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# The tax gap: America's underreported revenues

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THE TAX GAP:  
AMERICA'S UNDERREPORTED REVENUES

A Thesis  
Submitted  
in Partial Fulfillment  
of the Requirements for the Designation  
University Honors

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University of Northern Iowa  
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Entitled: The Tax Gap: America's Underreported Revenues

has been approved as meeting the thesis or project requirement for the Designation  
University Honors.

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Jessica Moon, Director, University Honors Program

## I. INTRODUCTION

Americans owed over \$2 trillion in income taxes in 2001. More than 83 percent of the income taxes due were paid willingly and timely. However, 16 percent of the total tax liability was not paid, leaving the Federal government without \$345 billion in tax revenues (Tax Year 2001 Federal Tax Gap 2007, 1). Imagine the potential opportunities available to the federal government with the availability of an additional \$345 billion each year. It could perhaps finance a large share of the recent government credit crisis bailout package, fund (with \$200 billion excess) the war in Iraq each year (Lindsey 2008, 1) or pay a large share of the \$400 billion federal deficit (Montgomery 2008, 1). As our nation faces the reality of the growing national debt, the prospect of additional government revenues becomes an increasingly relevant topic.

Each year the government forgoes \$345 billion in additional taxpayer funding because taxes are not properly reported and paid. This \$345 billion is known as the tax gap, the difference between taxes due and taxes collected (Tax Year 2001 Federal Tax Gap 2007, 1). Though the United States experiences one of the world's highest compliance rates, there is definitely room for improvement, as each percentage point of noncompliance costs the government \$21 billion in lost revenue (Lewis 2008, 2). The tax gap is incredibly detrimental to the well-being of the nation's government because it leads to increases in the federal deficit as well as an enlarging of the nation's debt. The additional strain on government funding due to the lost revenues of the tax gap pressures the government to cut funding and services. Unfortunately, as a result, compliant taxpayers often face higher tax rates as part of the government's efforts to collect the lost revenues from the tax gap (Sahadi 2007, 1).

The largest portion of the tax gap, \$109 billion, is attributable to individual business income (Tax Year 2001 Federal Tax Gap 2007, 1). Individual business income is income attributable to a business operation that is reported on a Schedule C attached to an individual's tax return. Small businesses, most commonly operated as sole-proprietorships, along with farmers are the reporters of individual business income. Other major contributors to the tax gap include individual non-business income, self-employment tax and tax underpayments, though none are even half the size of the tax gap resulting from individual business income.

In addition to proposals that are targeted at reducing the tax gap in its entirety, there are a number of proposals that directly address the issue of individual business income due to its large role in the tax gap. The proposals aim at increasing the accuracy of reported individual business, thus reducing the opportunity for underreporting of income to occur. Though the proposals would no doubt have an impact in reducing the size of the tax gap, they also need to be examined thoroughly as they will most likely have a large impact on the operations of the nation's small businesses. The benefits of the proposals must be weighed against the associated costs in order to determine the most effective and efficient ways to reduce the continued problem of the tax gap and tap into one of the nation's viable sources of additional funding.

The remainder of this paper will discuss the tax gap, both as an overall national issue and as related to individual business income. First, the relevance of the tax gap in today's economy will be addressed and background information regarding the tax gap will be provided. Next the small business environment will be examined, focusing on why the tax gap is so prevalent there. Proposed tax gap reduction measures will be

explored, including an examination of the benefits and shortcomings associated with each measure. Future challenges will also be looked at, focusing on the impact such proposed measures will have on the operations of the nation's small businesses. Finally, a recommendation will be given as to the most effective and efficient tax gap reduction strategy in both the short-term and long-term.

## **II. THE RELEVANCE OF THE TAX GAP**

The existence of the tax gap has a large impact on the public and is of great importance, requiring immediate attention by our nation's government. A consequence of the tax gap can be seen in the reduced level of taxpayer resources. The purpose of taxes is to fund government activities that benefit members of a nation's society. The government structures the types and levels of services it plans to provide based on the amount of funding it will receive, mainly through tax revenues. As the level of revenues and available funding is decreased due to uncollected taxes, it becomes increasingly difficult for the government to offer the intended services (Lewis 2008, 4). The government is then faced with the decision of decreasing the level of government services to align with the reduced level of funding or attempting to increase the level of available funding. The level of available funding may be increased by shifting the tax burden to compliant taxpayers through taxing them at higher rates or through increasing the national debt, consequently resulting in higher interest payments on the increased debt as well. Regardless of the choice the government makes, the elimination of the tax gap would increase taxpayer well-being either through a reduction in tax liabilities or through an increase in the amount of government services offered (Lewis 2008, 4).

Public opinion of the tax system is also affected by the existence of the tax gap. Many taxpayers question the integrity of the tax system due to the high level of uncollected taxes. The system appears ineffective and unfair because all taxpayers are not held responsible for their justly owed tax liability. As this happens, members of society begin to lose trust in the government as a capable financial manager. Though the extent to which a negative opinion of the tax system reduces taxpayer compliance is unknown, it could potentially lead to taxpayers questioning why they must pay their fair share of taxes if their neighbors are going to get away with not paying their share. The negative opinion of the government's ability to successfully collect taxes could potentially be reflected in a reduced level of support for the operations of the federal government as their ability to operate efficiently and effectively is questioned (Lewis 2008, 4).

The tax gap is a continued area of government focus because it has the potential to provide substantial additional government revenues. The United States Senate has been presented with and is currently evaluating a tax gap reduction strategy, as generated by the United States Department of the Treasury. The measures are summarized in a report issued in August 2007. The tax gap reduction strategy consists of seven key areas of focus: reduce opportunities for evasion, make a multiyear commitment to research, continue improvements in information technology, improve compliance activities, enhance taxpayer service, reform and simplify the tax law, and coordinate with partners and stakeholders (Reducing the Federal Tax Gap 2007, 19). After extensive analysis and revision, the chairman of the Senate Finance Committee, Democratic Senator Max

Baucus, feels “very encouraged and believes that it is an important step toward fairer and more efficient tax administration” (Phillips 2008, 5).

