

# Federal Tax Compliance Research

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Gross and Net Employment Tax Gap  
Estimates for 1984-1997

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**Internal  
Revenue  
Service**

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**Gross and Net Employment Tax Gap  
Estimates for 1984-1997**

October 1993

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## Executive Summary

This report presents the Internal Revenue Service's (IRS's) tax gap estimates for social security, Medicare, and federal unemployment insurance taxes. Both gross and net gap estimates are presented. The concept of the gross *employment* tax gap used in this report is analogous to the concept of the gross *income* tax gap presented in previous reports: the gross employment tax gap for a given tax year is the aggregate amount of that year's tax liability that is not paid voluntarily and timely. The gap is the net of underpaid and overpaid tax liabilities. In theory the tax gap could be negative (in the aggregate taxpayers could voluntarily overpay their liabilities) or perhaps even zero. The available compliance data, however, suggest that, in the aggregate, taxpayers underpay their liabilities. Through its enforcement activities, though, IRS assesses and collects some of the underpaid amounts. The *net* employment tax gap estimates reflect the amount of the gross gap remaining after IRS enforcement activities--the amount of tax owed but not paid either voluntarily or involuntarily. The report presents two series of gross and net tax gap estimates based upon slightly different estimation methodologies.

For this study, the term "employment taxes" refers to social security, Medicare, federal unemployment insurance, railroad retirement, and railroad unemployment repayment taxes. Although the estimates presented in this report are the most comprehensive obtainable given the available data, the lack of compliance data precludes the estimation of several components of the gap. The estimates, therefore, are likely to be underestimates of the "true" employment tax gap. The estimates reflect the gaps associated with social security and Medicare taxes (Federal Insurance Contributions Act, FICA, and Self-Employment Contributions Act, SECA) and Federal Unemployment Tax Act (FUTA) taxes only. Information on compliance with Railroad Retirement Tax Act (RRTA) and Railroad Unemployment Repayment Tax (RURT) laws is not available; therefore, estimates were not developed for these taxes. In addition, the social security, Medicare, and FUTA gap estimates do not reflect the gaps associated with agricultural and household employment because, as for RRTA and RURT taxes, reliable compliance information is not available.

The net employment tax gap is the gross employment tax gap minus the tax component of the employment tax portion of IRS direct enforcement revenue. Direct enforcement revenues are collections of tax, penalty, and interest that are attributable to a direct enforcement interaction between a taxpayer and the IRS. Because the gross gap reflects underpaid tax only (interest and penalties on underpaid tax are not part of the tax gap), only the tax component of direct enforcement revenue is used in estimating the net tax gap. Additionally, because a complete accounting of revenue attributable to IRS enforcement activity is possible only many years following the tax year, the measures of enforcement revenue are *estimates* of the eventual revenue likely to be collected because of IRS enforcement actions. They are not tabulations of actual receipts.

The estimates developed for this report are based on information from various compliance studies and on data extracts from IRS masterfiles of tax return information. The two primary sources of information are (1) *Income Tax Compliance Research: Supporting Appendices to Publication 7285* (Publication 1415) and (2) the Strategic Initiative on Withholding Noncompliance Study (WNS). Publication 1415 contains descriptions of the methodology used to estimate the gross *income* tax gap. It also has detailed information on underreported self-employment and tip income. Estimates of underreported SECA, FICA, and FUTA tax are derived in part from these underreported income estimates.

The Withholding Noncompliance Study was designed to determine the extent of noncompliance in the withholding area. It involved thorough examinations of tax year 1984 employment tax returns of approximately 3,300 employers and follow-up employee surveys of certain individuals identified in the employer surveys. The examined employers were selected randomly from employers known to IRS through Forms 941 and 941E filing records. The study addressed various aspects of withholding compliance, including the classification of workers as independent contractors or employees. The social security, Medicare, and FUTA tax liability and payment data from this study are used primarily to calculate the portion of the gap attributable to the misclassification of employees as independent contractors and to the understatement of wages and salaries subject to FICA and FUTA taxes.

As mentioned above, two series of estimates based on slightly different methodologies were developed. Both series of estimates suggest that overall employment tax noncompliance is relatively low. Noncompliance is measured by the Noncompliance Rate (NCR). The NCR is defined as the gross tax gap as a percentage of “true” tax liability. The estimated overall NCR for tax year (TY) 1987 is about 11 percent (11.0 percent, Alternative I estimate; 10.0 percent, Alternative II estimate.) The NCRs for FICA, SECA, and FUTA taxes, computed using the Alternative I estimates are 4.5 percent, 55.7 percent, and 7.6 percent respectively. The corresponding NCRs computed from the Alternative II estimates are slightly lower.

The Alternative I estimate of the gross employment tax gap for tax year 1987 is \$25.1 billion; the Alternative II estimate is \$22.5 billion. In either case, social security and Medicare noncompliance accounts for more than 98 percent of the gap (\$24.7 billion, Alternative I; \$22.2 billion, Alternative II). The FUTA gap accounts for less than 2 percent (\$.4 billion, Alternative I; \$.3 billion, Alternative II). The SECA gap is the larger of the two social security and Medicare gap components and is estimated to be \$16.0 billion using the Alternative I methodology and \$14.0 billion using the Alternative II methodology. The FICA gaps, therefore, are estimated to be \$8.7 billion and \$8.2 billion, respectively.

The estimate of the tax component of the employment tax portion of direct enforcement revenue for TY 1987 is \$3.8 billion. This results in net employment tax gap

estimates of \$21.2 billion (Alternative I estimate) or \$18.6 billion (Alternative II estimate). The net gap for social security tax is \$20.9 billion (Alternative I estimate) or \$18.3 billion (Alternative II estimate) and for FUTA tax is \$.4 billion (Alternative I estimate) or \$.3 billion (Alternative II estimate).

Estimates for tax years 1984 through 1997 also are presented. Based upon these estimates, the TY 1997 gross tax gap is projected to be approximately two and a half times as large as the TY 1984 gap. The gap is projected to increase from \$18.9 billion to \$50.2 billion as estimated using the Alternative I methodology or from \$17.0 billion to \$45.3 billion as estimated using the Alternative II methodology. The net tax gap is projected to increase by a slightly greater percentage, from \$15.8 billion to \$43.0 billion or \$13.9 billion to \$38.2 billion as estimated using the Alternative I and II methodologies, respectively. The NCRs are projected to remain relatively stable during the period. The projected NCR for TY 1997, 10.2 percent, is 1.3 percentage points lower than the estimated NCR for TY 1984 (Alternative I estimates).





## I. Introduction

This report presents the Internal Revenue Service's (IRS's) tax gap estimates for social security, Medicare, and federal unemployment insurance taxes.<sup>1</sup> Both gross and net gap estimates are presented. The *gross* employment tax gap estimates for a particular tax year (TY) reflect the aggregate amount of employment tax liabilities that are not paid voluntarily and timely. These estimates are the net of underpaid and overpaid tax liabilities. In theory the tax gap could be negative (in the aggregate taxpayers could voluntarily overpay their liabilities) or perhaps even zero. The available compliance data, however, suggest that taxpayers overall underpay their liabilities. Through its enforcement activities, though, IRS assesses and collects some of the underpaid amounts. The *net* employment tax gap estimates reflect the amount of the gross gap remaining after IRS enforcement activities--the amount of tax owed but not paid either voluntarily or involuntarily. This report presents two series of gross and net tax gap estimates based upon slightly different estimation methodologies.

In previous reports, IRS presented estimates of the *income* tax gap.<sup>2</sup> The concepts of the gross and net *employment* tax gaps and the general approach used in their estimation are similar to those used in the estimation of the gross and net *income* tax gaps. The estimates in this report also are based partially on information developed for the income tax gap studies. In particular, IRS Publication 1415 (7-88), *Income Tax Compliance Research: Supporting Appendices to Publication 7285*, which contains descriptions of the estimation methodologies, assumptions, and intermediate estimates used in developing the income tax gap estimates, was a primary source of information for this report.

The following section of this report contains discussions of the gross and net employment tax gap concepts and the limitations of the estimates. The estimates are presented in Section III and a description of the estimation methodology is found in Section IV.

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<sup>1</sup> Social Security and Medicare taxes are taxes levied under the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA). In this report, the term social security taxes refers to Old-Age, Survivors, and Disability Insurance (OASDI) taxes. The term Medicare tax refers to Hospital Insurance (HI) tax. Similarly, federal unemployment insurance taxes are levied under the Federal Unemployment Tax Act (FUTA).

The estimates in this report do not reflect the tax law changes of the Omnibus Reconciliation Act of 1993.

<sup>2</sup> See Internal Revenue Service, *Income Tax Compliance Research : Gross Tax Gap Estimates and Projections for 1973-1992*, March, 1988 and Internal Revenue Service, *Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates (Supplement to Publication 7285)*, April, 1990.

## II. Gross and Net Employment Tax Gap Concepts

### A. Gross Tax Gap

The concept of the gross *employment* tax gap used in this report is analogous to the concept of the gross *income* tax gap presented in previous reports: the gross employment tax gap for a given year is the aggregate amount of that year's tax liability that is not paid voluntarily. As previously noted, the gap is net of underpaid and overpaid liabilities. The *gross* gap reflects the liabilities not paid voluntarily prior to any IRS efforts to collect the unpaid amounts through its enforcement activities. These activities include the running of computer programs that check the arithmetic accuracy and the internal consistency of filed returns, the matching of information documents with information reported by taxpayers to determine reporting accuracy or return non-filing, the examination of returns, and the collection of assessed but unpaid liabilities.

