

The Tax Gap

- The **difference between** the **tax** that **taxpayers should pay** and what they **actually pay** on a **timely basis**
- Includes three components:
 - **Nonfiling** (failure to file a tax return)
 - **Underreporting** (understating income, overstating deductions)
 - **Underpayment** (failure to fully pay reported taxes owed)
- An **understanding** of the **Tax Gap** and its components allows the legislative and executive branches of government to make **better decisions** about **tax policy** and the **allocation** of **resources** for **tax administration**

National Research Program

- The IRS National Research Program (**NRP**) **measures noncompliance** that makes up the Tax Gap.
- **Detailed research** on taxpayer compliance was **last conducted** for **Tax Year 1988**.
- The **NRP** has now **completed** its **initial assessment of individual taxpayer compliance** for **Tax Year 2001**. The research sample covered 46,000 tax returns, including an oversampling of high income returns. The research provides a statistically valid representation of the overall population. **NRP has not updated the corporate Tax Gap**.
- Current **data are preliminary**, so **Tax Gap estimates are shown as ranges**. As refinements are made to the analysis, **some estimates may change**. It is unlikely, but possible, that the final estimates of the Tax Gap will fall outside the established range.

Estimated TY2001 Federal Tax Gap

(in Billions of Dollars)

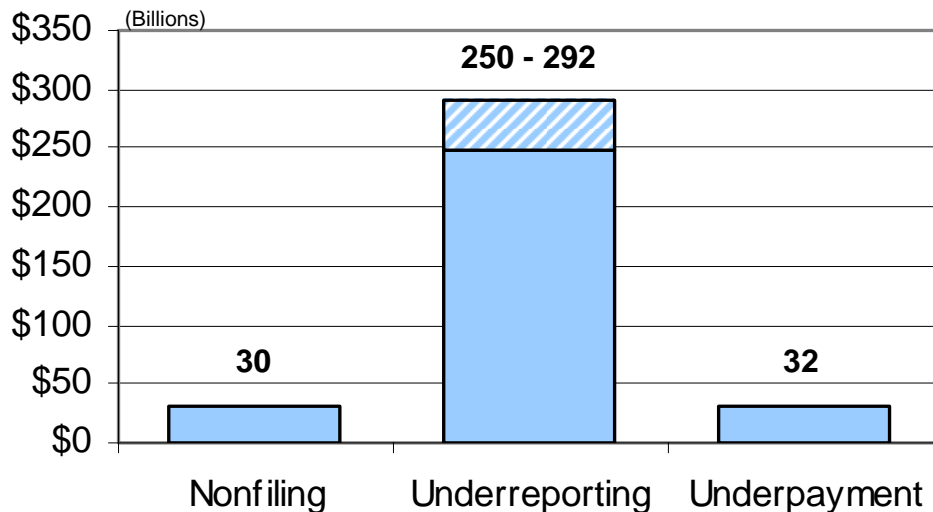
Gross Tax Gap*	312 – 353
Enforced and Late Payments	(55)
Net Tax Gap	257 – 298
Noncompliance Rate	15.0% – 16.6%

•Compares to \$311 billion estimate for 2001 using rules from 1988 and earlier studies.

Two Views of the Tax Gap

- By Type of Noncompliance
 - Nonfiling
 - Underreporting
 - Underpayment
- By Type of Tax
 - Income
 - Individual
 - Corporation
 - Employment
 - Self-Employment
 - FICA and Unemployment
 - Estate
 - Excise
- The NRP for TY2001 addresses the underreporting of income and self-employment taxes by individual taxpayers.

Underreporting Noncompliance is the Largest Component of the Tax Gap

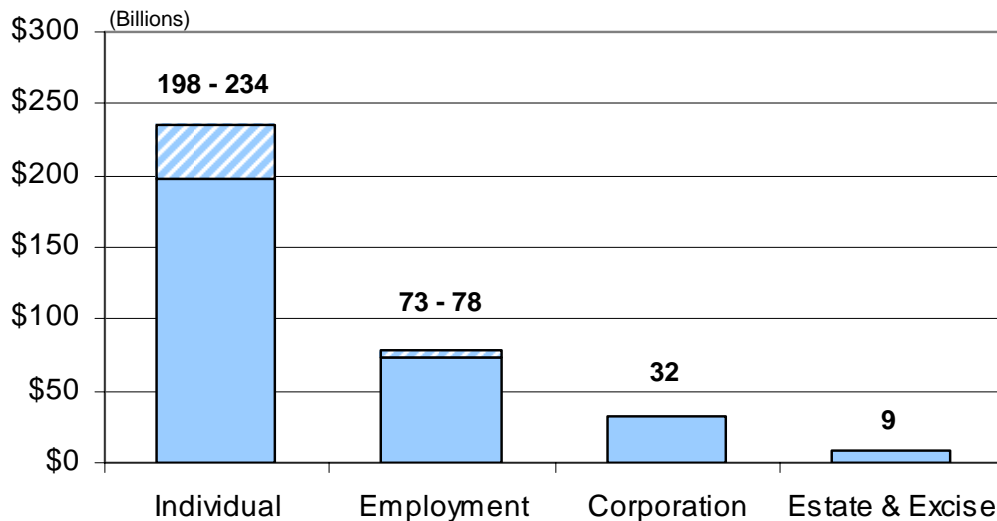


Underreporting sources:

- understated income
- improper deductions
- overstated expenses
- erroneously claimed credits

Preliminary estimates of noncompliance from **underreporting** account for **more than 80% of the Tax Gap**.

