Tax Year 2022
Connecticut Tax Gap Report

Research, Analytics & Forecasting Unit

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CONNECTICUT
Revenue Services

Contents

Executive Summary

In accordance with Public Act 23-204 §374, the Connecticut Department of Revenue Services (DRS) is required to estimate the state's "tax gap," conduct analyses related to tax compliance, and develop strategies to address tax avoidance. Under this act, the tax gap is defined as the difference between (1) the total state taxes and fees owed under full compliance with all state tax laws and (2) the amount of state taxes and fees voluntarily paid. This discrepancy can arise due to non-filing, underreporting of tax liability, or non-payment of all taxes and fees owed.

The act mandates the DRS Commissioner to perform the following tasks on an annual basis:

- Estimate the state tax gap and develop an overall strategy to promote compliance and discourage tax avoidance. The estimate must include a detailed analysis of the tax gap by income and population distribution by deciles, as well as specific breakdowns for the top 5%, 1% and 0.5% of all personal income taxpayers.

- Evaluate the Department's staffing needs to implement the strategy and reduce the state tax gap, while assessing progress towards meeting these needs.

- Conduct a cost-benefit analysis of major tax compliance initiatives undertaken by the Department in the preceding fiscal year, including tax amnesty programs and an analysis of audit rates by income level.

The legislation further requires that the DRS Commissioner submit a report addressing these items by December 15, 2024, and annually thereafter. By July 1, 2025, the DRS is expected to publish a comprehensive plan with measurable goals for closing the tax gap, which will be posted on the DRS website and updated annually.

This report serves as the first in a series of annual submissions and outlines the current state of the tax gap in Connecticut, key findings from the analysis, and recommendations for improving tax compliance and reducing the tax gap.

Introduction: Understanding the Tax Gap

Defining the Tax Gap

The tax gap is a critical measure for assessing the effectiveness of a state's tax system. It represents the difference between the total amount of taxes owed by individuals and businesses, assuming full compliance with the law, and the amount that is voluntarily paid on time. By highlighting areas of non-compliance, the tax gap reveals opportunities to improve tax collection efforts. For this study, we differentiate between the gross tax gap and the net tax gap.

Components of the Gross Tax Gap

The **Gross Tax Gap** refers to the total amount of taxes owed in a given year that remains unpaid by the payment due date. In other words, it is the gap between what should have been paid voluntarily and timely and what was actually paid. The calculation of the gross tax gap is the sum of the following three components:

$$Gross\ Tax\ Gap = Underpayment + Underreporting + Nonfiling$$

Broadly, the gross tax gap is broken down into three primary components:

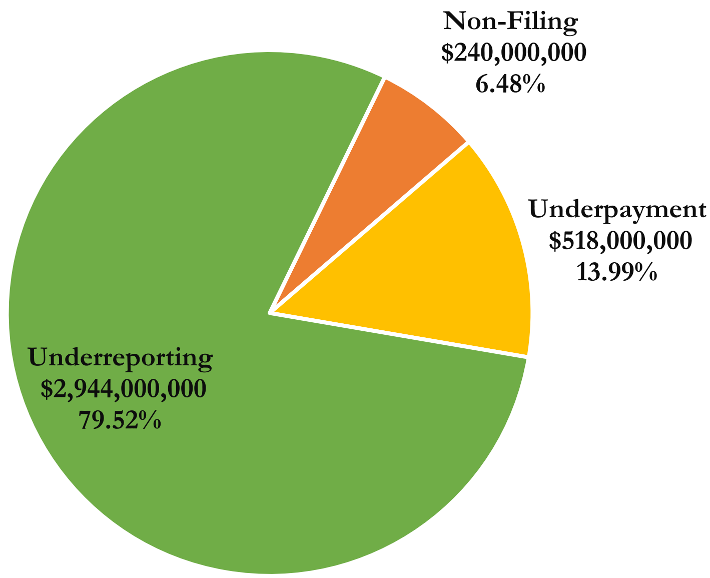
1. **Underpayment**: Underpayment occurs when taxpayers correctly file their required returns and correctly report their tax liabilities but fail to pay the full amount owed by the due date. These unpaid amounts contribute directly to the tax gap until they are resolved through late payments, enforcement actions, or other means.

2. **Underreporting**: Underreporting occurs when taxpayers understate their income, overstate deductions such as charitable contributions, or improperly claim credits, resulting in inaccurate information on timely filed returns. This can happen due to honest mistakes, a lack of understanding of tax laws, or deliberate attempts to evade taxes. Underreporting is often the largest contributor to the tax gap.

3. **Non-filing**: Non-filing includes individuals and businesses that either do not register with the Department or, despite being registered, do not submit required returns. Non-filing also includes cases where returns are filed late (after the original due date or valid extension date) with full or partial payments.

The approach used in this report estimates each component of the tax gap separately using various methods. We then combine these different estimates to obtain an overall gross tax gap estimate for the 2022 tax year. Where data is available, we also provide estimates by tax type. Strategies specific to each component of the gap are described in their respective sections below. **In Connecticut, underreporting comprises 79.52% of the gross tax gap, followed by underpayment at 13.99%, and non-filing at 6.48%, as illustrated in the chart below.**

Figure 1: Components Of The Connecticut Gross Tax Gap ($3.702 Billion)



Enforced and Other Late Payments

Not all of the gross tax gap remains uncollected indefinitely. A portion of unpaid taxes is eventually collected through enforcement actions and other late payments by taxpayers. This includes:

- **Late payments**: Taxes paid after the due date or valid extension, either voluntarily or as a result of enforcement efforts.
- **Payment Plans**: Arrangements made with the taxpayers to pay outstanding balances over time.
- **Audit Settlements**: Payments made as a result of audit findings where underreporting or other forms of non-compliance are identified.

All of these enforcement actions and voluntary late payments help reduce the tax gap; they do not completely eliminate it.

Net Tax Gap

The remaining difference between taxes owed and taxes paid, after accounting for late payments and enforcement actions, is referred to as the **Net Tax Gap**. This net tax gap is a critical measure of the effectiveness of tax compliance efforts, and it is the portion of the gross tax gap that is likely to remain unpaid.

Summary of CT Gross and Net Tax Gap

The overall gross tax gap for tax year 2022 is estimated to be $3.702 billion, with approximately $704 million expected to be collected through enforced and other late payments. This results in an estimated net tax gap of $2.998 billion for tax year 2022.

	Non-filing	$ 240,000,000
+	Underpayment	$ 518,000,000
+	Underreporting	$ 2,944,000,000
=	Gross Tax Gap	$ 3,702,000,000
-	*Enforced & Late Payments*	$ 704,000,000
=	**Net Tax Gap**	$ 2,998,000,000

IRS vs. DRS Tax Gap Estimates

Comparison of IRS & DRS Tax Gap Estimates (in $ billions)

	Total True Tax Liability	Tax Paid Voluntarily & Timely	Gross Tax Gap	Voluntary Compliance Rate	Net Tax Gap	Net Compliance Rate
IRS	$3,307	$2,811	$496	85.0%	$428	87.1%
DRS	$24.1	$20.4	$3.7	84.6%	$3.0	87.6%

The chart compares the tax gap estimates produced by the Internal Revenue Services (IRS) and Connecticut Department of Revenue Services (DRS), highlighting differences in tax liability, voluntary compliance, and net compliance rates. The voluntary compliance rate represents the total tax liabilities paid voluntarily on time by taxpayers, highlighting their willingness to comply without enforcements. In contrast, the net compliance rate accounts for all taxes paid, including those collected through enforcement and late payments, as a percentage of total true tax liability. Together, these metrics provide insight into taxpayer behavior and the challenges of tax collection at both the federal and state levels.

It is important to note that the IRS estimates presented in this chart are from the 2014-2016 study[1], as the historical data for DRS used to estimate underreporting is from 2016-2020.

[1] Internal Revenue Service Research, Applied Analytics & Statistics Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016 Publication 1415 (Rev. 08-2022) Washington, DC August 2022

The total true tax liability is the sum of taxes paid voluntarily and on time and the gross tax gap. This is the tax amount that *should* have been paid. The IRS estimates a total true tax liability of $3.307 trillion, reflecting the comprehensive federal tax base. In comparison, the DRS estimates Connecticut's true tax liability at $24.1 billion, showcasing the significant difference in scale between federal and state tax systems.

Despite the difference in scale, the voluntary compliance and net compliance rates are nearly identical between the IRS and DRS. This consistency suggests that taxpayer behavior in Connecticut is reflective of broader national trends.

Both the IRS and DRS demonstrate that even with enforcement efforts, a significant portion of the tax gap remains uncollected. For example, the IRS closes only approximately 2% of the tax gap through enforced and late payments, a limitation that likely applies to DRS as well.

