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CLOSING THE TAX GAP

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The Internal Revenue Service recently released updated estimates showing that the tax gap – which it describes as "the difference between what taxpayers should have paid and what they actually paid on a timely basis" — was $345 billion in Tax Year 2001. (This does not include unpaid taxes on illegal activities.)[1] This represents a non-compliance rate of 16.3 percent. The IRS recovered about $55 billion of this sum, leaving a net tax gap of $290 billion.

As Nina Olson, the National Taxpayer Advocate has noted, this amounts to a per-taxpayer "'surtax' of some $2,000 per year to subsidize noncompliance."[2] Alternatively, it means that other taxpayers pay about 17 percent more in taxes to subsidize those who do not pay the taxes they owe. In addition, the tax gap is economically inefficient because it provides an incentive for the misallocation of labor and capital into sectors of the economy that facilitate tax avoidance. Most fundamentally, the American tax system relies on a substantial amount of voluntary compliance. When large amounts of taxes go uncollected, it can lead other people to believe it is not fair for them to pay taxes either, leading to a downward spiral in compliance and thus even higher taxes on the compliant taxpayers.

Reducing the tax gap could help reduce the nation's large budget deficits, modestly reducing the need for tax increases or spending reductions. Steps also should be taken to close legal loopholes and abuses that reduce tax revenues.

Sources of the Tax Gap

The IRS has been conducting the National Research Program (NRP), a survey of 46,000 tax returns, to determine the tax gap in 2001. This is the first comprehensive effort to measure the tax gap since 1988. As shown in the table on the following page, the majority of the gross tax gap ($244

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[1] Internal Revenue Service, "IRS Updates Tax Gap Estimates," February 14, 2006, http://www.irs.gov/newsroom/article/0,,id=154496,00.html.

[2] Nina E. Olson, "Written Statement of Nina E. Olson, National Taxpayer Advocate Before the Committee on the Budget, United States Senate," February 15, 2006, http://budget.senate.gov/republican/hearingarchive/testimonies/2006/NinaOlsenTestimony.pdf.

IRS's Tax Year 2001 Gross Tax Gap Estimates (billions of dollars)

Type of Noncompliance	Individual Income Tax	Payroll and UI Taxes	Corporate Income Taxes	Other Taxes	**Total**
Underreporting	$197	$54	$30	$4	**$285**
Underpayment	23	$5	$2	$3	**$34**
Nonfiling	25	NA	NA	$2	**$27**
Total	**$244**	**$59**	**$32**	**$9**	**$345**

Source: GAO, "Tax Gap," February 15, 2006 reporting estimates from the IRS.

billion of the $345 billion) comes from individual income taxes. The bulk of this — $166 billion — was the result of underreported income. Of this amount, $109 billion is the result of underreporting of income by small businesses, such as sole proprietors, partnerships, and S corporations, while the other $56 billion reflects underreporting of wages, tips, capital gains, and other non-business income. This underreporting of income also generated $54 billion in uncollected FICA and unemployment insurance taxes.

The largest source of the tax gap is the "cash economy," taxable payments that are not required to be reported to the IRS by third parties. Employers, for example, send W2 forms to the IRS to report the wages paid to their employees, and banks and financial institutions send 1099s to report interest, dividends, and proceeds from the sale of financial assets. But payments to contractors and tips, for example, only need to be reported by the recipient of the payment. As Olson explains, "Where taxable payments are reported to the IRS by third parties, the IRS generally collects well over 90 percent of the tax due. Where taxable payments are not reported to the IRS by third parties, compliance drops precipitously to a range from about 20 percent to about 68 percent, depending on the type of transaction."[3] In particular, the noncompliance rate ranges from 1 percent for wages, salaries and tips to 57 percent for small business income and 72 percent for farm income.

Steps to Close the Tax Gap

It would be impossible to close the entire tax gap. Addressing the tax gap entails balancing the desire to collect taxes that are owed with the importance of minimizing intrusive and complicated reporting requirements and audits.

