THE TAX GAP – AN ELUSIVE SEARCH FOR A SOLUTION

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Abstract
Reducing the Tax Gap (Gross Tax Gap) is one of the persistent issues facing the Internal Revenue Service. In a perfect world or economy devoid of anti-tax citizen and business groups, politics as it is currently played out, social and inequalities, knowledge gap and lawless citizens, the issue of tax gap will be less of a priority to the government and the Internal Revenue Service (IRS). Unfortunately we do live in such a world and will probably, never. Instead, we must embrace the alternative; an environment that must accept the tax gap issue as a national concern, and the solution to it as a complex and ever elusive one.

To underscore the importance and urgency given to the topic of the tax gap, we note as clearly stated in one of IRS News releases the following statement "Since IRS Commissioner Doug Shulman began his five-year term in March 2008, virtually all major initiatives launched by the IRS since 2008 have been designed to focus on the tax gap through more effective enforcement or improved service to taxpayers".

The tax gap or gross tax gap is generally defined as the difference between taxes owed and taxes paid in a timely manner. The same definition is adopted by the IRS as it continues to grabble with the number estimated to be $350 billion in 2001 and $450 billion in 2006 and the increasing cost of reducing the gap through enforcement and late payments estimated at $55 million and $66 million in 2001 and 2006 respectively.

The gross tax gap, however, is different from the net tax gap which is the amount of tax liability that is never paid, which is also defined as the amount of true tax liability that is not paid on time and is not collected subsequently, either voluntarily or as the result of enforcement activities.

In this paper we examine in detail the tax gap, components of the gap and the strategies and instruments used to reduce it and the challenges that are faced by the IRS in the search for a reliable estimate and workable and cost-effective solution.

The result of our research will hopefully bring some exposure to the topic as well as help generate interest from academia and other researchers who will contribute in finding and identifying potential strategies, measures and instruments that may be used to address the subject, and to estimate and reduce the gap.

Key Words: Tax gap, Nonfiling gap, Underreporting gap, Underpayment gap, Voluntary tax compliance, tax avoidance.

Introduction
Reducing the Tax Gap (Gross Tax Gap) is one of the persistent issues facing the Internal Revenue Service. In a perfect world or economy devoid of anti-tax citizen and business groups, politics as it is currently played out, social and inequalities, knowledge gap and lawless citizens, the issue of tax gap will be less of a priority to the government and the Internal Revenue Service (IRS). Unfortunately we do live in such a world and will probably, never. Instead, we must embrace the alternative; an environment that must accept the tax gap issue as a national concern, and the solution to it as a complex and ever elusive one.

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Components of the Tax Gap
According to the Internal Revenue Service, the tax gap consists of three components: (1) non-filing (taxes not paid by those with a filing requirement who fail to file), (2) underreporting (taxes underpaid by those who file but underreport what they owe), and (3) underpayment (taxes not paid by those who fail to remit reported amounts owed when due). IRS reports the tax gap for separate tax sources, including (a) individual income taxes, (b) corporate income taxes, (c) employment taxes, and (d) estate taxes.

The contributions of these sources to the overall tax gap is clearly shown in Table 1 with much off the gap resulting from Underreporting gap, followed by Underpayment gap and Nonfiling gap. For all the gaps, Underreporting, Underpayment and Nonfiling gaps, the gap resulting from Individual Income tax remain the largest source; a finding that should place future IRS efforts in finding strategies to reduce Individual Income Tax gaps.

IRS Estimating Tools

Estimating the tax gap remains as challenging as the task of exploring avenues for reducing the tax gap.

The IRS has employed various methodologies and testing techniques that have evolved over the years. Improvements in the methodology used have often been advanced to support revised or updated estimates of the tax gap. One of the new methodologies and techniques include the use of IRS operational audit data in estimating the estate tax underreporting gap. In determining Nonfiling gaps, particularly for individual Income tax, the IRS has also made use of a variety of tools including Detection-Controlled Estimation (DCE), econometric models and audit experience, IRS administrative data, tax calculator, third party information returns, updated data and improved estimation techniques.

