Who Evades Taxes?
The Distribution of the U.S. Tax Gap

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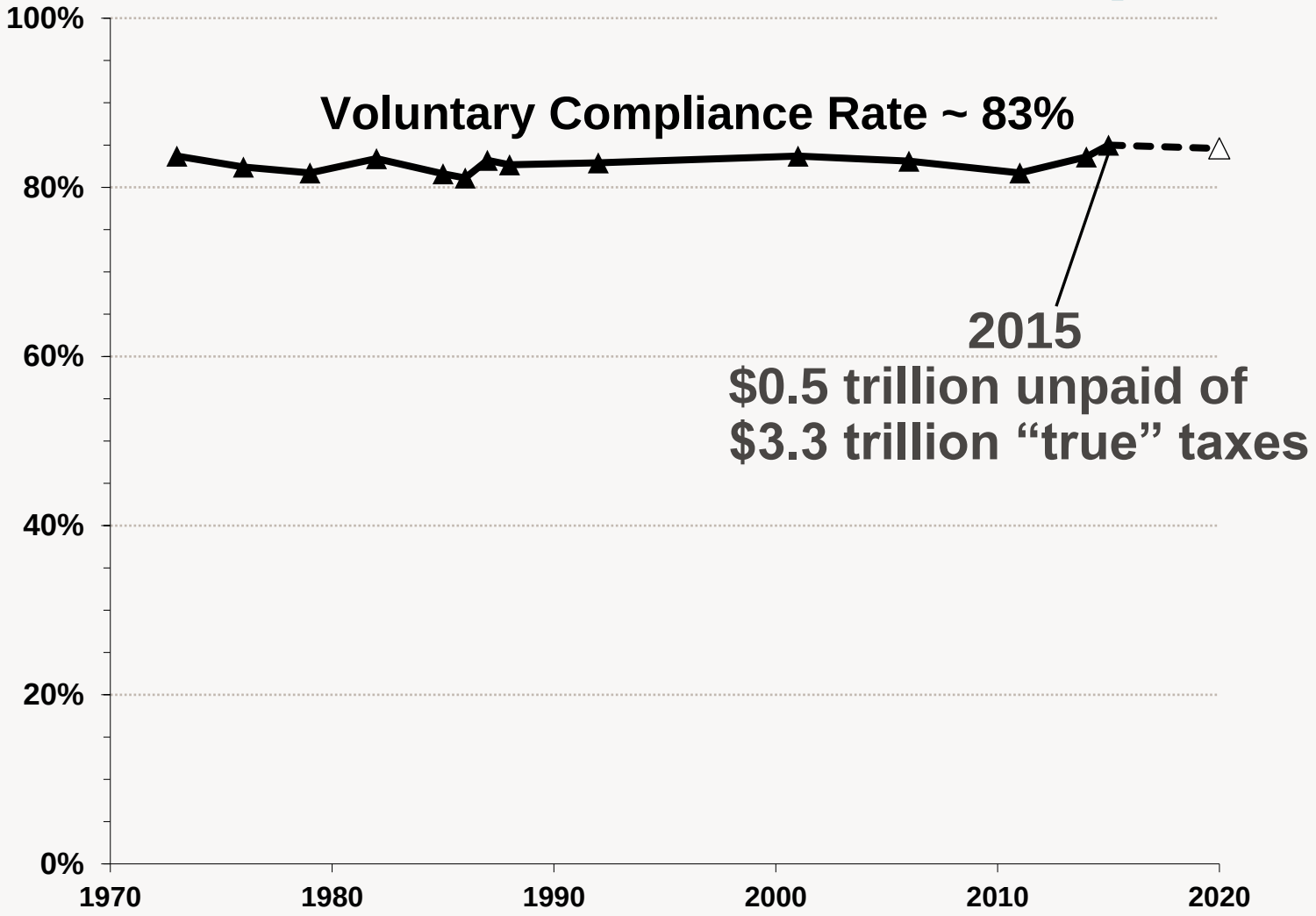
This paper embodies work undertaken for the staff of the Joint Committee on Taxation, but as members of both parties and both houses of Congress comprise the Joint Committee on Taxation, this work should not be construed to represent the position of any member of the Committee.

IRS tax compliance measures do not show who is noncompliant



Source: IRS Tax Gaps.

Overview

Contributions

- **IRS estimates overall tax gap (huge effort!) but no distributions**
- **We estimate income distributions of the tax gap**
- **Limitations of tax gap estimates & macro implications**

Hemel, Holtzblatt, and Rosenthal 2022; GAO 2024

Special Audit Studies

- **Widespread noncompliance among about half of tax returns**
- **Noncompliance largely from sole proprietors**
- **Income distribution more equal with audit-based underreporting**

Gross and Net Tax Gap

- **Gross tax gap: filers, non-filers, corp., estate, underpayments**
- **Net tax gap: deduct late payments (1.5% taxes) & audits (0.3% taxes)**
- **Noncompliance rates highest for low incomes**

Related findings: Christian 1994, Cay Johnston 2008; Johns and Slemrod 2010; DeBacker et al. 2020; Auten & Langetieg 2023

Audit effects limited: Audit rates fell by half as tax compliance increased

Operational vs. Random Audits

Operational audits

- Returns selected based on likelihood of non-compliance
- Only select lines of return are audited

Random audits: Special audit studies

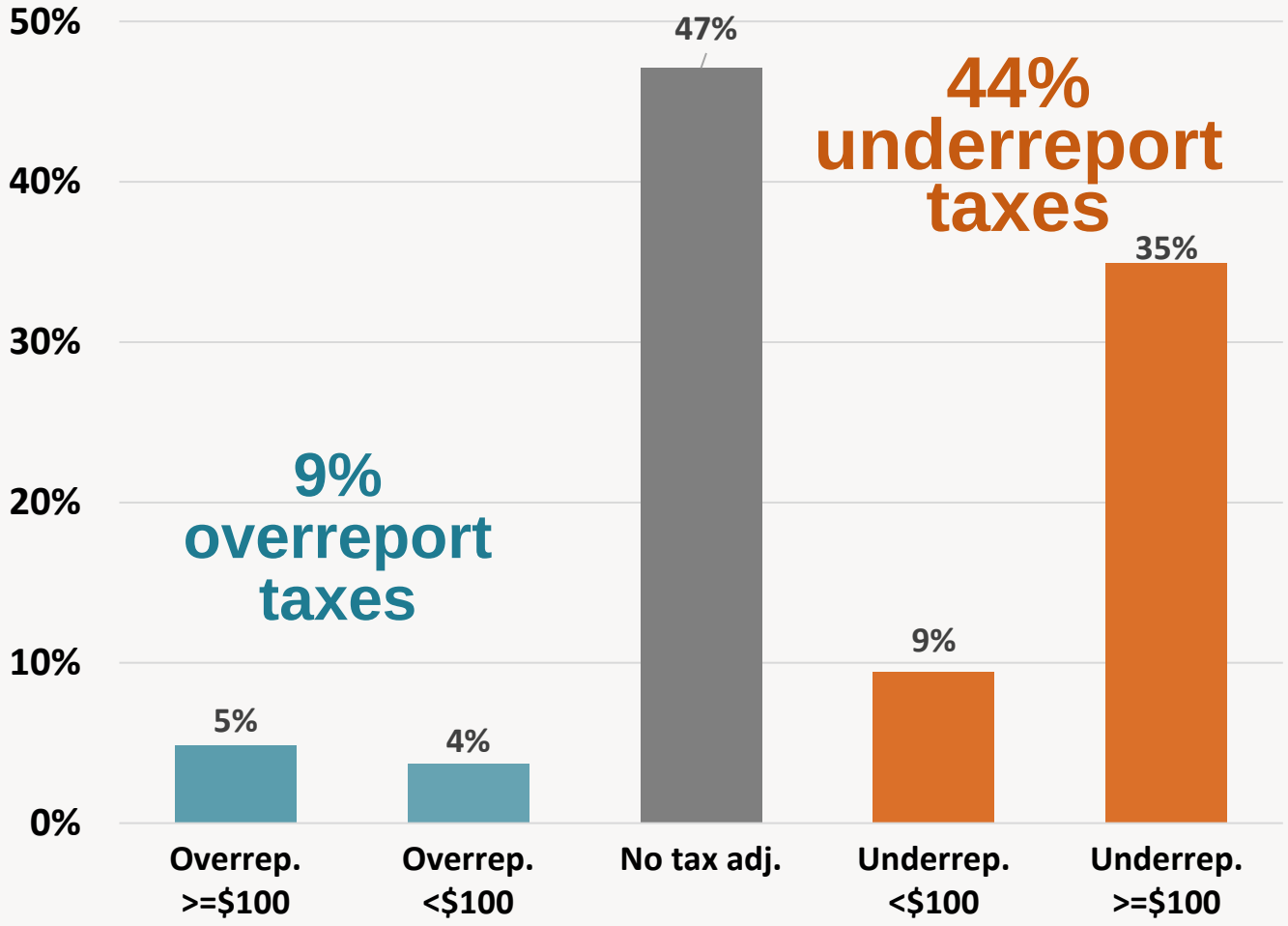
- National Research Program (NRP): 14K indiv. tax returns
- Represents all returns: oversamples high-income returns
- More comprehensive audits
- Includes all changes by auditor—from accidental errors, missing documents, and when rules uncertain

