Chairman Whitehouse, Ranking Member Thune and members of the Subcommittee, thank you for the opportunity to discuss the tax gap.

Understanding the tax gap and its components helps government make better decisions about tax policy and the allocation of resources to tax administration. The IRS continues to pursue many different angles to address the tax gap. We are committed to enhancing taxpayer services and guidance, reducing noncompliance while ensuring fairness in the tax system and minimizing taxpayer burden.

MEASURING THE TAX GAP

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.

Tax Gap Methodology and Data

The tax gap is determined by the IRS Research, Applied Analytics and Statistics (RAAS) organization. The most recent tax gap study released in 2019 covered Tax Years (TY) 2011-2013 (generally returns filed during calendar years 2012-2014). For that time period, the estimated gross tax gap (the amount of “true” tax that is not paid voluntarily and timely) was $441 billion.

The net tax gap is the amount of tax that will not be paid after subtracting from the gross tax gap the portion that eventually will be collected as a result of IRS enforcement activities or paid late but voluntarily by taxpayers. RAAS estimated that $60 billion of the gross tax gap eventually would be paid – either voluntarily or collected through IRS administrative and enforcement activities – resulting in an annual net tax gap of $381 billion of taxes owed as compared to what is actually paid. Without action to address this gap, the potential growth in the amount of taxes left unpaid and uncollected could result in a tax gap totaling several trillion dollars over the next decade.
When looked at by mode of compliance, the tax gap can generally 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.

Looking at the components of the tax gap, the non-filing gross tax gap was estimated at $39 billion, the underreporting gross tax gap was $352 billion and the underpayment gross tax gap was $50 billion. And by the various types of taxes, the estimated gross tax gap for individual income tax was estimated at $314 billion, the gross tax gap for corporate income tax was $42 billion, the gross tax gap for employment tax was $81 billion, and the gross tax gap for estate and excise tax combined was $3 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 actual audit data. For the individual income tax, this involves audits of a stratified random statistical sample of tax returns. These audits are time consuming, but they constitute a viable 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 compliance/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 compliance issues 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 possible cases under our risk-based models. This work also offers other more detailed insights about compliant and noncompliant behavior. Those insights are used throughout the IRS to 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 2011-2013, 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 5 percent for amounts subject to substantial information reporting without withholding. But the NMP jumped to 55 percent for amounts subject to small amounts of or no information reporting or withholding.

In terms of what makes up the tax gap, the detected underreporting of business income by individual taxpayers – income of sole proprietors and those earning rental, royalty, partnership, and S Corporation income – is the largest contributor, accounting for $110 billion of the total $441 billion in the 2011-2013 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.

Over the years, our studies have consistently suggested that overall tax compliance is holding steady in the 82 percent to 84 percent range (the actual dollars represented by the tax gap can be impacted by whether the country is experiencing a recessionary economy but the percentage has remained mostly steady since about 2001). For TY 2011-2013, the estimated tax gap translated into about 83.6 percent of taxes paid voluntarily and on time, which is in line with recent levels. This estimate is essentially unchanged from a revised TY 2008-2010 estimate of 83.8 percent. After enforcement efforts are taken into account, the estimated share of taxes eventually paid is 85.8 percent for both periods and is in line with the estimates for TY 2001 and TY 2006 of 86.3 percent and 85.5 percent, respectively.

The IRS is in the process of preparing a new study on the tax gap, covering tax years 2014-2016 and we expect to release the updated report next year. It is important to note that the data needed to produce tax gap estimates using our traditional methodology takes 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 traditionally trail the tax year as we gather data about compliance upon which to base the estimates. Current efforts to produce more timely estimates are detailed below.

**Modernizing IRS Tax Gap Estimates**

While the IRS’s tax gap estimation methodology has been deemed a gold standard by other tax administrators because it is grounded in classical statistical methods, there is room for improvement. Technology and data collection and analysis are continuing to improve. In 2020, the Office of the Chief Statistician’s Federal Committee on Statistical Methodology released a Framework for Data Quality, which builds on the Information Quality Act and advances the Federal Data Strategy. Timeliness, defined as the length of time between the event or phenomenon the data describe and their availability, was added as a key component of data quality. Likewise, as part of the IRS’s ongoing efforts to improve tax gap estimation, the IRS is researching methods to reduce the lag between the focus tax years and release of the tax gap estimates by incorporating newer estimation methods that have emerged from the big data revolution.