Notwithstanding the methods used in estimating the tax gap and their shortcomings, members of the Tax Gap Subgroup in their 2010 IRPAC Report “emphasized the need to explain carefully the determinants of the tax gap estimates and the degree of confidence associated with various components”. In their view, this will avoid any misunderstanding.

Measuring Progress

To measure Progress towards increasing/improving the compliance rate for tax filers the IRS relies in part on the tax gap estimates but does acknowledge that “it is not an adequate guide on IRS service and enforcement initiatives”. On this score, the voluntary Compliance Rate (VCR) which is defined as the percentage of total tax revenues paid on a timely basis becomes an important annual or periodic statistics as the growth (or the lack of it) of the gross as well as the net tax gaps.

In January 2012, the IRS released the tax gap estimates for the 2006 tax year, “the first full update of the report in 5 years”. Estimated at about 83%, the results showed the gap remained unchanged when compared to the estimate for the 2001 tax year.

The Latest Tax Gap Estimates

“The current tax gap estimate was published in 2006, based on tax year 2001 liabilities. An update, including re-estimation of all components using more recent data and improved methodologies, has been completed. The update is based on tax year 2006 liabilities. The increase in the gap since 2001, for which the gap estimate is $345 billion, is due almost entirely to the increase in total tax liabilities over the intervening period and does not reflect any significant change in compliance rates "

The basic finding of the tax gap update is that the change in the estimated VCR, to 83.1% in 2006 from 83.7% in 2001, is sufficiently small that it is statistically unchanged.

The IRS defines the tax gap as the amount of tax liability faced by taxpayers that is not paid on time. The Internal Revenue Service collects more than $2 trillion annually in taxes so producing an estimate of the tax gap is a major statistical effort that it undertakes every few years.

In 2012, the IRS released a new set of tax gap estimates for tax year 2006. The new tax gap estimate represents the first full update of the report in five years, and it shows the nation's compliance rate is essentially unchanged at about 83 percent from the last review covering tax year 2001.

The net tax gap for 2006 is estimated to be $385 billion. The net tax gap takes into account receipts from enforcement activities and late payments.

Since IRS Commissioner Doug Shulman began his five-year term in March 2008, virtually all major initiatives launched by the IRS since 2008 have been designed to focus on the tax gap through more effective enforcement or improved service to taxpayers.

The tax gap statistic is a helpful guide to the scale of tax compliance and to the persisting sources of low compliance, but according to the IRS, it is not an adequate guide to year-to-year changes in IRS programs or to year-to-year returns on IRS service and enforcement initiatives.

"Tax gap estimates take years to produce. For example, taxpayers have until late 2007 to file 2006 tax returns, and it takes several years to measure IRS enforcement of those liabilities from 2006. Furthermore, statistically valid estimates require resource-intensive, time-consuming research gathered from a wide range of sources, including statistically selected audits of taxpayers. Other information, such as income and expenditure information from other sources, additional financial information, and information about best practices in tax return examination, supplement the audit findings."

Compliance Rate

The voluntary compliance rate (VCR) for 2006 remained essentially unchanged at 83.1%, which is within the range of error of the previous estimate of 83.7% for 2001. (The VCR is defined as 1 minus the ratio of the gross tax gap to total liabilities.)

The estimated net compliance rate (NCR) for 2006 is 85.5% which is within the range of error of the previous estimate of 86.3% for 2001. (The NCR is defined as 1 minus the ratio of the net tax gap to total liabilities.) The 85.5% NCR means that 14.5% of the estimated total tax liability for 2006 will never be paid. (See Table 1.)