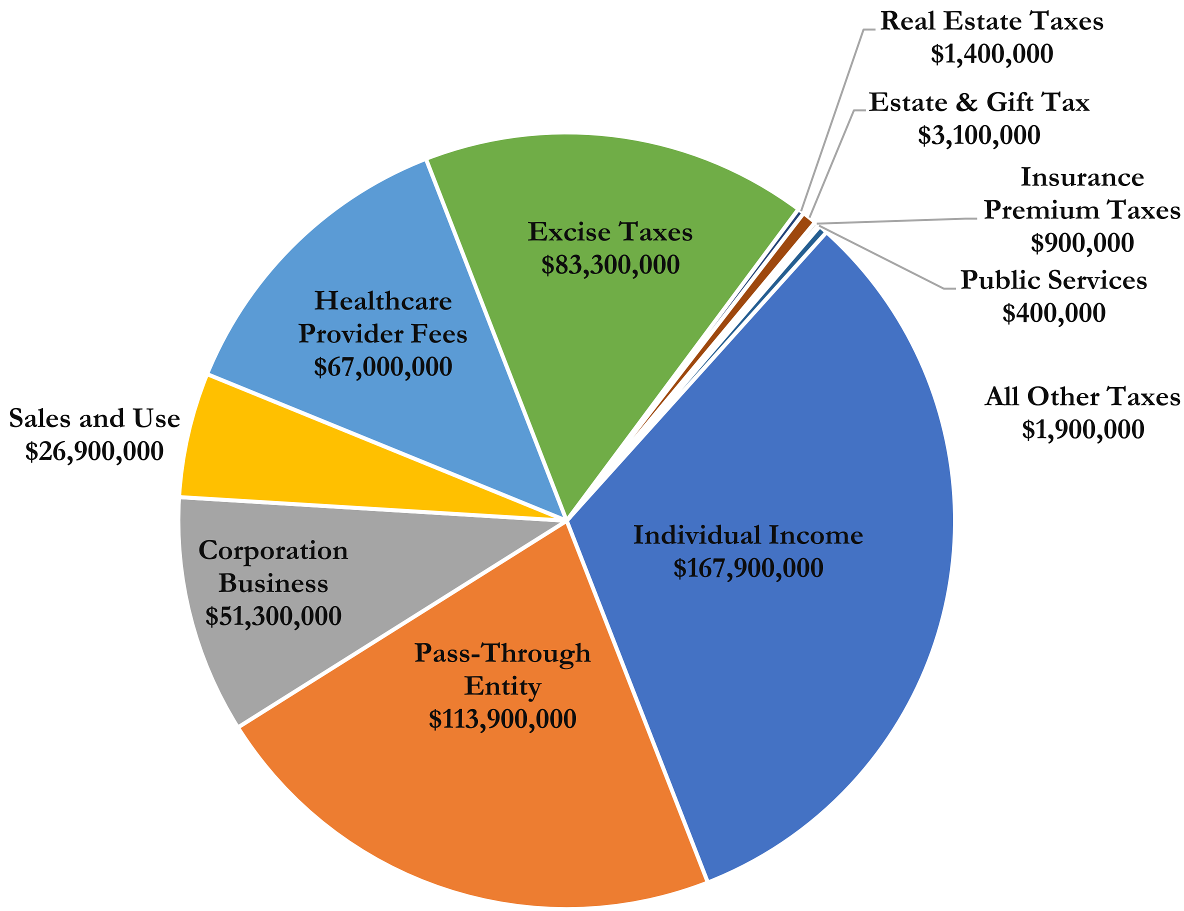
Connecticut's tax gap aligns with national trends, emphasizing that the gap is not unique or indicative of easy-to-recover revenue. Efforts to close the gap are constrained by similar factors at both the federal and state levels, including limited enforcement resources and taxpayer behavior.

Underpayments

The underpayment tax gap consists of taxpayers not timely paying in full the tax that is reported on timely filed returns. In other words, the proper amount of tax was reported by the return's original due date or valid extension date, but not paid in full by the original due date.

The underpayment gap is calculated for all taxes and fees administered by the Connecticut Department of Revenue Services using the DRS administrative data for tax year or income year 2022, depending upon the tax type. These compliance measures are not estimations, as the tax amounts reported on timely filed returns and the payments and credits applied toward these tax liabilities are directly captured in the agency's financial data systems. The **gross underpayment gap** is **$518 million** for tax year 2022, making it the second largest component of the gross tax gap.

Figure 2: Gross Underpayment Tax Gap ($518M)



For purposes of this tax gap analysis, underpayment of withholding taxes is included in the individual income taxes gap as the withholding payments are ultimately applied to the employees' personal income tax liability. The tax types included in the **individual income taxes group** are personal income tax, withholding tax, and income tax trust and estate. Accordingly, individual income taxes comprise the largest component of the gross underpayment gap (32 percent), totaling $167.9 million for tax year

2022. Underpayment of the pass-through entity tax is the second largest component (22 percent), totaling $113.9 million. Underpayment of excise taxes totals $83.3 million, accounting for 16 percent of the gross underpayment gap. (Excise taxes include the alcoholic beverages tax, cigarette taxes, electronic cigarette products tax, tobacco products tax, motor carrier and motor vehicle fuels taxes, petroleum products gross earnings tax, and the special fuel tax).

Underpayment of healthcare provider fees is $67 million and accounts for about 13 percent of the gross underpayment gap. Corporation business taxes ($51.3 million) and sales and use taxes ($26.9 million) account for 10 percent and 5 percent, respectively, of the gross underpayment gap for tax year 2022. Real estate taxes, estate and gift tax, insurance premium taxes, public services taxes, and all other taxes total $7.7 million, or about 1.5 percent of the gross underpayment gap.

Post-Filing Coupons

The DRS employs a variety of strategies to promote compliance and discourage tax avoidance. One such example is the Post Filing Coupon notice. This notice is issued to the taxpayer in a variety of situations that surround the posting of a deficient, miscalculated, or amended return. The Post Filing Coupon notice is generated systematically when a return requests a carry forward, refund, or contribution amount that does not match the credit amount in the taxpayer's financials. Depending upon the tax type, the DRS begins issuing this notice approximately one month before the return due date. This gives the taxpayer time to submit the correct payment amount before the due date and avoid penalty and interest from accruing. If the return due date has passed, the Post Filing Coupon is issued as soon as the return is received, thus helping the taxpayer minimize interest from accruing.

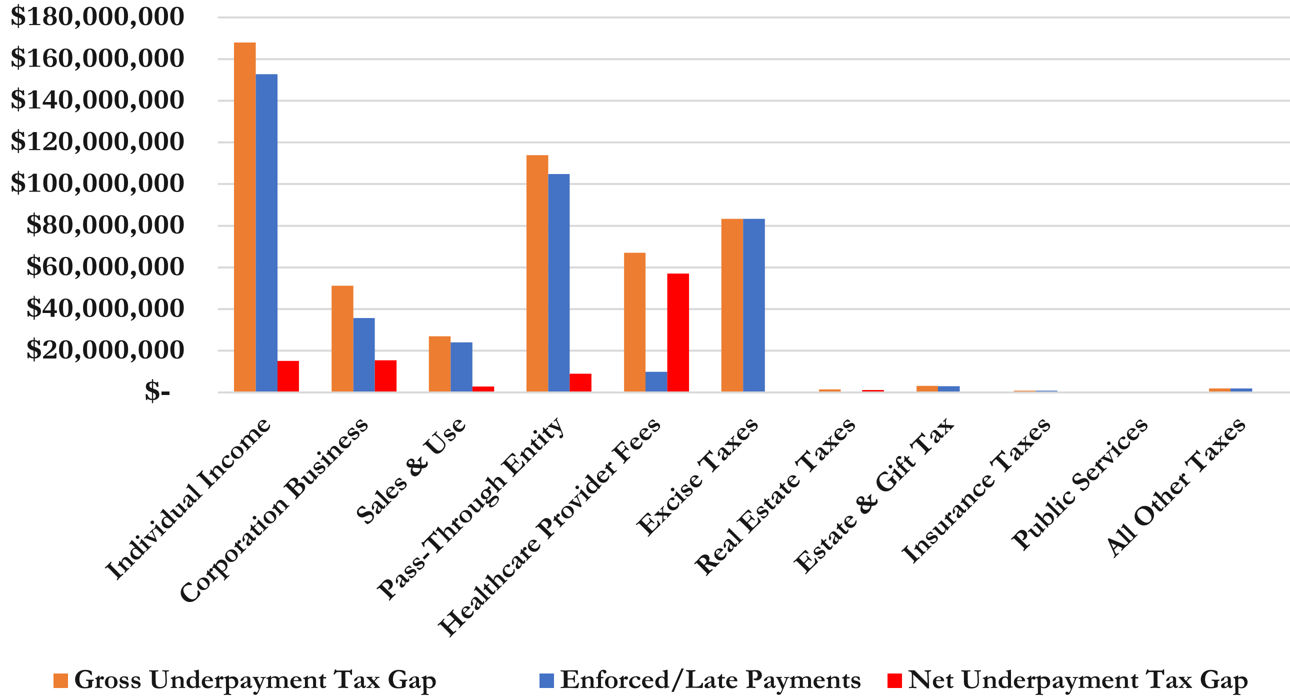
Historically, this letter was issued by the DRS for the following tax types: corporation business tax, domestic and foreign insurance, estate and gift tax, health care center tax, income tax trust and estate, personal income tax, pass-through entity, unrelated business income, and withholding tax. The DRS is now issuing the Post Filing Coupon notice for all tax types administered by the agency.

The impact of issuing the Post Filling Coupon notice for personal income tax on voluntary compliance is significant. For income year 2022, approximately 38,000 Post Filing Coupon notices were issued for personal income tax accounts that were underpaid by $36.7 million. Approximately 24,000 of these accounts, or 63 percent, were paid in full by the due date, totaling $25.6 million in revenue for the state. Thus, the issuing of the Post Filing Coupon notice effectively reduces the underpayment gap for personal income tax by almost 15 percent each year.

Enforced and Other Late Payments

Some of the $518 million gross underpayment tax gap is collected through the DRS enforcement and administrative efforts and some is paid late without any agency action taken. The sum of enforced and other late payments is the amount of the gross tax gap that eventually will be paid. Enforced and other late payments recovered by the agency for timely underpaid returns are estimated for a given tax group for 2022 in Figure 3. It is the sum of actual late payments received to date and projections of future late payments based on historical payment patterns observed for earlier tax years. This amount does not include payments applied to interest and penalties, since those amounts are not included in the gross tax gap.