This new methodology will make greater use of information collected during operational audits to augment a smaller, focused random statistical sample. By applying modern machine learning techniques to our data in close to real time, we hope to produce more timely estimates and projections of the tax gap that will better support strategic planning. These analyses will be grounded in data reported on tax returns and informed by contemporaneous audit results. In our preliminary research, applying this methodology to the 2011-2013 official estimate of the gross tax gap, $441 billion, suggests the gross tax gap for 2019 would be approximately $600 billion.

Making greater use of the full range of filing and audit data collected by the IRS and evolving technology, we also hope to ensure that future tax gap measures better capture emerging issues. For example, data that underlie the tax year 2011-2013 estimates largely omit the platform economy and cryptocurrency because both were just beginning to gain popularity at that time. Today, these contribute significantly to the U.S. economy. Some estimates suggest that today the global cryptocurrency market may be as high as $2 trillion dollars, suggesting the potential non-compliance from transactions involving this asset may be significant. Later this year, IRS will release statistics on the number of individual income taxpayers who reported holding cryptocurrency in their portfolio and through collaborations between IRS researchers, field agents and Criminal Investigation teams, we eventually hope to be able to estimate the contribution of this asset to the tax gap.
Making greater use of operational audit data, combined with advanced analytics will also provide insights into issues that are not well measured through statistical samples because they are highly concentrated in relatively small segments of the tax filing population. A recently released National Bureau for Economic Research (NBER) working paper, “Tax Evasion at the Top of the Income Distribution: Theory and Evidence,” demonstrates the utility of the operational audit data for this purpose. By combining data from randomly selected audit cases and operational audits, the research team was able to measure sophisticated tax evasion by taxpayers at the very top of the income distribution that is not fully captured by our legacy tax gap estimation methodology. Based on the findings from that paper, IRS researchers estimated that though the use of offshore bank accounts and/or complex pass-through business structures, this evasion contributed an additional $33 billion to the 2011-2013 tax gap, which would amount to about $46 billion for Tax Year 2019. While this work is still undergoing peer review, the results seem very plausible.

Combining historically representative audit data, operational audit data, and data selected through a focused set of artificial intelligence workstreams with economic and budget projection data will allow us to estimate changes in the tax gap under different economic and budget scenarios. Incorporating enforcement resource data into this modeling and analysis will further aid us in developing strategies to change compliance behavior in response to emerging issues. This approach will also facilitate better tracking of IRS performance against strategic objectives, highlighting the role of IRS service and enforcement in promoting voluntary compliance.

In summary, by more fully leveraging IRS data collected during audits and applying cutting edge analytic methods, we believe that we will be able to improve both the timeliness and coverage of the tax gap estimates so that these statistics will be more useful in helping shape IRS service and enforcement strategies. Our analysis so far shows that this approach can help us better detect and measure both emerging issues and issues that are concentrated in small segments of the population. It remains to be seen whether or not this approach will also help us do a better job of measuring other, difficult to detect issues, such as the cash economy and even illegal source income, both of which likely contribute significantly to the tax gap but by their nature, are largely missing from our current measures.

**Making Better Use of Analytics at the IRS**

Our progress in improving measures of the tax gap is just one of the many ways the IRS is using data, analytics, and cutting-edge technology to modernize tax administration. The machine learning-based approach described above is part of a broader strategy to develop new models for risk identification and workload selection to reduce the underreporting gap. The goal is to improve our ability to better identify returns with the highest probabilities of non-compliance and to
prioritize those returns to ensure teams of highly specialized, highly trained examiners work those with the largest potential unreported tax liability first. As noted, one of the benefits of this approach is that by regularly updating the models using the most recent audit findings, we will incorporate emerging areas of risk into selection models.

The IRS is also incorporating behavioral insights in many aspects of our work, including pilots to inform improvements to IRS notices and outreach activities. We have employed plain language and other enhancements to certain notices alerting taxpayers to underpayment of taxes or delinquencies. We have also added QR codes to allow taxpayers who prefer using online tools to easily access a web page that allows them to make online payments or set up a payment plan. The early results of these activities suggest that taxpayers resolve issues earlier, reducing the need to send follow-up notices without increasing phone calls, which help to reduce the underpayment gap.