Additionally, President Bush’s 2008 budget emphasized the increased taxpayer compliance component of the reduction strategy. The component called for sixteen measures to be put in place. The measures can be simplified into four key areas of focus: expanding information reporting, improving compliance by businesses, strengthening tax administration and strengthening penalties (Reducing the Federal Tax Gap 2007, 20-22). The proposed measures to increase taxpayer compliance are estimated to bring in \$29 billion of additional tax revenue over the next decade. While this amount is sizeable, it must be understood that this is a meager \$2.9 billion per year compared to the yearly tax gap of \$365 billion. Some tax analysts counter that the additional revenues may be higher as voluntary compliance increases as the public becomes aware of a more enforcement focused IRS (Sahadi 2007, 1). Even with the additional revenues as a result of increased voluntary compliance, measures beyond these aimed at increasing taxpayer compliance would need to be put in place in order to significantly reduce the size of the tax gap.

The Democratic leadership that currently is in control of Congress has continually emphasized their commitment to deficit reduction. Chairman for the Senate Finance Committee, Democratic Senator Max Baucus, recently emphasized the great importance and urgency of improved tax collection when he told Treasury Secretary Henry Paulson that “we’re not asking for the moon. We’re asking for more than one cent on the dollar” (Sahadi 2007, 1). Tax collection is very challenging because of the continuous resistance of taxpayers; no one wants to hand their money over to the government. Baucus



understood this and knew that the tax gap will never be completely eliminated because of the opposition to increased taxes. He made it clear that such opposition is no excuse for the existence of the tax gap and without further action the tax gap could potentially spiral out of control. In fact he has pressured the IRS to reduce the size of the tax gap by \$30 billion a year, more than ten times the proposed amount presented in the Treasury plan (Tuccille 2008, 4). As Congress continues to look for additional government revenues due to an extremely strained Federal budget, pressure will continue to be applied to tax gap reduction strategies.

In addition to Congressional support, all honest American taxpayers should demand that action be taken immediately to reduce the tax gap. Many taxpayers are not aware of the size of the tax gap, yet it has a direct impact on the amount of their tax liabilities and therefore should be of importance to them.

Unless you are personally cheating by one-fifth or more [the percent the tax gap represents of the total national tax liability], you should be mad at the IRS- not because it's too vigilant, but because it's not nearly vigilant enough. Why should you pay your fair share when the agency lets a few hundred billion dollars of other people's money go uncollected every year? (Dubner 2006, 1).

The reduction of the tax gap should be made a priority of all compliant taxpayers.

### **III. A BACKGROUND ON THE TAX GAP**

The tax gap has long been a concern of the Internal Revenue Service (IRS). As part of the Taxpayer Compliance Measurement Program, periodic studies of taxpayer conformity were completed beginning in 1963. However, the program was discontinued in 1988 because the costs were thought to be too high, both financially and through

additional burdens felt by the taxpayer due to the intrusive nature of the program (Lewis 2008, 4).

The recent commitment of reducing the tax gap by the new Assistant Attorney General for Tax, Nathan Hochman, has reestablished an IRS research effort. In order to determine the areas with the largest compliance issues, the IRS launched the National Research Program (NRP) in 2001. The NRP was designed to measure the level of compliance of individual taxpayers and did not examine the corporate tax gap. It was a three year project that examined returns from 2001. More than 46,000 tax returns were randomly selected and intensively reviewed. The results were released in 2005 and provide the latest estimates for the extent and makeup of the tax gap (Understanding the Tax Gap 2005, 1). Although the percentage of tax liabilities the tax gap represents has most likely not changed since the National Research Program conducted its study in 2001, the absolute size of the tax gap has presumably increased at the same rate as economic growth. Therefore, the size of the tax gap is most likely larger than the \$345 billion it was found to be in 2001 simply because there is a larger real amount of taxes due now as compared to seven years ago (Lewis 2008, 3).

When discussing the tax gap, it's important to understand the difference between the gross tax gap and the net tax gap. The gross tax gap is the total difference between income taxes due and income taxes paid when tax returns are originally filed. Through the NRP the gross tax gap was found to be \$345 billion. On the other hand, the net tax gap is the gross tax gap adjusted for the taxes collected through IRS enforcement activities and late payments. The net tax gap is \$290 billion (Tax Year 2001 Federal Tax Gap 2007, 1). In regards to research efforts, the gross tax gap is the tax gap of concern

because it illustrates the problem in its entirety and is the amount ideally achieved if taxes due equal taxes collected. The tax gap referred to further is the gross income tax gap.

The tax gap is made up of three components: nonfiling, underpayments, and underreporting. The tax gap attributable to citizens not filing tax returns is \$27 billion, or 8 percent of the tax gap. Failure to fully pay the reported tax liability on a filed tax return accounts for \$34 billion, or 10 percent of the tax gap. The largest share of the tax gap is due to the underreporting of taxpayers' tax liabilities. This is attributed to both understating taxpayer income and overstating taxpayer deductions. Underreporting composes \$285 billion, or 83 percent of the tax gap (Tax Year 2001 Federal Tax Gap 2007, 1).

The underreporting segment of the tax gap can be further broken down to aid in analysis and reduction strategy development. Categorical listings include individual income tax (\$197 billion), corporation income tax (\$30 billion), employment tax (\$54 billion), and estate and excise tax (\$4 billion). The individual income tax portion makes up the largest segment, accounting for \$197 billion of the tax gap (Tax Year 2001 Federal Tax Gap 2007, 1).

The tax gap attributable to individual income taxes can be segmented further into underreported non-business income (\$56 billion), underreported business income (\$109 billion), overstated adjustments, deductions and exemptions (\$15 billion) and overstated credits (\$17 billion). As a component of the overall tax gap, individual business income accounts for 31.6 percent of the tax gap, the largest single segment (Tax Year 2001 Federal Tax Gap 2007, 1).

The individual business income component of the tax gap contains four subdivisions: nonfarm proprietor income, farm income, rents and royalties income and partnerships, s-corporations, estate and trust income. Nonfarm proprietor income was found to be the largest contributor with a contribution to the tax gap of \$68 billion, misreported by 57 percent. Farm income had a much smaller real impact with a tax gap of \$6 billion, but was found to be misreported by 72 percent. Rents and royalties contributed \$13 billion to the tax gap, misreported by 51 percent, while partnership, S-corporation, estate and trust income contributed \$22 billion, misreported by 18 percent (Tax Year 2001 Federal Tax Gap, 3).

