**WRITTEN TESTIMONY OF
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BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
ON THE TAX GAP
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Chairman Neal, Ranking Member Brady and members of the Committee, my name is Benjamin Herndon. I have been the IRS's chief research and analytics officer since 2016. In that role I direct the agency's office of Research, Applied Analytics and Statistics. My organization oversees the data collection and methodology the IRS uses to measure the tax gap. I appreciate the opportunity to testify and discuss my office's work related to the methodology underlying the tax gap analysis.

The tax gap is defined as the difference between the amount of tax owed by taxpayers for a given year and the amount that is actually paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws.

The most recent IRS study of the tax gap was released in 2016, and it covered tax years 2008 through 2010. The study estimated the average annual gross tax gap for that period at $458 billion, and the voluntary compliance rate at 81.7 percent. The previous study covering tax year 2006 estimated the gross tax gap at $450 billion, and the voluntary compliance rate at 83.1 percent. The IRS is in the process of preparing a new study on the tax gap, covering tax years 2011-2013. We expect to release the updated report later this year.

It is important to note that the data needed for the tax gap estimates take a few years to collect, due to a number of factors. For example, taxpayers have until late in a given year to file a previous year's tax returns, and it then takes a few years to measure compliance. The IRS uses examination data to estimate some components of the tax gap, and that takes the longest amount of time to collect. Furthermore, reliable estimates require resource-intensive, time-consuming research gathered from a wide range of sources, including statistically selected in-person audits of taxpayers. The audit findings are supplemented by other information sources, such as income and expenditure information from third-party sources; information from late-filed returns; and tabulations from IRS master files of enforced and other collections. These steps mean that tax gap estimates always trail the tax year as we gather data about compliance upon which to base the estimates.

In regard to the IRS's most recent tax gap report, it should be noted that the gross estimate of $458 billion does not account for the revenue brought in through enforcement activities, such as audits and document matching. After factoring in IRS enforcement efforts through things like audits and collections, the average net tax gap for the 2008-2010 period is estimated to be $406 billion per year.

When looked at by mode of compliance, the tax gap can be divided into three components:

- Nonfiling, or not filing required returns on time;
- Underreporting, or not reporting one's full tax liability when the return is filed on time; and
- Underpayment, or not paying by the due date the full amount of tax reported on a timely filed return.

By far the largest component of the tax gap is underreporting, representing $387 billion of the $458 billion total. Individual underreporting comprises $264 billion of that $387 billion, while employment tax represents $81 billion, corporate tax $41 billion and excise tax $1 billion.

As for the two other components of the tax gap estimate of $458 billion: Underpayment represents $39 billion (individual underpayment is $29 billion of the $39 billion) and nonfiling $32 billion of the total (individual nonfiling is $26 billion of that $32 billion).

The underpayment gap is the easiest component to measure, because it is calculated directly from IRS administrative records for the individual income tax, the corporate income tax, employment taxes, estate tax, and excise taxes. Taxpayers who have filed returns indicating taxes owed but who have not paid the full amounts on time are identified upon filing. The difference between taxes owed as reported on returns and the amounts paid on time is the underpayment gap.

The other two components of the tax gap – nonfiling and underreporting – present vastly greater estimation challenges because they measure activity that is either not revealed to the IRS at all (such as failure to file a return) or may be reported in an understated fashion.

The predominant method used to calculate the underreporting gap involves audit data. For the individual income tax, this involves audits of a statistically selected sample of tax returns. These audits are time consuming, but they constitute the ideal method for estimating the underreporting gap for the individual income tax. These audits are done under a program called the National Research Program (NRP) that has been in place since 2000. The audits are potentially broader in scope than the typical risk-based audits, in that they examine a set of issues that are determined by the NRP procedures, instead of focusing on the top few problems with a given tax return. The information gleaned from these audits helps us refine our audit selection tools, helping to ensure that our examiners are working the best cases under our risk-based models. This work also offers other more detailed insights about noncompliant behavior. Those insights are used throughout the IRS to better focus our taxpayer service and enforcement work.

One of the key findings from our ongoing research on the tax gap has been that tax compliance is far higher when reported amounts are subject to information reporting and, more so, when subject to withholding as well. In our report on tax years 2008-2010, the net misreporting percentage (NMP) was calculated by looking at the net amount that was misreported (which includes both under- and overreporting items) and expressing it as a ratio of the absolute value of the correct amount that should have been reported. This ratio was 1 percent for amounts subject to substantial information reporting and withholding, and 7 percent for amounts subject to substantial information reporting without withholding. But the NMP jumped to 63 percent for amounts subject to small amounts of or no information reporting or withholding.

In terms of what makes up the tax gap, the underreporting of business income by individual taxpayers – income of sole proprietors, farmers and those earning rental, royalty, partnership, and S Corporation income – is the largest contributor, accounting for $125 billion of the total $458 billion in the 2008-2010 period. The IRS believes that the lack of reliable and comprehensive reporting and withholding for business income received by individuals is the main reason for these findings.

These statistics provide further confirmation that “visibility” of income sources and financial transactions is a significant contributor to increasing the compliance rates, and enhanced information reporting is one of the few means of sizably increasing the compliance rate. Business income reported on Form 1040s is a much lower-visibility income source because it is not often subject to the same information reporting and withholding requirements that exist for salary and wage income.

Chairman Neal, Ranking Member Brady, and Members of the Committee, thank you again for the opportunity to discuss the tax gap. This concludes my statement, and I would be happy to take your questions.