What is the tax gap?

The gross tax gap is the difference between total taxes owed and taxes paid on time.

OVERVIEW

The Internal Revenue Service (IRS) estimates that over the past 30 years, the tax gap has ranged from 16 to 20 percent of total tax liability. Some view the tax gap as a major revenue source that could be used to close the federal budget deficit without raising taxes. In practice, though, the potential revenue gains from proposals to improve enforcement are quite limited.

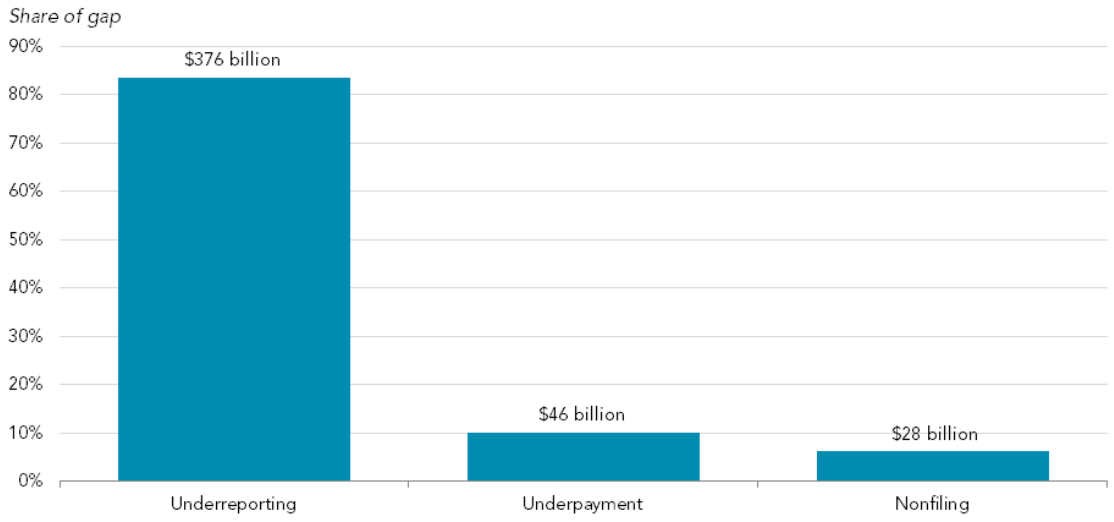
2006

In 2006, the IRS reported a $450 billion gross tax gap (or slightly under 17 percent of tax liability), of which $65 billion was eventually recovered through voluntary late payments and enforcement activities. That left a net tax gap of about $385 billion.

Nonfiling and underpayment of reported taxes account for only 16 percent of the gross tax gap (figure 1); underreporting on timely filed tax returns makes up the bulk of it. Underreporting on individual income tax returns alone (including self-employment tax) accounted for about 65 percent of the gross tax gap in 2006.

FIGURE 1

Components of the $450 Billion Gross Tax Gap
2006

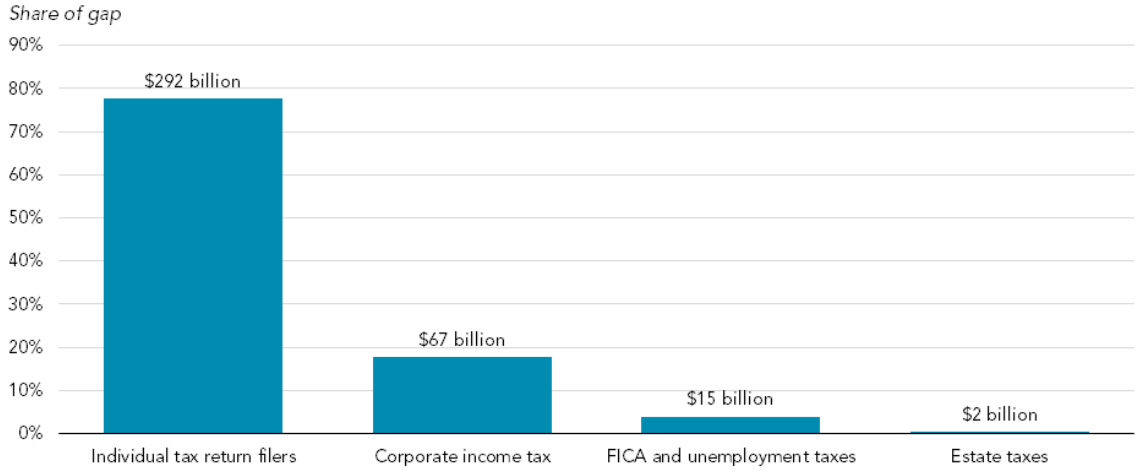


Source: Internal Revenue Service.

Over 60 percent of underreported individual tax is owed on business and self-employment income, which the IRS has no easy way to verify independently. About 18 percent of the underreporting gap is attributable to corporate income tax, and only 0.5 percent to the estate tax (figure 2).

FIGURE 2

Components of the $376 Billion Underreporting Gap
2006



Source: Internal Revenue Service.

Individual taxpayers fail to report about 56 percent of income from sources for which there is no information reporting, such as sole proprietorships. In contrast, only 8 percent of income from easily verified sources—interest, dividends, and pensions—goes unreported. When income is subject to both information returns and tax withholding, as is the case with wages, only about 1 percent goes unreported.

Further Reading

Bloomquist, Kim, Ed Emblom, Drew Johns, and Patrick Langetieg. 2012. "Estimates of the Tax Year 2006 Individual Reporting Gap." Washington, DC: Internal Revenue Service.

Erard, Brian, Mark Payne, and Alan Plumley. 2012. "Advances in Non-filing Measures." Washington, DC: Internal Revenue Service.

Internal Revenue Service. 2012. "Tax Gap for the Year 2006 – Overview." Washington, DC: Internal Revenue Service.

Mazur, Mark J., and Alan Plumley. 2007. "Understanding the Tax Gap." *National Tax Journal* 60 (3): 569–76.

Toder, Eric J. 2007. "What is the Tax Gap?" *Tax Notes*, October 22.