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Understanding the Tax Gap

Executive Summary

- The tax gap is an estimate of the difference between the taxes – individual, corporate, employment, estate, and excise – that the IRS believes *should have* been paid on time, voluntarily and what was *actually* paid for a specific year.

- The IRS estimates that the current gross tax gap is $345 billion, and the net tax gap (which is computed by subtracting late payments and taxes eventually collected from the overall tax gap) is about $290 billion.

- It is important to remember the limitations of the tax gap estimate.

- Regardless of its precise amount, the tax gap threatens taxpayer confidence in the voluntary nature of our tax system and raises the issue of fundamental fairness. The tax gap is also a problem that hampers fiscal sustainability.

- The IRS is unable to determine how much of the tax gap is attributable to willful tax evasion rather than honest mistakes. Without such information, it is difficult to develop strategies to combat the tax gap because different reasons for noncompliance require different solutions.

  - Willful noncompliance would require increased enforcement, more efficient use of IRS resources, and statutory and regulatory changes; whereas, innocent mistakes would require simplification, increased taxpayer service, and better tax-preparer education.

- Because of the large size of the tax gap, even a small reduction would produce substantial returns. For example, based on the IRS' most recent estimate, each *one-percent* reduction in the net tax gap would likely produce an estimated *$3 billion* annually.

- Even though realistic improvements can, and should, be made to reduce the tax gap, in reality there will never be 100 percent compliance.

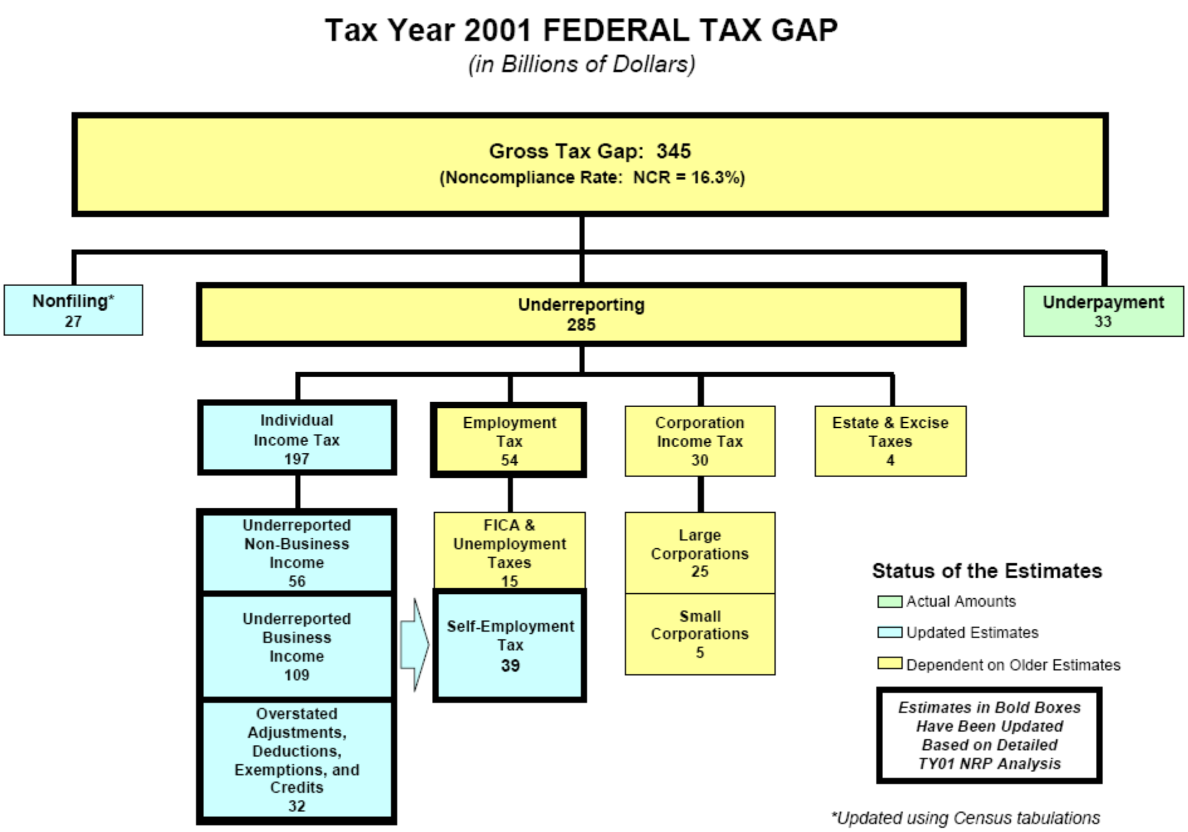
- Any solution that aims at reducing the tax gap must address the level of burden on taxpayers as well as the effect on taxpayer rights.