Figure 3: Underpayment Tax Gap & Enforced/Other Late Payments



For most tax types and fees, the DRS recovers a substantial amount of the gross underpayment tax gap though enforcement and collection efforts. The total amount of enforced and other late payments for timely underpaid returns is estimated to be $417 million for tax year 2022. Accordingly, for all taxes and fees administered by the Department, the estimated **net underpayment gap** for tax year 2022 is **$101 million.**

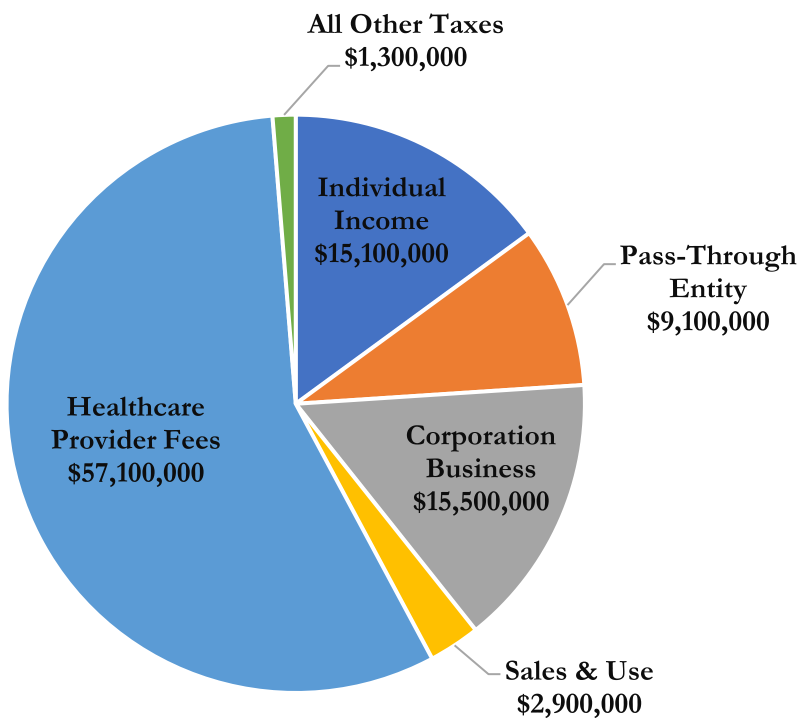
Approximately 90 percent of the underpaid tax amount on timely filed returns for individual income taxes, withholding tax, sales and use taxes, and the pass-through entity tax are recovered by the DRS within two years of the payment due date. About 37 percent of the estimated enforced and other late payments total, or $153 million, is associated with underpaid individual income taxes, including withholding tax. About 25 percent of the total, or $105 million, is associated with pass-through entity tax enforced and other late payments. Sales and use tax enforced and other late payments are 6 percent of the total or $24 million. Timely underpaid cigarette distributor tax returns make up the largest component of the underpayment gap for the excise taxes. With $83 million in enforced and other late payments, the net underpayment gap for excise taxes is effectively zero for tax year 2022.

The agency is less successful recovering the underpaid tax amount on timely filed returns for several taxes. After approximately 1.5 years of collection efforts, more than 30 percent of the corporation business tax underpayment gap is still outstanding ($15.5 million). The $67 million gross underpayment gap for healthcare provider fees is primarily attributable to the second hospital user fee and the nursing home provider fee. Of the $38.4 million underpayment gap for the second hospital user fee, the Department has not collected any revenue toward the 2022 liabilities as of this date. The estimate for enforced and other late payments toward all healthcare provider fees is $10 million. Thus, the net underpayment gap for all healthcare provider fees is approximately $57 million, making it the largest component of the net underpayment gap for 2022.

Net Underpayment Gap

Estimates of enforced and other late payments by type of tax were subtracted from the respective gross underpayment tax gap amounts to obtain the net underpayment gap estimates by type of tax. As shown in Figure 4, the net underpayment gap for all taxes and fees is estimated to total $101 million for 2022. The net underpayment gap for corporation business and individual income taxes are estimated to be $15.5 million and $15.1 million, respectively for income year 2022. The net underpayment gap for healthcare provider fees is estimated to be $57.1 million, or 57 percent of the total net underpayment gap. The pass-through entity net underpayment gap is estimated to be $9.1 million for tax year 2022, while sales and use taxes contribute $2.9 million to the net underpayment gap. All other taxes combined add approximately $1.5 million to the net underpayment gap or 1.5 percent of the total.

Figure 4: Net Underpayment Tax Gap ($101M)



Non-Filing

The non-filing tax gap is the gap associated with required tax returns that were not filed at all or were filed after the return due date or valid extension date. The non-filing gap is tax not paid on time by those who do not file on time. Non-filers include entities that are registered but not filing required returns on time, as well as entities that are not registered for the appropriate tax types. Depending upon the tax type, this report's estimate of the non-filing gap includes entities that filed late, as well as entities that are registered but did not file required returns.

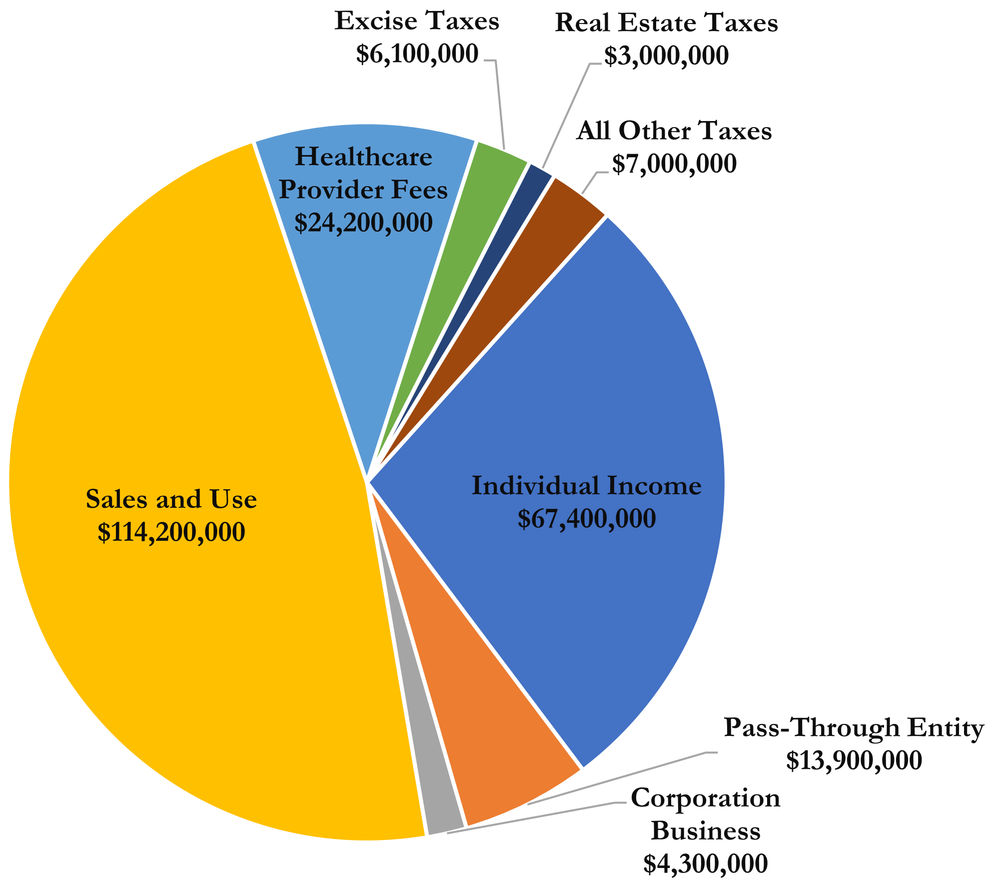
Late filed returns for all taxes and fees administered by the Connecticut Department of Revenue Services are included in this analysis of the non-filing gap. In addition, the Audit division conducts several non-filer projects for individual income taxes and the pass-through entity tax. The returns received in response to the audit non-filer projects and audit assessments for non-filers are also included in this estimate of the non-filing gap. In addition, estimates of the non-filing gap for sales and use taxes, withholding tax, corporation business taxes, and the pass-through entity tax are based on historical filing of late returns for prior tax years.

Estimated returns generated by the agency's systematic delinquency process for several taxes are also included in the non-filing gap analysis. These estimates include tax owed by entities that are registered with the DRS but did not file a required return for a 2022 period. Rather than file their own return, these non-filers made late payments or had timely credits applied toward the estimated tax amount generated through the agency's delinquency process. Non-filers with estimated returns that are paid in full as of the date of this report are included for withholding and sales and use taxes. The estimated non-filing gap for each tax group is the amount of tax owed after accounting for timely credits and payments received on or before the return's original due date.

The **gross non-filing gap** is estimated to be **$240 million** for tax year 2022. Sales and use taxes are about 48 percent of the total non-filing gap or $114.2 million. As with the underpayment gap, non-filing of withholding taxes is included in the individual income taxes non-filing gap as the ultimate liability is the employees' personal income tax. About 28 percent of the estimated total, or $67.4 million, is associated with individual income taxes.

Healthcare provider fees are 10 percent of the gross non-filing gap or $24.2 million. The non-filing gap for the pass-through entity tax is $13.9 million, or almost 6 percent, and excise taxes account for about 2.5 percent of the total ($6.1 million). Approximately $4.3 million of the estimated non-filing gap is attributed to corporation business tax non-filers. Real estate taxes, estate and gift tax, insurance premium taxes, and public services taxes are estimated to be almost $6 million or about 2.5 percent of the gross non-filing gap for tax year 2022. All other taxes account for about 3 percent of the estimated non-filing gap. These estimates will be updated annually as additional compliance data become available and improvements are made to the non-filing estimation methodologies.