We are utilizing data and analytics to assist IRS employees by automating formerly time-consuming processes. This includes incorporating supervised robotic process automations that can quickly execute queries across multiple systems and compile them for human review and analysis, greatly reducing the time employees formerly spent on the same activities. Similarly, we are increasing our use of graphical databases that can be used to review clusters of activities or to provide a holistic view of all tax returns and information documents related to a specific entity, such as a business, tax-exempt entity or individual. For example, it can help an auditor see and drill down into all returns filed by partnerships in a complex business structure. This approach is also helping uncover sophisticated identity theft schemes, protecting millions of dollars in revenue from being paid in fraudulent refund claims.

ADDRESSING THE TAX GAP

*Tax Gap Enforcement Efforts*

The IRS uses the tax gap data to help decide where to deploy our resources, both to minimize burden on compliant taxpayers (e.g., we would rather not audit someone who paid fully and timely) and to concentrate on reaching noncompliant taxpayers. Thanks to the help of artificial intelligence, advanced data, and analytic strategies, we have enhanced our capabilities to identify areas of noncompliance in ways that were not remotely possible just a few years ago. With that said, there is room to further modernize these efforts.

Yet, we cannot devote all of our resources to just the deepest pockets of noncompliance but also must ensure that tax enforcement has an indirect “deterrence” effect on taxpayers generally.
Enforcement supports the efforts of compliant taxpayers. To do this, we are exercising our best efforts with limited numbers of experienced, specialized examination personnel covering taxpayer compliance from several angles. Since 2018, we have shifted significant examination resources and technology to increase our focus on high-income/high-wealth taxpayers. We have also initiated a Compliance Initiative Project to ensure that we continue to maintain a high rate of audit coverage of taxpayers at the highest income categories using examiners across each of our operating divisions. Our specialized, most highly trained examination personnel are conducting audits of high-income/high-wealth taxpayers at an examination rate far higher than any other category of individual filers.

Investing in the agency that interacts with more Americans than almost any other public or private organization and collects almost 96% of the gross revenue of the United States of America is important. We must invest in meaningful taxpayer services, technology, data and analytics to improve the effectiveness of our existing enforcement workforce and programs, restore base enforcement functions that have declined substantially over the last decade, tackle key compliance priorities and emerging issues, and invest in programs that are essential to maintaining the broad compliance framework even though they may not directly generate revenue.

**Funding and Enforcement Trends**

The Congressional Budget Office (CBO) reported in “Trends in the Internal Revenue Service’s Funding and Enforcement” in July 2020 that IRS appropriations have fallen by 20 percent in inflation-adjusted dollars between 2010 and 2018, resulting in a decline of 22 percent in the number of IRS staff. Because labor costs account for about 70 percent of the IRS’s budget, measures to reduce the IRS workforce were instituted, including a hiring freeze from 2011 - 2018. The amount of funding and staff allocated to enforcement activities has declined by about 30 percent since 2010. In this regard, the CBO determined that experienced Revenue Agents, who handle complex enforcement examinations, fell by 35 percent and Revenue Officers, who manage difficult collection matters, dropped by 48 percent. According to the CBO, the number of examinations since FY 2010 dropped by about 40 percent even as the number of returns filed grew by 5 percent. The disruptions stemming from the 2020 coronavirus pandemic have further reduced the ability of the IRS to enforce tax laws.

The loss of more than 17,000 enforcement employees since FY 2010 led to a significant reduction in the number of examinations and the number of follow-ups on discrepancies between returns and third-party data, as well as an increase in assessments that were not collected and unfiled returns that were not secured. Enhancements in IRS technology are clearly helpful in offsetting some portion of the declining enforcement workforce, but we must acknowledge that such enhancements are hard pressed to significantly offset the increased sophistication
of taxpayers and their transactions operating in a digital world economy coupled with the overall complexity of tax law.

As noted later in this testimony, the President has made a series of proposals as part of the American Families Plan to invest in the IRS and improve tax administration – including funding for increased enforcement activities – that will generate an additional $700 billion in tax revenue over the course of a decade, net of the investments made. This is important, because the IRS’s enforcement activities also have an indirect, deterrent effect on the tax gap by discouraging taxpayers from making misstatements on their returns.