Individual Income Tax is the Single Largest Source of the Annual Tax Gap

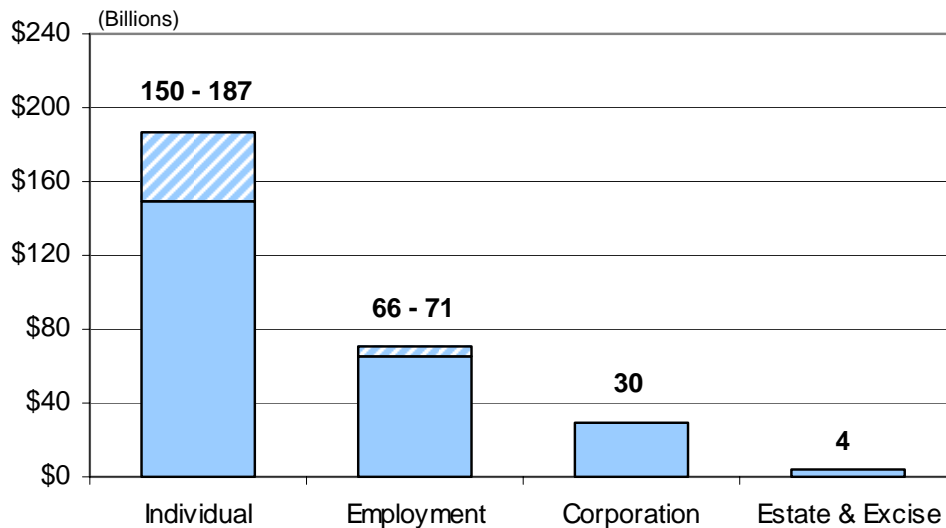


Individual Tax Gap includes:

- nonfiling
- underreporting
 - non-business income
 - business income
 - overstated deductions, credits, exemptions
- underpayment

Preliminary NRP results indicate that the **individual income tax** accounts for about **two-thirds** of the **Tax Gap**.