#### **IV. THE SMALL BUSINESS ENVIRONMENT**

Nonfarm proprietors are the largest single contributor to the tax gap. It's important to first understand who these taxpayers are and how they operate before determining the appropriate proposals to reduce the size of the tax gap attributable to such income. Nonfarm proprietors are commonly referred to as small businesses. Small businesses are unincorporated. The income resulting from business activities is attached to the individual income tax return of the owner, a Form 1040. The attached form showing the business income and expenses is a Schedule C.

The majority of what are commonly termed small businesses operate in the form of sole proprietorships. In fact, sole proprietorships account for 72 percent of all businesses in the United States. Though the number of sole proprietorships is quite large, they make up only 4.8 percent of all business receipts (US Government Accountability Office, Tax Gap 2007, 5). Tax returns containing a Schedule C now

account for more than 15 percent of all individual tax returns (Committee on Small Business 2005, 14). In 2003, 20.6 million such tax returns were filed in conjunction with the nation's sole proprietorships. Over 13 million of these tax returns, or 62 percent, reported gross receipts of less than \$25,000. This demonstrates the large number of businesses that appear to be run as a side business rather than as the primary income generator for such individuals. Furthermore, of the original 20.6 million tax returns that include individual business income, only 15 million tax returns, or 73 percent, reported net income, illustrating the large number of businesses that operate at a loss (Satagaj 2007, 3).

As found in the National Research Program study of the tax gap, sole proprietorships frequently misreport their income. In fact, sole proprietor income was underreported by \$68 billion, or 57 percent. As with all underreporting estimates, this number is likely to be understated as detecting underreported income in a very difficult task (US Government Accountability Office, Tax Gap 2007, 3).

The extent to which sole proprietors misreport tax liabilities varies. The lower half of taxes misreported by sole proprietors were understated by less than \$903. On the other hand, the upper 10 percent of misreported taxes were understatements of more than \$6,200. In fact, "the 11.2 million sole proprietors at and below the 90<sup>th</sup> percentile understated their taxes by a cumulative \$14.3 billion. The remaining 10 percent (1.25 million) above the 90<sup>th</sup> percentile understated a cumulative \$22.6 billion in taxes, accounting for 61 percent of the total" (US Government Accountability Office, Tax Gap 2001, 15). This characteristic of sole proprietor misreporting is significant because it must be considered when evaluating reduction strategies. Because the vast majority of

sole proprietors are misreporting their taxes by a relatively small amount, the added costs to such businesses must be evaluated to ensure that they do not outweigh the small gain in tax accuracy for those businesses.

Currently the IRS targets sole proprietor compliance through two key methods, the Automated Underreporter Program and audits. Though effective when applied, a very limited number of sole proprietors actually come in contact with either effort. The Automated Underreporter Program (AUR) matches information submitted by third-parties, often through Forms 1099-MISC, to that submitted by sole proprietors. It contacts only 3 percent of noncompliant sole proprietors, as only about a quarter of all sole proprietor revenue is submitted by third-parties. Audits are performed on even less noncompliant sole proprietors, at a mere 2 percent contact rate (US Government Accountability Office, Tax Gap 2007, 3-4). These methods do decrease the level of noncompliance present in sole proprietor tax returns, yet because of their limited contact rate other methods need to be put in place as well.

In examining the tax gap attributable to small business income, it's easy to charge such business owners as liars and cheats. Yet the environment and organizational structure must be considered, noting that cheating seems all but impossible to resist. "The small business crowd steals, not because they're worse morally than anybody else, but because they have the opportunity. Mom and Pop are running the business, and they have access to the cash register and to the other records. They can do it without the participation of a lot of people," said Sheldon S. Cohen, IRS commissioner during the administration of President Lyndon B. Johnson (Sawicky 2005, 24-25). The small business environment offers unique challenges to tax enforcement. Though it's a

difficult area of noncompliance to tackle, its large impact on the tax gap makes it an absolute necessity.

## **V. PROPOSED TAX GAP REDUCTION MEASURES**

The tax gap can be attributed to all segments of government taxation, resulting in proposals that reach across taxpayer groups. Nonetheless, individual business income is by far the largest contributor to the tax gap, thus resulting in some proposals targeted towards small businesses specifically. Because no proposal is able to address all factors that contribute to the tax gap, a number of proposals would need to be implemented in order to make a sufficient attempt at reducing the size of the tax gap, including both proposals targeting the overall tax gap and that resulting from individual business income specifically. It's important to remember that one solution will not fit all problem areas. Additionally, some proposals serve, to an extent, as substitutes for each other; if one proposal were to be put in place, the implementation of others would not be as necessary.

The five proposals examined below meet multiple tax gap reduction objectives, addressing both the overall occurrence of the tax gap and the losses specifically related to individual business income. Increased IRS funding, restructured enforcement efforts, tax simplification and improved taxpayer education and assistance all address the tax gap in its entirety. The benefits felt by such strategies would reach outside the small business community. Alternatively, the proposal of additional third-party reporting is meant to target the tax gap resulting from individual business income and would have no effect on the tax gap arising from other areas. No single strategy is intended to solve the tax gap

single-handedly, making the ideal tax gap reduction strategy a combination of more than one of the following proposals.

*A. Increased IRS Funding*

The IRS collects 95 percent of the revenues that fund the federal government, meaning the existence of our government directly depends on the successful operation of the IRS. The IRS faces continued pressure to minimize costs, similar to the pressure felt by all government agencies. Yet at the same time the demands felt by the IRS to improve performance by maximizing tax dollars collected has increased (Budget in Brief FY 2008: Appropriated Accounts 2007, 3). This creates an internal challenge that needs to be addressed; expectations related to increased IRS collections must be examined against the decrease in IRS funding.

Former IRS Commissioner, Charles Rossotti, saw the reduction in funding combined with increased taxpayer demands as the direct cause of the tax gap, as he told the IRS Oversight Board in 2002:

The source of this problem is two conflicting long-term trends: one, ever increasing demands on the tax administration system due to rapid growth in the size and complexity of the economy; and two, a steady decline in IRS resources due to budget constraints. The cumulative effect of these conflicting trends over a 10-year period has been to create a huge gap between the number of taxpayers who are not filing, not reporting or not paying what they owe, and the IRS' capacity to require them to comply (Rossotti 2002, 14).

The coupling of these two factors has led to a deterioration of IRS performance.