The gross tax gap has two major components--a reporting gap and a remittance gap. These concepts are identical to their income tax gap counterparts. As defined in the earlier income tax gap report, the reporting gap is "the amount of tax liability that taxpayers do not voluntarily report," and the remittance gap is "the amount that taxpayers report on their returns as due, but which is not voluntarily paid."<sup>3</sup>

The reporting gap is further divided into two categories which reflect ways in which employment taxes are not paid voluntarily: (1) underreported/misreported earnings and (2) math errors. The *underreported/misreported* earnings category includes situations in which compensation subject to employment tax either is underreported or is misreported as a different type of compensation subject to different tax treatment. In the case of individuals in business for themselves, this may arise from underreporting earnings from self-employment or from misreporting self-employment earnings as wages or "other" income. Employers and employees also may underreport wages, tips, and other remuneration that are subject to employment taxes. Employment taxes also may be understated because required employment tax returns are not filed. Finally, because of the difference in the tax treatment of compensation of employees and the self-employed, situations in which workers have been classified incorrectly as independent contractors rather than as employees may result in the underreporting of FUTA and FICA taxes and overreporting of SECA tax.<sup>4</sup>

<sup>3</sup> Internal Revenue Service, *Net Tax Gap and Remittance Gap Estimates*, p.1.

<sup>4</sup> Appendix A contains a discussion of the issue of worker misclassification. In cases of misclassification, underreporting and/or overreporting of tax will depend on individual circumstances. In particular, the eligibility of the employer for relief under section 530 and the employee's reporting behavior will determine whether tax is over and/or underreported. (As is noted in Appendix A, the term *section 530* refers to section 530 of the Revenue Act of 1978. This section provides relief from federal income tax withholding and employment tax liabilities to eligible employers.)

For example, take the case of the misclassified worker whose employer qualifies for relief under section 530. Even though the worker is an employee, the employer is not liable for FUTA tax or the employer's share

The second category, *math errors*, includes arithmetic mistakes or transcription errors made by taxpayers while completing tax forms. For example, taxpayers may multiply two numbers incorrectly or miscopy a number from one form to another or from one line to another. These mistakes may cause them to report and pay an incorrect amount of tax and are included, therefore, as a component of the gross employment tax gap.

The remittance gap reflects situations in which taxpayers file tax returns where they report liabilities greater than the payments made throughout the tax year and fail to pay the balances due on the accounts. In the case of employer-filed employment tax returns, these balances due reflect unpaid employer and employee FICA tax liabilities and employer FUTA tax liability.<sup>5</sup> Self-employed individuals report their employment tax liabilities, SECA tax, along with their income tax liabilities on Form 1040; therefore, any balances due on these returns are partially an underpayment of SECA tax.<sup>6</sup>

### Limitations of the Gross Gap Estimates

The foregoing taxonomy accounts for the various categories of the employment tax gap that would be included in a set of comprehensive estimates. Although the estimates of the gross employment tax gap are the most comprehensive obtainable given the available data, the lack of compliance data precludes the estimation of several components of the gap. The estimates, therefore, are likely to be underestimates of the "true" gross employment tax gap. The various components of the tax gap and the availability of data useful for their estimation are discussed below.

The estimates in this report include estimates for social security and Medicare (FICA and SECA), and FUTA taxes only. Information on compliance with Railroad Retirement Tax Act (RRTA) and Railroad Unemployment Repayment Tax (RURT) laws are not available; consequently, the gap for these taxes was not estimated. Railroad

of FICA tax. Therefore, there is no reporting gap associated with these two taxes. In this situation, however, the employee is liable for the employee share of FICA. The employee's reporting behavior and understanding of his or her tax obligation will determine whether the employee's share of FICA tax and/or SECA tax is underreported or overreported. If the employee is aware that he or she is liable for the employee share of FICA, and correctly reports the remuneration as wages subject to FICA, there is no associated gap. If, however, the employee mistakenly reports the remuneration as earnings from self-employment, the result is underreporting of FICA tax and overreporting of SECA tax.

<sup>5</sup> In these situations, the underpayment of *employee* FICA generally reflects the failure of *employers* to turn over to the government, the *employee* FICA tax they have collected from employees via withholding. The employees, therefore, have "paid" their tax, but their employers have not turned the withheld taxes over to the federal government.

<sup>6</sup> There are three other situations in which insufficient payment of the balance due on a 1040 return is partially an insufficient remittance of employment taxes: (1) cases in which individuals are reporting additional FICA liability on tip income that was not reported to their employer, (2) cases in which individuals are paying FICA liability on tip income that was reported to their employer but for which employee funds were not available for withholding, and (3) cases in which a misclassified worker, whose employer is eligible for relief under section 530, is paying the employee share of FICA tax.

employment taxes, however, make up such a small portion of total employment taxes that it is unlikely that their omission contributes to a substantial underestimate of the "true" employment tax gap.

The estimates of the social security and Medicare tax component of the gross reporting gap presented in this report include estimates of the gaps attributable to the underreporting of (1) net earnings from self-employment by individuals in business for themselves, (2) tip income by persons receiving tips, and (3) wages and salaries by non-household and non-agricultural employers.<sup>7</sup> The estimates associated with tip and self-employment income reflect the gaps for both filers and nonfilers of returns. The estimates related to wages and salaries reflect the gap only for those employers who are filers of Form 941 or Form 941E. The wage and salary estimates also reflect the gap stemming from the misclassification of employees as independent contractors. Similarly, the estimates of the FUTA tax component of the gross reporting gap reflect the FUTA tax gap associated with underreported tip income and underreported wage and salary income by non-household and non-agricultural employers who file returns.

Due to the lack of compliance data, however, the estimates do not reflect some components of the reporting gap. Several components that were not estimated are the FICA and the FUTA reporting gaps associated with noncompliance by household and agricultural employers who file employment tax returns and with noncompliance by nonfilers of all types of employment tax returns.<sup>8</sup> It also was not possible to estimate the gap associated with math errors. Data associating net additional taxes due because of math errors that affect social security, Medicare, and FUTA tax liability and payment computations are not available.

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<sup>7</sup> Non-household and non-agricultural employers are employers who should file employment tax Form 941 or Form 941E. Household employers file Form 942 and agricultural employers file Form 943 to report social security tax liability. See Appendix B for a list and description of the various tax forms mentioned in this report.

<sup>8</sup> The Withholding Noncompliance Study (WNS), on which most of the FICA and FUTA tax gap estimates are based, focused solely on employers who--at some time--had filed a Form 941 or Form 941E with the IRS. We concluded that it was not appropriate to generalize the results from this study to other types of employers, and therefore did not develop estimates of the reporting gap associated with these taxpayers.

Although noncompliance with household employment taxes is presumed to be widespread, the associated gap is probably small relative to the size of the total employment tax gap presented in this report. Additional work is underway to attempt to identify sources of information from which estimates could be developed.

An exception to the statement that the estimates do not reflect the gap associated with employment tax nonfilers applies to nonfilers of Form 940 who did file Form 941 or Form 941E. The study that provided the basis for the estimates of the social security, Medicare, and FUTA tax gaps stemming from underreported wage and salary income was based on a sample of employers who file (or had filed) Form 941 or Form 941E. Because the survey examined both FICA and FUTA tax compliance, if an employer had filed a Form 941 and should have but did not file a Form 940, the survey would have identified the FUTA noncompliance associated with this employer.

The remittance gap estimates reflect only the underpayment of reported employer and withheld employee social security and Medicare tax by employers who file Form 941 and Form 941E. As was the case with the reporting gap, several components of the remittance portion of the gap were not estimated because the data were not available. These include the gaps attributable to underpayment of (1) SECA tax, (2) uncollected employee social security and Medicare tax on reported tip income, (3) social security and Medicare tax on tip income not reported to the employer, (4) employee-reported employee FICA tax for misclassified workers, (5) employer and withheld employee FICA tax by household and agricultural employers, (6) FUTA tax, (7) RRTA tax, and (8) RURT tax.

The accuracy of the estimates depends not only on the availability of a broad range of reliable information which enables the estimation of the various pieces of the gap, but also on the accuracy with which taxpayers' "true" liabilities can be determined. In general, the estimation of "true" tax liabilities is approached in two ways: (1) through the use of information about underreporting of tax liabilities generated from the examination (audit) of tax returns, and (2) through the use of total income and tax liability estimates derived from non-examination-based research studies.

Section III of this report contains two series of estimates calculated using different approaches to estimating "true" tax liabilities. The major difference in the estimates results from the differences in estimating "true" tax liabilities from information generated by examining tax returns. The Alternative I estimates are based on the assumption that IRS examiners' *recommendations* of additional tax reflect the amount of taxpayers' "true" tax liabilities that were not reported voluntarily. The Alternative II figures use estimates of additional tax eventually *assessed* as the result of examinations in determining taxpayers' "true" tax liabilities.<sup>9</sup> Discussions of the issues surrounding the definition and measurement of "true" tax liabilities and the shortcomings of the various approaches used in their estimation are found in the earlier *income* tax gap reports.