Figure 5: Gross Non-Filing Tax Gap ($240M)

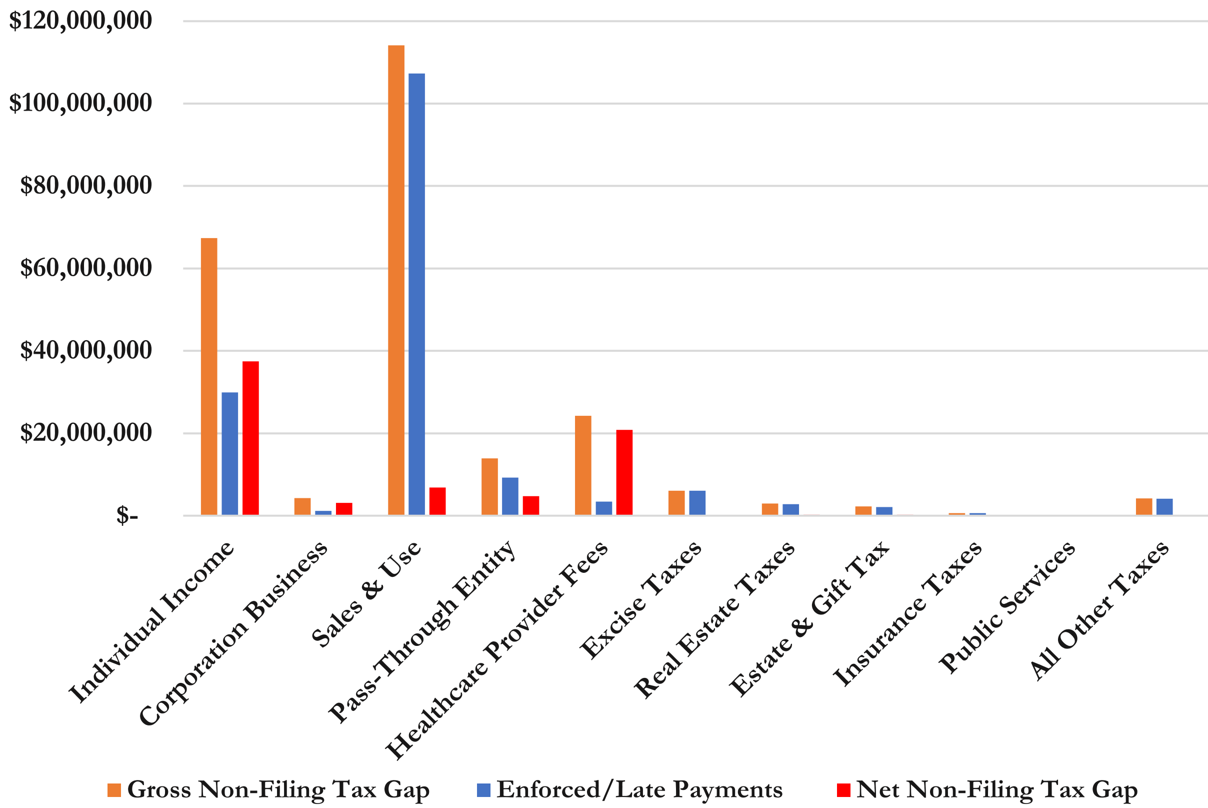


Enforced and Other Late Payments

Some of the $240 million gross non-filing tax gap is collected through the DRS enforcement and collection efforts and some is paid late without any agency action taken. Enforced and other late payments recovered by the agency for the gross non-filing gap are estimated for a given tax group for 2022 in Figure 6. It is the sum of actual late payments received to date and projections of future late payments based on historical payment patterns observed for earlier tax years.

The total amount of enforced and other late payments for the non-filing gap is estimated to be $167 million for tax year 2022. Accordingly, for all taxes and fees administered by the Department, the estimated **net non-filing gap** for tax year 2022 is **$73 million**. Between 90 to 100 percent of the tax amount owed on late filed returns for sales and use taxes, excise taxes, real estate taxes, estate and gift tax, insurance premium taxes, and public service companies taxes are recovered by the DRS within two years of the payment due date. Overall, the Department is estimated to recover about 69 percent of the true tax owed for late filed returns though enforcement and collection efforts.

Figure 6: Non-Filing Tax Gap & Enforced/Late Payments



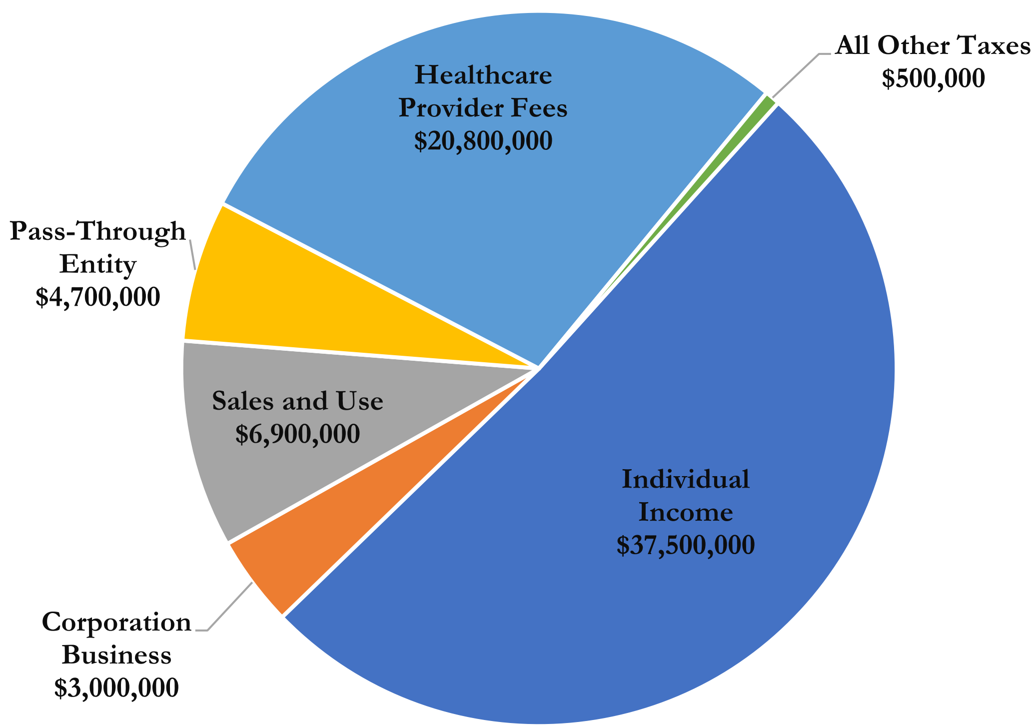
About 64 percent of the estimated enforced and other late payments total, or $107 million, is associated with late filed sales and use tax returns. About 18 percent of the total, or $30 million, is associated with late filed individual income taxes, including withholding tax. Pass-through entity tax enforced and other late payments are almost 6 percent of the total or $9 million. Late underpaid cigarette distributor tax returns make up the largest component of the gross non-filing gap for the excise taxes. With $6 million in enforced and other late payments, the net non-filing gap for excise taxes is effectively zero for tax year 2022.

The agency is comparatively less successful recovering the tax owed for late filed corporation business tax returns and the healthcare provider fees. After approximately 1.5 years of collection efforts, about 70 percent of the corporation business tax non-filing gap is still outstanding (about $3 million). The $24.2 million gross non-filing gap for healthcare provider fees is primarily attributable to the second hospital user fee and the nursing home provider fee. The estimate for enforced and other late payments toward all healthcare fees is $3.4 million. Thus, the net non-filing gap for all healthcare provider fees is $20.8 million, making it the second largest component of the net non-filing gap.

Net Non-Filing Gap

Estimates of enforced and other late payments by type of tax were subtracted from the respective gross non-filing tax gap amounts to obtain net non-filing gap estimates by tax group. As shown in Figure 7 below, the net non-filing gap for all taxes and fees is estimated to total $73 million for 2022. The net non-filing gap for individual income taxes, including withholding, is estimated to be $37.5 million for income year 2022, which is 51 percent of the total. The net non-filing gap for healthcare provider fees is estimated to be $20.8 million, or 28 percent of the total net non-filing gap. The sales and use tax net non-filing gap is estimated to be about $6.9 million for tax year 2022, while the pass-through entity tax contributes $4.7 million to the net non-filing gap. The net non-filing gap for corporation business tax is estimated to be $3 million for income year 2022. All other taxes combined add $500,000, less than 1 percent of the total, to the net non-filing gap.

Figure 7: Net Non-Filing Tax Gap ($73M)



Underreporting

What is underreporting?

Underreporting is one of the primary drivers of the tax gap. It occurs when individuals or businesses fail to accurately report their income or deductions and credits, often due to errors or omissions. In more severe cases, it can result from deliberate tax evasion. Essentially, the underreporting tax gap is the discrepancy between what taxpayers actually owe and what they report on their tax returns.

Audit-Based Detection Methods

Currently, most underreporting is detected through audits, which the DRS has a dedicated division for – the Audit Division. However, audit-based methods have several limitations:

- **Time-Consuming and Resource-Intensive**: Audits require significant human and financial resources. Auditors often have to conduct field visits; review returns line by line and go through individual business transactions. While we discuss the cost of these audits later in the report, it's worth noting that in many cases, the cost of conducting an audit outweighs the additional revenue collected, particularly in smaller cases. For this reason, audits tend to focus on cases with higher revenue potential.
- **Limited Audit Coverage**: The DRS audits only a portion of all tax returns filed each year. Not every taxpayer is audited, especially due to resource constraints.
- **Audit Delays**: Audits are usually performed a few years after the tax return has been filed. The DRS has a three-year statute of limitations for assessing tax after a return is due. However, if a return is audited, the DRS can review prior years as well. This means that any additional revenue from underreporting may take years to recover – if it's recovered at all.

Tax Evasion and Intentional Misreporting

A substantial portion of underreporting could be a result of deliberate tax evasion, where taxpayers intentionally misreport their income, deductions, or credits to reduce their tax liability. Addressing tax evasion presents several challenges:

- **Underground Economy**: Income earned through informal or irregular channels often goes unreported, particularly when there is limited documentation or reporting requirements. One example is cash tips or cash businesses. Transactions conducted outside the formal systems can make it difficult to verify the actual income earned.

Overall, the uncertainty around these unreported cash transactions poses a significant limitation in closing the underreporting tax gap. Without clear, reliable data, it is challenging to determine what should have been reported in the first place.

Data

The audit data used for this analysis was derived from a comprehensive dataset maintained by the Department. It includes audit records from 2016 through mid-2024, capturing approximately 149,700 audit cases. This dataset provides information on key variables such as the total additional tax assessed, the year each audit case was closed, the tax periods under audit, and payments made by the taxpayer. These variables form the foundation for analyzing the underreporting tax gap.

To ensure data quality and reliability, several steps were taken to clean and prepare it for analysis. This process included removing null and duplicate entries. Additionally, approximately 1,400 records were removed because they lacked a closed date, indicating they were still open audit cases, such as those in the appellate stage or protest period.

On average, audit collection efforts have brought in approximately $185 million annually from 2016-2024. It is important to note that several external and internal factors have contributed to fluctuations in audit activity and tax assessments over the years. For instance, the Tax Cuts and Jobs Act of 2017 introduced substantial changes to the tax laws, particularly affecting pass-through entities, which impacted audit processes and outcomes. Similarly, the onset of the COVID-19 pandemic led to a sharp decline in field audits due to the restricted access to businesses and taxpayers. Furthermore, the Department faced significant staff shortages during this period, as retirements outpaced new hires. These challenges were compounded by the rollout of a new internal tax processing system, which required significant staff resources to implement and ensure seamless data migration.