Individuals are the Dominant Source of the Underreporting Gap

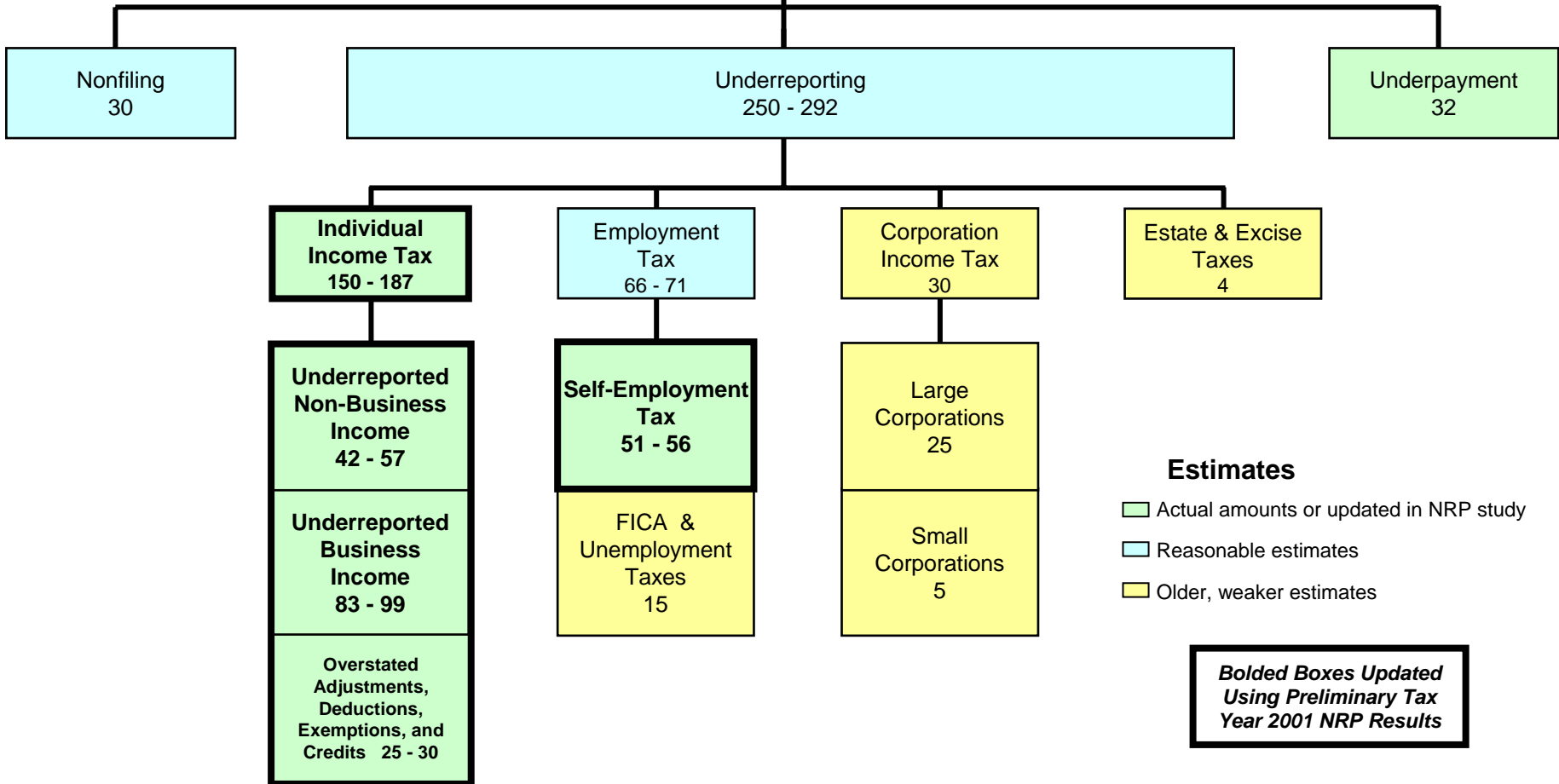


- **Understated income**, not overstated deductions, accounts for **over 80% of individual underreporting**.
- **Business activities**, not wages or investment income, account for **most of the understated individual income**.

2001 FEDERAL TAX GAP

(in Billions of Dollars)

Gross Tax Gap
312 - 353



Net tax gap after recoveries of 55 = 257 - 298

Composite 2001 Individual Tax Return

(Dollars in Billions)

Form 1040 (2001) Department of the Treasury—Internal Revenue Service

U.S. Individual Income Tax Return 2001

(99) IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0074

For the year Jan. 1-Dec. 31, 2001, or other tax year beginning , 2001, ending , 20

Your first name and initial Last name Your social security number

If a joint return, spouse's first name and initial Last name Spouse's social security number

Home address (number and street). If you have a P.O. box, see page 19. Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.

Important! You must enter your SSN(s) above.

Presidential Election Campaign (See page 13) Note. Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want \$3 to go to this fund? You Yes No Spouse Yes No

Filing Status

1 Single

2 Married filing joint return (even if only one had income)

3 Married filing separate return. Enter spouse's social security no. above and full name here. ▶

4 Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶

5 Qualifying widow(er) with dependent child (your spouse died ▶) (See page 19.)

Exemptions

6a Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a

b Spouse

c Dependents:

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) If qualifying child for child tax credit (see page 20)	No. of boxes checked on 6a and 6b	No. of your children on 6c who:
				<input type="checkbox"/>		<ul style="list-style-type: none"> lived with you did not live with you due to divorce or separation (see page 20)
				<input type="checkbox"/>		Dependents on 6c not entered above
				<input type="checkbox"/>		Add numbers entered on lines above ▶

d Total number of exemptions claimed

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 4,565

8a Taxable interest. Attach Schedule B if required 8a 198

b Tax-exempt interest. Do not include on line 8a 8b 56

9 Ordinary dividends. Attach Schedule B if required 9 120

10 Taxable refunds, credits, or offsets of state and local income taxes (see page 22) 10 21

11 Alimony received 11 7

12 Business income or (loss). Attach Schedule C or C-EZ 12 217

13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ 13 327

14 Other gains or (losses). Attach Form 4797 14 -2

15a Total IRA distributions 15a 119 b Taxable amount (see page 23) 15b 94

16a Total pensions and annuities 16a 533 b Taxable amount (see page 23) 16b 339

17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17 268

18 Farm income or (loss). Attach Schedule F 18 -11

19 Unemployment compensation 19 27

20a Social security benefits 20a 197 b Taxable amount (see page 25) 20b 94

21 Other income. List type and amount (see page 27) 21 -32

22 Add the amounts in the far right column for lines 7 through 21. This is your total income ▶ 22 6,231

Adjusted Gross Income

23 IRA deduction (see page 27) 23 7

24 Student loan interest deduction (see page 28) 24 3

25 Archer MSA deduction. Attach Form 8853 25 0.1

26 Moving expenses. Attach Form 3903 26 2

27 One-half of self-employment tax. Attach Schedule SE 27 18

28 Self-employed health insurance deduction (see page 30) 28 8

29 Self-employed SEP, SIMPLE, and qualified plans 29 13

30 Penalty on early withdrawal of savings 30 0.2

31a Alimony paid b Recipient's SSN ▶ 31a 7

32 Add lines 23 through 31a 32 61

33 Subtract line 32 from line 22. This is your adjusted gross income 33 6,171

Form 1040 (2001)