Tax Gap does not estimate evasion

- Evasion is a felony from willfully noncomplying

Detected Tax Adjustments, 2015

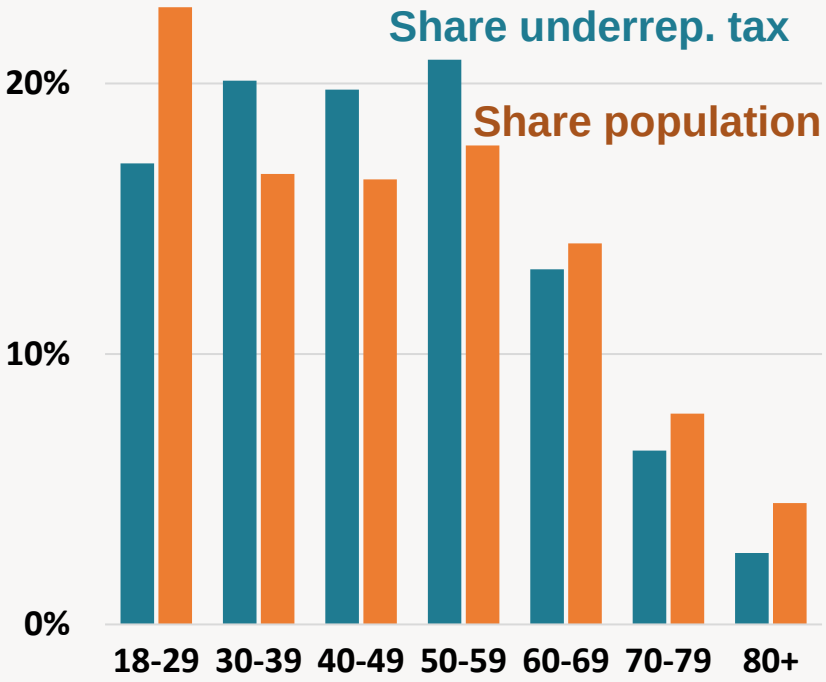
Nearly half of tax returns had tax positive adjustments



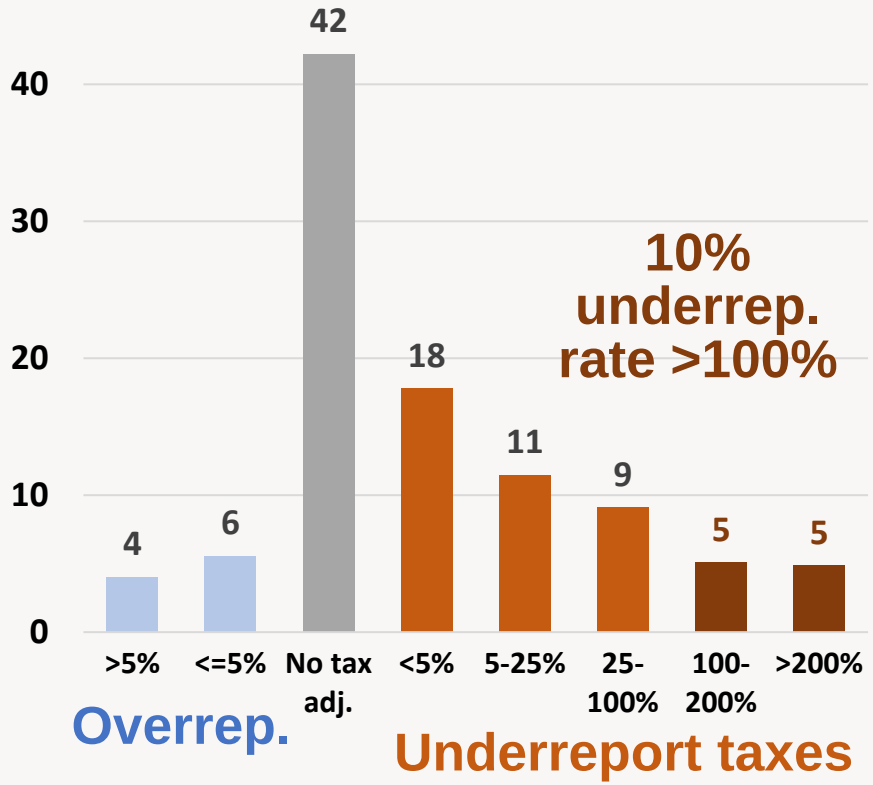
Source: Authors' calculations with 2015 NRP.

Detected Tax Adjustments, 2015

About proportional by age



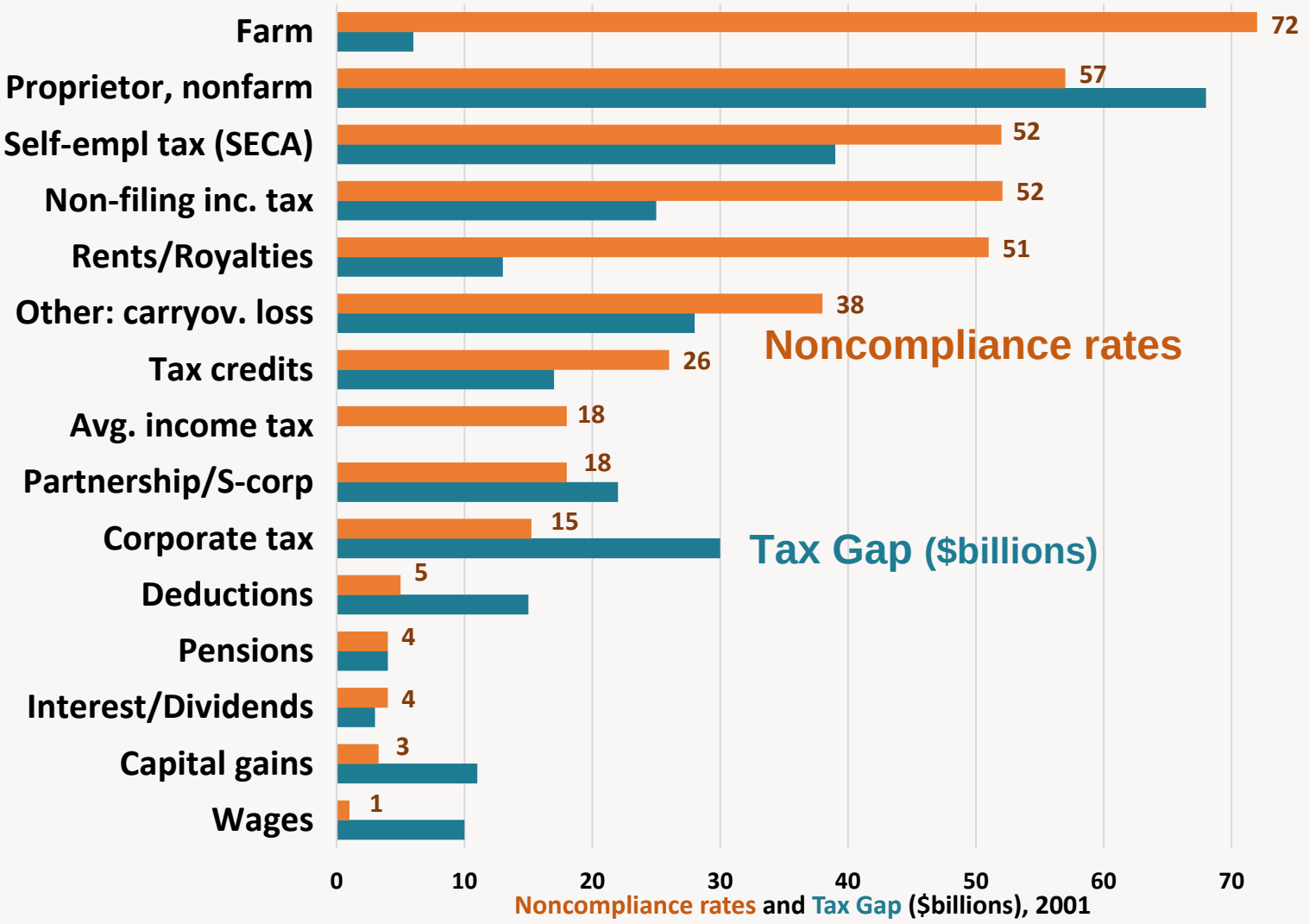
Some have very high tax underreporting rates



Notes: Only detected tax adjustments. Right figure is detected tax adjustment divided by absolute value of reported tax liability among returns with >=$100 of reported tax. *Source*: Authors' calculations with 2015 NRP & Census.