The finding established with the 2001 tax gap that compliance is far higher when reported amounts are subject to information reporting and, more so, when subject to withholding, holds unchanged with the 2006 tax gap. For example, the net misreporting percentage, or NMP, (defined as the net misreported amount as a ratio of the true amount) for amounts subject to substantial information reporting and withholding is 1%; for amounts subject to substantial information reporting but no withholding, it is 8%; and for amounts subject to little or no information reporting, such as business income, it is 56%. See Chart 1.

Table 1: Tax Gap Statistic, Tax Year 2006 Compared to Tax Year 2001

[Money amounts are in billions of dollars]

Tax Gap Component	TY2006	TY2001
Estimated Total Tax Liability	**2,660**	**2,112**
Gross Tax Gap	**450**	**345**
Overall Voluntary Compliance Rate	**83.1%**	**83.7%**
Net Tax Gap *	**385**	**290**
Overall Net Compliance Rate	**85.5%**	**86.3%**
Nonfiling Gap	**28**	**27**
Individual Income Tax	25	25
Estate Tax	3	2
Underreporting Gap	**376**	**285**
Individual Income Tax	235	197
Non-Business Income	68	56
Business Income	122	109
Adjustments, Deductions, Exemptions	17	15
Credits	28	17
Corporation Income Tax	67	30
Small Corporations (assets under $10M)	19	5
Large Corporations (assets of $10M or more)	48	25
Employment Tax	72	54
Self-Employment Tax	57	39
FICA and Unemployment Tax	15	15
Estate Tax	2	4
Underpayment Gap	**46**	**33**
Individual Income Tax	36	23
Corporation Income Tax	4	2
Employment Tax	4	5
Estate Tax	2	2
Excise Tax	0.1	0.5

* Net tax gap is defined as tax liabilities, incurred in that year, that remain outstanding after IRS enforcement efforts.

Internal Revenue Service, December 2011

http://www.irs.gov/pub/irs-pdf/p3415.pdf

	Tax Year 2001 (*billions*)	Tax Year 2006 (*billions*)
Total Tax Liabilities	$2,112	$2,660
Gross Tax Gap	$345 (83.7% compliance)	$450 (83.1% compliance)
Enforcement and Late Payments	$55	$65
Net Tax Gap	$290 (86.3% compliance)	$385 (85.5% compliance)

http://www.irs.gov/newsroom/article/0,,id=252038,00.html

IR-2012-4, Jan. 6, 2012

IRS Initiatives to address the Tax Gap

A number of initiatives have been employed in recent years by the IRS to address the tax gap. They include the following

Tax Return Preparers

"The IRS initiated a comprehensive review of the tax return preparation industry in 2009. A multi-faceted return preparer strategy was launched in 2010 to ensure top-notch professional and ethical service to taxpayers. Prior to this initiative, only CPAs, attorneys and Enrolled Agents were subject to professional credentialing. All other paid return preparers were not subject to any mandatory training or testing.

- The compliance strategy is being phased in over several years. The end result will be: all paid return preparers will be registered with the IRS, identified on the returns they prepare, pass a competency exam, and complete annual continuing education of tax law and professional conduct.
- This compliance strategy will cut down on inaccurate and fraudulent returns. It also makes it easier for the IRS to catch unscrupulous return preparers. In addition, these efforts will help improve service to taxpayers and assist with voluntary compliance.

Basis Reporting

Third-party reporting and transparency is also crucial to high compliance among individual taxpayers. Basis reporting associated with the buying and selling of securities was an area that was in need of third-party reporting based on previous studies that showed low levels of compliance.

The IRS issued proposed regulations in 2009 and final regulations in 2010 under a new law that will require reporting of basis and other information by stock brokers and mutual fund companies for most stock purchased in 2011 and all stock purchased in 2012 and later years. The reporting will be made to investors and the IRS.

Business Taxes

Third-party reporting and transparency are hallmarks of high levels of tax compliance. The IRS undertook several initiatives in recent years to improve those aspects in the world of business taxes, where the efficient allocation of limited resources is particularly important to sound tax administration.