Tax and Credits

34 Amount from line 33 (adjusted gross income) 34 6,171

35a Check if: You were 65 or older, Blind, Spouse was 65 or older, Blind. Add the number of boxes checked above and enter the total here ▶ 35a

b If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here ▶ 35b

36 Itemized deductions (from Schedule A) or your standard deduction (see left margin) 36 1,366

37 Subtract line 36 from line 34 37 4,910

38 If line 34 is \$99,725 or less, multiply \$2,900 by the total number of exemptions claimed on line 6d. If line 34 is over \$99,725, see the worksheet on page 32 38 728

39 Taxable income. Subtract line 38 from line 37. If line 39 is more than line 37, enter -0- 39 4,269

40 Tax (see page 33). Check if any tax is from a Form(s) 8814 b Form 4972 40 927

41 Alternative minimum tax (see page 34). Attach Form 6251 41 7

42 Add lines 40 and 41 42 934

43 Foreign tax credit. Attach Form 1116 if required 43 6

44 Credit for child and dependent care expenses. Attach Form 2441 44 3

45 Credit for the elderly or the disabled. Attach Schedule R 45 .003

46 Education credits. Attach Form 8863 46 5

47 Rate reduction credit. See the worksheet on page 36 47 5

48 Child tax credit (see page 37) 48 22

49 Adoption credit. Attach Form 8839 49 0.1

50 Other credits from: a Form 3800 b Form 8396 c Form 8801 d Form (specify) 50 3

51 Add lines 43 through 50. These are your total credits 51 44

52 Subtract line 51 from line 42. If line 51 is more than line 42, enter -0- ▶ 52 889

Other Taxes

53 Self-employment tax. Attach Schedule SE 53 36

54 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137 54 .004

55 Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required 55 3

56 Advance earned income credit payments from Form(s) W-2 56 .005

57 Household employment taxes. Attach Schedule H 57 1

58 Add lines 52 through 57. This is your total tax 58 930

Payments

59 Federal income tax withheld from Forms W-2 and 1099 59 773

60 2001 estimated tax payments and amount applied from 2000 return 60 220

61a Earned income credit (EIC) 61a 33

b Nontaxable earned income 61b 3

62 Excess social security and RRTA tax withheld (see page 51) 62 2

63 Additional child tax credit. Attach Form 8812 63 5

64 Amount paid with request for extension to file (see page 51) 64 42

65 Other payments. Check if from a Form 2439 b Form 4136 65 0.2

66 Add lines 59, 60, 61a, and 62 through 65. These are your total payments ▶ 66 1,077

Refund

67 If line 66 is more than line 58, subtract line 58 from line 66. This is the amount you overpaid 67 237

68a Amount of line 67 you want refunded to you 68a 202

b Routing number

c Type: Checking Savings

d Account number

69 Amount of line 67 you want applied to your 2002 estimated tax ▶ 69 35

Amount You Owe

70 Amount you owe. Subtract line 66 from line 58. For details on how to pay, see page 52 70 1

71 Estimated tax penalty. Also include on line 70 71 1

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? Yes. Complete the following. No

Designee's name Phone no. () Personal identification number (PIN) ()

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 19. Keep a copy for your records. ▶

Your signature Date Your occupation Daytime phone number ()

Spouse's signature. If a joint return, both must sign. Date Spouse's occupation

Paid Preparer's Use Only

Preparer's signature Date Check if self-employed Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code EIN Phone no. ()

2001 Individual Income Tax Gap

Major Contributors Ranked by Dollars

Form 1040 Line	Preliminary Estimate* (\$ Billions)
Total	150 – 187
Non-Business Income	42 – 57
Other income (gambling winnings, awards, etc.)	14 – 18
Wages, salaries, tips, etc.	13 – 15
Net capital gains, distributions, other gains	6 – 9
Taxable pension, annuities, IRA distributions	4 – 8
Taxable interest and dividend income	3 – 5
Miscellaneous	< 3
Business Income	83 – 99
Non-farm proprietor net income	59 – 65
Partnership, S-Corp, estate and trust net income	16 – 24
Rent, royalty net income	7 – 8
Farm net income	2 – 3
Offsets to Income or to Tax	25 – 30
Deductions	15 – 18
Credits	11 – 14
Exemptions	5
Adjustments: All Other	≤ 1
Adjustments: 1/2 of Self-Employment Tax	-6 to -7

* Line item **estimates subject to significant changes**; detailed analyses to be completed by the end of 2005.