Noncompliance Rates & Tax Gap, 2001

By income source: Sole proprietors ~40% of tax gap



Source: Johns and Slemrod (2010) and authors' calculations for non-filing, corporate, & cap gains noncompliance.

Add undetected underrep. income

Detection Controlled Estimation (DCE)

- Accounts for **undetected** underreported income
- Among similar returns, DCE brings smaller auditor income adjustments up to largest auditor adjustments
- Total **detected** underreported income is about **tripled**
- Undetected income causes tax adjustments to **double** (GAO 2024)

2015 NRP: Indiv. tax returns only (approx., $billions)

$400 detected underrep. income	$800 undetected income
$150 detected tax adj.	$130 undetected tax adj.

Undetected Income: DCE multipliers

Old method used in academic studies: Simple multipliers proportionally scaled up each return's detected underreporting. Gives incorrect distributions. (IRS has updated its DCE methods)

- **DeBacker et al. (2020, p. 1106)**

"Because the **published multipliers are applied to all auditors regardless of skill level**, the biggest amounts of undetected misreporting will be attributed to the audits with the largest amounts of detected misreporting. **This runs counter to the intended application of the adjustments** and can exaggerate the true variation in misreporting."

- **Johns and Slemrod (2010, p. 400)**

"DCE multipliers will **understate** estimates of undetected income for some taxpayers …it may **overstate** estimates of undetected income for other taxpayers."

- **Bloomquist, Emblom, Johns, and Langetieg (2012, p. 71)**

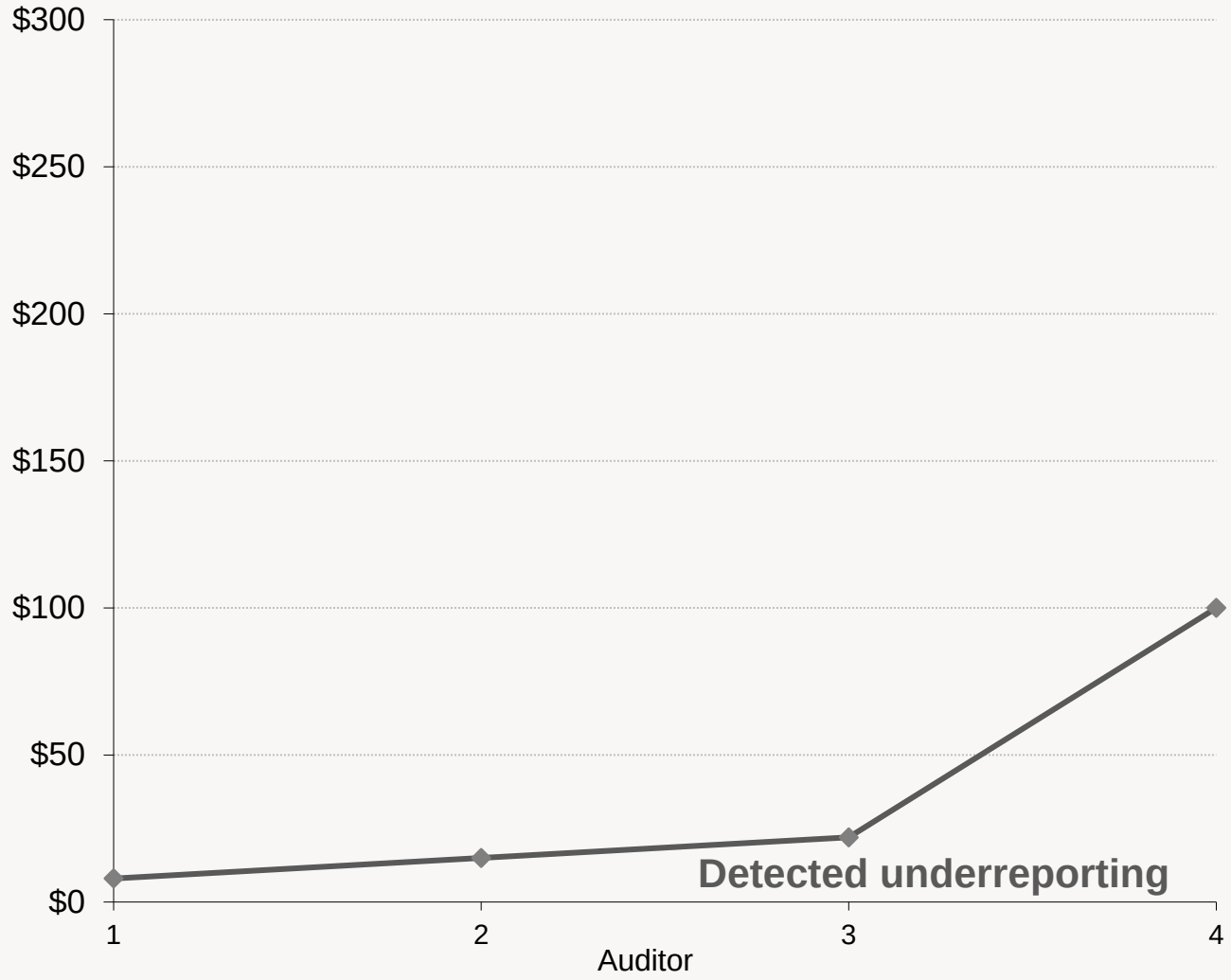
The simple DCE multiplier "approach was still primarily an **aggregate approach** …**some returns were allocated more undetected income than they should have** been while other returns were allocated less."

Multipliers for these estimates (not official IRS approach for DCE)

Distributionally consistent multipliers bring all closer to top auditor

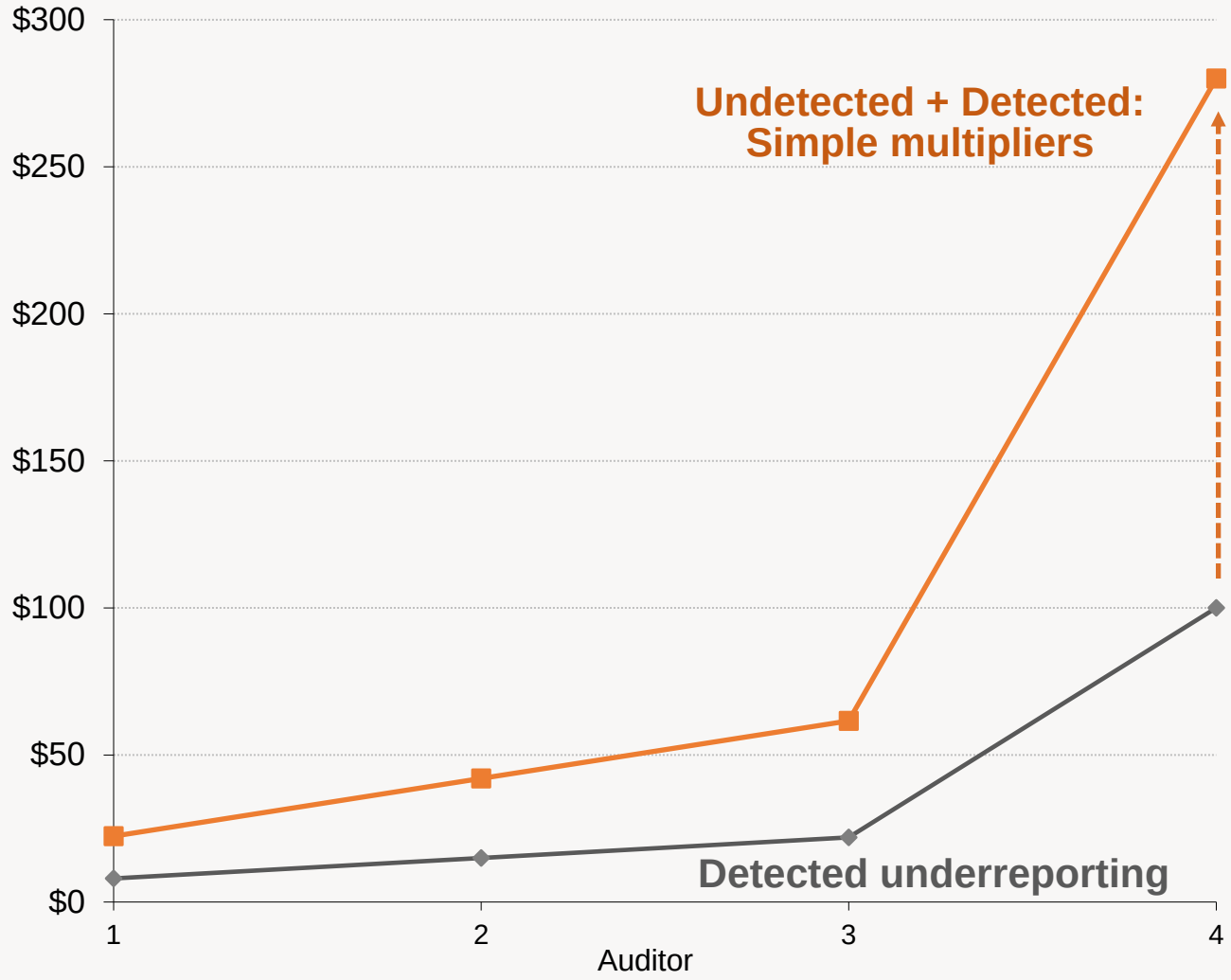
No access to auditor identities → Use gradient approach (Auten & Splinter 2021)