## **B. Net Tax Gap**

The net employment tax gap is simply the gross employment tax gap minus the tax component of the employment tax portion of IRS direct enforcement revenue. Direct enforcement revenues are collections of tax, penalty, and interest that are attributable to a direct enforcement interaction between a taxpayer and the IRS. As mentioned earlier, these collections are the result of various IRS activities such as math checks, information document matching, examination of tax returns, and the collection of assessed but unpaid tax liabilities through notices, levies, and seizures.

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<sup>9</sup> During examinations, IRS examiners make recommendations of additional tax liability. If a taxpayer agrees with the examiner's determination, the recommended amounts are assessed. Otherwise, the taxpayer may appeal the recommendation. The amount eventually assessed in these cases may differ from the amount the examiner initially recommended. In the aggregate, the amounts eventually assessed to taxpayers as the result of examinations are less than the amounts recommended.

### Limitations of the Net Gap Estimates

The estimation of the tax component of the employment tax portion of direct enforcement revenue for a particular tax year is complicated by several factors. First, IRS information generally is available by the fiscal year of IRS activity rather than by tax year--which is the tax gap reference. Second, the information generally is aggregated. Tax, penalty, and interest frequently are not separately identified, nor are FICA or SECA tax payments identified separately from income tax payments. Lastly, a complete accounting of enforcement revenue for a particular tax year, if one could be made, would not be available until many years after the tax year because the process of identifying and collecting payment on tax liability not voluntarily paid by taxpayers often takes years.

The measures of enforcement revenue, therefore, are *estimates* of the eventual tax revenue likely to be collected because of IRS enforcement actions.<sup>10</sup> They are not tabulations of actual receipts. The estimates of the tax component of the employment tax portion of direct enforcement revenue reflect the revenue attributable to the collection of employer and withheld employee social security and Medicare tax not deposited by filers of Form 941, the examination of employment tax returns, and a portion of the examinations of individual tax returns on which additional SECA tax is assessed.

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<sup>10</sup> All of the estimates presented in the next section of the report reflect tax liabilities and tax collections only. The estimates do not reflect interest and/or penalties assessed or collected on the tax liabilities that are not paid voluntarily. In some cases, the total amount of tax, interest, and penalty eventually collected on a tax liability that was not paid voluntarily may be greater than the original tax liability. Information from the Fiscal Year (FY) 1991 Direct Enforcement Revenue Report suggests that approximately \$850 million of penalty and interest on FICA and FUTA tax liabilities were collected during FY 1991.

### III. Estimates

#### A. Alternative I Estimates

The major difference between the two series of estimates presented in this section of the report is the approach used to estimate a taxpayer's "true" tax liability.<sup>11</sup> As noted earlier, there are various ways of defining and measuring "true" tax liability and, consequently, the tax gap. Special IRS compliance studies are the major source of data on underpaid taxes. These studies report IRS examiners' determinations--"recommendations"--of underpaid tax. These determinations may be greater than the amounts eventually assessed on taxpayers' accounts and for which they are liable for payment. In this subsection, the tax gap estimates use IRS examiners' *recommendations* as a measure of underreported liabilities. Tax gap estimates based on estimates of amounts eventually *assessed* are presented in the following subsection.

Estimates of the employment tax gap were developed for TY 1984 through TY 1997. The focus of this report, however, is the estimates for TY 1987 and selected tax years from 1984 through 1997. TY 1987 was selected as the focal year because it is the year that is highlighted in the previously mentioned income tax gap reports.

#### Alternative I Gross Gap Estimates: TY 1987

The estimate of the gross employment tax gap for TY 1987 is \$25.1 billion. This gap is comprised of a social security and Medicare (FICA and SECA) tax component and a FUTA tax component. As is illustrated in Chart 1, approximately \$24.7 billion, or more than 98 percent of the estimated gap, is the FICA and SECA tax gaps. The remaining portion, about \$.4 billion, is the FUTA tax gap.

About 78 percent, or \$19.5 billion, of the gap is the reporting gap which is attributable to underreported or misreported income. The remaining 22 percent, or \$5.6 billion, is the remittance gap which is the result of the failure by taxpayers to remit full payment of reported tax liabilities.

As measured by noncompliance rates (NCRs), overall employment tax noncompliance is lower than either individual or corporation income tax noncompliance.<sup>12</sup> The overall employment tax NCR is 11.0 percent. The corresponding NCRs for individual and corporation income taxes are 18.6 percent and 18.9 percent respectively.<sup>13</sup> Both FICA and FUTA tax noncompliance are substantially

<sup>11</sup> There is one other difference, discussed in Section IV of this report, in the methodologies used to develop the two series of estimates.

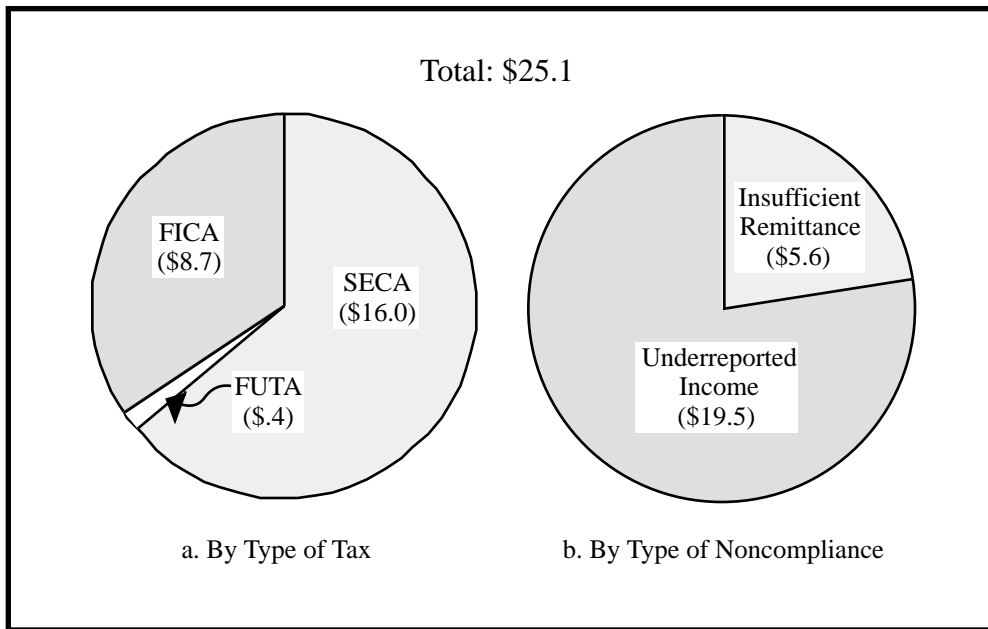
<sup>12</sup> The noncompliance rate is a measure of tax noncompliance. It is defined as the gross tax gap as a percentage of "true" tax liability.

<sup>13</sup> The income tax NCRs were obtained from an unpublished table dated April 8, 1993. Caution must be used

lower than SECA noncompliance. The NCR's for FICA, FUTA, and SECA are 4.5 percent, 7.6 percent, and 55.7 percent, respectively.

For two reasons, neither of these results is surprising. First, FICA taxes are the predominant employment tax and therefore heavily influence the overall NCR. Second, the FICA and FUTA tax bases are wages and salaries which generally are well reported, whereas the SECA tax base is self-employment earnings which generally are reported much less accurately.<sup>14</sup>

**Chart 1. Alternative I Gross Employment Tax Gap Estimates, TY 1987, By Type of Tax and Type of Noncompliance (\$ billions)**



#### *Social Security and Medicare Gap: TY 1987*

As noted above, the estimate of the social security and Medicare component of the TY 1987 gross employment tax gap is \$24.7 billion. Table 1, below, provides

when comparing the income tax and employment tax NCRs because of the greater comprehensiveness of the income tax gap estimates and the high probability that the noncompliance levels of the components of the employment tax gap that could not be estimated are higher than those that were estimated. If these omitted components could have been included in the tax gap estimates, the employment tax NCR probably would have been higher.

<sup>14</sup> From the WNS and the income tax gap reports we have the following voluntary reporting percentages (VRPs) for various income categories: (1) Form 941 taxable wages: 98.7, (2) Form 940 taxable FUTA wages: 98.4, (3) wages and salaries for income tax filers: 99.5, (4) informal supplier income: 13.1. Although the VRPs for nonfarm and farm sole proprietors were not computed because of the distortions caused by negative values, accurate reporting of this type of income is much worse than that of wages and salaries.

VRPs are computed as the amount of income reported voluntarily as a percentage of the amount that should have been reported.



information on the Alternative I gross employment tax gap. As shown in the table, approximately 77 percent of the social security and Medicare gap, \$19.1 billion, arises from taxpayers underreporting or misreporting earnings and the remaining 23 percent, \$5.6 billion, from taxpayers failing to remit full payment of reported tax liability. The underpayment of FICA tax accounts for about 35 percent of the social security gap, \$8.7 billion, and the underpayment of SECA tax accounts for the remaining 65 percent, \$16.0 billion.