Foreign Account Tax Compliance Act (FATCA) Compliance Efforts

Congress enacted the Foreign Account Tax Compliance Act (FATCA) in 2010 to improve tax reporting compliance of U.S. Account Holders with assets held in Foreign Financial Institutions (FFI). Account Holders are required to annually report specified assets to the IRS on Form 8938, Statement of Specified Foreign Financial Assets, while FFIs are required to annually report to the IRS the specified assets of United States Account Holders on Form 8966, FATCA Report.

The IRS continues to perform outreach to ensure U.S. Account Holders and FFIs are aware of and able to timely and accurately report specified assets held abroad. Indeed, we coordinate with treaty partners and financial institutions to provide updated information which they may translate for improved use by those who are not proficient in English.

In addition to our ongoing outreach efforts, we have undertaken multiple efforts to improve compliance of United States Account Holders and FFIs to include the following:

- The IRS uses a variety of treatment streams such as soft letters, examinations and termination of an FFI’s FATCA status.
- Examination, Collection, the Office of Fraud Enforcement (OFE) and Criminal Investigation (CI) use the information to either identify noncompliant taxpayers and FFIs or to assist with developing specific cases. For example:
  - CI has referred cases for examination based on FATCA data;
  - Examination, Collection, the OFE and CI are working to identify more instances of non-reporting of offshore accounts.
  - Collection utilizes FATCA data on balance due accounts to identify assets for collection as well as to identify certain non-filer/delinquent return cases of high-income non-filers.
- The IRS has a campaign to compare the filings by FFIs and individuals (i.e., Form 8966, FATCA Report, and Form 8938, Statement of Specified Foreign Financial Assets). We began with soft letters to remind them of
the need to timely and accurately report their assets and have examined others who have not.

- The IRS also has a campaign that compares the filings of FFIs and individuals for withholding compliance purposes.
- We conduct compliance checks of FFI certifications and send follow-up letters enabling FFIs to bring themselves into compliance. For those FFIs who will not comply, we will terminate them resulting in 30% withholding on certain United States Source Income. The IRS has terminated the FATCA status for nearly 1,000 non-compliant FFIs.
- FATCA data is associated with individual examination cases involving identified offshore-related issues, and third-party FATCA information received is also reconciled in numerous compliance activities on an ad hoc basis.
- The substantial increase in Foreign Bank Account Reporting (FBAR) filings, as well as the voluminous Form 8938 filings, both of which reflect the increased disclosure of individuals’ foreign financial account holdings, demonstrate the significant voluntary compliance impacts of the FATCA regime. Indeed, the number of Forms 8938, Statement of Specified Foreign Financial Assets filed has grown from ~ 1.3 Million in 2014 to ~2.0 Million in 2019; FBAR reporting has grown from ~ 538,000 in 2010 to ~ 1.4 Million in 2019, and; the number of Form 8966, FATCA Report has grown from ~ 1.6 Million in 2014 to ~ 6.3 Million in 2019.

While the IRS has significantly increased its compliance efforts in recent years, we continue to be limited by technological and staffing limitations. Improved systems and data analytics capabilities, as well as more data scientists, analysts and enforcement personnel would improve our ability to better assist those United States Account Holders and FFIs who want to comply and improve fairness to all by taking appropriate enforcement actions on those who do not want to or will not comply.

The American Families Plan

A robust and sustained investment in the IRS is necessary to ensure it can do its job of administering a fair and effective tax system. In the American Families Plan, the President has included a series of proposals that overhaul tax administration and provide the IRS the resources and information it needs to address tax evasion. All told, these reforms will generate an additional $700 billion in tax revenue over the course of a decade. Specifically, the tax administration reforms will:

- **Provide the IRS the resources it needs to stop sophisticated tax evasion.** The IRS needs resources to pursue costly tax evasion. These cases are not easy to resolve; the average investigation of a high-wealth individual takes two years to complete and often requires the IRS to commit substantial resources. Moreover, the lack of investment in compliance has significant revenue consequences. Altogether, the proposal would provide roughly $80
billion to the IRS over a decade to fund an array of priorities—including overhauling technology to improve enforcement efforts. This investment will also facilitate the IRS hiring and training auditors to focus on complex investigations of large corporations, partnerships, and global high-wealth individuals. The President’s proposal would ensure that additional resources go toward enforcement against those with the highest incomes, rather than Americans with actual income of less than $400,000.