Comparing DCE multipliers



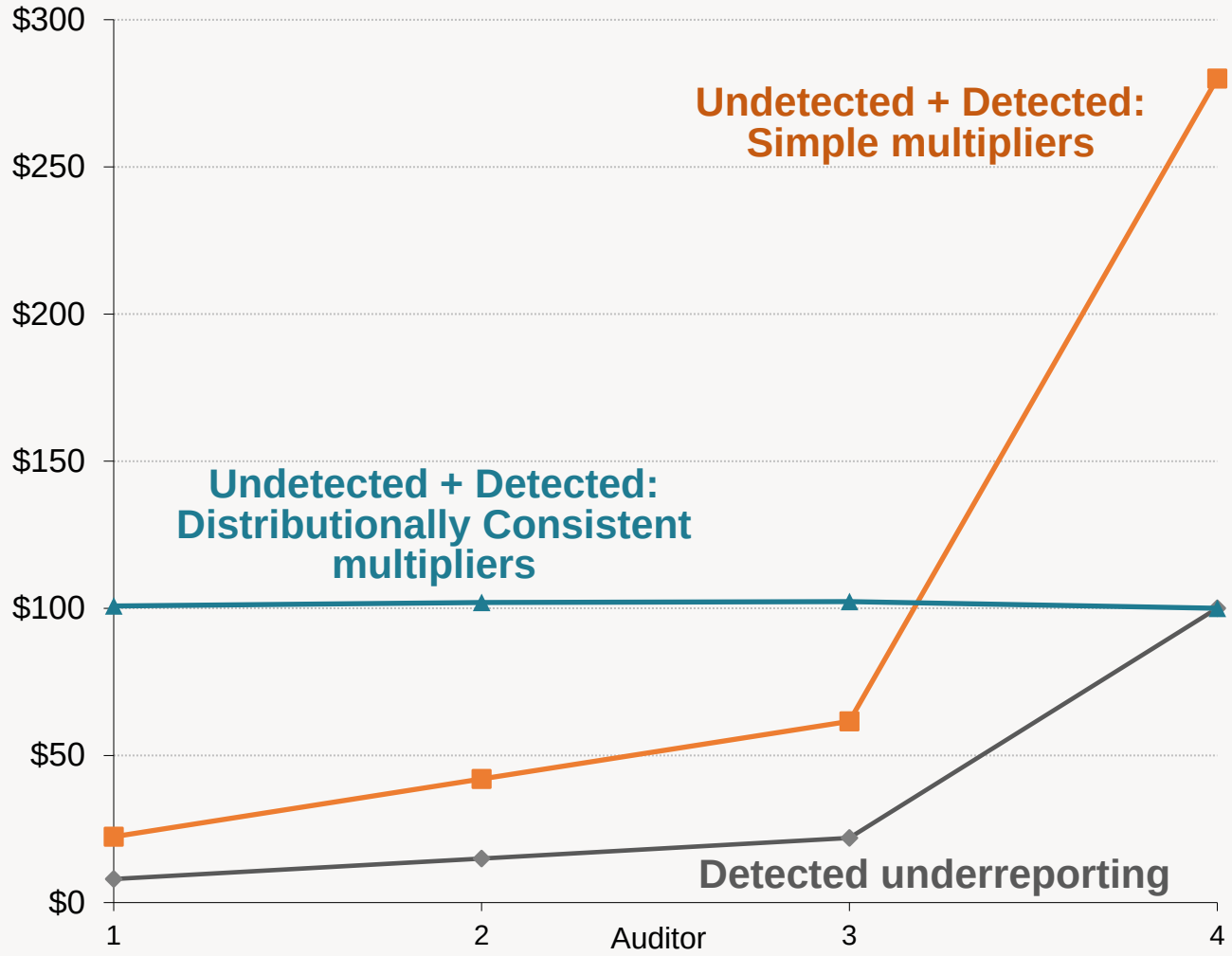
Source: Example from authors' calculations. Actual DCE multipliers require more auditors in a group.

Comparing DCE multipliers:
Simple multipliers exaggerate underrep. for top auditor



Source: Example from authors' calculations. Actual DCE multipliers require more auditors in a group.

Comparing DCE multipliers:
Distributionally consist multipliers closer to DCE method

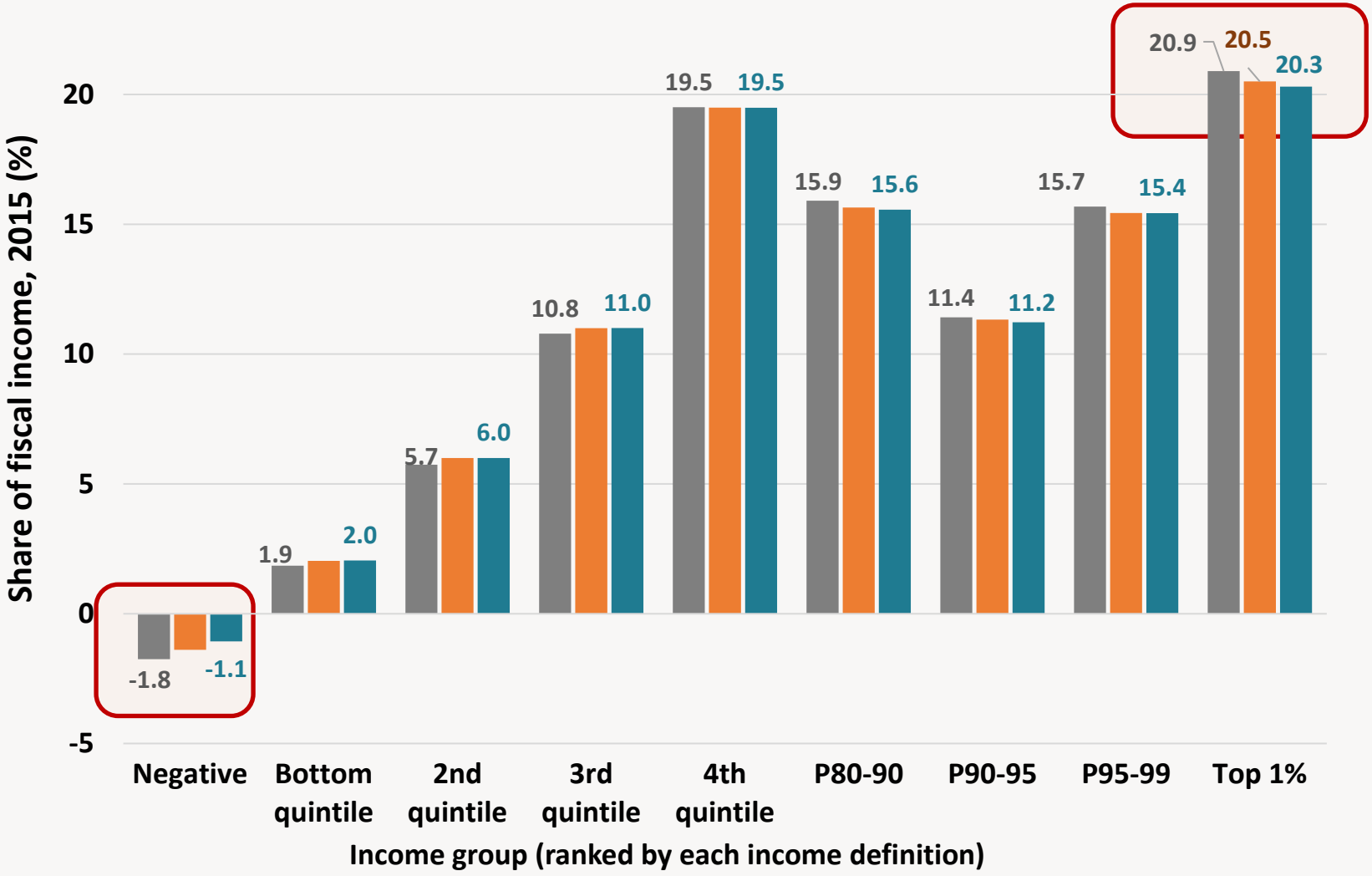


Source: Example from authors' calculations. Actual DCE multipliers require more auditors in a group. The same undetected amounts are allocated with the two methods, but they vary across auditors.