**Table 1. Alternative I Employment Tax Gross Gap, NCR, Net Gap, and Enforcement Revenue Estimates: Tax Year 1987**

	FICA	SECA	Subtotal	FUTA	Total
Gross Employment Tax Gap (\$ millions)	\$8,660	\$16,040	\$24,700	\$373	\$25,072
Reporting Gap	3,049	16,040	19,088	373	19,461
Self-Employment Income	-	16,595	16,595	-	16,595
Wages and Salaries	2,634	(556)	2,078	363	2,441
Misclassified Wages	2,476	(556)	1,920	339	2,259
Other Underreporting	158	-	158	24	182
Tips	415	-	415	9	424
Remittance Gap	5,611	*	5,611	*	5,611
Noncompliance Rate (percent)	4.5%	55.7%	11.1%	7.6%	11.0%
Direct Enforcement Revenue (\$ millions)	\$3,757	\$72	\$3,828	\$4	\$3,832
Reporting Gap	53	72	125	4	129
Remittance Gap	3,704	*	3,704	*	3,704
Net Employment Tax Gap (\$ millions)	\$4,904	\$15,968	\$20,871	\$369	\$21,240
Reporting Gap	2,996	15,968	18,964	369	19,333
Remittance Gap	1,908	*	1,908	*	1,908

\* - Estimate not available at this time.

Note: Detail may not add due to rounding.

Almost 65 percent of the FICA gap, \$5.6 billion, is a remittance gap attributable to employer underdeposit of (or total failure to deposit) employer and withheld employee FICA taxes.<sup>15</sup> The underreporting of wages and salaries and the underreporting of tip income account for only 30 percent and 5 percent, respectively, of the FICA gap. Approximately 94 percent of the underreported wage and salary portion of the FICA tax gap, \$2.5 billion, is attributable to misclassification of

<sup>15</sup> Generally, employees do not pay their share of FICA tax to the government directly. Instead, employers withhold the employee share of FICA tax from employees' wages and transfer this money to the government on the employees' behalf. At the same time, employers also transfer the employer share of FICA tax and withheld employee income taxes. Much of the employee tax portion of the FICA remittance gap, therefore, is the result of noncompliance on the part of the employer, through the failure to turn over the employee's withheld taxes, rather than noncompliance on the part of the employee.

employees<sup>16</sup>. Six percent, \$.2 billion, is attributable to underreporting of wages of employees for whom employment status is not an issue.

The SECA tax gap estimates reflect the gap due to underreporting of self-employment income net of SECA tax paid incorrectly by misclassified employees. For TY 1987, an estimated \$16.6 billion in SECA tax was underpaid due to underreporting of self-employment income and \$.6 billion was paid incorrectly by misclassified employees yielding a SECA tax gap estimate of \$16.0 billion.<sup>17</sup>

#### *FUTA Gap: TY 1987*

The estimate of the FUTA tax gap for TY 1987 is \$.4 billion. Approximately 98 percent is due to underreported and misreported wages and salaries. The remaining 2 percent is due to underreported tip income. A large portion of the FUTA wage and salary reporting gap is the result of the misclassification of workers. The portion attributable to misclassification was estimated using information from the WNS. These data suggest that about 93 percent of the FUTA wage and salary reporting gap results from misclassification with the remaining 7 percent stemming from underreporting of earnings of workers correctly classified as employees.

#### Alternative I Net Gap Estimates: TY 1987

The Alternative I estimates of the net employment tax gap for TY 1987 are presented in Table 1. For TY 1987, IRS enforcement activities are estimated to generate enforcement revenue of \$3.8 billion, resulting in a net employment tax gap of \$21.2 billion.<sup>18</sup> The collection of underdeposited social security and Medicare taxes accounts for about 97 percent of this enforcement revenue. The remaining 3 percent is attributable to the examination of returns. The social security and Medicare portion of the net tax gap accounts for \$20.9 billion, or about 98 percent of the total net gap, while the FUTA portion accounts for \$.4 billion, or 2 percent.

#### Alternative I Gross Gap, Noncompliance Rate, Enforcement Revenue, and Net Gap Estimates: Selected Tax Years 1984-1997

Table 2 presents the gross tax gap, noncompliance rate, enforcement revenue, and net tax gap estimates for selected tax years from 1984 through 1997. The TY 1997

<sup>16</sup> Ninety-three percent of the \$2.5 billion gap attributable to misclassification, \$2.3 billion, reflects the FICA liabilities on the remuneration of misclassified employees whose employers *would not* qualify for section 530 relief. The remaining \$.2 billion reflects FICA liability on the remuneration of misclassified employees whose employers *would* qualify for section 530 relief.

<sup>17</sup> Approximately \$447 million of the incorrectly paid SECA tax is attributable to misclassified employees whose employers *would not* qualify for section 530 relief and \$109 million to misclassified employees whose employers *would* qualify for relief.

<sup>18</sup> To simplify the exposition, for the next two sections of the report the term enforcement revenue will reflect the tax component of the employment tax portion of direct enforcement revenue.

**Table 2. Alternative I Employment Tax Gross Gap, NCR, Net Gap, and Enforcement Revenue Estimates: Selected Tax Years 1984-1997**

	1984	1987	1992	1994	1997
Gross Tax Gap (\$ billions)	\$18.9	\$25.1	\$39.0	\$43.1	\$50.2
Social Security and Medicare	18.7	24.7	38.5	42.6	49.7
FICA	6.7	8.7	12.6	14.6	18.1
Reporting Gap	2.2	3.0	5.3	6.1	7.6
Wages and Salaries	1.9	2.6	4.0	4.7	5.8
Tips	.3	.4	1.3	1.5	1.8
Remittance Gap	4.5	5.6	7.3	8.4	10.5
SECA					
Reporting Gap	12.0	16.0	25.9	28.1	31.6
Federal Unemployment Insurance					
Reporting Gap	.2	.4	.4	.5	.5
Wages and Salaries	.2	.4	.4	.5	.5
Tips	-	▼	▼	▼	▼
Noncompliance Rate (percent)	11.5%	11.0%	11.2%	10.8%	10.2%
Social Security and Medicare	11.7	11.1	11.2	10.8	10.3
FICA	4.9	4.5	4.2	4.2	4.2
SECA	55.1	55.7	58.7	58.7	58.7
Federal Unemployment Insurance	4.6	7.6	7.6	7.6	7.6
Direct Enforcement Revenue (\$ billions)	\$3.1	\$3.8	\$5.0	\$5.8	\$7.1
Social Security and Medicare	3.1	3.8	5.0	5.8	7.1
FICA	3.0	3.8	4.9	5.6	7.0
Reporting Gap	.1	.1	.1	.1	.1
Remittance Gap	3.0	3.7	4.8	5.6	6.9
SECA	▼	.1	.1	.1	.1
Federal Unemployment Insurance	▼	▼	▼	▼	▼
Net Employment Tax Gap (\$ billions)	\$15.8	\$21.2	\$34.0	\$37.3	\$43.0
Social Security and Medicare	15.6	20.9	33.5	36.9	42.5
FICA	3.7	4.9	7.7	8.9	11.1
Reporting Gap	2.1	3.0	5.2	6.0	7.5
Remittance Gap	1.5	1.9	2.5	2.9	3.6
SECA	11.9	16.0	25.8	28.0	31.4
Federal Unemployment Insurance	.2	.4	.4	.5	.5

▼ - Less than \$ .1 billion.

Note: Detail may not add due to rounding.

gap, in nominal dollars, is projected to be approximately two and a half times as large as the TY 1984 gap. The NCRs are projected to remain relatively stable over this period.

The projected NCR for TY 1997, 10.2 percent, is 1.3 percentage points lower than the estimated NCR for TY 1984.<sup>19</sup> These projections reflect estimated changes in the tax base and tax rates over time rather than changes in taxpayer behavior because in developing the estimates the voluntary reporting rates were assumed to remain constant.<sup>20</sup>

During the period 1984 through 1997 the estimated net gap is projected to increase by approximately 170 percent from \$15.8 billion to \$43.0 billion. This estimated increase is slightly greater than the estimated increase in the gross employment tax gap. In part, the increase in the gross gap reflects expansion of social security, Medicare, and FUTA coverage; and real economic growth. Our estimates of enforcement revenue do not assume any corresponding increases in IRS resources being applied to this area; therefore, we project that the ratio of the net gap to the gross gap will increase.

## **B. Alternative II Estimates**

The estimates presented in this subsection were developed using a methodology which includes the assumption that the amounts of additional tax *assessed* as the result of examinations reflect the underreported part of taxpayers' "true" tax liabilities. The methodology also reflects the assumption that TCMP examinations do not completely address the worker misclassification issue. To the extent this assumption is correct, there is the theoretical possibility that combining the results from the TCMP and the WNS studies results in doublecounting. The Alternative II methodology corrects for potential overcounting.<sup>21</sup>

The Alternative II estimates overall are somewhat lower than the Alternative I estimates. The difference in methodology results primarily in differences in the levels of the estimates and has minimal impact on the distribution of the various components of the gap--the latter breakouts are only slightly different for the two series of estimates. Table 3 contains the Alternative II estimates for TY 1987. For selected tax years from 1984 to 1997, the gross gap, noncompliance rate, enforcement revenue, and net gap estimates are presented in Table 4.