Additional government funding is required in order for the IRS to adequately serve its function as the enforcer of taxpayer compliance.

The IRS budget is composed of three main funding areas: taxpayer services, enforcement and operations support. The taxpayer services component provides



education and assistance to taxpayers and during 2008, received appropriations of \$2.1 billion. The enforcement component, mainly responsible for taxpayer audits, accounts for the largest share of the IRS budget with \$4.9 billion of appropriations in 2008.

Operations support is the information technology function of the IRS and received \$3.7 billion in government appropriations in 2008 (Budget in Brief FY 2008: Appropriated Accounts 2007, 1).

After adjusting for inflation, IRS funding levels have remained static since the mid-1990s. The enforcement component of the IRS has felt the largest strain due to funding limitations. In 1995, the enforcement function received \$4.43 billion in appropriations. By 2006 that amount had only increased to \$4.465 billion. Because the economy is continuously growing, 42 percent between 1995 and 2006, the funding level has not kept up with the additional pressures put on the enforcement function. The number of tax returns had increased by 11 percent over the same period. Additionally, by year 2006, the 1995 funding had lost 36 percent of its value due to inflation (Lewis 2008, 5). All of these factors combined mean the enforcement branch of the IRS is under extreme pressure to produce a continued level of results while operating under an increasingly strained budget.

The IRS is an unusual government agency in the fact that additional investments in IRS funding result in a return. As more IRS agents are hired, they are able to collect additional tax dollars through enforcement activities, resulting in a return on investment. The IRS Oversight Board recognized the presence of such a return in their review and approval of 2008 IRS budget requests. "According to the IRS, there is generally a direct four-to-one return on every dollar invested in tax law enforcement. Moreover, there is a

positive but difficult-to-measure indirect effect of IRS service and enforcement on taxpayer voluntary compliance, which can be of greater magnitude than four-to-one” (Internal Revenue Service Oversight Board 2008, 9). The ability to generate a return on investment is a huge factor that needs to be considered when discussing increased IRS funding, as a dollar put into the IRS will result in a net gain of at least three dollars of additional government revenue.

Taxpayer audits are a large portion of the work performed by the enforcement branch of the IRS. Audits are very labor intensive. The extent to which the IRS is able to audit a sufficient number of taxpayers is largely dependent on the workforce of the IRS and therefore, related to the funding of the IRS. During the period of 1995 to 2006, the number of IRS employees decreased from 114,000 to 92,000, a drop of 18 percent. Revenue agents and officers, the IRS employees responsible for performing audits, decreased at an even greater rate of 35 percent (Lewis 2008, 6). The decrease in staff levels has decreased the number of audits performed while the increased number of tax returns has created an increased demand for audits.

Audits are an essential element of the IRS effort to expand taxpayer compliance. Because the majority of the tax gap is attributable to the underreporting of tax liabilities due to understating income or overstating deductions, audits are a fundamental tool used to determine the lawful taxpayer liability. In 2006, 1.4 million individual taxpayer audits, or 0.8 percent of all filed tax returns, were performed finding that taxpayer liabilities were understated by \$43.95 billion on the returns that were audited. That is about 2.5 percent of the total amount of tax revenues collected (Lewis 2008, 7). This is a significant amount of additional government tax revenues that would have been forgone

without the efforts of IRS auditors, thus making the case that audits are an essential feature of the IRS tax collection process.

Yet over the last decade there has been a decline in the number of audits performed and the percentage of tax returns that were audited. In 1996, 1,942,000 audits were performed (US Government Accountability Office, Tax Gap 2007, 13) with an audit coverage rate of 1.67 percent (Lewis 2008, 7). The number dropped to 618,000 by year 2000, a decline of over 65 percent (US Government Accountability Office, Tax Gap 2007, 13), dropping the audit coverage rate to 0.5 percent (Lewis 2008, 7). Though the number of audits has since increased and was at just over 1,000,000 for 2006 (US Government Accountability Office, Tax Gap 2007, 13), the number is still far less than those performed in the past and has not kept up with the increase in economic activity and number of returns filed.

Audits have been identified by tax experts as a viable way to reduce the tax gap associated with small business income. Former IRS Commissioner, Sheldon S. Cohen, saw them as an essential tool for small business tax gap reduction, as the high level of variability within the small businesses causes challenges for most other approaches.

Small businesses are so varied; you can't have a cookie-cutter solution. You've got a small consultant firm that does economic consulting, and you've got one that does accounting, and you've got one that does law, and you've got one that runs a grocery store, and one that runs a sewing shop. Each one has a different problem. It's like saying you could have one universal accounting system that will work for everybody. You can't, because the systems are too varied (Sawicky 2005, 25)

Cohen saw the solution lying in increased audits, as they were able to provide individual taxpayer assistance tailored to a specific business' environment. For example, the tax gap reduction proposal of additional third-party reporting of credit card sales would not

be applicable in a business that has very minimal credit sales, for instance coffee shops, yet would likely be very beneficial in other industries, like an auto repair shop. Audits allow the IRS agent to look at the specific situation of the business and work from there, rather than trying to force each business into the same context.

The IRS seems to have agreed with the importance of Schedule C audits, as the audit coverage rate has increased drastically in recent years. From 2001 to 2006, the number of audits containing a Schedule C increased by 132 percent, with an audit coverage rate of about 3 percent for 2006. None the less, as business income is the largest contributor to the tax gap, additional audits would still be greatly beneficial. Because Schedule C audits are much more complex, they cost about 50 percent more to complete than non-Schedule C audits, making the case for further increases in IRS funding in order to allow for an optimal increase in business income examinations (US Government Accountability Office, Tax Gap 2007, 22).

Increased enforcement efforts would undoubtedly have a strong impact on the reduction of the tax gap. In addition to the direct increase in tax dollars collected, voluntary tax compliance would also most likely increase. Currently, when taxpayers were asked as part of an IRS Oversight Board poll what motivates them to report and pay their taxes honestly, fear of an audit was the response of 62 percent of the participants (Dubner 2006, 1). Consequently then as the number of audits increase, the public's fear of being selected for an IRS audit also increases and therefore affects the accuracy at which tax returns are prepared. Thus, as the level of enforcement activities increases there is a dual effect on tax revenues, first an increase due to direct dollars collected through uncovering underreported tax liabilities and secondly through increased

voluntary compliance. The increased enforcement efforts would have to be maintained over the years in order to maintain taxpayer honesty. If the increased enforcement efforts were allowed to taper off, taxpayers would likely fall back into their old habits of underreporting income and overstating deductions as they saw their chance of audit selection decline.