- New merchant card reporting requirements were established for the 2011 tax year. They provide third-party reporting data on business receipts for the first time, making it easier for the IRS to identify businesses that are either under-reporting receipts or not reporting at all. The IRS issued final regulations in 2010 and the new reporting requirements took effect on Jan. 1, 2011. In general, these requirements apply to government entities and private businesses, as well as most types of payment cards, such as credit and debit cards.
- In recent years, the IRS has focused its business audits more toward issues with the highest compliance risks. Risk-based audit selection leads to a more-efficient use of limited resources and a higher return on investment. The IRS continues to improve its exam selections to focus on the most-pressing issues.

Offshore Tax Avoidance

Stopping offshore tax cheating and getting these people, especially high net-worth individuals, back into the tax system has been a top priority of the IRS.

- An offshore voluntary disclosure program was made available in 2009 and again in 2011. So far the two voluntary disclosure programs have encouraged over 30,000 taxpayers to come forward and get right with the U.S. tax system, and billions of dollars in back taxes, interest and penalties have been collected to date.

- Offshore tax avoidance is also being addressed through actions against foreign banks that have helped U.S. taxpayers hide their assets. A landmark enforcement victory against a Swiss bank in 2009 has led to the erosion of Swiss bank secrecy, and work by the IRS and Justice Department continues in this area.

- The Foreign Account Tax Compliance Act (FATCA), which was enacted in 2010 and requires foreign financial institutions to report to the IRS information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. FATCA will be phased in by the IRS in the next several years.

Other International Efforts

Globalization of the U.S. economy has been a major trend for many years. In response, the IRS realigned its relevant business divisions and personnel to address the changing landscape for both big companies and high-net-worth individuals who use ever-more sophisticated investment strategies.

- In August 2010, the IRS announced the realignment of the Large and Mid-Size Business (LMSB) division to create a more centralized organization dedicated to improving international tax compliance, known as the Large Business and International division (LB&I).
- This move strengthened international tax enforcement in several ways, including identifying emerging international compliance issues more quickly and ensuring the right compliance resources are allocated to the right cases. More IRS staff is focusing on and specializing around international issues.
- In November 2009, the IRS's Global High Wealth unit began operation. It was formed to better cope with the growing complexity of income and assets of the high-income, high-wealth population.

Uncertain Tax Positions

In 2011, certain large corporations were required to start making "uncertain tax position" (UTP) disclosures on their 2010 tax returns. The IRS issued the final UTP Schedule and instructions in September 2010. UTP reporting fosters certainty for taxpayers by speeding up the time it takes to find issues and complete exams. It also helps the IRS work through corporate returns more efficiently and see where further guidance is needed to reduce uncertainty. A UTP is generally defined as a stance on a tax return where the corporation sets aside a reserve to either pay the higher amount of tax later or litigate the matter in the future.

Real-Time Tax System

The IRS has started work exploring how to implement a series of long-term changes to the tax system which will result in higher compliance. Commissioner Shulman has described a vision where the IRS would move away from the traditional "look back" model of compliance, and instead perform substantially more "real time," or upfront information return matching with tax returns when they are first filed with the IRS. The goal of this initiative is to improve the tax filing process by reducing burden for taxpayers and improving overall compliance upfront.

In general, the IRS prides itself as "one of the world's most efficient tax administrators. In fiscal year 2010, the IRS collected more than $2.3 trillion in revenue and processed more than 230 million tax returns, while spending just 53 cents for each $100 collected. The IRS takes a balanced approach to tax administration."

Conclusion:

With the issue of tax gap still a top priority for the IRS and the paucity of academic research in this area future and or more research in this area will be a welcome addition. Additional strategies, including new and improved estimation techniques will certainly help with IRS continued goal of increasing voluntary tax compliance and reducing the tag gap.

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