Underreported income lowers inequality

Detected underreporting lowers inequality: negative ↑ 0.4 pp, top 1% ↓ 0.4 pp

Detected + Undetected underrep. lowers ineq.: neg. ↑ 0.7 pp, top 1% ↓ 0.6 pp

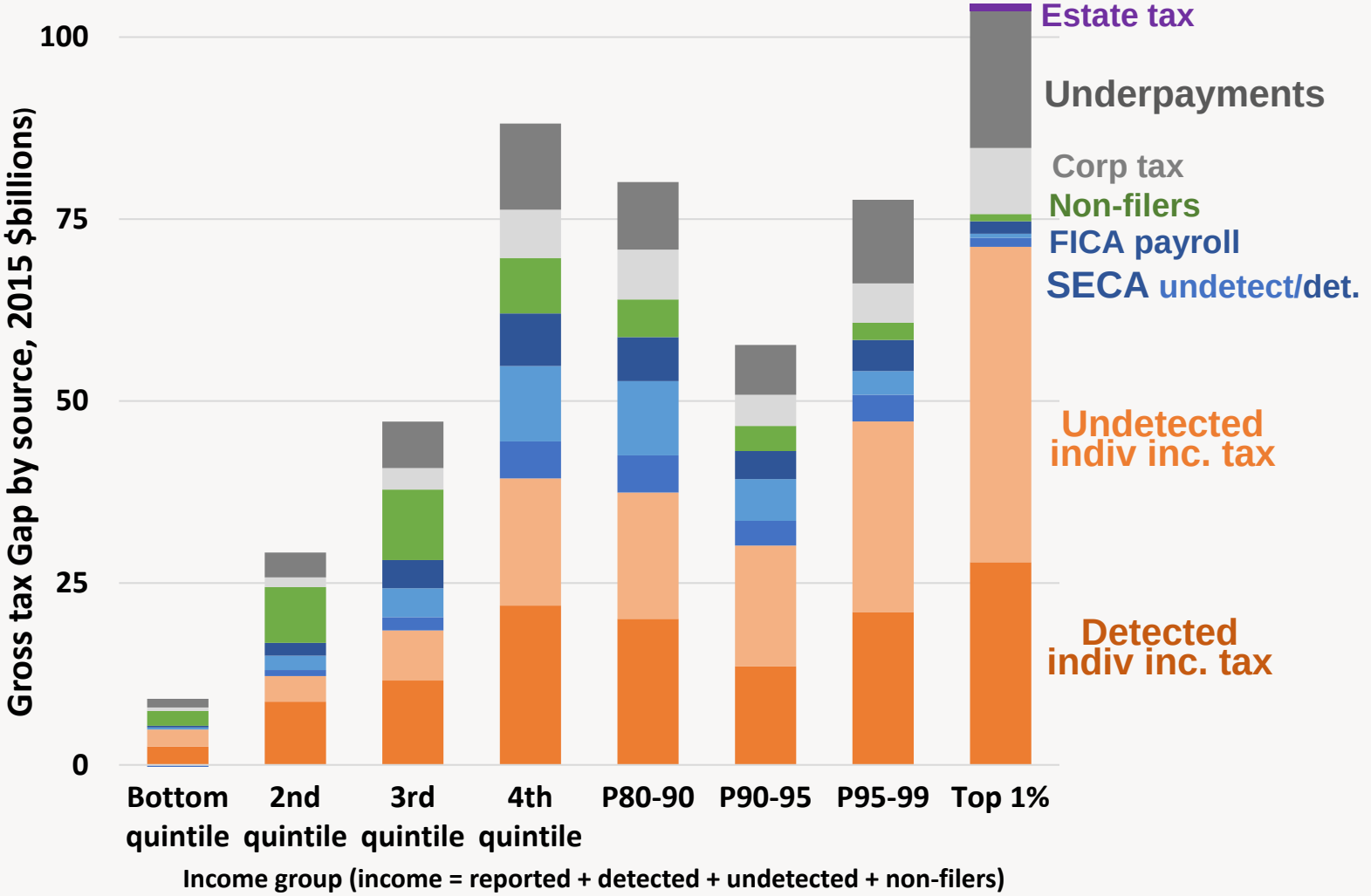


Notes: Gradient DCE multipliers (overall 2.8, smaller than 3.0). Source: Authors' calculations using 2015 NRP.

Gross tax gap: Distribution & Sources

Non-filers added using information returns (W2s and 1099s)

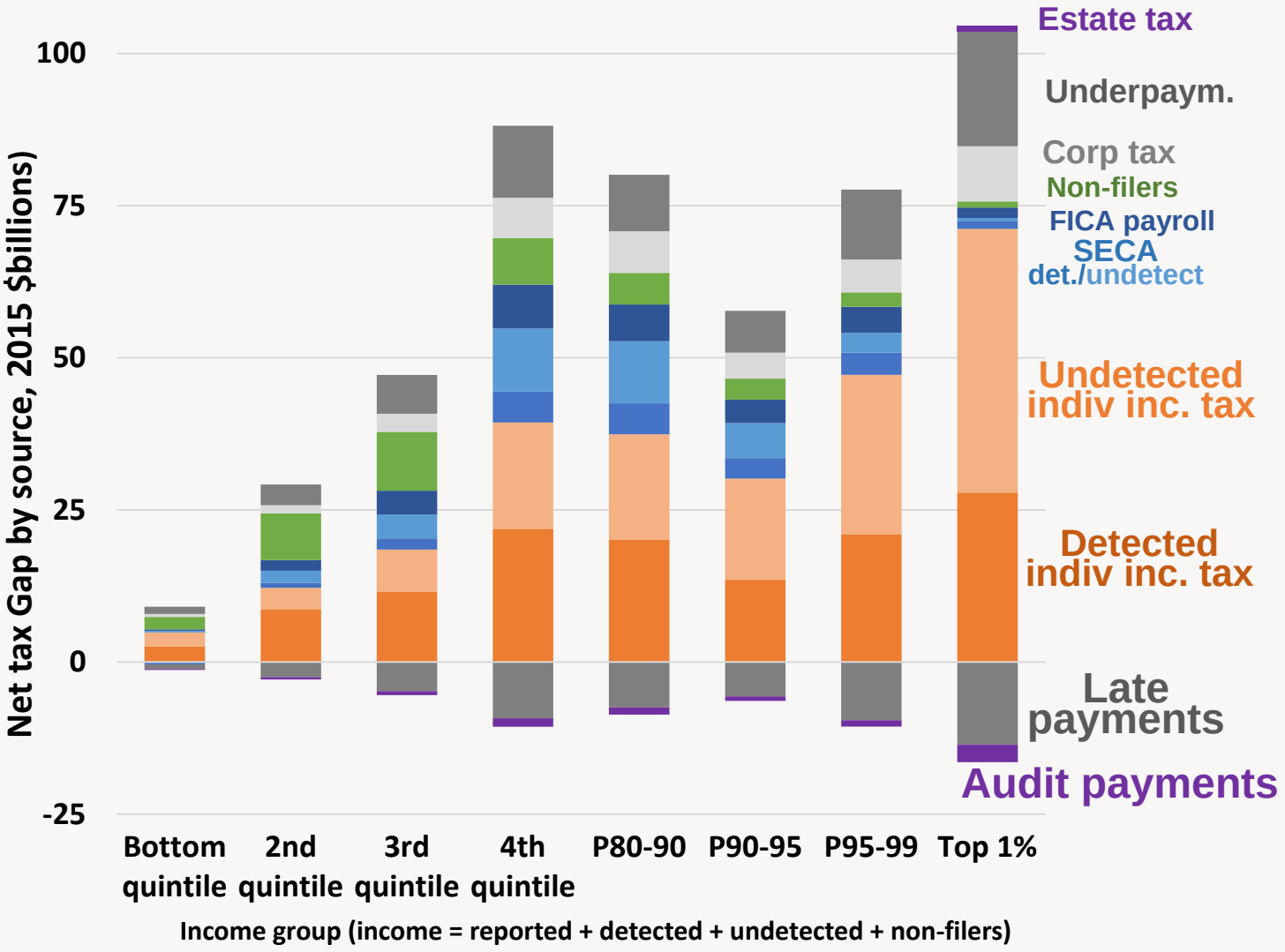
Target NRP 2014-16 totals for undetected, corporate, non-filer, & estate taxes



Source: Authors' calculations using 2015 NRP, GAO (2024), and non-filer data.

