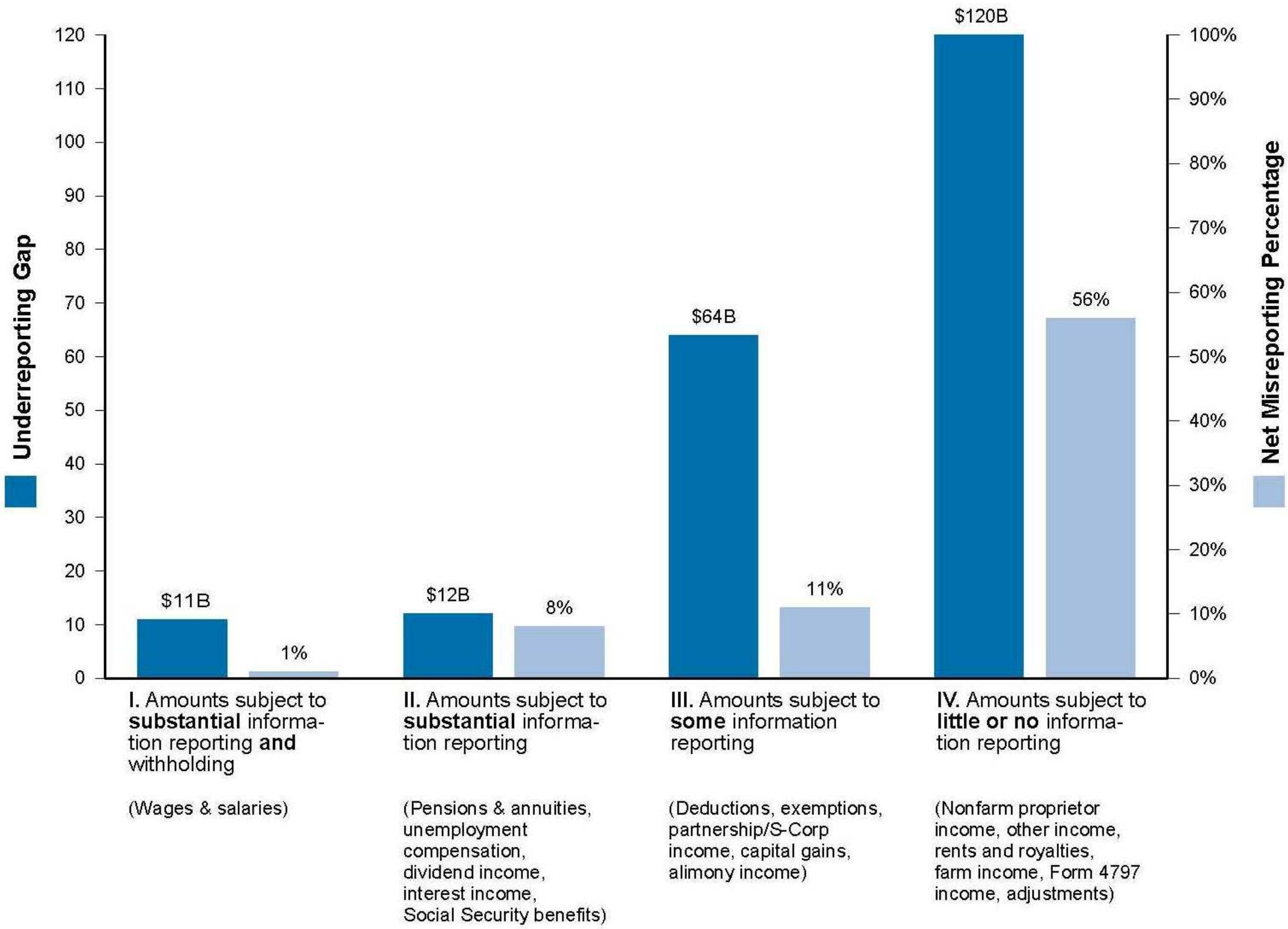
Tax Gap Component	TY2006	TY2001
Estimated Total Tax Liability	**2,660**	**2,112**
Gross Tax Gap	**450**	**345**
Overall Voluntary Compliance Rate	**83.1%**	**83.7%**
Net Tax Gap *	**385**	**290**
Overall Net Compliance Rate	**85.5%**	**86.3%**
Nonfiling Gap	**28**	**27**
Individual Income Tax	25	25
Estate Tax	3	2
Underreporting Gap	**376**	**285**
Individual Income Tax	235	197
Non-Business Income	68	56
Business Income	122	109
Adjustments, Deductions, Exemptions	17	15
Credits	28	17
Corporation Income Tax	67	30
Small Corporations (assets under $10M)	19	5
Large Corporations (assets of $10M or more)	48	25
Employment Tax	72	54
Self-Employment Tax	57	39
FICA and Unemployment Tax	15	15
Estate Tax	2	4
Underpayment Gap	**46**	**33**
Individual Income Tax	36	23
Corporation Income Tax	4	2
Employment Tax	4	5
Estate Tax	2	2
Excise Tax	0.1	0.5

* Net tax gap is defined as tax liabilities, incurred in that year, that remain outstanding after IRS enforcement efforts.

Internal Revenue Service, December 2011

Chart 1: Effect of Information Reporting on Taxpayer Compliance

Tax Year 2006 Individual Income Tax Underreporting Gap and Net Misreporting Percentage, by "Visibility" Category



NOTE: Net Misreporting Percentage is defined as the net misreported amount of income as a ratio of the true amount.

Internal Revenue Service, December 2011