2001 Individual Income Tax Gap

Major Contributors Ranked by Misreporting Percentage

Form 1040 Line	Tax Gap (\$ Billions)	Preliminary Misreporting %*
Non-Business Income		
Alimony income	< 1	21.0 – 23.8
Unemployment compensation	≤ 1	8.3 – 15.3
State income tax refunds	< 1	5.9 – 6.5
Taxable pension, annuities, IRA distributions	4 – 8	4.1 – 7.4
Taxable interest and dividend income	3 – 5	3.9 – 5.7
Taxable Social Security benefits	1	3.9 – 4.0
Wages, salaries, tips, etc	13 – 15	1.2 – 1.4
Net capital gains, distributions, other gains	6 – 9	n/a
Other income (gambling winnings, awards, etc.)	14 – 18	n/a
Business Income		
Non-farm proprietor net income	59 – 65	n/a
Partnership, S-Corp, estate and trust net income	16 – 24	n/a
Rent, royalty net income	7 – 8	n/a
Farm net income	2 – 3	n/a
Offsets to Income or to Tax		
Credits	11 – 14	17.1 – 22.5
Deductions	15 – 18	5.2 – 6.0
Exemptions	5	4.8 – 5.0
Adjustments: All Other	≤ 1	n/a
Adjustments: 1/2 of Self-Employment Tax	-6 to -7	n/a

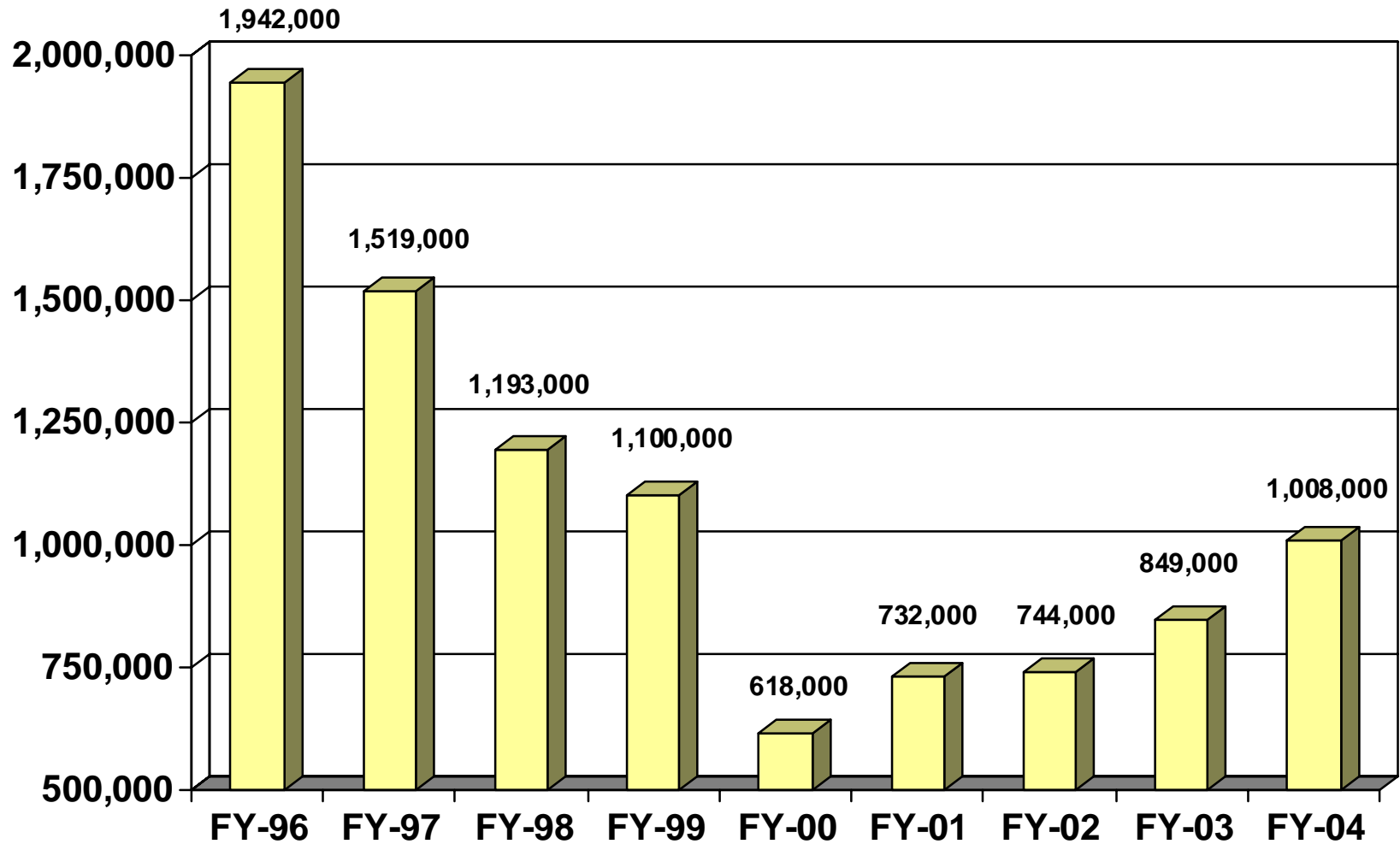
* Line item **estimates subject to significant changes**; detailed analyses to be completed by the end of 2005.