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<sup>19</sup> The trend in the NCR should not be interpreted as a measure of the trend in the behavior of taxpayers. In general, we had only one tax year of compliance data from which to develop our estimates. In developing our estimates, therefore, we made the same assumption we had made in estimating the income tax gap-- we assumed that taxpayers voluntarily report a constant percentage of a particular income type. The changes in the overall NCR, therefore, are a reflection of the effects of changes in the relative sizes of the FICA, SECA, and FUTA tax bases and changes in the various tax rates over time rather than of changes in taxpayer behavior.

<sup>20</sup> See Appendix C for a list of FICA, SECA, and FUTA tax rates and major coverage changes for the years 1984-1997. Prior to 1988, only tips deemed to be wages were subject to employer FICA.

<sup>21</sup> This issue is discussed in more detail in Section IV.

Alternative II Gross Gap, Noncompliance Rate, Enforcement Revenue, and Net Gap Estimates: Tax Year 1987

As is shown in Table 3, the TY 1987 Alternative II gross employment tax gap estimate is \$22.5 billion, \$2.6 billion lower than the corresponding Alternative I estimate. The breakout of the gross gap between social security and Medicare and FUTA, however, is almost identical to the Alternative I estimates--more than 98 percent of the gap is attributable to social security and Medicare and less than 2 percent to FUTA. Most of the \$2.6 billion difference in the Alternative I and II estimates is a consequence of a lower social security and Medicare estimate, \$22.2 billion, which is approximately \$2.5 billion lower than the Alternative I estimate. The Alternative II FUTA estimate is approximately \$.3 billion; \$.1 billion lower than the Alternative I estimate.

The Alternative II NCR estimates are slightly lower than the Alternative I NCR estimates because the gross gap estimates are lower. The overall NCR is one percentage point lower. For the gap components, the differences in NCRs between the two sets of estimates range from .3 percentage points for FICA tax to 3.4 percentage points for SECA tax.

The distribution of the Alternative II social security and Medicare gap estimate between FICA and SECA gaps and between reporting and remittance gaps is only slightly different from the Alternative I distribution. The SECA gap is a relatively smaller portion of the Alternative II gross social security and Medicare gap estimate than it is of the corresponding Alternative I estimate (63.1 percent versus 64.9 percent). The FICA gap, therefore, is relatively larger (36.9 percent versus 35.1 percent). The reporting gap accounts for a smaller portion of the estimated Alternative II gap than it does of the Alternative I gap (74.7 percent versus 77.3 percent) and the remittance gap accounts for a larger portion (25.3 percent versus 22.7 percent).

Since the methodology for estimating employment-tax-related enforcement revenue is unaffected by the choice of methods for estimating the gross employment tax gap, the enforcement revenue estimates presented in Table 3 are the same as those presented earlier in Table 1. Consequently, the dollar differences between the Alternative I and II gross gap and net gap estimates are identical. The Alternative II net gap is \$18.6 billion. The major portion is the \$18.3 billion social security and Medicare component (\$4.4 billion FICA, \$13.9 billion SECA). The net FUTA tax gap is \$.3 billion.

Alternative II Gross Gap, Noncompliance Rate, Enforcement Revenue, and Net Gap Estimates: Selected Tax Years 1984-1997

The Alternative II estimates for selected tax years from 1984 to 1997 are presented in Table 4. The projected growth in gross and net gaps during this period, based on the Alternative II estimates, is nearly identical to the projected growth based on

the Alternative I estimates. Based on the Alternative II estimates, the gross gap will increase by about 166 percent from \$17.0 billion to \$45.3 billion and the net gap will increase, by a slightly greater percentage, from \$13.9 billion to \$38.2 billion.

The Alternative II NCR estimates, like the Alternative I estimates, are projected to remain relatively stable over the time period. The Alternative II NCRs, however, are slightly lower than the Alternative I NCRs.

**Table 3. Alternative II Employment Tax Gross Gap, NCR, Net Gap, and Enforcement Revenue Estimates: Tax Year 1987**

	FICA	SECA	Subtotal	FUTA	Total
Gross Employment Tax Gap (\$ millions)	\$8,168	\$13,986	\$22,154	\$301	\$22,455
Reporting Gap	2,557	13,986	16,543	301	16,844
Self-Employment Income	-	14,455	14,455	-	14,455
Wages and Salaries	2,142	(469)	1,673	292	1,965
Misclassified Wages	1,984	(469)	1,515	272	1,787
Other Underreporting	158	-	158	19	177
Tips	415	-	415	9	424
Remittance Gap	5,611	*	5,611	*	5,611
Noncompliance Rate (percent)	4.2%	52.3%	10.0%	6.2%	10.0%
Direct Enforcement Revenue (\$ millions)	\$3,757	\$72	\$3,828	\$4	\$3,832
Reporting Gap	53	72	125	4	129
Remittance Gap	3,704	*	3,704	*	3,704
Net Employment Tax Gap (\$ millions)	\$4,412	\$13,914	\$18,326	\$297	\$18,623
Reporting Gap	2,504	13,914	16,418	297	16,715
Remittance Gap	1,908	*	1,908	*	1,908

\* - Estimate not available at this time.

Note: Detail may not add due to rounding.

**Table 4. Alternative II Employment Tax Gross Gap, NCR, Net Gap, and Enforcement Revenue Estimates: Selected Tax Years 1984-1997**

	1984	1987	1992	1994	1997
<b>Gross Tax Gap (\$ billions)</b>	<b>\$17.0</b>	<b>\$22.5</b>	<b>\$35.1</b>	<b>\$38.9</b>	<b>\$45.3</b>
Social Security and Medicare	16.8	22.2	34.8	38.5	44.9
FICA	6.3	8.2	11.9	13.7	17.1
Reporting Gap	1.8	2.6	4.6	5.3	6.6
Wages and Salaries	1.5	2.1	3.3	3.8	4.8
Tips	.3	.4	1.3	1.5	1.8
Remittance Gap	4.5	5.6	7.3	8.4	10.5
SECA					
Reporting Gap	10.5	14.0	22.9	24.8	27.9
Federal Unemployment Insurance					
Reporting Gap	.2	.3	.4	.4	.4
Wages and Salaries	.2	.3	.3	.4	.4
Tips	-	▼	▼	▼	▼
<b>Noncompliance Rate (percent)</b>	<b>10.5%</b>	<b>10.0%</b>	<b>10.2%</b>	<b>9.8%</b>	<b>9.3%</b>
Social Security and Medicare	10.7	10.0	10.2	9.9	9.4
FICA	4.6	4.2	4.0	4.0	4.0
SECA	51.8	52.3	55.6	55.6	55.6
Federal Unemployment Insurance	3.7	6.2	6.2	6.3	6.2
<b>Direct Enforcement Revenue (\$ billions)</b>	<b>\$3.1</b>	<b>\$3.8</b>	<b>\$5.0</b>	<b>\$5.8</b>	<b>\$7.1</b>
Social Security and Medicare	3.1	3.8	5.0	5.8	7.1
FICA	3.0	3.8	4.9	5.6	7.0
Reporting Gap	.1	.1	.1	.1	.1
Remittance Gap	3.0	3.7	4.8	5.6	6.9
SECA	▼	.1	.1	.1	.1
Federal Unemployment Insurance	▼	▼	▼	▼	▼
<b>Net Employment Tax Gap (\$ billions)</b>	<b>\$13.9</b>	<b>\$18.6</b>	<b>\$30.1</b>	<b>\$33.1</b>	<b>\$38.2</b>
Social Security and Medicare	13.8	18.3	29.8	32.7	37.8
FICA	3.3	4.4	7.0	8.1	10.1
Reporting Gap	1.8	2.5	4.5	5.2	6.5
Remittance Gap	1.5	1.9	2.5	2.9	3.6
SECA	10.5	13.9	22.8	24.7	27.7
Federal Unemployment Insurance	.2	.3	.3	.4	.4

▼ - Less than \$ .1 billion.

Note: Detail may not add due to rounding.

## IV. Methodology

The estimates developed for this report are based on information from various compliance studies and on data extracts from IRS masterfiles of tax return information. The two primary sources of information are *Income Tax Compliance Research: Supporting Appendices to Publication 7285* (Publication 1415) and the Strategic Initiative on Withholding Noncompliance Study (WNS).<sup>22</sup> Publication 1415 contains descriptions of the methodology used to estimate the gross *income* tax gap. It also has detailed information on underreported self-employment and tip income. Estimates of underreported SECA, FICA, and FUTA tax were derived in part from these underreported income estimates.

The Withholding Noncompliance Study was designed to determine the extent of noncompliance in the withholding area.<sup>23</sup> It involved thorough examinations of TY 1984 employment tax returns of approximately 3,300 employers and follow-up employee surveys of certain individuals identified in the employer surveys. The examined employers were selected randomly from employers known to IRS through Form 941 and Form 941E filing records. The study addressed various aspects of withholding compliance, including the classification of workers as independent contractors or employees. Social security, Medicare, and FUTA tax liability and payment data from this study were used primarily to calculate the portions of the gap attributable to the misclassification of workers as independent contractors and to the understatement of wages and salaries subject to FICA and FUTA.

The methodology used to develop the TY 1984 through TY 1992 Alternative I estimates is described in detail below. The estimates for TY 1993 through TY 1997 were extrapolated from the TY 1992 estimates using growth rates in projected reported tax liability. The methodology used to develop the Alternative II estimates differs from the Alternative I methodology only in that it incorporates the following two assumptions: (1) that the amounts eventually *assessed* on returns examined by IRS, rather than the amounts *recommended*, best reflect the underreported portion of taxpayers' "true" tax liabilities and (2) that Taxpayer Compliance Measurement Program (TCMP) examinations do not completely address the worker misclassification issue.<sup>24</sup> To the extent this latter

<sup>22</sup> The latter study is also known as SVC-1.