Despite these challenges, the DRS has continued to make progress in addressing underreporting through audits.

Methodology

Method 1: Applying the IRS Non-Compliance Rates

The first approach used to estimate Connecticut's underreporting tax gap involves the application of the Internal Revenue Service (IRS) noncompliance rates. Since federal and state tax systems are interconnected – particularly for income and corporate taxes – it is reasonable to assume that the taxpayers who underreport on their federal returns are likely doing the same on their state returns. Leveraging IRS research provides a foundation for estimating the underreporting tax gap at the state level.

IRS Noncompliance Rates:

The IRS's National Research Program (NRP) conducted extensive research on taxpayer compliance. Their most recent estimates show that:

- **15.98%** of individual income taxes are underreported at the federal level
- **10.45%** of corporate taxes are underreported at the federal level

For individual income taxes, these estimates are based on a statistically representative sample, using a combination of field and desk audits. These audits are supplemented by an econometric technique called Detection Controlled Estimates (DCE), to adjust for undetected income and ensure the estimates account for both detected and undetected underreporting.

However, corporate income tax underreporting estimates follow a different approach from statistically random sampling. The estimates are developed from "risk-based" operation audits, which focus on small corporations (with assets under $10 million) and larger corporations (with assets greater than $10 million) separately. Proposed adjustments from these audits are projected to estimate noncompliance across the entire corporate taxpayer population. Due to the limitations of this approach, corporate tax estimates do not include adjustments for the undetected noncompliance, leading to a greater degree of uncertainty in the results[2].

Despite these limitations, the IRS's corporate noncompliance rates still offer a reasonable estimate for understanding tax noncompliance at the federal level, which can inform Connecticut's state level estimates.

Application to Connecticut's 2022 Tax Base

We applied the IRS noncompliance rates to Connecticut's 2022 tax base. The total tax liability for Connecticut in 2022 was as follows:

- **Income tax liability:** $10.253 billion
- **Corporate tax liability:** $1.218 billion

To align with IRS methodology, the tax gap was calculated based on the total tax liability, based on the amount that should have been reported, rather than the reported tax base. The formula is as follows:

$$Tax\ Gap = \left(\frac{Reported\ Tax\ Base}{1-Underreporting\ Percentage}\right) - Reported\ Tax\ Base$$

Using this formula:

- **Estimated 2022 Income Gross Tax Gap:**
  $\frac{10.253}{1-0.1598} - 10.253 = \$1.951\ billion$

- **Estimated 2022 Corporate Gross Tax Gap:**
  $\frac{1.218}{1-0.1045} - 1.218 = \$142\ million$

Net Tax Gap on Income & Corporate Taxes:

After deducting the Connecticut's audit efforts in 2022, the net tax gap is calculated as:

- **Estimated 2022 Income Net Tax Gap:**
  $\$1.951\ billion\ - \$12.8\ million = \$1.938\ billion$

[2] Internal Revenue Service Research, Applied Analytics & Statistics Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016 Publication 1415 (Rev. 08-2022) Washington, DC August 2022

- **Estimated 2022 Corporate Net Tax Gap:**
  $\$142\ million - \$6.6\ million = \$135.4\ million$

Limitations:

Several important limitations need to be acknowledged when applying the IRS noncompliance rates to Connecticut's tax base:

- **Federal vs. State Tax Law:** There are significant differences between federal and Connecticut tax laws that affect the applicability of federal noncompliance rates to the state-level tax gap estimates. For example, federal income tax rates are much higher, with the top rate reaching 37%, whereas Connecticut's highest rate is 6.99%. Additionally, certain taxes that generate substantial revenue for Connecticut, such as sales and use tax, are absent at the federal level. Finally, differences in deductions, exemptions, and credits also play a role. For example, the federal tax system includes the Child Tax Credit, which does not exist in Connecticut. Federal tax credits like this contribute to underreporting and impact the overall tax gap, making the direct application of federal noncompliance rates to Connecticut's tax system more complex.

- **Distribution Of Taxpayers:** Nationwide, non-farm sole proprietors represent a significant portion of underreporting. However, given the income distribution among taxpayers, it is uncertain whether Connecticut's taxpayer base follows a similar pattern.

- **Corporate Tax Data:** The IRS corporate tax gap estimates are derived from "risk-based" audits rather than statistically random samples, which introduces statistical bias. Moreover, the estimates do not include adjustments for undetected income, which increases uncertainty in the final figures.

- **Broad Application**: Applying a single ratio across multiple tax areas provides an aggregate estimate but may overlook specific compliance patterns within individual tax categories. Additionally, applying this ratio to the total taxpayer base assumes similar behavior across audited and non-audited populations, which may not always hold true.

Method 2: Analysis of Connecticut's Audit Data

To estimate Connecticut's underreporting tax gap, an alternative approach was developed using state-specific audit data. This method calculates a baseline underreporting ratio by analyzing the additional taxes assessed during audits in relation to the total tax liability of audited taxpayers. By leveraging Connecticut's historical audit data from 2016 to 2020, we determine a median underreporting ratio that reflects trends in taxpayer compliance over time. This ratio is then applied to the total reported tax liability for 2022, enabling an estimate of the underreporting tax gap. While this methodology provides a state-centered perspective, it assumes that all taxpayers underreport their liabilities to some extent, which is likely an overgeneralization. Nevertheless, this approach offers a practical framework to incorporate state-specific compliance trends into the tax gap estimation process.

Methodology:

1. We calculated a baseline underreporting ratio by comparing additional tax assessed in Connecticut audit cases to the total tax liability of those audited taxpayers.
2. Using Connecticut historical median underreporting ratio, we project underreporting beyond audited cases for a comprehensive estimate.

Income Tax:

To estimate the underreporting income tax gap for 2022, we apply the median underreporting ratio (16.4%) derived from 2016 to 2020 to Connecticut's 2022 total reported income tax liability:

Table 1: Breakdown of Additional Tax Assessed & Total Tax Due for Audited Income Taxpayers

Audit Case Closed	Add'l Tax Assessed	Total Tax Due (Audited Taxpayers)	Underreporting Ratio
2016	$ 38,461,325	$ 234,480,291	16.40%
2017	43,337,243	286,464,559	15.13%
2018	23,515,725	76,269,644	30.83%
2019	22,516,259	189,994,364	11.85%
2020	31,225,313	140,890,354	22.16%

- 2022 Total Income Tax Liability (before PE Credits): $10.253 billion
- Estimated Additional Tax for 2022: $10.253 billion X 16.4% = $1.681 billion

Corporation Business:

We use the same approach for the corporation business tax, applying the median underreporting ratio (15.6%) derived from 2016 to 2020.

Table 2: Breakdown of Additional Tax Assessed & Tax Due for Audited Corporation Business Taxpayers

Audit Case Closed	Add'l Tax Assessed	Total Tax Due (Audited Taxpayers)	Underreporting Ratio
2016	$ 139,359,213	$ 236,645,788	58.89%
2017	35,455,532	227,306,346	15.60%
2018	43,892,951	285,766,458	15.36%
2019	25,820,160	208,452,743	12.39%
2020	31,536,810	177,165,435	17.80%

- 2022 Total Corporation Tax Liability (before PE Credits): $1.218 billion
- Estimated Additional Tax for 2022: $1.218 billion X 15.6% = $190.1 million

Sales Tax:

Table 3: Breakdown of Additional Tax Assessed & Total Tax Due for Audited Sales & Use Taxpayers

Audit Case Closed	Add'l Tax Assessed	Total Tax Due (Audited Taxpayers)	Underreporting Ratio
2016	$ 88,977,171	$ 1,450,449,161	6.13%
2017	58,460,239	1,076,689,398	5.43%
2018	83,231,281	1,631,400,421	5.10%
2019	88,541,648	1,362,733,483	6.50%
2020	56,358,355	738,266,121	7.63%

For Connecticut, Sales & Use tax audits are typically longer, spanning around 3 years. The median sales and use tax underreporting ratio derived from 2016-2020 is 6.13%.

- 2022 Total Sales & Use Tax Liability: $6.001 billion
- Estimated Additional Tax for 2022: $6.001 billion X 6.13% = $368.1 million

Total Underreporting Gross Tax Estimate:

Combining the estimate for the three tax areas:

- Income: $1.682 billion
- Corp: $190.1 million
- Sales: $368.1 million
- Total: $2.240 billion

Extrapolating the tax gap:

Since these three tax areas contribute approximately 76% of the total tax assessed, we extrapolate the total underreporting gross tax gap across all tax types as:

- **Total Estimated Gross Tax Gap:** $2.944 billion ($2.240 billion / 0.76)
- **Net Underreporting Tax Gap** (after 2022 audit recoveries of 120.2 million): $2.824 billion.

Limitations:

- **Assumption Of Universal Underreporting:** These estimates assume that all taxpayers underreport at the same rate, while in reality, compliance may vary significantly across different types of taxpayers (individuals vs. businesses, small businesses vs. large enterprises).

- **Selective Auditing:** Audit cases are often selected based on perceived likelihood of noncompliance, which could introduce bias. This method may overestimate the tax gap if audited taxpayers are not representative of the entire population.

- **Limited Data on the Underground Economy**: Certain areas of the economy, such as cash-based businesses, tip income, and sole proprietors, are more prone to tax evasion. However, data for these sectors in often incomplete or unavailable, making it difficult to produce accurate estimates.

- **Five-Year Median:** The use of a five-year median provides stability but may not fully capture recent changes in taxpayer behavior or economic conditions.

- **Use of Historical Data:** While historical data is essential for trend analysis, it may not capture evolving patterns of underreporting, especially in light of recent economic disruptions or policy changes.

- **Resource Constraints:** Staffing shortages, the need for training new personnel, and other resource limitations may affect the consistency of audit results year over year.

Results

Capturing a full picture of the underreporting gross tax gap is extremely difficult. Many estimates rely on assumptions. For instance, applying an aggregated underreporting percentage overlooks shifts in tax laws and economic conditions year-over-year. Additionally, it is difficult to apply the national averages to state level data due to differences in tax structures; the IRS does not factor in sales and use taxes or certain excise taxes, which are significant revenue sources for Connecticut.