Increased IRS funding is a difficult proposal to pass in the legislature. Politicians are apprehensive about supporting such a bill because of the negative response from constituents. People don't enjoy paying taxes, so by increasing funding to the IRS you are strengthening the agency that collects money from citizens as well as possibly increasing the rate of taxation in the short run in order to pay for the additional funding. But it also must be remembered and stressed that increased IRS funding actually results in a return on investment, meaning tax rates may be allowed to decrease in the long-run as previously uncollected taxes are recovered through additional enforcement activities. It will definitely be a challenge for increased IRS funding to become reality, but the strong benefits and return associated with it continue to place it as one of the most obvious and advocated proposals in consideration.

#### *B. Restructured Enforcement Efforts*

Increased IRS funding will allow for an increase in the audit coverage rate, resulting in an increase in taxpayer compliance and a reduction of the tax gap. An even greater reduction in the tax gap due to increased enforcement efforts would be realized if the audit function was restructured. Taxpayer audits would yield much higher returns if they were targeted to specific problem groups of taxpayers. Small businesses are often

named as such a group being they are such large contributors to the tax gap and clearly have compliance issues (Block 2008, 2).

As demonstrated previously, as a group begins to experience audits at a higher rate, word is passed among the group and voluntary compliance increases. IRS Taxpayer Advocate Nina Olson provides an example demonstrating this effect on the problem group of sole proprietors paid in cash. If the IRS audited one New York hot dog vendor, he would likely talk about it with other vendors. This would cause the other vendors to increase the reporting of the cash income they receive out of fear of an audit, therefore increasing voluntary income reporting. Olson says a targeted technique is much more effective than the “scattered audits” that are currently taking place (Block 2008, 2). Of course, the level of taxpayer audits must be maintained in order to continue the increased level of voluntary compliance. As soon as the risk of audit is seen to have decreased, it is likely taxpayers will revert back to old, less honest tax reporting.

Taxpayer audits definitely have a part in tax gap reduction, but it is important to remember the limits they hold, as even the IRS has acknowledged. Former IRS Commissioner Mark Everson stated, “We can never audit our way out of the tax gap” (Everson 2007, 15). While increased and restructured enforcement efforts will decrease the occurrence of unreported revenues due to both audit corrections and voluntary compliance, other measure must be put in place as well.

### *C. Simplified Tax Code*

The tax system of the United States is one of the most complex in the world. Only four nations have more pages of “primary tax legislation” than the United States (PricewaterhouseCoopers and World Bank 2006, 17). This causes taxpayers that want to

report their tax liability in accordance with the tax law great difficulty. They are often unsure of the applicable tax law or how to properly apply it. This results in the tax liability often being misstated and contributing to the tax gap. Complexity is also a continued challenge for IRS enforcement efforts, as “individuals who seek to pay less than what they owe often hide behind the Code’s complexity in order to escape detections by the IRS and pay less” (Committee on Small Business 2005, 4).

The impact the complexity of the tax code has on the tax gap has been recognized by the former IRS Commissioner, Mark Everson, in testimony to the House Budget Committee. He said, “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” (Everson 2007, 13).

The overwhelming amount of complex tax law makes it very difficult for even the most willing taxpayer to report their tax liability in full accordance with that legally owed. Small business owner Dennis Waters, who buys and sells antique photographs, finds the evolving nature of the tax system quite challenging to keep up with. “They don’t make it easy for you. Every year, they’re changing the rules, changing the types of deductions. You can’t plan ahead to try and do something” (Block 2008, 1). Waters illustrates that a portion of the tax gap is attributable to honest taxpayers making honest mistakes because they are not able to properly apply the increasingly complex tax law to their businesses. A simplified tax code would increase the accuracy of reported business income because taxpayers would be able to distinguish the tax law that applies to their situation.

Changes to the current tax system could come in several fashions, but all would result in additional tax revenues because of increased compliance. The Code could be harmonized to provide unified definitions of tax related concepts. Also credits and deductions could be combined, which would decrease the number of opportunities taxpayers would have to manipulate their tax returns in order to qualify for a credit or deduction (Sahadi 2007, 2).

Simplification was an underlying theme in many of President Bush's proposals to reduce the tax gap, but has since then not received much attention, most likely due to the high short-term costs associated with a tax system overhaul (Sahadi 2007, 2). Studies must be completed to determine the effectiveness of simplification strategies, legislative approval must be passed and tax preparers must be educated. Some people advocate a complete overhaul of the current tax system in which the entire Code would be rewritten. A proposal that recently received attention was the FairTax plan in which a national sales tax would be used in replacement of the income tax. The challenge to such a policy is the high cost of change in the short-run. It is possible that the tax gap would be greatly reduced in the long-run through a drastic simplification effort, but the upfront costs to the public would be very high, often discouraging such drastic proposals.

The savings felt by a tax simplification strategy are immense due to the great amount of resources currently expended on tax preparation. In fact, Americans spent \$279 billion in 2006 in association with the preparation of their tax returns. This amount is close to the size of the tax gap. Some proponents of tax simplification argue that in simplifying the tax code the government would actually be receiving additional tax revenue because the money saved by individuals in preparing their own taxes could be



reinvested in the economy and create additional tax dollars through the likes of sales or property taxes (Fraser 2007, 1). On the other hand, of course, is the issue that even through tax simplification the costs associated with tax preparation would not be able to be completely eliminated.

When discussing tax simplification it is important to remember that the IRS has limited ability to influence the tax law as the legislature holds that power. The IRS clearly states this distinction as well as their responsibilities in the three prong explanation of the IRS' mission and environment. "In the United States, the Congress passes tax laws and requires taxpayers to comply. The taxpayer's role is to understand and meet his or her tax obligations. The IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share" (The Agency, Its Mission and Statutory Authority, 1). Many people see the complexity of the tax code as a result of the IRS and become frustrated with the Service because of it. In all reality, steps toward tax simplification would need to be driven by Congress, as the role of the IRS is to enforce the laws as established by the legislature. The IRS would most definitely have a part in the simplification of the tax law, as they are the expert branch with the practical experience of tax application, but Congress would be the establishing body for simplification.