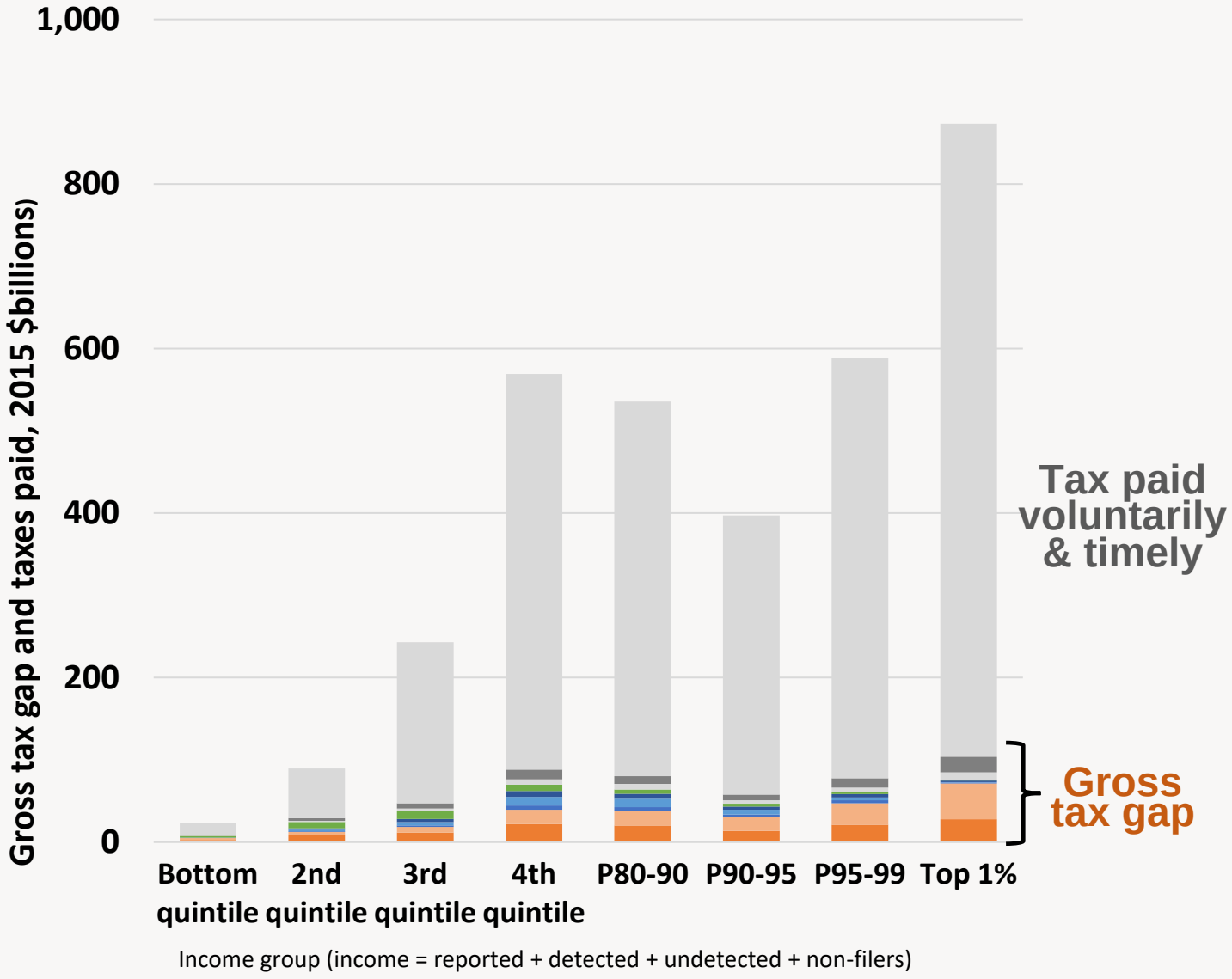
Net tax gap: Distribution & Sources

Underpayments offset by late-payments/enforcement → Net tax gap



Source: Authors' calculations using 2015 NRP, GAO (2024), and non-filer data.

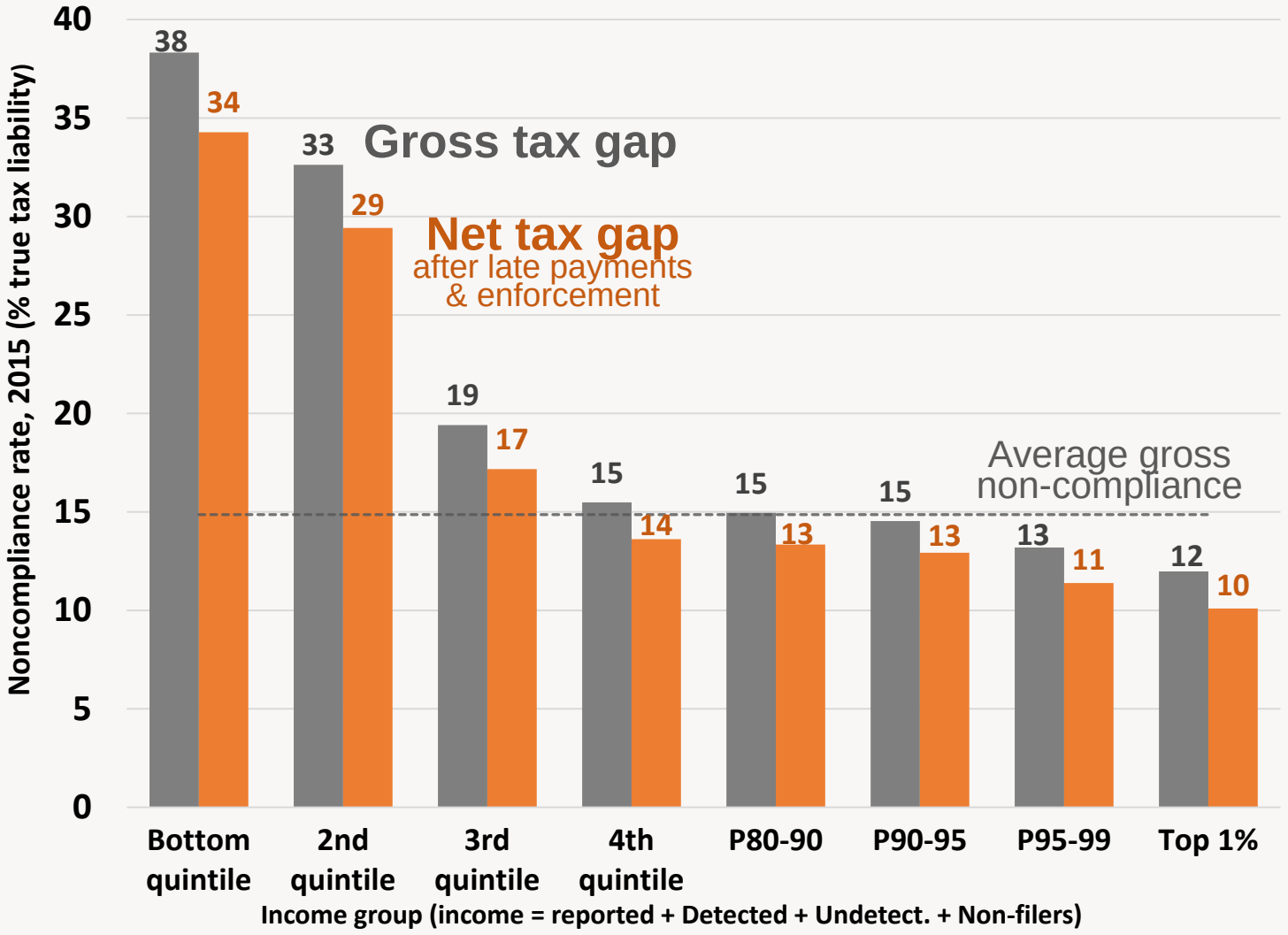
Gross tax gap & progressive taxes



Source: Authors' calculations using 2015 NRP, GAO (2024), and non-filer data.