n/a – not available

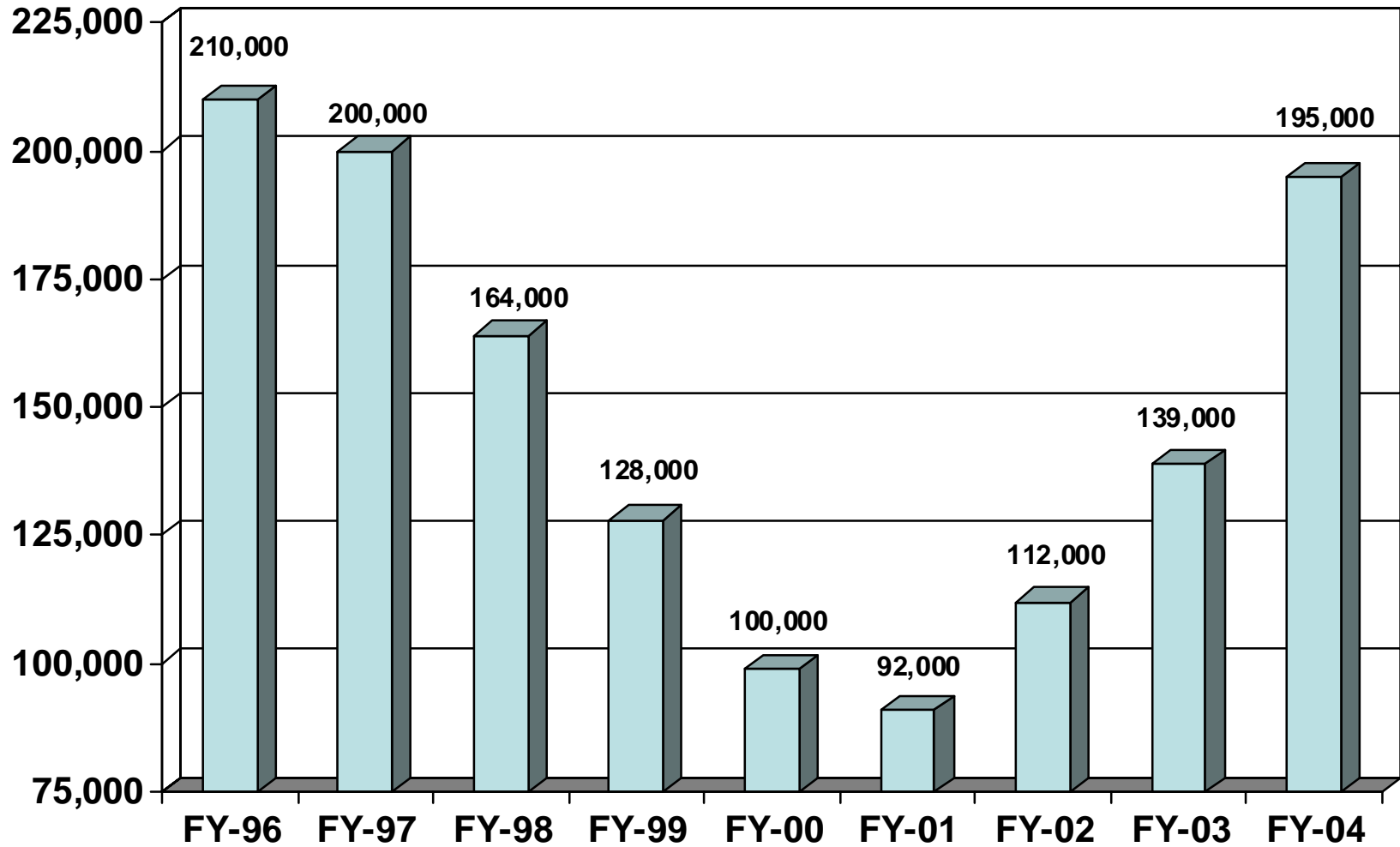
Next Steps

- **Refine estimates** from the individual taxpayer study to further update Tax Gap estimates. Comprehensive estimates should be **completed by the end of 2005**.
- **Update estimates for other areas** of the Tax Gap—first area to be addressed is reporting compliance study of **flow-through entities** (S-Corporations and partnerships).
- Use data from the individual taxpayer study to **build new audit models** and develop **other ways to address noncompliance**.