Furthermore, there are significant uncertainties around areas prone to tax evasion, such as cash-based businesses, tip income, and sole proprietors. Limited data in these areas compounds the challenge. Furthermore, given resource constraints, we cannot audit every taxpayer; typically, audits are conducted when there is a known risk, which means some taxpayers may evade scrutiny altogether.

Despite these limitations, Method 2 provides an important perspective on the tax gap by providing an upper-bound estimate of Connecticut's underreporting tax gap, adjusting for state-specific data. Therefore, we conclude a net underreporting tax gap for Connecticut of approximately $2.824 billion.

It is important to note that this estimate is not perfect, as the limitations outlined in the prior section demonstrate. In the future, we will work on refining our methodology to capture more of these uncertainties and improve the accuracy of our estimates.

Recommendations for Improvement:

- **Incorporate Random Sampling:** Introduce randomized audits alongside risk-based audits to create a representative sample and reduce selection bias.

- **Segment by Income Type:** Analyze underreporting separately for various income types (e.g., wages and salaries, capital gains, business income, and tips) to account for their unique characteristics.

- **Expand Data Collection on the Underground Economy:** Gather data on cash-based businesses, tip income, and other sectors prone to tax evasion

- **Dynamic Underreporting Ratios:** Update Underreporting ratios annually to reflect recent changes in economic conditions, taxpayer behavior, and new tax legislation

- **Use Predictive Modeling and Machine Learning Techniques:** Leverage machine learning algorithms to analyze historical audit data and identify patterns of noncompliance.

This year's estimates provide a high-level starting point for Connecticut's underreporting tax gap. We are committed to improving these methodologies by incorporating advanced machine learning techniques, expanding data coverage, and continuously evaluating the accuracy of our estimates. Over time, these enhancements will provide a clearer and more precise picture of Connecticut's underreporting tax gap.

Strategy to Promote Compliance and Discourage Tax Avoidance

This section outlines strategies to encourage voluntary compliance and reduce tax avoidance. To provide context, it is important to recognize that the U.S. tax system - like most state and local tax systems – is fundamentally based on self-reporting. Taxpayers are responsible for reporting their income, calculating their tax liabilities, and filing returns by the required deadlines. However, in any voluntary system, some portion of the population will evade their tax responsibilities.

Tax administrators can implement targeted strategies to mitigate the tax gap. While achieving full compliance is unlikely due to the complexity of contributing factors, these efforts can significantly reduce the gap.

The department's strategy to address the tax gap includes four key components:

1. **People** – Assess staffing levels and invest in workforce development
2. **Processes** – Drive efficiencies through process improvements
3. **Technology** – Modernize systems to enable data-driven decision-making
4. **Commitment to the Development of Tax Policy** – Provide a series of ideas to mitigate the tax gap that would require legislative action.

Each component is essential, and their collective implementation is critical to effectively mitigate the tax gap.

People

The department's strategy begins with its most valuable resources: its employees. Administrating the state's tax code effectively depends on a well-trained workforce and sufficient staffing levels. Over the years, reductions in staffing have significantly diminished the agency's capacity to fulfill its mission and enforce compliance contributing to the tax gap.

Data reveals a 20% decline in staffing levels over recent years, which has led to fewer audits, collection cases, and responses to taxpayer inquiries. This trend has weakened enforcement efforts and reduced public engagement with the agency. As a result, taxpayers may be less aware of their obligations or the consequences of noncompliance.

Reversing the decline is critical. Adequate staffing is directly linked to the agency's ability to support enforcement and taxpayer assistance, both of which are vital to mitigating the tax gap. The public's awareness of an interaction with the agency can be restored through targeted investments in staffing, which will enhance the DRS's capacity to meet its mission.

Table 4: Yearly Agency Staffing Levels

Fiscal Year	# of Positions	
	Agency Wide	Audit Division
2012	734	284
2013	670	266
2014	665	264
2015	665	262
2016	660	261
2017	660	265
2018	660	259
2019	660	256
2020	627	252
2021	627	258
2022	625	245
2023	593	257
2024	593	214
2025	593	228

In summary, addressing staffing shortages is a logical and essential step to reducing the tax gap. The following section outlines the recent reductions in staffing and their impact.

The Audit Coverage Rate

The audit coverage rate measures the percentage of registered taxpayers audited for a specific tax type. This rate reflects the Department's ability to effectively audit the taxpayer population. There is a clear correlation between the number of auditors and the percentage of taxpayers audited. According to the recent benchmarking study conducted by McKinsey & Company in 2015[3], the average audit coverage rate among state tax agencies was 3%. *Table 5* below shows the DRS's audit coverage rates by tax type for fiscal years ending June 30, 2023, and June 30, 2024.

Table 5: Audit Coverage Rates

Tax Type	FY 2023	FY 2024
Sales Tax	0.87%	0.69%
Personal Income Tax	0.43%	0.39%
Corporation Business Tax	0.28%	0.24%
Pass-Through Entity Tax	0.25%	0.27%

The benchmark average of 3% far exceeds DRS's current audit coverage rates. Increasing the audit coverage rate is critical for reducing the tax gap. A higher audit rate not only results in more tax dollars collected but also fosters greater voluntary compliance by increasing the perceived likelihood of audits.

Improving audit coverage does not simply mean hiring more auditors. Instead, DRS can adopt a strategic approach that combines hiring additional staff, reallocating resources, enhancing audit processes, and targeting known areas of noncompliance. For example, the IRS has identified small business owners and sole proprietors as significant contributors to the tax gap, primarily due to inconsistent or non-existing financial reporting.[4]

To address this issue, DRS has established a Small Business and Self-Employed Audit Unit. This unit focuses on underreported income tax from self-employed individuals. In its first six months of operations, with a limited staff, the unit closed 229 cases and assessed additional revenue of $3.3 million. Performance metrics are being implemented to evaluate the unit's effectiveness and its impact on reducing the tax gap.

Audit Assessments and Recoveries

When proposing an increase in staffing resources, fundamental questions arise: Is the investment worthwhile? What is the return on investment (ROI), and can it be justified? The DRS contends that these questions can be effectively answered through data-driven analytics. To illustrate this point, the following chart highlights the additional revenue assessed by the Audit Division, rounded to the nearest

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[3] McKinsey & Company. (2015). *Tax Benchmarking Research.* Stamford: McKinsey & Company.

[4] IRS. (n.d.). *Sole Proprietorships*. Retrieved from https://www.irs.gov/businesses/small-businesses-self-employed/sole-proprietorships

10,000, the number of cases closed, and the total amount recovered (collected) from those assessments. The chart provides a comparison spanning from calendar year 2016 through July 25, 2024.

Table 6: Additional Revenue Assessed by Audit Division

Year	Closed Cases	Audit Production	Total Recovered: Breakdown	
	(# of Assessments)	*(Total Assessed)*	Audit Payment	Collection Payment
2016	24,261	$ 381,271,099	$ 155,078,431	$ 51,019,814
2017	31,987	271,685,595	152,767,270	53,860,474
2018	21,078	462,997,139	154,288,573	60,610,694
2019	29,364	342,226,194	94,109,997	59,005,582
2020	12,132	264,710,378	142,102,647	18,817,755
2021	13,243	243,944,377	148,755,376	17,609,792
2022	11,491	238,146,771	157,347,166	5,867,216
2023	6,291	216,586,292	119,227,372	4,489,469
**2024*	*6,873*	*147,001,218*	*92,056,534*	*576,297*
	156,720	$ 2,568,569,063	$ 1,215,733,367	$ 271,857,092

**Data for Calendar Year 2024 is available up to 7/25/2024.*

****Audit production & Total Recovered include penalties and interest, in addition to the tax assessed.**
***Total recovered represents the amounts paid toward the audit assessments.
****Audit Payment vs. Collection Payment: An audit payment is made during the course of the audit while a collection payment is made after the audit is complete.

The data reveals a concerning trend: audit production, closed cases, and total recoveries have declined by 40% between 2016 and 2023. Several factors contributed to this decline, including the COVID-19 pandemic (when audits were largely suspended), a wave of retirements, the installation of new tax administration system, and reduced staffing in the Audit Division.

Despite these challenges, the audit division has still managed to generate **$1.5 billion** ($1.215 billion + $271 million) **in additional revenue** over the past several years. This underscores the critical role of audit staffing in producing significant returns. The data clearly supports the conclusion that investments in audit staffing yield returns far exceeding the associated costs.

Moreover, there is a direct correlation between audit recoveries and the growth of the net tax gap. As recoveries decline, the net tax gap expands. Conversely, increasing audit recoveries slows or even reduces the growth of the tax gap. Addressing these staffing and resource challenges is crucial for mitigating the tax gap effectively.

Collections Division:

The Department's collection staff plays a vital role in mitigating the tax gap. This team is responsible for recovering overdue balances from taxpayers who have failed to pay their obligations. Revenue agents, who provide both in-house and field collection services, are essential to these efforts.

A comprehensive strategy to address the tax gap must include an evaluation of collection unit staffing. Since 2012, the unit has experienced a decline of six positions, representing a 7% reduction, as shown in the chart below. While this decrease is not as significant as the staffing decline in the audit division, it has a notable impact. Each collector is responsible for recovering $2-4 million annually, underscoring the critical need for adequate staffing to maintain and enhance recovery efforts.

Table 7: Collections Unit Staffing Levels

Fiscal Year	# of Positions
2012	83
2013	58
2014	58
2015	55
2016	52
2017	54
2018	61
2019	66
2020	60
2021	58
2022	59
2023	68
2024	81
2025	77

Criminal Enforcement:

As noted earlier, the public generally prefers to avoid interaction with the DRS. Encouraging compliance is therefore critical to minimizing such contact. To maintain and enhance compliance, the DRS must conduct robust and visible criminal investigations.

The department is currently rebuilding and refocusing its Criminal Investigations Division (CID), which has been impacted by attrition. CID consists of sworn law enforcement officers who operate statewide to enforce criminal violations of Connecticut's tax laws. These officers investigate a broad range of tax crimes, including financial fraud and illegal trafficking of cigarettes and tobacco products.