Tax noncompliance rates (%true tax)

Noncompliance rates higher at lower incomes

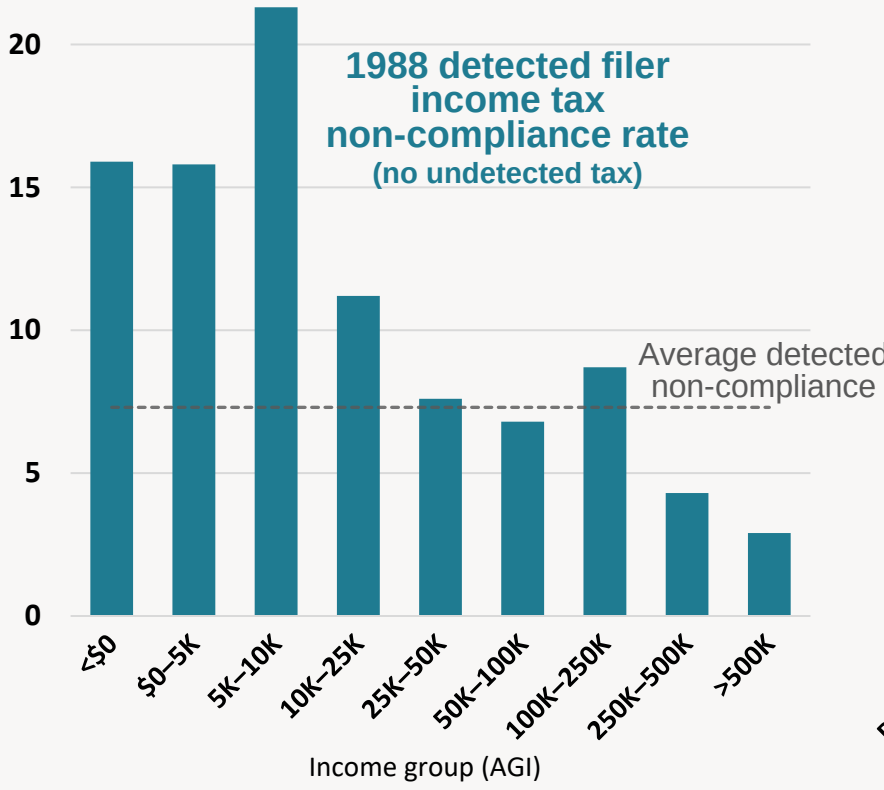


Source: Authors' calculations using 2015 NRP.

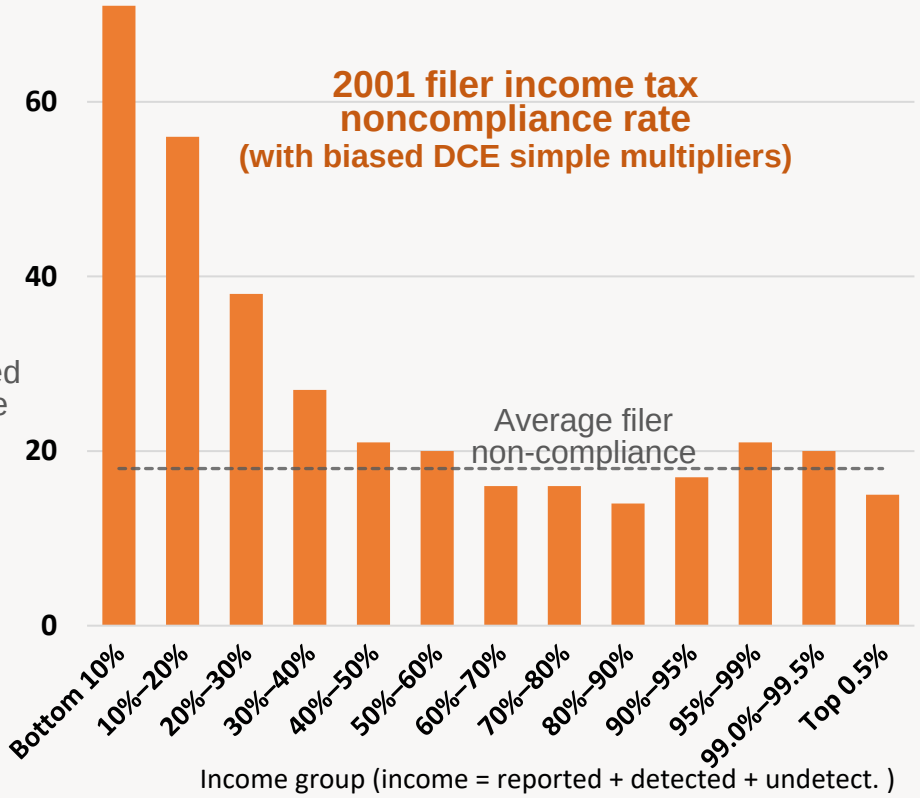
Same finding: other estimates ~half tax gap

Income tax noncompliance rates higher at lower incomes

1988 Filer detected
(%reported + det. income tax)



2001 Filer det. + undet.
(%rep. + det. + undet. income tax)



Sources: Christian (1994) and Johns and Slemrod (2010).

Audit study limitations?

Guyton, Langetieg, Reck, Risch, & Zucman (2021)

- Unreported offshore income: NRP missed >90% cases (~1% tax gap)
- Is there sufficient coverage of passthrough business underreporting?

Audit study probably not missing a large share of passthrough income

- S Corporation audit study by IRS found NRP after DCE

"likely account for **more** misreporting of S-Corporation income than was detected in the S-Corporation study…**No additional adjustment is presently recommended to the Schedule E partnership and S-Corporation tax gap estimate**." (IRS 2008, p. 14)

- Recently IRS doubled audits for indiv. returns >$10 million but found "these audits were unproductive having high no-change rates." (TIGTA 2024)

- Large partnership audits result in avg. income decreases (GAO 2023)

Audit study limitations?

Audit-based underreporting nearly 5% of GDP

But may overstate underreporting → overstate GDP

~1/2 recommended additional tax disputed in operational audits

1/3 recommended taxes were "abated" by IRS in 2015

Grey areas for taxes (Hemel, Holtzblatt, and Rosenthal 2022)

Is DCE tripling of detected underreporting too high?

DCE based on auditor with largest adjustment, not most accurate

Tax Gaps: US 16%, Australia 7%, UK is 6%, Canada 11% (Advani 2022)

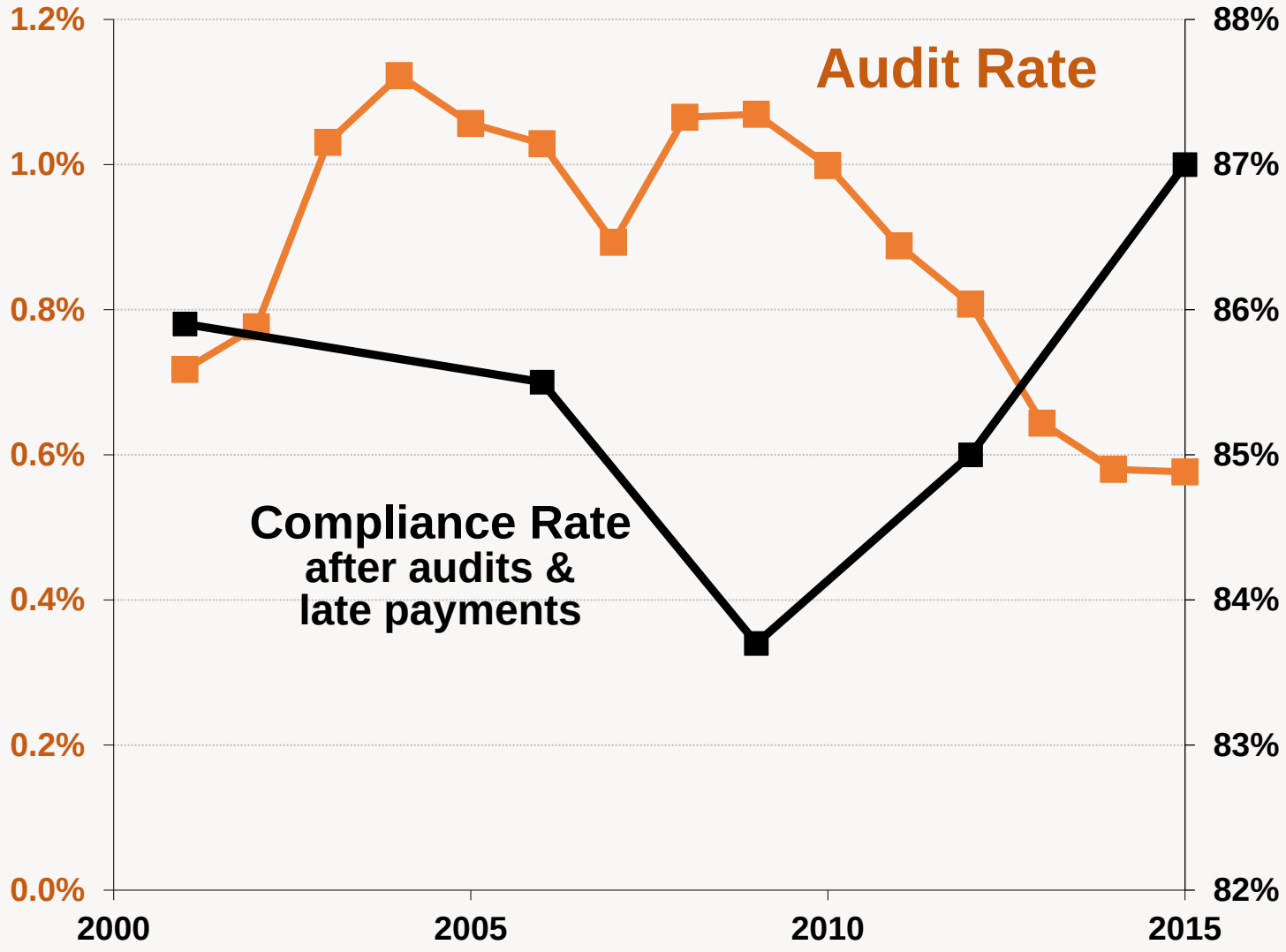
Without DCE, US tax gap would only be 10%