Tax simplification is an area that holds great promise in the reduction of the tax gap. The public supports simplification efforts, something that many other proposals, such as increased IRS funding, lack. The effects of simplification would be felt both by taxpayers and the IRS, as both would benefit if the Code became easier to interpret and apply.

*D. Improved Taxpayer Education and Assistance*

Americans are asked to navigate a very complex tax system in determining their tax liability. Without a doubt questions arise. Yet too often taxpayers have trouble attaining sufficient assistance from the IRS. Former IRS Commissioner, Charles Rossotti, expressed confusion as to why the IRS would not be doing everything in their power to ensure taxpayers are getting all the help they need. “I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money” (Sawicky 2005, 15). As Rossotti illustrated, through neglecting taxpayer education and assistance, the IRS is most likely causing taxpayers to misreport their tax liability and increasing the tax gap. Ideally a simplified tax system would make it easier for the ordinary taxpayer to file a tax return. But until measures are taken to make the tax code less complex, the need is still present for government education and assistance for tax return preparation.

The IRS currently provides taxpayer assistance through many means such as outreach and education programs, tax forms and publications, regulations and other published guidance, toll-free call centers, the IRS website, and Taxpayer Assistance Centers. Also, during tax season additional taxpayer assistance services are provided, including Volunteer Income Tax Assistance and Tax Counseling for the Elderly, which both provide free return preparation for qualified taxpayers (Reducing the Federal Tax Gap 2007, 42). These methods do currently provide some level of taxpayer assistance, though expansion, as well as introduction of new methods would definitely be greatly beneficial in improving taxpayer understanding.

Increasing taxpayer service will reduce unintentional errors. “Given the increasing complexity of the tax code, providing taxpayers with assistance and clear and accurate information before they file their tax returns reduces unnecessary contacts afterwards, allowing the IRS to focus enforcement resources on taxpayers who intentionally evade their tax obligations” (Office of Tax Policy 2006, 3). Therefore, the reduction of the tax gap through increased taxpayer assistance is two-fold, both increasing the accuracy of reported income by reducing the level of unintentional errors and increasing the amount of time IRS employees have to focus on more severe, deliberate tax evaders.

The taxation of business income is a particular issue that could be benefited through additional education efforts. The rules related to Schedule C filings are very complex. As such returns are normally filed by small businesses, the resources to devote an individual specifically to tax recordkeeping and preparation are most likely not available. Instead other individuals, who are not tax experts, do the best they can to maintain records in accordance with tax filings. Because an advanced knowledge of the tax law is not present in most Schedule C filers, additional education efforts would increase the accuracy of such returns and reduce the tax gap attributable to unintentional errors (US Government Accountability Office, Tax Gap 2007, 42).

An increased focus on taxpayer education would likely reduce the number of audits due to a simple misunderstanding of the tax law. The IRS would prefer to limit the time spent on audits to reduce cost and obviously taxpayers prefer not to go through the tedious process. “The IRS will never have enough resources to police everyone and therefore enforce compliance... It would be much easier for a small business owner to

learn how to comply with the tax laws through taxpayer education and outreach than the adversarial audit and collection processes,” said Donald Manzullo, the chairman of the House of Representatives Committee on Small Business (Committee on Small Business 2005, 2). Small businesses, like all taxpayers, dread the thought of an IRS audit.

Opportunities to receive tax assistance and education would be a preferable option to all small business owners and would also benefit the IRS, as the accuracy of returns would be increased.

#### *E. Increased Third-party Reporting*

Required third-party reporting of income greatly increases the accuracy of tax returns. In fact, 68 percent of taxpayers surveyed through an IRS Oversight Board poll responded that the fact their income was being reported to the IRS by third parties motivated them to report and pay their taxes honestly (Dubner 2006, 1).

Compliance is the highest when there is third-party reporting along with tax withholding, such as Social Security taxes withheld from wage earner’s income. Compliance is the lowest when there is no withholding or third-party reporting, often the case in the operation of most small businesses.

The contrast is clearly evident when examining the tax gap that arises from different income sources. Wage income, sent to the IRS through the issuance of a W-2 and also subject to mandatory tax withholding, has the highest compliance rate. Wage income is misreported by only 1 percent, accounting for \$10 billion of the tax gap. Income subject to third-party reporting, but no withholding experiences a higher rate of noncompliance. Such income, like interest income and dividends, are misreported by 4.5 percent. The noncompliance rate is even higher, 8.6 percent, for income subject to

less extensive third-party reporting, such as alimony or capital gain income. On the extreme, income subject to very minimal, if any, third-party reporting and no tax withholding are misreported at a much higher rate as illustrated, for example, by nonfarm sole proprietor income, which is misreported by 57 percent (Office of Tax Policy 2006, 7-8).

As established by Statement of Auditing Standards Number 99 issued by the Auditing Standards Board, fraud is likely to occur when the opportunity is present, pressure or incentive exist and rationalization of the act is possible (Statement of Auditing Standards Number 99, 2002). When there is no third-party reporting, such as a restaurant operated as a sole proprietorship, the opportunity exists for the owner to misreport the business' income, thus allowing fraud. This is a stark contrast to the treatment of wage income. "The wage earners' taxes are automatically withheld from every check, while the restaurateur has all year to decide if, and how much, he will pay" (Dubner 2006, 1).

The incentive to cheat also exists in a small business environment. "Does this mean that the average self-employed worker is less honest than the average wage earner? Not necessarily. It's just that he has much more incentive to cheat. He knows that the only chance the IRS has of learning his true income and expenditures is to audit him. And all he has to do is look at the IRS's infinitely small audit rate... to feel pretty confident to go ahead and cheat" (Dubner 2006, 1).

Information reporting is already present to some extent, as small businesses often prepare and receive Forms 1099-MISC. Small businesses are required to complete a Form 1099-MISC for all service payments of \$600 or greater made to non-incorporated

organizations. The most common situation requiring the form is payments to subcontractors (Third-Party Reporting Reminders 2006, 1). Because subcontractors and the like do not receive wages reported on a W-2, their income is much more prone to misreporting. The use of Forms 1099-MISC are meant to target subcontractor income and create an element of third-party reporting similar to a W-2.