Numerous sensible steps to narrow the tax gap have been proposed, however, by the IRS, the Government Accountability Office (GAO), the Joint Committee on Taxation (JCT), the National Taxpayer Advocate, and other experts.[4] Potential steps include:

- **Improve services.** The IRS has made major strides in improving customer service, using the Internet, improving call centers, and in other ways. Further improvements to customer service should both facilitate tax paying and reduce the tax gap, especially the portion that is due to

[3] Nina E. Olson, *op. cit.*

[4] See, among others, National Taxpayer Advocate, *2005 Annual Report to Congress*; Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, January 27, 2005; and David Walker, "Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions," February 15, 2006.

Requiring Financial Institutions To Report Capital Gains Basis

Currently financial institutions are required to report dividends, interest payments and sale prices of financial assets to taxpayers and to the IRS. But capital gains taxes are based on the sales price minus the purchase price (or "basis"). Inflating the basis, and thus reducing the taxable gain, contributes to the tax gap.

The IRS estimates that the tax gap for capital gains is $11 billion (or a 12 percent noncompliance rate), more than three times the magnitude of the $3 billion tax gap (or 4 percent noncompliance rate) for interest and dividends. Other experts have estimated that inflated basis may cost $21 billion annually.[a]

The National Taxpayer Advocate has recommended legislation to require financial institutions to report basis to the IRS, concluding that "on balance… the revenue benefits of requiring brokers to track and report cost basis exceed the burdens the requirements would impose." Senator Evan Bayh has introduced such a proposal as S. 2414.[b] Although this policy would not eliminate the entire capital gains tax gap, it has the potential to narrow it. In addition, it would also to simplify filing for individuals, for whom calculating basis can be a source of complexity and require effective record keeping and potentially complicated calculations in situations such as stock splits or when mutual fund distributions have been reinvested.

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a Joseph M. Dodge and Jay A. Soled, "Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question," *Tax Notes*, January 24, 2005.

b National Taxpayer Advocate, *2005 Report to Congress*, 2005.

underpayments that stem from unintentional error.

- **Enforcement.** The IRS should dedicate more resources to enforcement, including auditing and collecting taxes that are owed. IRS audits of high-income individuals have dropped dramatically over the past decade. The audit rate for face-to-face audits fell from 2.9 percent of high-income tax filers in fiscal year 1992 to 0.38 percent in fiscal year 2001 and then drifted down to 0.35 percent in fiscal year 2004. At the same time, less in depth correspondence audits have rebounded since fiscal year 2001.[5]

  In addition, the IRS has identified tens of billions of dollars in underpayments that cannot be collected because it has insufficient staff resources. In a 2002 report, then IRS Commissioner Charles Rossotti estimated that the IRS could collect an additional $30 billion annually with a $2.2 billion budget increase to expand its staff.[6]

  Finally, Nina Olson has pointed out that the IRS pays far more attention to errors and fraud in the Earned Income Tax Credit than the substantially larger problem of the cash economy. She proposed that the IRS remedy this inefficient imbalance of attention by establishing a "cash

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[5] Transactional Records Access Clearinghouse, Syracuse University, http://trac.syr.edu/tracirs/highlights/current/highincomeIndividual.html.

[6] Charles Rossotti, "Report to the IRS Oversight Board: Assessment of the IRS and the Tax System," September 2002, http://www.treas.gov/irsob/documents/commissioner_report.pdf.

economy program office" to coordinate "research, outreach and compliance initiatives aimed at improving reporting compliance among cash economy participants."[7]

- **Legislative steps to reduce avoidance opportunities.** Congress could enact legislation to improve compliance and reduce tax avoidance opportunities, including beefing up third-party reporting requirements, regulation of paid tax return preparers, and other technical steps. One particularly promising policy would be to require financial institutions to report the basis (i.e., the original purchase price) for capital gains, a step that could simplify taxes for individuals while improving compliance (see box on page 3).

- **Tax simplification.** Tax simplification — from technical steps to harmonize the wide range of definitions and rules in the tax code to more sweeping reform — could reduce the non-compliance rate and potentially raise tax revenues without an increase in tax rates. For instance, proposals that would consolidate existing tax credits and deductions, or that would eliminate certain tax incentives entirely, could greatly simplify the tax code.[8].

[7] Nina E. Olson, *op. cit.*

[8] The President's Advisory Panel on Federal Tax Reform's Simplified Income Tax Plan includes such proposals to simplify the income tax code, although the reform as a whole would be very costly relative to current law.