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Lawmakers May Be Revisiting the Tax Gap

By Larry Brant on 2.12.16 | Posted in Internal Revenue Service, IRS Budget, Legislation, Tax Gap

The Department of the Treasury estimates the annual federal “tax gap” (the difference between what taxpayers should have paid and what they actually paid on a timely basis) exceeds $450 billion. IR-2012-4 (January 6, 2012). This figure correlates with a voluntary tax compliance rate of just shy of 86 percent.

Studies conducted by the National Research Program (“NRP”) conclude that the $450 billion “tax gap” is comprised of three components, namely non-filing of tax returns ($28 billion), underreporting of income ($376 billion) and underpayment of taxes ($46 billion).

On September 26, 2006, the Treasury’s Office of Tax Policy published a document titled “A Comprehensive Strategy for Reducing the Tax Gap.” Subsequent updates on “Reducing the Tax Gap” have been published. In these documents, Treasury emphasized its renewed commitment to dramatically reduce the tax gap.

Four key principles are set forth in these documents to guide IRS efforts to improve compliance:

- Address both unintentional taxpayer errors and intentional taxpayer evasion;
- Target sources of noncompliance with specificity;
- Combine enforcement activities with commitment to taxpayer service; and
- Policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of a burden on the taxpayer.

To accomplish its goals, these documents set forth several strategies, including:

- Continuing research to unveil common areas of noncompliance;
- Continuing improvements in information technology to enhance detection of noncompliance;
- Continuing expansion of examination and collection efforts;
- Continuing enhancement of taxpayer service to reduce unintentional errors;
- Continuing to seek tax law simplification to reduce unintentional errors, reduce opportunities for evasion, and simplify the Service's job of administering tax laws; and
- Coordinating efforts with local and foreign governments to enhance compliance and collection activities.

In 2006, IRS Commissioner Mark W. Everson stated, in support of the Service's increased compliance activity, that "[t]he magnitude of the tax gap highlights the critical role of enforcement in keeping our system of tax administration healthy." IR-2006-28 (February 14, 2006). Given the size of the tax gap and the fact that federal budget deficits are in the hundreds of billions of dollars, tax compliance should be a renewed priority of the IRS. While we saw a few years ago the IRS begin to increase its audit staff and start auditing taxpayers in greater numbers and more aggressively than in the past years, severe budget cuts have recently derailed this momentum. That said, given that the IRS is virtually the only federal agency that generates revenue, logic suggests lawmakers should work hard to restore the Service's budget.

On February 4, 2016, Senator Ron Wyden (D-OR), ranking member of the U.S. Senate Finance Committee, alerted IRS Commissioner John Koskinen (by letter) that $67 billion of the tax gap each year is attributable to corporations. He advises the Commissioner that a proper analysis of the causes of the tax gap is necessary in order for lawmakers to be able to create effective tools to eradicate it. Senator Wyden, in a direct and strong manner, alerts the Commissioner to some interesting things, including:

- The IRS tracks the portion of the tax gap attributable to corporations based on audit results, but it has no mechanism to track the specific sources of the corporate tax gap; and

- Without knowing the sources of the tax gap attributable to corporations, lawmakers cannot effectively design policies to reduce this portion of the tax gap.

Senator Wyden requested the Commissioner to provide him with certain information before the U.S. Senate Finance Committee's February 10, 2016, hearing on the IRS budget and a more full response within 60 days. He specifically requested:

- A specific explanation of the methodology used to estimate the corporate portion of the tax gap;

- Whether the IRS maintains a centralized repository of corporate audit issues;

- A list of top corporate audit issues and each issue's contribution to the corporate portion of the tax gap;

- A copy of all data and work papers used by the IRS to compute the corporate portion of the tax gap; and

- Any steps the IRS has taken to improve compliance as outlined in the 2006 Treasury Office of Tax Policy study (referenced above).

What is interesting is that Senator Wyden's robust letter to Commissioner Koskinen was delivered just days before the U.S. Senate Finance Committee held its hearing on the IRS budget. The timing seems to indicate that lawmakers mean business – they want the tax gap addressed. That said, without a sufficient budget, the IRS likely does not have the resources to tackle this major problem.

Of interesting note, the annual tax gap has increased by approximately $150 billion since 2001. Yet, the IRS has had its budget slashed by over $1 billion in the last five (5) years.

According to Commissioner Koskinen, the funding of the IRS this fiscal year ending September 30 is back to the 2008 funding level. He recently suggested the results will be felt by taxpayers and tax advisors, including:

- At least 46,000 fewer business and individual audits will conclude this fiscal year;
- Taxpayers will encounter about a thirty (30) minute wait when calling a service center to reach an IRS representative;
- 3,000 to 4,000 IRS employees will lose their jobs, and there is the possibility that employee furlough days will be implemented this fiscal year, reducing the ability of the IRS to provide taxpayer service;
- Approximately 280,000 fewer collections will be made this fiscal year;
- IT systems will not be replaced or updated this fiscal year as scheduled; and
- Implementation of taxpayer identification theft protections will have to be delayed until a future fiscal year.

Commissioner Koskinen predicts these most recent IRS budget cuts will ultimately result in a loss of $2 billion or more in tax revenue that would have otherwise been collected this fiscal year. Lawmakers need to work with the IRS to help eradicate this major problem. Without an adequate budget, however, the IRS will make little, if any, progress. Hopefully, lawmakers will properly fund the IRS. Time will tell.

Tags: Department of the Treasury, IRS Budget Cuts, IRS Commissioner John Koskinen, IRS Commissioner Mark W. Everson, Senator Ron Wyden