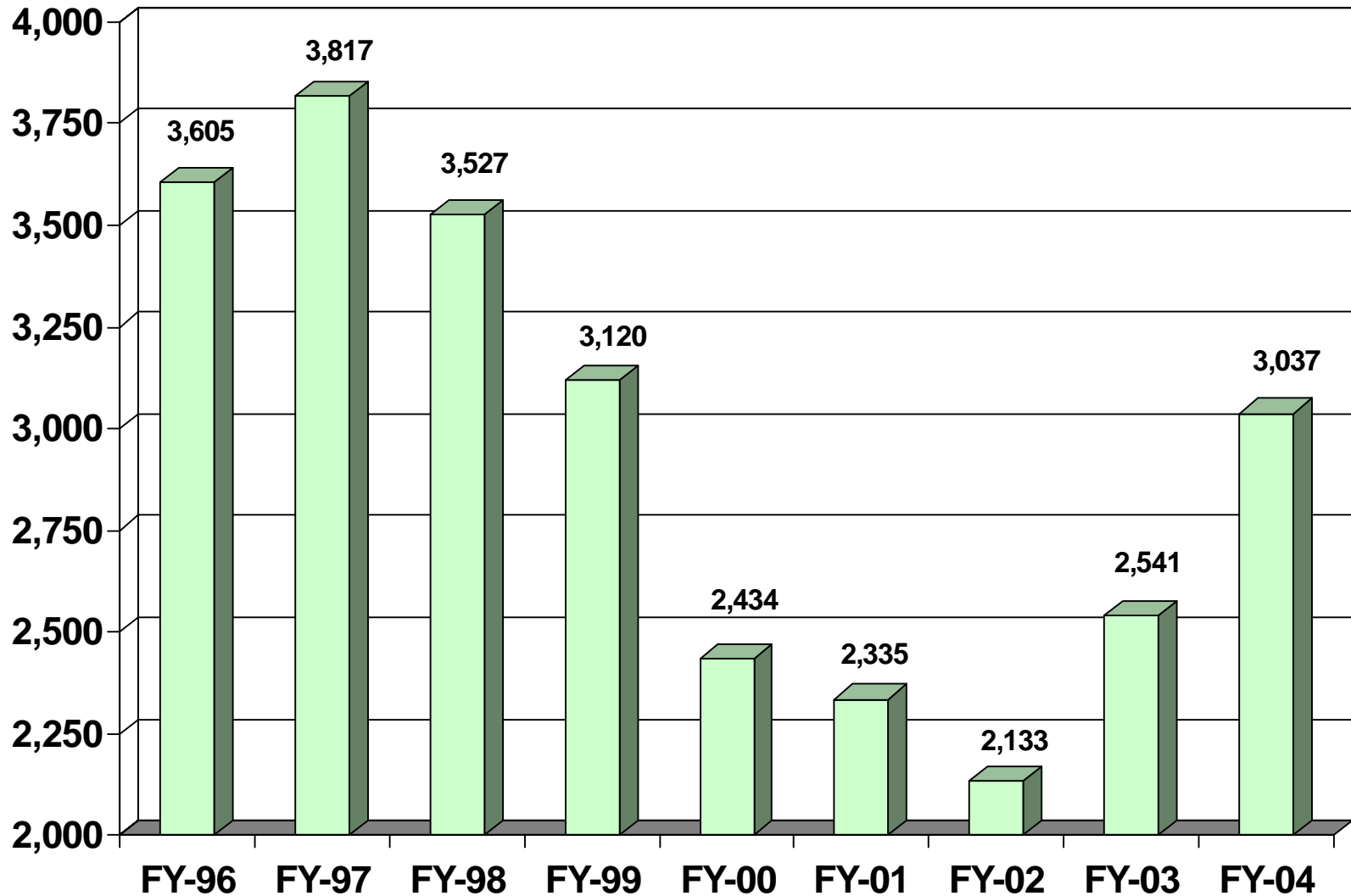
Individual Audits



High Income Audits

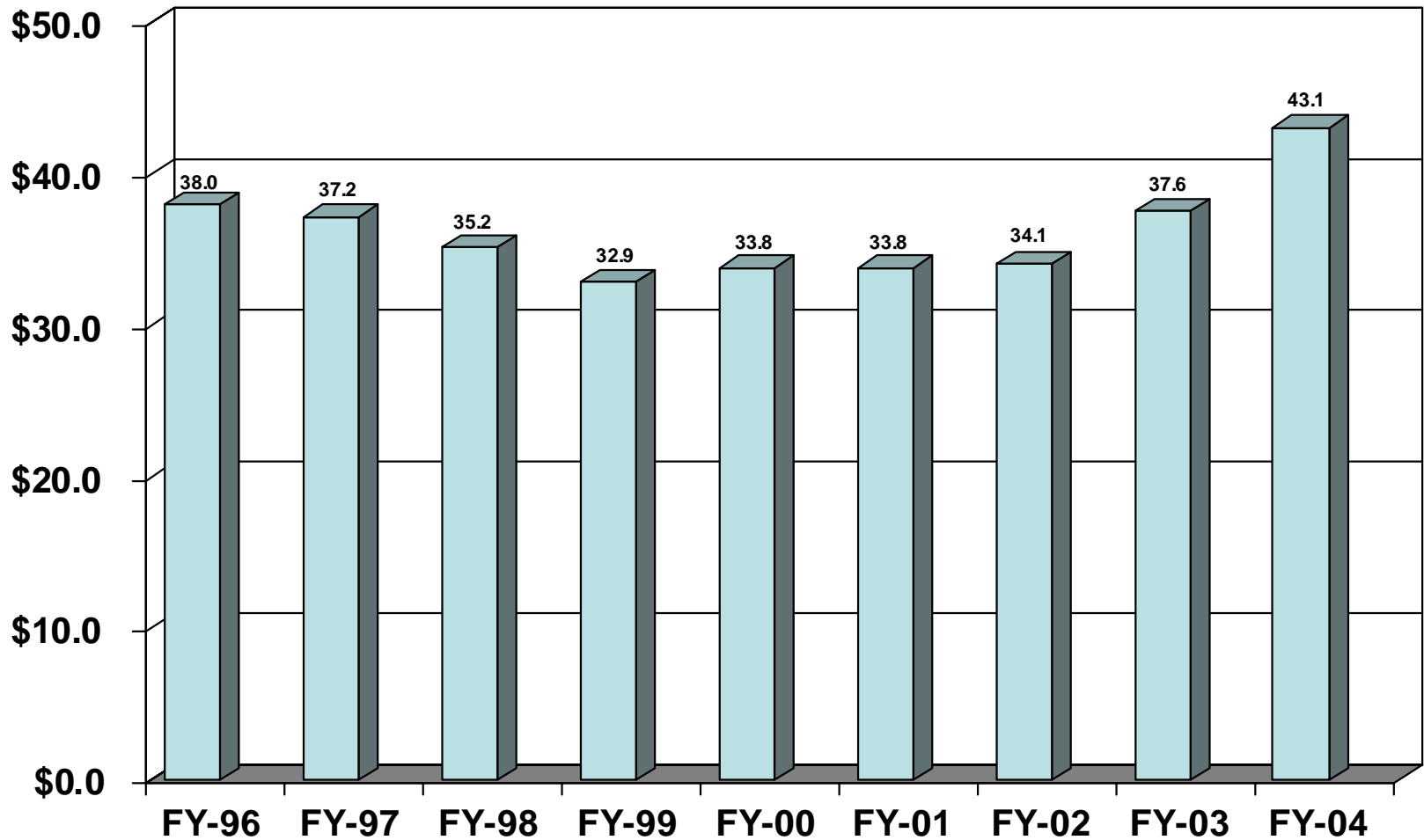


Criminal Prosecutions Recommended



IRS Enforcement Revenue