Introduction

The tax gap is an estimate of the difference between the taxes – individual, corporate, employment, estate, and excise – that *should have* been paid voluntarily and on time and what was *actually* paid for a specific year. This paper will examine the tax gap, the limitations of the estimate, and possible ways to reduce that gap.

Over the course of many years, numerous solutions have been proposed to address the tax gap,[1] but history reveals that there is no silver bullet, no quick fix. Rather, addressing the tax gap will require a comprehensive set of strategies that not only deal with noncompliance issues, but also balance taxpayer rights and burdens. The tax gap requires the consideration of various competing issues, such as burdens, benefits, and resources, in order to develop the most comprehensive and cost-effective plan; otherwise, the gap will continue to be a problem that simultaneously undermines the fairness of our voluntary tax system and produces corrosive effects on our nation's fiscal health.

Figure 1: Federal Tax Gap[2]



[1] For example, in 1993 the IRS formed a task group that performed an extensive review of the tax gap. The resulting task force report provided several recommendations: (1) enforcement is the most costly option and delivers only limited revenue; (2) methods to increase voluntary compliance are less costly but more burdensome to taxpayers; (3) legislative changes are needed as the primary means to increase compliance levels; and (4) the IRS needs to reevaluate its media and taxpayer education efforts. IRS Tax Gap Report: *Strategies for Closing the Tax Gap*, Oct. 1993.

[2] Source: Internal Revenue Service.

How Large is the Tax Gap?

The Internal Revenue Service (IRS) estimates that the current gross tax gap is $345 billion and the net tax gap, which is computed by subtracting late payments and taxes eventually collected from the overall tax gap, is about $290 billion.[3] As the above chart illustrates, the estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or on time. In order to develop its tax gap estimates, the IRS periodically measures the rate of taxpayer compliance, that is, the degree to which taxpayers fully and timely complied with their tax obligations. The rate of taxpayer compliance is then used, along with other data and assumptions, to estimate the dollar amount not timely and accurately paid.

History of the Tax Gap Figure

Beginning in the early 1960s through 1988, the IRS periodically[4] conducted the Taxpayer Compliance Measurement Program (TCMP), consisting of line-by-line audits of random samples of returns.[5] Although the program provided information on compliance trends, the method of data collection used by the TCMP was widely considered unduly burdensome on taxpayers.[6] The IRS did not conduct any TCMP studies after 1988; however, due to a need for current compliance data, the IRS implemented a new compliance study, called the National Research Program (NRP), in 2002. The NRP used a focused statistical selection process that resulted in the selection of approximately 46,000 individual tax returns and met certain objectives: (1) to estimate the overall extent of reporting compliance among individual tax filers; (2) to update the IRS' audit selection formulas; and (3) to reduce the burden imposed on taxpayers whose returns were selected for the study.[7] The NRP examined data for tax year 2001 and estimated the tax gap to be $345 billion and the net tax gap, $290 billion. Historically, the compliance rate has consistently hovered between 83-85 percent.

How Accurate is the Tax Gap Figure and What it Demonstrates

It is important to remember that the tax gap is just an <u>estimate</u>, and even with the estimated figure, there is concern regarding the certainty of the current tax gap figure. At best, the data is five years old, while some areas rely on even older data, dating as far back as the 1980s. The focus on the NRP study was on individual tax returns for tax year 2001, yet it did not provide estimates of noncompliance for other taxes, such as corporate income tax, estate tax, or employment tax.

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[3] "IRS Updates Tax Gap Estimates," IR-2006-028, from www.irs.gov/newsroom/article/0,,id=154496.00.html, February 14, 2006. The noncompliance rate associated with the annual gross tax gap is 16.3 percent.