NRP may understate business cycles

Underreporting in GDP interpolated/prior-year audits → little cyclicality

Compliance & audit rates

Compliance & audits: Inverse correlation



Source: IRS Data Books and authors' calculations using NRP data.

Why did compliance increase since 2009?

Increased third-party information reporting

- **"Gig" transactions: Form 1099-K since 2011** (Slemrod et al. 2017)
- **Capital gains basis: Form 1099-B since 2011**
- **Offshore income: FATCA and FBARs since about 2014**

Electronic filing rate doubled since 2003

- **E-filing rates from 44% to 94%** (Gorman, McGuire, & Splinter 2024)
- **About 5 million annual E-file rejections**

IRS math error corrections & paid preparer oversight

- **IRS automatic corrections:** e.g., hundreds $billions stimulus overclaims
- **Paid preparers:** Report an identifying number since 2010
  EITC due diligence since 2016

Conclusions

Widespread estimated tax noncompliance

- Half noncompliant: 44% returns tax adjustments & 6% underpay
- Noncompliance concentrated in sole proprietors
- Noncompliance rates:
  - Twice the average for bottom two quintiles
  - About average for higher incomes

Audits have little effect

- Audits close only 2% tax gap

Tax gap estimates rely on strong assumptions

- Triples detected underreporting using largest adjustments
- No correction for disputed adjustments
- Could bias GDP and business cycles

Comments: David.Splinter@jct.gov

Extra Slides

Distributionally consistent DCE multipliers
Gradient multipliers for undetected underreporting

Among similar returns, DCE brings smaller auditor income adjustments up to largest auditor adjustments. Gradient multipliers take this into account but without auditor identities (not available) to give distributionally consistent DCE adjustments.

Gradient multipliers

Larger multipliers for returns with relatively less detected underreported income as share of reported income. No undetected amounts added to returns with the highest detected underreporting rates (i.e., multiplier of 1).

Negative or Small incomes: Multiplier of 3 if reported AGI less than $10,000

Ratio Class (corrected/reported)	1-1.1	1.1-1.2	1.2-1.5	1.5-2	2-4	4-8	8+
Simple Multipliers (approx.)	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Gradient	3.6	3.2	2.7	2.3	1.9	1.4	1.0

Allocations (besides NRP detected amounts)

Taxes for undetected filer income

Apply marginal statutory rate by filing status and corrected AGI
Apply preferential rates to qualifying dividends and long-term capital gains
Proportionally scale down (~8%) to 2014-16 tax gap total amounts
Tax credits: increase neg. adjustments by 20% to conform to IRS (GAO 2024)
SECA: increase positive adjust. 200% (DCE of 3), HI portion only >tax max

Non-filers

Avg. of 2010/2018 non-filer incomes from info. returns (Auten and Splinter 2024)
Taxes paid = withheld income tax + wages • payroll tax rate
Unpaid taxes proportional to non-filer fiscal income (total from tax gap)

Corporate Tax (tax gap totals based only on detected amounts)

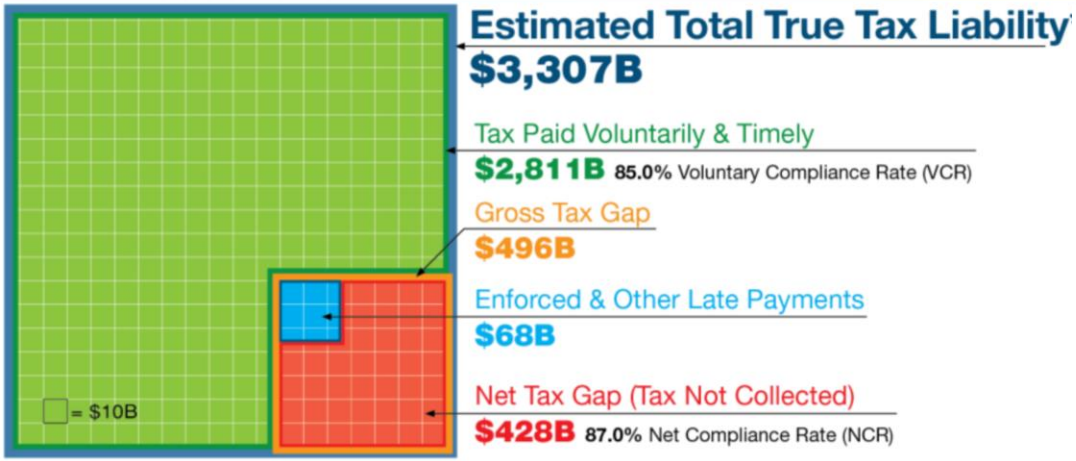
Allocate 2014-16 tax gap total by JCT approach: 25% by wages, 75% by capital
Simplified capital distribution:

- **50% retirement wealth (DFA), 38% dividends, 12% capital gains**

FICA: Allocate tax gap total proportional to payroll taxes withheld

Estate Tax: All to top 1% (simplifying assumption)

Underpayments/Late payments/Audits: enforcement population data



Tax Gap 2014-2016

Gross: $496B (15%)

Net: $428B (13%)

Total True Tax Liability	Tax Paid Voluntarily & Timely	Gross Tax Gap								Enforced & Other Late Payments	Net Tax Gap (Tax Not Collected)
		Nonfiling	Underreporting						Under-payment	Gross Tax Gap	
$3,307	$2,811	$39	+ $398						+ $59	= $496	– $68 = $428
By Type of Tax											
Individual Income Tax	Individual Income Tax	Individual Income Tax	Individual Income Tax						Individual Income Tax	Individual Income Tax	Individual Income Tax
$1,740	$1,383	$32	+ $278						+ $47	= $357	– $51 = $306
			Business Income $130	Non-Business Income $60	Credits $42	Income Offsets [1] $25	Filing Status $5	Other Taxes [2] $4	Unallocated Marginal Effects [3] $11		
Corporation Income Tax	Corporation Income Tax	Corporation Income Tax	Corporation Income Tax						Corporation Income Tax	Corporation Income Tax	Corporation Income Tax
$354	$313	#	+ $37						+ $4	= $41	– $8 = $34
			Large Corpo-rations $23	Small Corpo-rations $14							
Employment Tax	Employment Tax	Employment Tax [4]	Employment Tax						Employment Tax	Employment Tax	Employment Tax
$1,131	$1,038	$7	+ $82						+ $5	= $93	– $6 = $87
			Self-Employ-ment Tax $53	FICA & Uncollected FICA TAX $28	FUTA $1						
Estate Tax	Estate Tax	Estate Tax	Estate Tax						Estate Tax	Estate Tax	Estate Tax
$22	$17	$<0.5	+ $1						+ $3	= $5	– $3 = $2