<sup>23</sup> See unpublished papers "Strategic Initiative on Withholding NonCompliance (SVC-1), Misclassified Employee Survey, Report of Findings", September 1989 and "Strategic Initiative on Withholding NonCompliance (SVC-1), Employer Survey, Report of Findings", June 1989. Also see "Form W-4 Compliance: Evidence From Survey Data and Returns Processing" in *Trend Analyses and Related Statistics--1989 Update*, IRS Document 6011.

<sup>24</sup> The TCMP is the primary source of information on taxpayer compliance. Tax returns selected for examination under this program are randomly selected and are subject to line-by-line review by IRS examiners. The information collected as a result of these examinations provides detailed line-by-line data on what taxpayers reported on their returns and on what IRS examiners believed they should have reported. The *Taxpayer Compliance Measurement Program Handbook* provides additional information on the TCMP.



assumption is correct, there is a theoretical possibility of doublecounting from combining the results of the TCMP and WNS studies. The Alternative II methodology adjusts for the theoretical overcounting.<sup>25</sup>

## **A. Gross Employment Tax Gap Methodology**

### Social Security and Medicare Gap

The social security and Medicare tax gap is developed from separate estimates of four components. These components are: (1) the additional tax due on underreported tip income, (2) the additional tax due on underreported wage and salary income, (3) the additional tax due on underreported self-employment income, and (4) the underdeposit by employers of employer and withheld employee social security and Medicare tax. The estimated additional tax liabilities are attributed to either FICA or SECA tax. The methodology used to estimate each component is described below.

#### *Tip Income*

Estimates of the portion of the social security and Medicare tax gap attributable to underreported tip income are based upon the tip income data found in Publication 1415. Estimates of FICA-taxable underreported tips were derived from these data and then multiplied by the appropriate FICA tax rates to generate estimates of the underreported tip income component of the social security and Medicare tax gap.

#### *Underreported Wages and Salaries*

The estimates of the social security and Medicare tax gap resulting from underreported wage and salary income are based upon information obtained from the WNS. These estimates reflect underreporting of employee earnings--including part of the underreporting stemming from the incorrect treatment of employee remuneration as earnings from self-employment. Reports of the results of the WNS contain estimates of underreported earnings and associated social security and Medicare and FUTA revenue losses for TY 1984. Tax gap estimates for TY 1984 were developed directly from the WNS data. Estimates for TY 1985 through TY 1992 were developed from the 1984 WNS data and from estimates and projections of reported social security and Medicare taxable wages. Separate estimates were developed for misclassified employees and for SECA and FICA tax. For TY 1991 and TY 1992, separate estimates were made for social security taxes and for Medicare taxes.

<sup>25</sup> The adjustment involves reducing the SECA estimates to account for the fact that the TCMP-based SECA tax gap estimates may overstate the SECA gap. To the extent that TCMP examinations do not detect the misclassification of wages as self-employment income, the TCMP-based SECA gap estimates will count as SECA noncompliance the underreporting of employment tax attributable to misclassified workers. This noncompliance, which should be counted as FICA noncompliance, is already accounted for in the FICA tax gap estimates that are based on the WNS data.

The tax gap projections for TY 1985 through TY 1992 were obtained by multiplying estimates of underreported FICA-taxable earnings by the appropriate tax rates. The former estimates were calculated using estimates of reported FICA-taxable wages by assuming that the percentage of FICA-taxable wages voluntarily reported remained constant at the 1984 level. This assumption was necessary because more current compliance information is not available.

### *Underreported Self-Employment Income*

SECA gap estimates attributable to underreported net earnings from self-employment are estimated by computerized income tax gap models in conjunction with the income tax gap estimates and are contained in the tables in Publication 1415. These estimates are generated by multiplying estimates of underreported net earnings from self-employment by estimates of average marginal SECA tax rates. The estimates for TY 1991 and TY 1992 were adjusted upward to account for the increase in the Medicare tax base.

### *Remittance Gap*

The estimates of employer underdeposited employer and withheld employee FICA tax were developed from special extracts of Form 941 data for TY 1986 through TY 1989. These extracts provided estimates of tax liabilities and payments attributable to social security and Medicare tax from which we calculated the underdeposit estimates for those years.<sup>26</sup> The estimates for the remaining years were projected backward from 1986 and forward from 1989 using estimates of the growth in reported FICA tax.

Given the relative sizes of the withheld income tax and FICA tax liabilities, one would expect that the corresponding underdeposit remittance gap estimates would be of similar magnitude. The use of the new extract data, however, results in estimates for the remittance gap attributable to employer underdeposit of employer and withheld employee FICA tax that are almost twice as large as the estimates of the employer underdeposit of withheld income tax portion of the income tax remittance gap presented in our net income tax gap report. The employer underdeposit of withheld income tax remittance gap estimates for TYs 1986 and later are projections based on TY 1984 and 1985 data and are not actual amounts obtained from the masterfile. Based upon the actual data now available, the TY 1987 estimate would be nearly double the \$2.9 billion shown in the net income tax gap report.

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<sup>26</sup> The data from the extracts are estimates in the sense that we allocate actual payments between FICA and income tax. Employers make combined payments of withheld income and social security taxes. These payments, reported by employers, are not specifically designated as either income or FICA tax payments. Information reported on Form 941 allows the identification of separate tax liabilities, but payments are not designated to a specific tax liability. We allocated underdeposits to each type of tax on a *pro rata* basis. That is, in attributing payments to each liability, we assume that the share of the combined *payment* attributable to each type of tax is the same as its share of the combined tax *liability*.

## Federal Unemployment Insurance Tax Gap

### *FUTA Gap on Underreported Tip Income*

The FUTA gap attributable to underreported tip income was developed from tip income data obtained from Publication 1415. Estimates of FUTA-taxable underreported tips, assumed to be approximately 17 percent of total underreported tips, were multiplied by the net FUTA tax rate to arrive at the estimates of this component of the FUTA gap.

### *FUTA Gap on Underreported Wages and Salaries*

This component of the gap was estimated using the information from the WNS. The TY 1984 estimate was taken directly from the WNS employer survey report. The estimates for TYs 1985 through 1992 were determined by multiplying estimates of FUTA-taxable underreported wages by estimates of net FUTA tax rates.<sup>27</sup> The estimates of FUTA-taxable underreported wages were based on the assumption that the percentage of FUTA-taxable wages voluntarily reported remained constant at the 1984 level.

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<sup>27</sup> The estimated FUTA gap attributable to underreported wages and salaries reflects the reduction in the credit allowable for state contributions. The net FUTA rate facing employers depends on the credit to which they are allowed. If employers are entitled to the maximum credit, the net FUTA rate is .008. This is equal to the gross rate, .062 (.035, TY 1984), minus the credit rate, .054 (.027). One situation in which the credit may be reduced is in the case where the employer pays wages in a state which has unrepaid advances from the federal government. In that case the employer may pay a FUTA rate as high as the gross rate.

The net FUTA rate also depends on compliance with state unemployment laws. If an employer were noncompliant with state unemployment laws but fully compliant with federal unemployment laws, no credit would be allowed because the employer had made no state contributions and the net FUTA rate facing this employer would be the gross FUTA rate. If, however, the employer were compliant with both, the maximum credit would be allowed, resulting in a net FUTA rate equal to the gross rate minus the credit rate.

The average effective marginal FUTA rates used in estimating the tax gap reflect these credit reductions. The rates for 1985 through 1992 were estimated by assuming a constant ratio of the actual average marginal credit rate to the statutory maximum credit rate. This ratio was calculated from TY 1984 data. The rates for 1985 through 1992, therefore, reflect the 1984 compliance with state laws and repayment of unpaid advances.

This method probably results in an overestimate of the marginal rates because the number of localities subject to repayment declined from 15 in 1984 to zero in 1988. The effect is likely to be small, though, because most of the additional FUTA liability in the 1984 study is attributable to misclassification of employees. It is unlikely, therefore, that state contributions would have been made by the employer. Consequently, the employer would be paying the gross FUTA rate, and the "credit reduction" for unrepaid state advances would be zero. In most cases, the credit reduction results from noncompliance with state law. It seems reasonable to assume that most of the credit reduction in the 1984 study can be attributed to state noncompliance rather than the repayment of state advances.

It should also be noted that the FUTA gap estimates reflect the federal FUTA tax liability not voluntarily paid *given* the level of employer compliance with state law. The greater the compliance with state law, the lower the FUTA gap estimates; and the lower the compliance, the greater the estimates. This again is a consequence of the interaction between state compliance and the net FUTA rate through the credit reduction. The FUTA gap estimates derived by assuming that employers had correctly reported and paid their state liabilities would be substantially lower than the amounts presented in this report.

## B. Net Employment Tax Gap Methodology

The net employment tax gap estimates were developed by subtracting estimates of the tax component of the employment tax portion of direct enforcement revenue from the estimates of the gross employment tax gap. The direct enforcement revenue estimates are based primarily on IRS masterfile and tax return examination information. Several assumptions were necessary to develop tax year estimates from the available fiscal year (FY) information. The detailed methodologies for the various components of direct enforcement revenue are discussed below.