[4] Approximately every three years from 1963 to 1988, the IRS conducted studies to measure tax compliance. Kim M. Bloomquist et al., Internal Revenue Service, *Tax Noncompliance in the United States: Measurement and Recent Enforcement Initiatives* (2004).

[5] Mark Everson, Commissioner of Internal Revenue Service, testimony before Senate Finance Committee, *The $350 Billion Questions: How to Solve the Tax Gap*, April 14, 2005.

[6] Mark Mazur, Director of Research, Analysis, and Statistics for the Internal Revenue Service, testimony before Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, *A Closer Look at the Size and Sources of the Tax Gap*, July 26, 2006 (hereinafter "Mazur Testimony"). According to Mazur's testimony, "One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without benefit of death."

[7] Mazur Testimony. Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders in the design and implementation of the study.

Rather, the estimates for these non-compliance rates were based on projections from the most recent compliance data (i.e., 1988 or earlier when the last TCMP study was conducted).[8]

In addition to the problems associated with up-to-date data, some types of compliance are inherently difficult to measure. The IRS has no estimates for corporate income, employment, and excise tax nonfiling or for excise tax underreporting – categories that the IRS maintains are too imprecise, unavailable, or too difficult to collect.[9] Furthermore, the IRS contends that various types of underreporting or nonfiling, such as tracking cash payments that businesses make to their employees, are also too difficult to measure.[10]

The estimates indicate that the tax gap can be broken down into a variety of general sources. Underreporting comprises nearly 82 percent of the gross tax gap, while nonfiling accounts for 8.6 percent and underpayment 9.6 percent.[11] Individual income tax accounted for roughly one-half of all tax receipts in 2001, yet as figure 2 below indicates, individual income tax underreporting accounted for 56 percent of the tax gap.

Figure 2: NRP-Based Tax Gap Estimates, Tax Year 2001[12]

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**197**	**56%**
Understated non-business income	56	16%
Understated net business income	109	31%
Overstated adjustments, deductions, exemptions and credits	32	9%
Self-Employment tax underreporting gap	**39**	**11%**
All other components of the tax gap	**109**	**33%**
Total Tax Gap	**345**	
Note: Detail does not add due to rounding		

Although the estimates present valuable information, some vital information is unknown. Namely, how much of the tax gap is attributable to willful tax evasion rather than honest mistakes. IRS Commissioner Mark Everson notes the IRS is attempting to discern this important distinction:

> The tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, though, at this point, we do not have sufficiently good data to help us

[8] Mazur Testimony.
[9] Michael Brostek, Director, Tax Issues, Strategic Issues Team, GAO, testimony before Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, *A Closer Look at the Size and Sources of the Tax Gap*, July 26, 2006 (hereinafter "Brostek Testimony").
[10] Brostek Testimony.
[11] Raymond Wagner, IRS Oversight Board Chairman, testimony before Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, *A Closer Look at the Size and Sources of the Tax Gap*, July 26, 2006.
[12] Mazur Testimony.

> know how much arises from willfulness as opposed to innocent mistakes. This is an arena where we expect future research to improve our understanding.[13]

Without such information, it is difficult to develop strategies to combat the tax gap because the reasons for noncompliance each require their own tailored solution.

Regular Data Collection is Needed

Regular – as opposed to periodic – measurements of compliance could produce a plethora of benefits, including helping IRS better identify new types of noncompliance, identifying changes in tax laws that would improve compliance,[14] targeting examinations of tax returns more effectively, and allocating resources more efficiently.[15] Without current data, the IRS will not be as able to determine the areas of noncompliance to address nor will it maximize the use of its limited resources. Up-to-date research would allow the IRS to more effectively focus its service and enforcement programs on areas that have the greatest impact on taxpayer compliance, and then it could monitor the changes in the taxpayer compliance rates to use as a gauge for the effectiveness of IRS programs.[16]

The Tax Gap Cannot be Ignored

Even while it is an imprecise number, the tax gap contains both social and economic costs. Regardless of its precise amount, the tax gap threatens taxpayer confidence in the voluntary nature of our tax system and raises the issue of fundamental fairness. Because of taxpayer noncompliance, the burden of funding the nation's commitments falls disproportionately on taxpayers who willingly and accurately pay their taxes. Because the IRS receives approximately 130 million individual income tax returns each year, given the current size of the net tax gap, the average tax return includes a $2,000 per year "surtax" to subsidize noncompliance.[17]