As part of the reorganization of CID, the agency is prioritizing training for its officers and fostering collaboration with the IRS criminal investigators. The primary goal of these efforts is to strengthen the agency's ability to identify noncompliance and efficiently target enforcement efforts. This collaborative approach ensures that criminal enforcement remains an effective tool for reducing the tax gap.

Taxpayer Services

Civil and criminal enforcement are essential drivers of voluntary compliance and play a key role in mitigating the tax gap. However, enforcement alone is not sufficient. A comprehensive tax gap mitigation strategy must also include education and outreach, which could prove to be more effective in promoting compliance.

The Department's strategy will continue to prioritize education and outreach to ensure taxpayers understand and comply with Connecticut tax laws. To achieve this goal, it is essential to allocate appropriate resources and staffing to support these initiatives.

People are the agency's most valuable resource. The data clearly demonstrates that current staffing levels are insufficient to effectively address the tax gap. Staffing levels on the enforcement side as well as the taxpayer assistance side can and should be enhanced. The department welcomes dialogue with leadership on establishing a principled approach to determining the staffing levels that can be achieved at DRS.

Processes

A component of the DRS mission statement is to continuously improve agency performance. Evaluating the effectiveness of processes and identifying where they can be improved will allow the agency to better deliver necessary services. The following components of the departments process improvement strategy will assist in mitigating the tax gap.

Several process improvement efforts are underway to enhance the efficiency of the department's audit staff:

- **Desk Audit Program:** Additional staffing will improve the department's audit coverage rate, but process changes can also make significant strides. The department is developing a desk audit program to enable the auditing of more sales and use tax returns without traditional field audits. The proposed desk audit program will focus on specific return entries. These audits are quicker and would allow the department to address and review a larger number of taxpayers, enhancing overall audit efficiency.

- **Cash Business Audit Team:** Businesses that operate primarily in cash present compliance challenges due to limited or nonexistent reporting of cash transactions. To address this, the department has formed a specialized audit team compromising of experienced sales and use tax auditors. This team focuses on identifying and addressing noncompliance related to unreported cash transactions and the use of sales suppression software.

- **Voluntary Compliance Program:** One of the cost-effective tools for addressing noncompliance is the Department's voluntary compliance program. However, the current program relies on a labor-intensive manual process that can be difficult for taxpayers to navigate. To improve efficiency, the department is transitioning to an electronic process using its online portal, myConneCT. This shift is expected to streamline operations, increase taxpayer participation, and generate higher revenues. In FY 2023, the manual program generated $25.2 million in additional revenue. An updated, user-friendly process will further encourage voluntary compliance and reduce future tax gaps.

- **Audit Case Inventory Management:** The department is emphasizing case inventory management by implementing performance metrics to monitor and benchmark year-over-year results. Reducing audit completion times will allow for an increased number of cases to be resolved, ultimately improving the audit coverage rate.

- **Underground Economy Detection:** A significant portion of the tax gap arises from income earned in the "underground economy," where businesses operate without registration or proper reporting. To address this, the Department has proposed establishing a discovery task force staffed with experienced auditors and leveraging advanced data mining and social media tools. This effort would help identify businesses operating outside of the formal economy.

- **Multistate Collaboration**: partnering with third parties to conduct audits is another strategy to improve audit coverage. The department is exploring participation in the Multistate Tax Commission (MTC) Audit Program, which allows member states to share resources and audit information. Connecticut, while currently a member of the MTC, does not participate in this program. Joining the audit program would significantly enhance audit coverage and reduce the tax gap.

Taxpayer Services Processes

Taxpayer education and outreach are key components of the Department's tax gap mitigation strategy. Although difficult to quantify, these efforts play an essential role in fostering compliance. Recent initiatives by the Taxpayer Service Division include:

- **Contacting New Registrants:** The Department has begun reaching out to new registrants to explain filing and payment requirements. Research indicates that 50% of new registrants fail to file their first sales and use tax return, often due to a lack of understanding. Early outreach helps ensure that new taxpayers are informed about their obligations and remain compliant.

- **Early Intervention for Non-Filers:** The Department now contacts taxpayers who fail to file a sales and use tax return within days of the due date. The modernization of the tax administration system enables real-time identification of non-filers, allowing for prompt follow-up. This approach significantly improves compliance rates and ensures timely revenue collection.

Technology

A comprehensive tax gap mitigation strategy must include a strong technological component. Modern technology enables tax agencies to serve their constituents more effectively and understand the factors contributing to the tax gap. By adopting the latest tools and increasing its digital footprint, the Department aims to simplify interactions with taxpayers, encouraging compliance. Streamlined, user-friendly systems reduce barriers to filing and payment, minimizing noncompliance.

- **Modernized Tax Administration System**: The Department has implemented a state-of-the-art tax administration system known as **CTax**, which is utilized in over 30 state revenue departments. This platform offers self-service options, simplifying tasks such as filing returns, making payments, and managing accounts. Complementing this system, is the online taxpayer portal, **myConneCT**, which further enhances convenience by allowing taxpayers to handle their tax obligations efficiently. Additionally, myConneCT has improved communication by enabling automated reminders and reducing instances of late filings.

- **Research, Analytics, and Forecasting (RAF) Unit**: The DRS has established the RAF unit to analyze collected data and identify areas of noncompliance or emerging challenges. By leveraging this information, the Department can make informed decisions and direct education and outreach efforts to high-priority areas. This targeted approach improves overall compliance and operational efficiency.

- **Predictive Modeling and Collection Scoring**: To optimize collection efforts, the DRS plans to invest in predictive modeling tools. These models will enable the department to identify high-risk cases, directing resources towards taxpayers with a lower likelihood of payment. Without this technology, collection staff risk spending valuable time on cases that would resolve without intervention. Predictive modeling ensures efficiency and enhances workflow within the Collections Unit.

- **Artificial Intelligence (AI):** AI is rapidly emerging as a critical tool for tax administrators. AI-driven models can help identify populations contributing to the tax gap and improve audit selection by flagging returns with potential errors or underreporting. Additionally, AI can expedite the processing of returns, allowing the Department to address issues in real time rather than relying on slower traditional audit processes. This technology will provide significant potential for enhancing tax administration and reducing the tax gap.[5]

Commitment to the Development of Tax Policy

Sound tax policy is essential when addressing the tax gap. While the DRS Is tasked with administering tax laws as written, it also possesses valuable knowledge and expertise on taxation. This expertise can serve as a resource for the General Assembly when considering policy improvements. Effective tax policy should embody 4 key principles: simplicity, transparency, fairness, and certainty. With these principles in mind, the DRS has identified several policy concepts that could help reduce the tax gap:

- **Out-of-State Collections**: A significant amount of tax debt is owed to Connecticut by out-of-state individuals and businesses. Currently, only the Attorney General's Office has the authority to collect this debt. Given resource constraints, the DRS proposes taking on this responsibility in collaboration with the General Assembly and the Attorney General's Office. This shift could enhance the state's ability to recover outstanding debts more efficiently.

[5] U.S. Government Accountability Office. (2024, June 6). *Artificial Intelligence may Help IRS Close the Tax Gap*. Retrieved from https://www.gao.gov/blog/artificial-intelligence-may-help-irs-close-tax-gap

- **Driver's License Suspension**: Many states successfully utilize driver's license suspensions to encourage tax compliance. For example, California Department of Tax and Fee Administration has employed this tool since 2012 for sales and use taxpayers with liabilities exceeding $100,000. In 2023, California collected approximately $10 million using this method with the efforts of just one employee. Similarly, Louisiana has utilized driver's license suspension since 2006, generating $114.2 million between 2019 and 2023. South Dakota has also implemented this program, collecting $2.8 million since 2017.

  Massachusetts provides another compelling example. The state has used driver's license suspensions for outstanding account balances of $10,000 or more since 2008. In 2023 alone, the Massachusetts Department of Revenue issued 5,024 notices warning taxpayers that their driver's licenses would be suspended if they fail to resolve their debts. Notably, 99% of these accounts were resolved after receiving the notice, without requiring actual suspension. Massachusetts also incorporates exclusions for individuals requiring their licenses for medical appointments or livelihoods involving driving.

  Officials from Massachusetts Department of Revenue emphasized the program's effectiveness, particularly in reaching unbanked taxpayers or those working off the books. These individuals are often able to function without enforcement until the program prompted action. The driver's license and vehicle registration suspensions effectively bring this segment of the population into compliance, as the action – or even the threat of action – encourages taxpayers to contact the department and resolve their debts.

  Connecticut municipalities already utilize non-renewal of vehicle registrations to collect overdue property taxes, with the collection rate on motor vehicle property taxes exceeding 95% in most towns.

- **Simplification**: Not all contributors to the tax gap are intentional. In many cases, underreporting results from a lack of understanding of complex tax statues. Business owners, for example, often know how to manage their operations but not the intricacies of applicable tax laws. Simplifying tax statutes and filing requirements wherever possible would reduce confusion, promote compliance, and align with the principles of sound tax policy.

Appendix

I. Audit Rates by Income Level

Table 8: Distribution of FY 2024 Individual Income Tax Audit Cases by CT AGI

Income Bracket	Income Audit Cases	% of Bracket Audited	% of Total Audits	Audit Production
Less than $0	132	0.53%	1.99%	$ 1,352,993
$0 to $50,000	1,321	0.14%	19.95%	1,626,445
$50,000 to $99,999	1,595	0.35%	24.09%	2,456,179
$100,000 to $299,999	1,919	0.41%	28.98%	3,874,755
$300,000 to $1,000,000	828	0.71%	12.50%	3,447,614
Greater than $1,000,000	827	2.22%	12.49%	24,975,840

Note: CT AGI refers to Connecticut Adjusted Gross Income. Audit production represents the total assessed tax, excluding penalties and interest, identified during audits in FY 2024.

The analysis focuses on individual income tax audits conducted during fiscal year 2024. It is important to note that this distribution excludes cases where taxpayers did not file a return they were audited for, as their Connecticut AGI could not be determined.

Based on the distribution of audited taxpayers, the largest portion of cases falls within the income brackets of $50k to <$100k and $100k to <300k. Together, these two middle income groups account for over half, or 53.07% of all income tax audit cases.