- **Provide the IRS with more complete information.** When the IRS has information from third parties, income is accurately reported, and taxes are fully paid. However, high-income taxpayers disproportionately accrue income in opaque sources—like partnership and proprietorship income—where the IRS struggles to verify tax filings. This proposal would provide the IRS information on account flows so that it has a lens into investment and business activity—similar to the information provided on income streams such as wage, pension, and unemployment income. Importantly, this proposal provides additional information to the IRS without any increased burden for taxpayers. Instead, it leverages the information that financial institutions already know about account holders, simply requiring that they add to their regular, annual reports information about aggregate account outflows and inflows. Providing the IRS this information will help improve audit selection so it can better target its enforcement activity on the most suspect evaders, avoiding unnecessary (and costly) audits of ordinary taxpayers.

- **Overhaul outdated technology to help the IRS identify tax evasion.** Elements of IRS IT systems are antiquated and make it difficult for the IRS to identify those who are not paying what they owe and to help those who want to comply. The President’s proposal provides the IRS much-needed resources to modernize its technological infrastructure. Leveraging 21st century data analytic tools will enable the IRS to make use of new information about income that accrues to high-earners and will help revenue agents unpack complex structures, like partnerships, where income is not easily traced.

- **Improve taxpayer service and deliver tax credits.** A well-functioning tax system requires that taxpayers be able to interact with the IRS in an efficient and meaningful manner. Inadequate resources often mean that IRS employees are unable to provide taxpayers timely answers to their tax questions. Service enhancement will improve the ability of the IRS to communicate with taxpayers securely and promptly. Importantly, the proposal also includes the necessary resources to ensure that the IRS effectively and efficiently delivers tax credits to families and workers, including the Administration’s proposal to make the Child Tax Credit and the advance payments permanent.

- **Regulate paid tax preparers.** Taxpayers often make use of unregulated tax preparers who lack the ability to provide accurate tax assistance. These preparers submit more tax returns than all other preparers combined, and they make costly mistakes that subject their customers to painful audits,
sometimes even intentionally defrauding taxpayers for their own benefit. The President’s plan calls for giving the IRS the legal authority to implement safeguards in the tax preparation industry. It also includes stiffer penalties for unscrupulous preparers who fail to identify themselves on tax returns and defraud taxpayers (so-called “ghost preparers”).

Chairman Whitehouse, Ranking Member Thune, and Members of the Subcommittee, thank you again for the opportunity to discuss the tax gap. This concludes the IRS’ statement.
APPENDIX 1: TAX GAP VISIBILITY


Tax Gap Estimates for Tax Years 2011–2013

"Visibility" Chart
Tax Year 2011–2013 Individual Income Tax Underreporting Tax Gap and Net Misreporting Percentage Estimates by "Visibility" Category of Income Item

<table>
<thead>
<tr>
<th>Category</th>
<th>Underreporting Tax Gap ($)</th>
<th>Net Misreporting Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td>$9B</td>
<td>1%</td>
</tr>
<tr>
<td>II.</td>
<td>$12B</td>
<td>5%</td>
</tr>
<tr>
<td>III.</td>
<td>$36B</td>
<td>17%</td>
</tr>
<tr>
<td>IV.</td>
<td>$109B</td>
<td>55%</td>
</tr>
</tbody>
</table>

Notes:
1. The 2011–2013 estimates are the annual average for the 2011, 2012, and 2013 tax years. This chart displays the tax gap attributable to the underreported income category and the rate at which that income is misreported as measured by the net misreporting percentage.
2. The net misreporting percentage is the ratio of the net misreported amount to the sum of the absolute values of the amounts that should have been reported, expressed as a percentage. For categories I–IV, the net misreported amount is understatement of income and overstatement of expenses. On net, income is understated in these categories.
3. Includes wages & salaries.
5. Includes partnership capital gains, foreign income, capital gains, foreign income.
6. Includes nonfarm proprietor income, other income, rents and royalties, farm income, Form 4958 income.
APPENDIX 2: TAX GAP MAP

Department of the Treasury, Internal Revenue Service