Extending beyond the fundamental fairness issue, the tax gap is a problem that hampers fiscal sustainability. Long-term budget simulations, conducted by both the Government Accountability Office (GAO)[18] and the Congressional Budget Office (CBO),[19] indicate that the nation faces growing structural deficits due primarily to known demographic trends, rising health care costs, and an aging population. Because of the large size of the tax gap, even a small reduction would produce substantial returns. For example, based on the IRS' most recent estimate, each *one-percent* reduction in the net tax gap would likely produce an estimated *$3 billion* annually.[20] Thus, modest improvements in the tax gap have broad revenue ramifications for an economy that faces

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[13] Testimony before Senate Budget Committee, February 15, 2006.
[14] For example, analysis of the 1979 and 1982 TCMP data allowed the IRS to identify significant noncompliance with the number of dependents on tax returns. Such identification led to legislative changes, and in tax year 1987, five million fewer dependents were claimed than would have been expected without a change in the law.
[15] GAO, Tax Compliance: *Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T, 2005, p. 20.
[16] Raymond Wagner, IRS Oversight Board Chairman, testimony before Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, *A Closer Look at the Size and Sources of the Tax Gap*, July 26, 2006.
[17] Nina Olson, National Taxpayer Advocate, testimony before Senate Finance Committee, *The $350 Billion Questions: How to Solve the Tax Gap*, April 14, 2005.
[18] GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP, 2005.
[19] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, 2005.
[20] Brostek Testimony.

serious hurdles in the future. Reducing the current tax gap would not only help alleviate some of our nation's fiscal pressures, but it also would be more fair for those taxpayers who voluntarily comply with their tax obligations.

Addressing the Problem

The Compliance Rate Will Never be 100 Percent

Even though realistic improvements can, and should, be made to reduce the tax gap, in reality there will never be 100 percent compliance.[21] According to Mark Mazur, director of Research Analysis and Statistics for the IRS, "most countries would be thrilled to have a voluntary compliance rate of almost 84 percent."[22] Compliance rates that hover at unrealistically high rates theoretically would delve into a tax system that would require highly intrusive third-party reporting requirements and an agent in every household and in every small business; the practical effect would be the extinction of our "voluntary" tax system.

Any solution that aims at reducing the tax gap must address the level of burden on taxpayers as well as the effect on taxpayer rights. Many solutions may appear justifiable on paper, yet the practical impact could be devastating to the individual taxpayer. Each tax gap solution should opt for the maximum benefit and minimum burden, while promoting taxpayer rights to their fullest extent. For instance, increased third-party reporting may be seen as a possible solution, but the questions of what dollar threshold should be used, and to what extent third party reporting should be extended to goods as well as services, are just two of the considerations that should be addressed regarding this one possible solution.

Solutions Must Address Both Willful Noncompliance and Innocent Mistakes

A key limitation of the NSRP study is that there is no way of knowing what percentage of the tax gap is due to willful noncompliance and what percentage is due to innocent mistakes. This distinction must be noted when devising solutions because treatment requires very different alternatives: willful noncompliance would require increased enforcement, more efficient use of IRS resources, and statutory and regulatory changes; innocent mistakes would require simplification, increased taxpayer service, and better tax-preparer education.

Addressing Willful Noncompliance: Increased Enforcement, More Efficient Use of IRS Resources, and Statutory and Regulatory Changes

For those taxpayers who deliberately evade their tax obligations, the solutions extend beyond "increased enforcement" mechanisms, as the IRS will need to use multiple strategies to identify and deter noncompliance. While Congress may choose to increase the IRS' enforcement tools, such as increased third-party withholding and information reporting,[23] several other options are also available for addressing willful noncompliance. These options include: (1) more efficient use of IRS resources, i.e., business systems modernization to improve the use of information

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[21] The IRS has set an 85-percent compliance goal by 2009.
[22] Mazur Testimony (July 26, 2006).
[23] According to GAO, tax withholding and information reporting have been shown to lead to high levels of compliance because the income is transparent to both the individuals as well as the IRS. GAO, *Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T, 2006.

already detected in order to detect non-compliance, and using private collection agencies to assist IRS agents in its collection activities; and (2) statutory and regulatory changes to eliminate opportunities for evasion, such as changes to the Earned Income Tax Credit (EITC) and basis reporting for stock options.