### Enforcement Revenue: Underdeposit of FICA Tax

The enforcement revenue from the collection of employer underdeposited employer and withheld employee social security and Medicare taxes is estimated using the net *income* tax gap methodology for estimating the direct enforcement revenue from the collection of employer underdeposited withheld *income* taxes. Based upon data gathered by tracking the debit balances of a sample of debit-balance business masterfile accounts, we estimated that approximately 66 percent of the amount owed is eventually collected. Thus, the net employment tax gap attributable to the underdeposit of FICA tax is assumed to be 34 percent of the corresponding gross gap.

### Enforcement Revenue: Examination of Returns

Estimates of direct enforcement revenue generated from the examination of returns are based upon IRS Audit Information Management System (AIMS) data. Estimates were made for direct enforcement revenue generated by the examination of employment tax returns and individual income tax returns examined under the Service Center Self-Employment Tax Program. The general approach to estimating the enforcement revenue generated by examinations was to develop estimates of eventual *tax year* collections from the available *fiscal year* data on additional tax and penalty recommended (reported in various AIMS tables)

We adapted the "interim method" approach to translate recommendations of additional tax and penalty into collections of tax and penalty.<sup>28</sup> We used a return-level AIMS data base to develop tax year distributions for breaking out fiscal year AIMS recommendation data into tax year recommendations. These distributions also were used to develop estimates of *total* tax year recommendations from recommendations made through FY 1989. Finally, we used Direct Enforcement Revenue Report (DERR) data to separate tax collections from tax and penalty collections and--in the estimation of enforcement revenue from the examination of employment tax returns--to separate FUTA and FICA collections.

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<sup>28</sup> See Internal Revenue Service, *Evaluation of the IRS System of Projecting Enforcement Revenue (1990 Update)*, October, 1990, for details on the "interim" method.

**Appendix A**  
**List of Selected Employment-Tax-Related Forms\***

Form	Title	Purpose
940	Employer's Annual Federal Unemployment (FUTA) Tax Return	Used by employers to report federal unemployment (FUTA) tax.
940-EZ	Employer's Annual Federal Unemployment (FUTA) Tax Return	Used by employers to report federal unemployment (FUTA) tax. This form is a simplified version of Form 940.
941	Employer's Quarterly Federal Tax Return	Used by employers to report social security and Medicare taxes and income taxes withheld, advance earned income credit (EIC) and backup withholding.
941E	Quarterly Return of Withheld Federal Income and Medicare Tax	Used by State and local government employers and by other organizations that are not liable for social security taxes. A variation of Form 941.
942	Employer's Quarterly Tax Return for Household Employees	Used by household employers quarterly to report social security, Medicare, and income taxes withheld from wages of household employees.
943	Employer's Annual Tax Return for Agricultural Employees	Used by agricultural employers to report social security, Medicare, and income taxes withheld.
Schedule SE (Form 1040)	Self-Employment Tax	Used to figure self-employment tax.
4137	Social Security and Medicare Taxes on Unreported Tip Income	Used by employees who received tips subject to social security and Medicare taxes but failed to report them to employer and to report any unreported allocated tips shown on the Form W-2.

\* Excerpts from Internal Revenue Service, *Catalogue of Federal Tax Forms, Form Letters and Notices*, Publication 676, rev. 12/91.

## **Appendix B**

### **Misclassification of Workers and the Employment Tax Gap**

The issue of worker misclassification is relevant to the estimation of the employment tax gap because of differences in the tax treatment of employees and the self-employed. These differences in treatment affect the estimation of taxpayers' "true" tax liabilities and, therefore, the tax gap estimates. The interpretation of the tax gap estimates, as they currently are estimated, is very narrow. Consequently, the question addressed by the tax gap estimates, "What is the amount of tax liability not paid voluntarily?", as it applies to misclassified workers, differs from the questions addressed in other reports which examine the misclassification issue (the Department of the Treasury's report on section 1706 of the Tax Reform Act of 1986 and the IRS reports from the SVC-1 study). Because of the different focus and approach of each of these studies, their results are not directly comparable. They are best viewed as providing complementary information.

Employee and independent contractor compensation are subject to different taxes.<sup>29</sup> FICA and FUTA taxes are levied on employee compensation whereas SECA taxes are levied on self-employment earnings.

FICA taxes are divided into an employer share and an employee share. Generally, employers are responsible for transferring these taxes to the federal government. Employers are required to withhold employee FICA tax from their employees' wages and transfer these amounts, along with the employer share of FICA tax and withheld employee income tax, to the government. FUTA taxes are the responsibility of employers and are not withheld from employees' wages. Both FICA and FUTA tax payments are transferred to the government under the federal tax deposit system. Employers then file monthly, quarterly, or annual employment tax returns in which they assess their liabilities for the various employer and withheld employee taxes and reconcile their prepayments with their liabilities.

SECA taxes are levied on earnings from self-employment. Self-employed individuals generally are entitled to deductions for certain expenses in calculating self-employment earnings from total income received from a business. Individuals who are self-employed generally make quarterly estimated tax payments to cover both their income and SECA tax liabilities. They compute and assess their SECA liability annually using Schedule SE which is filed with the Form 1040.

The approach we use in defining and estimating the tax gap can be characterized as retrospective. In estimating taxpayers' "true" tax liabilities, and therefore the tax gap, this approach is best interpreted as taking, as given, the events and financial transactions

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<sup>29</sup> See Department of the Treasury, *Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986*, March 1991, for an overview of the differences in the tax treatment of employees and the self-employed.

that actually took place during the year.<sup>30</sup> Based on these particular facts, we determine taxpayers' "true" tax liabilities. In the case of misclassified workers, we take the following as given: (1) the compensation paid the worker, (2) the fact the worker is misclassified, and (3) the employer's eligibility for section 530 protection.<sup>31</sup> If an employer is eligible for section 530 relief, we define as the "true" liability the employee share of FICA tax. If an employer is not eligible for section 530 relief, we define as the "true" liability, both the employee and employer shares of FICA tax and FUTA tax. In either case, these taxes are computed on the amount of compensation actually paid to the worker as an "independent contractor". These assumptions limit the interpretations that can be given to the estimates.

The tax gap approach differs from the approaches found in the previously mentioned IRS and Treasury reports, and also from the amounts that would be assessed in an actual IRS audit. The reports of the SVC-1 study provide estimates of (1) the amount of additional tax liability that would be assessed on all Form 941-type employers if they were audited, and (2) the "revenue loss" associated with misclassification. These estimates differ in concept and measurement with the tax gap estimates. The estimate of (1) above reflects only the tax assessed to the employers and reflects assessments determined under Internal Revenue Code (IRC) section 3509, as appropriate. The estimate of (2) reflects the employer and employee FICA for misclassified employees whose employers qualify for relief under section 530 as well as for those whose employers do not qualify for relief. The SVC-1 reports also address income tax liability and revenue losses. The SVC-1 estimates, like the tax gap estimates, are retrospective and based on the compensation actually paid to the misclassified workers.

The issues addressed and the approach taken in the Treasury report are substantially different from those in this report. The Treasury report takes a broader approach in examining the misclassification issue and looks at income taxes as well as employment taxes. Using hypothetical situations, the report computes the tax revenue that would be generated if (1) the "employer" treated the worker as an employee, or if (2) the "employer" treated the worker as an independent contractor. These computations, however, assume that total compensation (money payments plus employer-paid benefits and taxes) is the same under either treatment; but that the employee would receive less of the total compensation in the form of money payments and more in the form of benefits than would the independent contractor. The treatment of money payments is an important difference between the approaches and results of the tax gap report and the 1706 report.

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<sup>30</sup> This is the approach we have taken in all our tax gap reports.

<sup>31</sup> Section 530 refers to section 530 of the Revenue Act of 1978. This section provides relief from federal income tax withholding and employment tax liabilities to eligible employers. Eligible employers need not withhold income or FICA taxes from their employees. They also are not liable for employer FICA and FUTA taxes. The remuneration paid to their employees is wages. The employee, therefore, is liable for the employee share of FICA and, for income tax purposes, must treat this remuneration as wages and not earnings from self-employment. See the Treasury *Section 1706* report for a summary of section 530.

The results of the examples in the 1706 study can be interpreted as showing the differences in tax revenue generated under different treatments of workers given the assumptions about the pattern of worker compensation that would likely exist under the different treatments. The tax gap estimates do not have a similar interpretation as the additional revenue that would have been collected if taxpayers had voluntarily paid their taxes. In the specific case of the tax gap estimates attributable to the misclassification of workers, the estimates do not reflect the additional revenue that would have been collected had employers classified their workers properly (i.e. as employees). In general, this is because in estimating the tax gap, the events and transactions are taken as given, whereas if all taxpayers decided to voluntarily pay their taxes, the patterns of transactions and events probably would be different from the ones under which the tax gap estimates are made. The tax revenue collected under those circumstance also would be different.

The tax gap estimates attributable to worker misclassification also differ from the additional assessments that would be made in an IRS audit if an employer is not eligible for section 530 relief. In general, an employer in this situation would be assessed the employer share of FICA. The employer also would be assessed a portion of the employee share of FICA that should have been withheld. This assessment would be determined, if appropriate, using section 3509 of the Internal Revenue Code. The employee, however, still would be liable for the employee share of FICA.

