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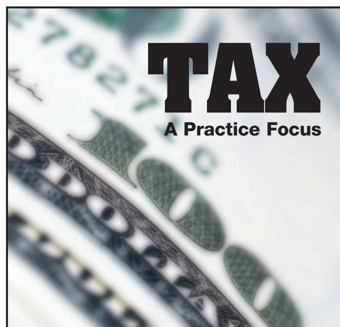
Will Congress Fill the Tax Gap?

Skeptics suggest that collecting that $290 billion is almost as difficult as finding gold at the end of the rainbow.

BY MARC GERSON
AND RYAN McCORMICK

Last October, Mark Matthews, deputy commissioner of the Internal Revenue Service, observed that Washington had acquired a case of "tax-gap fever." The city's obsession with the tax gap has continued to rise since Matthews' prescient observation. Unfortunately for lawmakers, the tax gap is unlikely to serve as a painless source of revenue for tax relief or other priorities.

The phrase "tax gap" refers to the difference between the amount of money that taxpayers *should* pay under the tax laws and the amount of money that they *actually* pay. The most recent study, released by the IRS in 2006, estimates an annual gross tax gap of $345 billion. Late tax payments and amounts recovered through IRS enforcement activities reduce the gap to an annual net amount of $290 billion. Thus, even after enforcement activities, it is estimated that nearly 14 cents of every tax dollar owed to the U.S. government goes uncollected.



When members of Congress, particularly Democrats, declare their intent to repeal the alternative minimum tax, enact new tax incentives for clean energy, or expand health and education tax breaks, they often list reducing the tax gap as one way to pay for their ambitious proposals. For Democrats eager to enact their policy agenda but wary of raising taxes, the politics of the tax gap are irresistible. If Congress could find a way to collect the annual $290 billion in uncollected taxes, legislators could finance their most elaborate proposals without imposing new taxes or increasing the deficit.

The tax gap is a top priority for Sen. Max Baucus (D-Mont.), now chairman of the Senate Finance Committee. Baucus delayed Eric Solomon's confirmation as assistant treasury secretary for tax policy until the administration submitted a comprehensive plan to reduce the tax gap, which it did in September. The administration subsequently included 16 specific legislative proposals in its recent budget submission for the 2008 fiscal year. These proposals would raise an estimated $2.9 billion per year in tax revenue, or just 1 percent of the annual net tax gap.

Skeptics argue that such low numbers prove that a meaningful reduction in the tax gap will be difficult, if not impossible, to achieve. Others argue that specific tax-gap proposals should be combined with additional funding of IRS enforcement efforts or tax simplification proposals to make compliance with the tax laws easier.

MISSING MONEY

The existence of a tax gap is not new; policy-makers have long recognized it and advocated its reduction. The IRS has undertaken detailed studies of the tax gap since at least 1965. However, tax-gap data are woefully incomplete.

The most recent estimate took a fresh look at individual tax returns only. The most recent tax-gap data on corporate, employment, estate, and excise tax returns date back to 1988. Declaring the tax-gap estimate "an unfinished picture," the Treasury Department's inspector general for tax administration recently testified that the IRS "still does not have sufficient information to completely and accurately assess" the overall tax gap and the voluntary-compliance rate.

Measuring the tax gap is extremely difficult, and methods used by the IRS raise additional concerns. For example, the IRS estimate does not take into account changes in tax liability resulting from taxpayer settlements with the IRS or from judicial decisions.

Notwithstanding flaws in the tax-gap methodology, the IRS estimates that more than 70 percent of the tax gap is attributable to unpaid individual income tax, which includes amounts earned by sole proprietors and small businesses operating as S corporations, partnerships, and limited-liability companies. An additional 17 percent is attributable to unpaid employment tax, and 9 percent is attributable to unpaid corporate income

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tax. In other words, the tax gap largely derives from the business activities of small businesses and the self-employed, and they are a politically unpopular target for aggressive enforcement measures.

The largest components of the tax gap are underreporting of income on individual income-tax returns and underreporting of self-employment taxes. Underreporting occurs when taxpayers understate earned income, claim improper deductions, overstate business expenses, or erroneously claim credits. Understated income accounts for more than 80 percent of underreporting by individuals. Many of these individuals generate income in cash transactions that are difficult to track and monitor.

Therefore, despite bipartisan consensus on the overall objective of reducing the tax gap, skeptics emphasize the administrative difficulty associated with improving tax compliance. Treasury Secretary Henry Paulson this year told the Senate Finance Committee that a "large portion of that [tax gap] is not 'gettable' unless we are willing to have much more onerous reporting requirements for income that I wouldn't support." Rep. Jim McCrery (R-La.), the ranking member on the House Ways and Means Committee, has noted that "as attractive as the tax gap may be as a rhetorical target, finding it is almost as difficult as finding the pot of gold at the end of a rainbow."

Elusive Remedies

As noted, less than 10 percent of the tax gap is caused by noncompliance with the corporate income tax. Although large corporations are not the main culprits, they stand to bear a sizable share of the cost imposed by tax-gap proposals.

Several of the proposals under consideration would require corporations to collect and report additional information to the IRS when they act as intermediaries in financial transactions. For example, the Joint Committee on Taxation has recommended requiring brokers to report the adjusted basis of securities to both the IRS and customers at the time of sale. The administration's most recent budget includes a proposal to require that banks processing credit-card payments report gross reimbursements made to merchants. Skeptics argue that these new information-reporting requirements would impose heavy burdens on businesses that are in compliance with the corporate income tax as a means to address noncompliance with the individual income tax.

A more nuanced critique of tax-gap fever holds that overemphasis on the tax gap will consume limited IRS resources and reduce enforcement in areas that are equally important but lack a direct effect on revenue. For example, criminal tax cases can be expensive to prosecute and generate little direct revenue. Yet criminal cases may be important symbolically to maintaining the integrity of the tax system. Likewise, crackdowns on abuse in the tax-exempt sector may not produce immediate revenue but are important for preserving the tax base over the long term. If the IRS had to choose between targeting individuals who are intentionally cheating on their taxes and targeting individuals who are committing inadvertent errors, a strong moral case could be made for going after the tax cheats, even if that produced less revenue and thus less of a reduction in the tax gap.

In the end, although the tax gap packs a rhetorical punch, members of Congress may eventually conclude that enforcement efforts have already picked the low-hanging fruit and what's left on the tree is much more elusive than it appears.

Marc Gerson is a member and Ryan McCormick is an associate at Miller & Chevalier in Washington, D.C. Gerson served as majority tax counsel to the House Ways and Means Committee from 2005 to 2006. *The authors thank colleagues Lawrence Gibbs, Phillip Mann, Leonard Bickwit Jr., and Rocco Femia for their input in preparing this article.* *The authors can be contacted at mgerson@milchev.com and rmccormick@milchev.com.*

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