Sole proprietors must make a number of observations to determine if a 1099-MISC is required, given that there are a number of exceptions that do not require the form. First it must be determined if the payment is going to an incorporated organization, as these organizations are exempt from 1099-MISC preparation. It also must be understood if the service provider is an employee or subcontractor, as employees receive Forms W-2 instead (US Government Accountability Office, Tax Gap 2007, 7). This can be quite a complex process.

Each year the Automated Underreporter Program receives more than 80 million Forms 1099-MISC. The program has on average generated about 371,000 notices each year due to discrepancies between 1099-MISC filings and that reported by the sole proprietor. This has on average resulted in more than \$665 million of additional tax revenues each year (US Government Accountability Office, Tax Gap 2007, 20). Forms 1099-MISC do have an impact on the amount of income that is misreported as demonstrated by the level of additional revenue generated through its implementation. Yet the effectiveness is limited as Forms 1099-MISC are not required for all business transactions. Additional third-party reporting should be explored as 1099-MISCs and the AUR program have experienced a level of success that could be increased through additional third-party reporting requirements.

One commonly expressed concern associated with increased third-party reporting is the ability of the IRS to handle the additional data. The IRS currently receives an enormous amount of information each year, approximately 1.5 billion data returns in 2005 (Sullivan 2007, 3). The additional third-party reporting would drastically increase the amount of data the IRS currently receives. The issue would have to be addressed as to whether the current IRS information technology system would be able to accommodate the increase in filed information. Significant changes to the technology infrastructure may be required due to the increase in third-party reporting. The benefits from the additional information would need to be weighed against the costs associated with such information system advancement.

Though additional third-party reporting requirements would decrease the amount of income that goes unreported, it would also cause additional effort on the parts of many. “No one wants to be obligated to file a document with the IRS every time he or she takes a cab ride, has someone mow their lawn or calls a plumber to fix a broken faucet,” says the IRS’s National Taxpayer Advocate Nina Olson (Fraser 2007, 1). There must be a balance between additional accuracy and effort required.

Some have suggested that individuals or businesses should be required to withhold a certain percentage of payment to independent contractors, as independent contractors mainly report their income as part of individual business income, likely contributing to the tax gap. The IRS would benefit as there would be a check put in place to ensure the full amount of income was being reported by independent contractors. Yet the withholding would closely resemble that found in an ordinary employer-employee relationship. Currently businesses benefit from hiring independent contractors as they are

not required to provide health care coverage or retirement benefits. They also do not have to pay employee payroll taxes (Stump 2004, 1). But if the independent contractors had a portion of their income withheld as taxes, the distinction between employee and contractor would be blurred. “Does the contractor then become a different class of employee and will [they] lose all of their tax incentives for being ‘independent’?” said Leonard Steinberg, a small business tax consultant (Kerrigan 2006, 2). The challenge in withholding would be the tendency toward an increasingly employee-like relationship, negating the benefits found in hiring independent contractors.

One such proposal for increased third-party reporting that specifically targets the small business community is the reporting by credit and debit card issuers of electronic payment transactions. Companies such as MasterCard, Visa or American Express would have to report the amounts businesses received through payments in the form of credit or debit cards. This proposal would be relatively simple to implement and should require minimal effort on the part of the credit card companies, as they already provide the information to the businesses themselves. Forwarding the amount to the IRS should not be overly burdensome, yet quite beneficial to compliance efforts (Nellen 2008, 2).

The IRS would then use the data to create industry profiles illustrating the average percent of income earned through credit and debit cards for a particular industry. For example, the IRS might come to the conclusion that book stores earn 40 percent of their income from credit and debit card sales. Tax returns would then be analyzed against their particular industry average to determine if they were in accordance with the expected results (McLoone 2008, 1). If the percent of sales reported as credit and debit card sales



was much higher than the industry average, it could be an indicator that cash sales have been underreported, resulting in an understatement of the individual's tax liability.

Industry profiles would need to be coupled with increased audits. When a business was identified as possibly underreporting its cash sales, the IRS would need to perform an audit to determine the accuracy of the claim and the increased tax liability because of the underreporting. The creation of such industry profiles would be a valid first step, but would require additional IRS funding and labor to fulfill the purpose it was intended to achieve.

The IRS is a strong advocate of this proposal because, as established, third-party reporting is the most efficient way to gain assurance that the total tax liability is accurate, but also because it comes at the lowest cost to the small business community. The credit card companies are the party required to prepare the reports and forward them to the IRS, requiring no additional actions by the small businesses themselves (McLoone 2008, 2).

Many members of the small business community are opposed to requiring credit and debit card issuers to report electronic payment transactions to the IRS. In a recent statement to a panel of the Senate Committee of Finance, the party reviewing the proposals to reduce the tax gap, The National Association for the Self-Employed (NASE) said they encouraged additional measures to increase compliance, but "the delicate balance between what is reasonable and what is detrimental has shifted to the latter" (McLoone 2008, 1).

The NASE has countered the IRS by saying that the industry averages will be used to unfairly single out businesses that have higher than average credit and debit card sales, often for different reasons. For example, the community makeup in which a

business operates can influence such a trend. The wealth or geographic region could be reasons for a differing level of electronic transactions. Also a business' policies, in terms of the number and types of credit cards accepted, can also play a role in the percent of sales accounted for by debit and credit cards (McLoone 2008, 1).

In order to counter the claim made by the NASE, the IRS would need to put in place measures to ensure that businesses are not unfairly targeted when they hold a legitimate reason for unusual cash to credit sale comparisons. A targeted business could be quickly compared to other small business in the community to examine the average level of electronic transactions in the geographic area. The number of cards accepted could also be determined, providing a possible explanation for the difference in electronic transactions. With the additional information reporting the IRS will have access to a larger amount of data. This will allow the IRS to examine possible businesses in detail before they take the final action of performing an audit. By evaluating the situation thoroughly before performing an audit, businesses will not be subject to unfair targeting because of explainable circumstances.

A possible shortcoming of the proposal is the chance that some businesses will stop offering the ability to pay by debit or credit card because they are afraid they will be unfairly discriminated against because of their natural business tendencies. This cost will be passed along to consumers as it becomes more inconvenient to shop because of the increased need for cash or check as the form of payment.

Third party reporting drastically increases the accuracy at which tax returns are prepared. The most important consideration before joining the cause for third party reporting is the associated costs required in order to comply with the additional reporting

requirements. The burden on taxpayers must be less than the benefits received in order for the proposal to be viewed as viable, yet this is not an easy judgment to make, causing continued debate between the IRS and the small business community.