Under current law and the assumptions we use to estimate the tax gap, misclassification per se does not necessarily imply a tax gap for social security and Medicare taxes although it does for FUTA tax. Assuming that workers improperly classified as independent contractors are *compliant* in paying the wrong tax (SECA), the issue of whether or not misclassification necessarily results in a tax gap depends on individual circumstances. In a case where an employer would not be eligible for relief under section 530, the FICA tax we would compute under our tax gap assumptions will at least equal the SECA tax liability. The FICA tax liability we would compute generally will be greater than the SECA tax liability if the taxpayer has deductible business expenses. In a case where an employer is eligible for section 530 relief, the differences in the SECA and FICA tax liabilities depend on the magnitude of deductible business expenses. The smaller the expenses, the larger the SECA liability and the greater the likelihood that the SECA tax liability is greater than the FICA tax liability.



## Appendix C\*

### FICA, SECA, and FUTA Tax Rates and Major Changes in Coverage

#### I. FICA and SECA Contribution Bases and Rates (dollars & percents)

Year	Contribution			FICA Contribution Rate						SECA Contribution Rate		
	Base			Employee			Employer					
	OASDI	HI	Total	OASDI	HI	Credit	OASDI	HI	Total	OASDI	HI	Credit
1984	37,800	37,800	13.7	5.7	1.3	.3	5.7	1.3	11.3	11.4	2.6	2.7
1985	39,600	39,600	14.1	5.7	1.35	-	5.7	1.35	11.8	11.4	2.7	2.3
1986	42,000	42,000	14.3	5.7	1.45	-	5.7	1.45	12.3	11.4	2.9	2.0
1987	43,800	43,800	14.3	5.7	1.45	-	5.7	1.45	12.3	11.4	2.9	2.0
1988	45,000	45,000	15.02	6.06	1.45	-	6.06	1.45	13.02	12.12	2.9	2.0
1989	48,000	48,000	15.02	6.06	1.45	-	6.06	1.45	13.02	12.12	2.9	2.0
1990	51,300	51,300	15.3	6.2	1.45	-	6.2	1.45	15.3	12.4	2.9	-
1991	53,400	125,000	15.3	6.2	1.45	-	6.2	1.45	15.3	12.4	2.9	-
1992	55,500	130,200	15.3	6.2	1.45	-	6.2	1.45	15.3	12.4	2.9	-
1993	57,600	135,000	15.3	6.2	1.45	-	6.2	1.45	15.3	12.4	2.9	-

\* OASDI: Old Age and Survivors and Disability Insurance

HI: Health Insurance

#### II. Major Changes in FICA and SECA: 1984-1997

##### Year

##### Effective

##### Change

1984	Compulsory Coverage: for Federal Employees hired on or after 1/1/84; employees of nonprofit organizations; US residents employed outside the USA by United States employers.
1986	Compulsory for HI (Part A.) only, non-covered State and local employees hired on or after 4/1/86
1987	Compulsory coverage of tips for Employer social security and Medicare
1990	Replacement of SECA credit with two deduction provisions that make the tax treatment of self-employed similar to that of employees.
1991	Compulsory coverage for State and local government employees not under a state or local government retirement system
1991	Increase in HI contribution base.

**III. FUTA Contribution Bases and Tax Rates (dollars & percents)**

Year	Contribution Base	Tax Rate	Maximum Credit Rate
1984	7,000	3.5	2.7
1985	7,000	6.2	5.4
1986	7,000	6.2	5.4
1987	7,000	6.2	5.4
1988	7,000	6.2	5.4
1989	7,000	6.2	5.4
1990	7,000	6.2	5.4
1991	7,000	6.2	5.4
1992	7,000	6.2	5.4
1993	7,000	6.2	5.4

**IV. Major Changes in FUTA: Tax Year 1984-1997**

<b><u>Year Effective</u></b>	<b><u>Change</u></b>
1986	Tip income included as covered wages
1997	Tax rate scheduled to be reduced from 6.2 percent to 6.0 percent.

**\* Sources**

Internal Revenue Service, *Publication 15 (Circular E)*, various years.

Social Security Administration, *Social Security Bulletin*, various issues.

Appendix D

Employment Tax Gap Estimates: Tax Years 1984-1997

TABLE D1. Employment Tax Gross Gap, Net Gap, and Noncompliance Rate Estimates by Tax Year

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
<b>ALTERNATIVE I ESTIMATES</b>														
Gross Tax Gap (\$ billions)	\$18.9	\$20.8	\$23.3	\$25.1	\$27.1	\$29.5	\$34.9	\$37.1	\$39.0	\$41.0	\$43.1	\$45.3	\$47.7	\$50.2
Social Security and Medicare	18.7	20.4	22.9	24.7	26.7	29.1	34.5	36.7	38.5	40.5	42.6	44.8	47.2	49.7
FICA	6.7	7.4	8.0	8.7	9.0	9.9	10.8	11.7	12.6	13.5	14.6	15.7	16.8	18.1
SECA	12.0	13.0	15.0	16.0	17.7	19.2	23.6	25.0	26.0	27.0	28.1	29.2	30.4	31.6
Federal Unemployment Insurance	.2	.3	.4	.4	.4	.4	.4	.4	.4	.4	.5	.5	.5	.5
Noncompliance Rate (percent)	11.5%	11.5%	11.9%	11.0%	10.6%	10.7%	11.5%	11.4%	11.2%	11.0%	10.8%	10.6%	10.4%	10.2%
Social Security and Medicare	11.7	11.6	12.0	11.1	10.7	10.8	11.6	11.4	11.2	11.0	10.8	10.6	10.5	10.3
FICA	4.9	4.9	4.9	4.5	4.1	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2
SECA	55.1	53.9	55.8	55.7	55.6	55.9	59.0	58.7	58.7	58.7	58.7	58.7	58.7	58.7
Federal Unemployment Insurance	4.6	7.4	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6
Net Employment Tax Gap (\$ billions)	\$15.8	\$17.4	\$19.6	\$21.2	\$23.6	\$25.5	\$30.6	\$32.5	\$34.0	\$35.6	\$37.3	\$39.1	\$41.0	\$43.0
Social Security and Medicare	15.6	17.0	19.3	20.9	23.2	25.1	30.2	32.0	33.5	35.2	36.9	38.7	40.6	42.5
FICA	3.7	4.1	4.4	4.9	5.6	6.0	6.6	7.2	7.7	8.3	8.9	9.6	10.3	11.1
SECA	11.9	13.0	14.9	16.0	17.6	19.1	23.6	24.9	25.8	26.9	28.0	29.1	30.2	31.4
Federal Unemployment Insurance	.2	.3	.4	.4	.4	.4	.4	.4	.4	.4	.4	.5	.5	.5
<b>ALTERNATIVE II ESTIMATES</b>														
Gross Tax Gap (\$ billions)	\$17.0	\$18.7	\$21.0	\$22.5	\$24.2	\$26.1	\$31.5	\$33.5	\$35.1	\$36.9	\$38.9	\$40.9	\$43.1	\$45.3
Social Security and Medicare	16.8	18.4	20.7	22.2	23.9	25.7	31.2	33.1	34.8	36.6	38.5	40.5	42.7	44.9
FICA	6.3	7.0	7.6	8.2	8.5	9.3	10.2	11.0	11.9	12.8	13.7	14.8	15.9	17.1
SECA	10.5	11.4	13.2	14.0	15.4	16.4	21.0	22.1	22.9	23.8	24.8	25.8	26.8	27.9
Federal Unemployment Insurance	.2	.3	.3	.3	.3	.3	.3	.3	.4	.4	.4	.4	.4	.4
Noncompliance Rate (percent)	10.5%	10.5%	10.9%	10.0%	9.6%	9.6%	10.5%	10.4%	10.2%	10.0%	9.8%	9.7%	9.5%	9.3%
Social Security and Medicare	10.7	10.6	11.0	10.0	9.6	9.6	10.6	10.4	10.2	10.1	9.9	9.7	9.6	9.4
FICA	4.6	4.6	4.6	4.2	3.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
SECA	51.8	50.5	52.6	52.3	52.1	52.1	56.1	55.8	55.6	55.6	55.6	55.6	55.6	55.6
Federal Unemployment Insurance	3.7	6.0	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.3	6.3	6.2
Net Employment Tax Gap (\$ billions)	\$13.9	\$15.3	\$17.4	\$18.6	\$20.7	\$22.1	\$27.2	\$28.8	\$30.1	\$31.6	\$33.1	\$34.7	\$36.4	\$38.2
Social Security and Medicare	13.8	15.0	17.1	18.3	20.4	21.8	26.9	28.5	29.8	31.2	32.7	34.3	36.0	37.8
FICA	3.3	3.7	4.0	4.4	5.0	5.5	6.0	6.5	7.0	7.5	8.1	8.7	9.4	10.1
SECA	10.5	11.3	13.1	13.9	15.3	16.3	20.9	22.0	22.8	23.7	24.7	25.6	26.7	27.7
Federal Unemployment Insurance	.2	.3	.3	.3	.3	.3	.3	.3	.3	.3	.4	.4	.4	.4

Note: Detail may not add due to rounding.



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