Addressing Innocent Mistakes: Simplification, Increased Taxpayer Service and Better Education

As the Taxpayer Advocate stated in the *2004 Annual Report to Congress*, the most serious problem facing taxpayers and the IRS is the complexity of the Internal Revenue Code (IRC).[24] The President's Advisory Panel on Federal Tax Reform made a similar observation:

> Since the last major reform effort in 1986, there have been more than 14,000 changes to the tax code, many adding special provisions and targeted tax benefits, some of which expire after only a few years. These myriad of changes decrease the stability, consistency, and transparency of our current tax system while making it drastically more complicated, unfair, and economically wasteful. Today, our tax system falls well short of the expectations of Americans that revenues needed for government should be raised in a manner that is simple, efficient and fair.[25]

One of the major effects attributed to the complexity of the tax code is a lower compliance rate. According to the American Institute of Certified Public Accountants, tax law complexity: (1) increases perception that the tax system is unfair; (2) increases costs for tax administration and tax compliance; (3) decreases the quality of tax administration and tax assistance; and (4) increases the number of inefficient economic decisions.[26] Efforts to simplify the tax code will help reduce the tax gap by making it easier for individuals and businesses to better comply with their tax obligations and will also promote sound economic decision making.

Efforts to decrease the number of honest mistakes extend beyond simplification into the areas of taxpayer service and taxpayer education. Providing quality services to taxpayers is a necessary step in any system designed to promote voluntary compliance. Educating taxpayers regarding confusing or commonly misunderstood tax requirements would alleviate unnecessary errors. For example, many of the forms and instructions that taxpayers use to prepare their taxes are unclear and cumbersome. Common sense dictates that the IRS should evaluate the forms before

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[24] National Taxpayer Advocate, Internal Revenue Service, *2004 Annual Report to Congress* (2004). In 2001, the Joint Committee on Taxation conducted a study on the complexity of the tax law and found that at that time, the tax code consisted of nearly 1.4 million words. There were 693 sections of the IRC applicable to individuals, 1,501 sections for businesses, and 445 sections for tax exempt organizations, employee plans, and governments. In 2001, a taxpayer filing an individual income tax return (Form 1040) could face a 79 line return, 144 pages of instructions, 11 schedules totaling 443 lines, and 19 separate worksheets. The complexity of the IRC exacerbates an otherwise compliant individual's efforts. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (2001).

[25] Statements by the Members of the President's Panel on Federal Tax Reform, *America Needs a Better Tax System*, April 13, 2005. According to Senator Connie Mack, Chairman of the Panel on Federal Tax Reform, "Instead of a tax system that draws revenue efficiently from the base of the nation's considerable economy, we have a tax code that distorts basic economic decisions, sets up incentives for unwise or unproductive investments, and induces people to work less, save less, and borrow more." Testimony before Senate Finance Committee, *Tax Reform Kick-Off*, August 3, 2006.

[26] J. Russell George, Treasury Inspector General for Tax Administration, testimony before Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, *A Closer Look at the Size and Sources of the Tax Gap*, July 26, 2006.

actual public use; however, in 2003 GAO reported that the IRS had tested revisions to only *five* individual forms from July 1997 to July 2002, even though *hundreds* of forms and instructions were revised.[27] If the IRS tested the forms more regularly and subsequently addressed the ensuing confusion, the number of unintentional errors would likely decrease.

Conclusion

As the Treasury Inspector General for Tax Administration said, "making the difficult changes necessary to address the tax gap is something that the IRS, the Department of Treasury, and Members of Congress will have to continue to wrestle with to help remedy this [tax gap] problem."[28] The size of the tax gap is an issue that will not go away overnight, but with a comprehensive set of strategies, ranging from a simpler tax code to better enforcement and quality customer service, improvements *can* be made to reduce it. The tax gap manifests itself through increased social and economic costs – costs that will pose serious implications on fiscal sustainability and the integrity of the tax system.

[27] GAO, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions,* GAO-03-486, 2003.
[28] J. Russell George, Treasury Inspector General for Tax Administration, testimony before Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, *A Closer Look at the Size and Sources of the Tax Gap*, July 26, 2006.