## **VI. SMALL BUSINESS CHALLENGES TO CONSIDER**

In an ideal world, the tax gap would be nonexistent. For that reason the optimal tax strategy would be one that reduces the size of the tax gap. While a reduction in the tax gap would be beneficial to the financial well-being of the United States, it also involves additional costs felt by some segments of the economy. Because a large portion of the tax gap is attributed to individual business income, some of the proposed measures specifically address small businesses that would report such income. The additional burden felt by small businesses in complying with the proposed measures must be considered in the evaluation of the proposals.

For small businesses, the cost of complying with federal tax regulations is much greater per employee than that felt by large businesses. Large organizations have the benefit of economies of scale, allowing tax specialization of some employees and great cost savings. Organizations with 20 or less employees incur \$1,304 per employee to comply with federal taxes. Organizations with 500 or more employees incur \$780 per employee. That being said, small businesses incur 40 percent greater costs than large businesses as related to federal tax compliance (Sullivan 2007, 2). Additionally, most small businesses do not have full time staff to devote to tax compliance issues. Instead they are forced to hire tax help from outside organizations. Also, small business owners are also likely to devote a portion of their valuable time to tax issues, thus drawing their

attention away from issues related to successful business operation (Committee on Small Business 2005, 6). Large companies, on the other hand, have staff devoted solely to tax minimization efforts and top business executive do not have the additional burden of tax oversight.

The current tax environment puts a strain on the small business community as they often do not have the resources to spend on the non-value added business transaction of tax preparation. Though the tax gap would be minimized by the proposed measures there would undoubtedly be an effect on the small business community and place further strain on the already tight situation. The challenge that is most often faced by the small business community is one of simple inability. So often the businesses want to comply with the tax law but are unable to because of the complexity and the cost associated with doing so. As previously stated, small businesses do not contribute to the tax gap because they are less honest individuals, but rather because they are faced with increasingly complex tax law, do not have access to the resources to ensure complete compliance and simply are given the opportunity to misreport their income. Tax gap reduction measures must be tailored to fit the unique environment of the small business community, ensuring that they do not bear an excessive burden in complying with the additional requirements.

## **VII. CONCLUSION**

The tax gap is an area that requires continued government dedication. Allowing the issue to continue to exist and expand is harmful to the nation in many ways. As government tax revenues received are less than that lawfully owed, the extent of government funded services is reduced. Citizens' opinion of the tax system is also

harmed, as the fairness of the system is questioned. This can further lead to additional tax noncompliance because taxpayers are more likely to misreport their income if they believe they will not be caught or do not feel morally obligated. Immediate actions need to be taken in order to prevent further negative effects of the tax gap.

The proposals presented all hold great benefits in increasing taxpayer compliance. Yet as with most anything of value, there are also associated costs. Tax simplification is greatly promising, as it would positively affect all segments of taxpayers and the IRS as well. The process would most likely be slow, as legislative commitment would need to be present, yet the benefits derived from it would undoubtedly be great. The area of tax simplification is a needed component of tax gap reduction, but it cannot solve the issue in its entirety as it does not address the deliberately noncompliant taxpayer.

Tax evasion must be addressed as well, with reduction coming from increased and restructured enforcement efforts. The IRS is responsible for collecting the vast majority of government funding. Without success on their part, the operation of the government would be in jeopardy. For that reason, it is a profitable investment to increase IRS funding. As the IRS is able to complete more audits due to greater funding they will be able to bring in additional tax revenues, offering a return on the government's investment. Another component of increased IRS funding is the additional education and assistance methods that would become available to the public. This would improve voluntary compliance as taxpayers would be better able to apply the Code. If a strong tax simplification effort is put in place, the need for additional taxpayer education and assistance would be reduced, demonstrating the substitutive nature of reduction proposals. Public opinion must also be considered in increasing IRS funding. The

nation's citizens are not fond of the idea of increased IRS funding and power, as they view the Service negatively because it reduces their disposable income. Increased IRS funding would definitely be greatly beneficial to tax gap reduction, but the reality of the limits the citizens would impose on such efforts must be realized as well.

Increased third-party reporting is a proposal that would undoubtedly improve compliance, yet comes with very high costs. When requiring additional reporting, the burden placed on taxpayers is increased. Some third-party reporting proposals apply the burden across economic segments, as illustrated in required credit card payment filings. Because of the present availability of the information, the implementation of such proposal would not be overly intrusive. Other methods, such as increased 1099-MISC reporting come with high costs, as additional time and effort is required to file such documents. There is also the continued risk that the requirement of 1099-MISC filings would be ignored, as possible in the cash based transactions of today.

Based on my research of the tax gap and the various proposals presented, I would recommend the strategy of increased third-party reporting and IRS funding to address the tax gap in the short-run. Both methods could be put in place relatively soon, as limited barriers exist to the implementation of either method. Increased third-party reporting would require the additional education efforts in order to ensure it is used properly and increased development of IRS information technology, but would definitely increase the accuracy at which income is reported. An increased level of IRS funding would be a difficult task to pass in the legislature, especially in light of the current economic crisis and resulting government shortages. Yet there is a high return on investment, as the increased funding will result in additional tax revenue collections. If the facts are

presented to illustrate such a return, the proposal could in fact be made a reality. I believe the best reduction strategy in the long-run is a simplification of the Code. I see this proposal as having the greatest benefits because it would improve voluntary compliance, as the opinion of the Code would be more positive, as well as simplifying the audit efforts of the IRS, allowing them to complete more audits in the same amount of time. Tax simplification cannot be rushed into, as the most effective strategies would have to be determined by extensive economic analysis. Though the initial investment in such a strategy would be quite high, the long-term return would be even greater.

The importance of the tax gap should not be understated as the public benefits associated with reductions are quite substantial. Often times the nation's small businesses are targeted as the leading culprit in association with the tax gap. This may be rightly so in many cases where taxpayer noncompliance is deliberate. Yet often the misreporting of business income is due to a high level of complexity associated with such returns. Tax gap reduction strategies must consider both intentional and unintentional misreporting in order to be as effective as possible. Through continued government focus, the tax gap related to both small businesses and taxpayers in general can be reduced. The task may not be easy, but it is essential for the continued and increased well-being of the nation's citizens.

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