Meanwhile, the lowest income brackets (<$0 and $0 to <$50k) collectively represent 21.94% of cases, with taxpayers with negative income accounting for 1.99% of audits, contributing $1.3 million in audit production. The highest income brackets ($300k to <$1 million and >$1 million) make up 24.99% of total audits. Notably, the >$1 million bracket contributes the highest audit production at $24.9 million.

From the chart above, we observe that the highest-income tax bracket is responsible for significant portions of total revenue in audit production. However, their audit rates (12.49%) are slightly lower than those in the middle-income range (24.09% - 28.98%). This is partly because audits for higher-income taxpayers are typically more complex and take more time to complete. Additionally, as shown in *Table 9* and *Table 10* on Page 33, the number of taxpayers decrease as income levels rise, resulting in fewer audits overall for higher-income groups.

The '% of Bracket Audited' column provides additional insight, showing that higher-income taxpayers, while audited at a lower-volume, are audited at higher rates relative to their total population within the income bracket. For example, 2.22% of taxpayers in the >$1 million bracket were audited, the highest percentage among all income brackets. By contrast, the audit rate for taxpayers in the 50k to <$100k bracket was 0.35%, despite accounting for a substantial share of total audits.

II. Income & Population Decile Analysis

The charts provide an in-depth view of the gross non-filing and underpayment gaps for personal income tax in 2022, analyzed across population and income deciles. The two charts include key metrics such as the median and mean Connecticut Adjusted Gross Income (CT AGI) for each decile and outline the non-filing gap and underpayment gap for each decile. By examining these gaps from both perspectives, the analysis sheds light on compliance challenges of varying income levels. Note that the underreporting tax gap for personal income tax is a high-level estimate and cannot be allocated to specific income or population deciles, thus it is not included here. Similarly, part of the non-filing tax gap is also estimated and difficult to assign to specific income groups. Therefore, this analysis focuses only on the late filers portion of the gross non-filing gap for personal income tax ($17,294,000) and the gross underpayment gap for personal income tax ($156,140,000).

In the **population decile view**, each decile represents 10% of the total taxpayer population, ordered ascending by Connecticut Adjusted Gross Income (CT AGI). Notably, as shown in Table 9, the top 10% of the population, represented in Decile 10, holds a total CT AGI of $330 billion and accounts for approximately $8.3 million (48%) of the gross non-filing gap and $89 million (57%) of the gross underpayment gap for personal income tax. In contrast, Decile 1, representing the bottom 10% of the population, has a significantly lower CT AGI of $462 million, with a non-filing gap of about $70,000 (0.41%) and an underpayment gap of $158,000 (0.1%).

This trend suggests that higher-income groups (in the upper deciles) tend to have larger absolute amounts in both the non-filing and underpayment gaps, though the percentage gap is more pronounced in the lower deciles when compared by population. Additionally, the mean CT AGI increases substantially in the higher population deciles. This view highlights a growing tax compliance gap as income rises, suggesting a potential focus area for compliance enforcements among higher-income groups.

In contrast, the **income decile view** as shown in Table 11 groups taxpayers by income levels, with each decile representing 10% of the total CT AGI, rather than the population. Decile 1 in the income view, which holds a total CT AGI of $44 billion, accounts for approximately $3.8 million (22.2%) of the gross non-filing gap and $26.5 million (16.97%) of the gross underpayment gap. However, this decile accounts for a substantial 64.9% of the population. In contrast, Decile 10 in the income view, representing only 26 taxpayers and holding a total CT AGI of $45 billion, has a non-filing gap of $0 and an underpayment gap of about $4,000. This disparity illustrates that while the non-filing and underpayment gaps are indeed higher in the lower income deciles, the large population within these deciles results in smaller per-taxpayer gaps. Therefore, the compliance gap in the lower-income decile is relatively modest.

The gross underpayment and non-filing gap for personal income tax are analyzed in more detail for the **top 5%, top 1%, and top 0.5%** of all income taxpayers in Table 12. This view highlights the trends depicted in the income decile view. The top 5% consists of about 80,000 filers, representing 4% of all income taxpayers, and has a median CT AGI of $650,000. This income group, which holds a total CT AGI of $61.7 billion, accounts for approximately $2.8 million (16%) of the gross non-filing gap and $34.3 million (22%) of the gross underpayment gap.

The top 1% has about 10,000 filers and represents 0.5% of all income taxpayers. The top 1% has a median CT AGI of $2.4 million and a total CT AGI of $25.7 billion. The top 1% of income taxpayers accounts for about $890,000 (5%) of the gross non-filing gap and $12.3 million (8%) of the gross underpayment gap.

The top 0.5% also has about 10,000 filers and represents 0.5% of all income taxpayers. The top 0.5% of income taxpayers has a total CT AGI of approximately $211.7 billion. As noted in the income decile analysis, the top 0.5% has a highly variable income range with a median CT AGI of $7.2 million and a mean CT AGI of $21 million. This group accounts for $2.7 million (15.5%) of the gross non-filing gap and $25.7 million (16.5%) of the gross underpayment gap.

Overall, these high-income groups account for 37% of the gross non-filing gap and 46% of the gross underpayment gap for personal income tax. However, it is relatively few taxpayers (less than 1%) within each group that file late and contribute to the non-filing gap. Similarly, the underpayment gap for the top 1% and top 0.5% of income taxpayers is attributable to a small number of taxpayers who fail to make timely estimated payments or extension payments to cover their tax liability in full. While they comply with timely filing their return on or before the valid extension date, they are not paid in full by the due date. While the non-filing and underpayment gaps are indeed higher in the top 5% income group, the larger population within this group results in smaller per-taxpayer gaps. Therefore, the compliance gap is relatively modest overall.

*Table 9: **Population Decile View** of 2022 Non-Filing and Underpayment Gap for Personal Income Tax*

Decile	Population	% of Population	Total CT AGI	Median CT AGI	Mean CT AGI	Non-Filing Gap ($)	Non-Filing Gap (%)	Underpayment Gap ($)	Underpayment Gap (%)
1	200,668	10%	$ 462,400,000	$ 2,000	$ 2,000	$ 72,000	0.42%	$ 158,000	0.10%
2	200,668	10%	2,329,000,000	12,000	12,000	33,000	0.19%	12,000	0.01%
3	200,668	10%	4,475,200,000	22,000	22,000	71,000	0.41%	521,000	0.33%
4	200,668	10%	6,850,400,000	34,000	34,000	440,000	2.54%	3,436,000	2.20%
5	200,668	10%	9,511,900,000	47,000	47,000	962,000	5.56%	7,216,000	4.62%
6	200,668	10%	12,994,000,000	64,000	65,000	1,474,000	8.52%	9,755,000	6.25%
7	200,668	10%	17,593,800,000	87,000	88,000	1,615,000	9.34%	11,192,000	7.17%
8	200,668	10%	24,485,800,000	121,000	122,000	1,992,000	11.52%	15,651,000	10.02%
9	200,668	10%	37,249,100,000	181,000	186,000	2,332,000	13.48%	18,960,000	12.14%
10	200,669	10%	330,386,300,000	419,000	1,646,000	8,303,000	48.01%	89,239,000	57.15%
Total	**2,006,681**	**100%**	**$446,337,864,000**			**$ 17,294,000**	**100%**	**$ 156,140,000***	**100%**

**The gross underpayment gap is for 2022 Personal Income Tax only. It is less than the "Individual Income Taxes" underpayment gap as it does not include Withholding and Income Tax Trust & Estate.*

*Table 10: **Income Decile View** of 2022 Non-Filing and Underpayment Gap for Personal Income Tax*

Decile	Population	% of Population	Total CT AGI	Median CT AGI	Mean CT AGI	Non-Filing Gap ($)	Non-Filing Gap (%)	Underpayment Gap ($)	Underpayment Gap (%)
1	1,302,995	64.93%	$ 44,633,700,000	$ 31,000	$ 34,000	$ 3,842,000	22.22%	$ 26,501,000	16.97%
2	369,829	18.43%	44,633,700,000	117,000	121,000	3,533,000	20.43%	27,241,000	17.45%
3	197,215	9.83%	44,633,700,000	217,000	226,000	2,597,000	15.02%	23,136,000	14.82%
4	90,884	4.53%	44,633,300,000	455,000	491,000	2,622,000	15.16%	25,078,000	16.06%
5	32,104	1.60%	44,631,700,000	1,242,000	1,390,000	1,656,000	9.58%	23,344,000	14.95%
6	9,578	0.48%	44,632,800,000	4,215,000	4,660,000	1,279,000	7.40%	14,451,000	9.26%
7	2,974	0.15%	44,610,000,000	13,399,000	15,000,000	502,000	2.90%	8,595,000	5.50%
8	877	0.04%	44,616,500,000	44,596,000	50,873,000	1,156,000	6.69%	5,208,000	3.34%
9	199	0.01%	44,145,200,000	175,462,000	221,835,000	105,000	0.61%	2,581,000	1.65%
10	26	0.00%	45,168,000,000	1,049,846,000	1,737,230,000	-	0.00%	4,000	0.00%
Total	2,006,681	**100.00%**	**$ 446,337,600,000**			**$ 17,294,000**	**100%**	**$ 156,140,000***	**100%**

Table 11: Non-Filing and Underpayment Gap for Top 5%, 1%, and 0.5% of Personal Income Tax Filers

Income Group	Population	% of Population	Total CT AGI	Median CT AGI	Mean CT AGI	Non-Filing Gap ($)	Non-Filing Gap (%)	Underpayment Gap ($)	Underpayment Gap (%)
Top 5% to 1%	80,267	4.00%	$ 61,709,000,000	$ 650,000	$ 769,000	$ 2,813,000	16.27%	$ 34,263,000	21.94%
Top 1% to 0.5%	10,033	0.50%	25,659,000,000	2,400,000	2,600,000	889,000	5.14%	12,283,000	7.87%
Top 0.5% to High	10,033	0.50%	211,680,000,000	7,200,000	21,000,000	2,689,000	15.55%	25,738,000	16.48%
Total	**100,333**	**5.00%**	**$ 299,048,000,000**			**$ 6,391,000**	**36.96%**	**$ 72,284,000**	**46.29%**