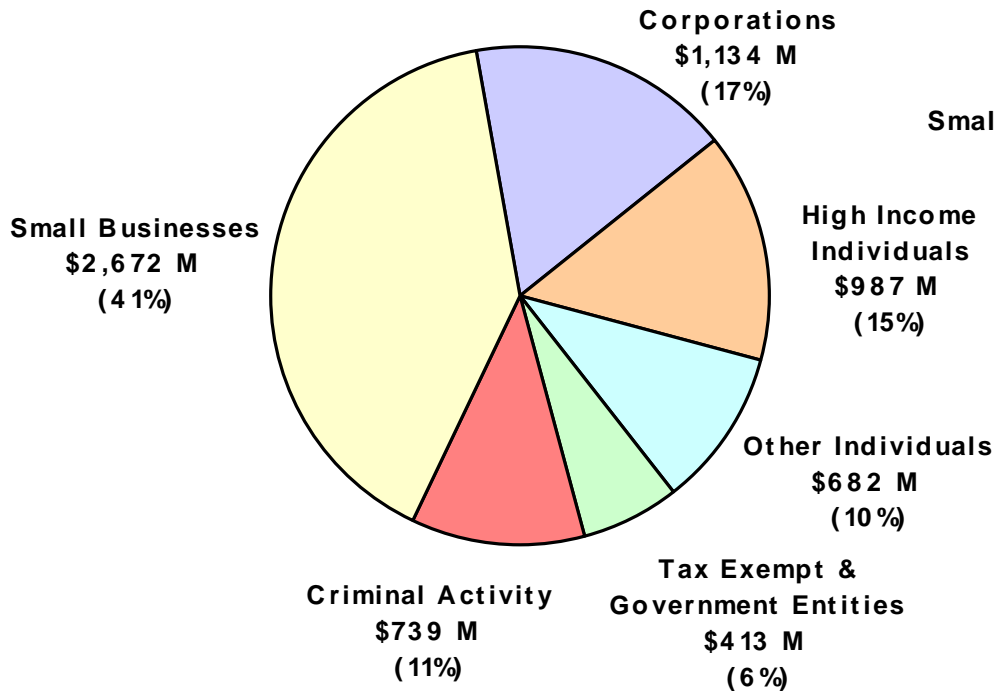
Dollars in Billions



Allocation of Enforcement Resources

Dollars in Millions

Base Enforcement Resources
Total = \$6,628 M



2006 Initiatives
Total = \$ 265 M

