Q. What is the tax gap?

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

The Internal Revenue Service (IRS) estimates that over the past 30 years, the tax gap has fluctuated in a narrow range—15 to 18 percent of total tax liability. Some view the tax gap as a possible 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.

The latest IRS tax gap report was prepared in 2016 and covered tax years 2008–10 (IRS Research, Analysis, and Statistics 2016). For those years, the IRS reported an average annual gross tax gap of $458 billion (slightly over 18 percent of tax liability). Of this, the IRS eventually recovered $52 billion through voluntary late payments and enforcement activities. That left a net tax gap of about $406 billion.

Failure to file a tax return (nonfiling) and underpayment of reported taxes account for just over 15 percent of the gross tax gap (figure 1). Underreporting on timely filed tax returns makes up the bulk of it: $387 billion, or 85 percent of the gross tax gap.

Underreporting on individual income tax returns alone (including self-employment tax) was $329 billion (figure 2), about 85 percent of the underreporting tax gap in 2008–10. Almost 60 percent of the underreported individual income tax is owed on business and self-employment income, which the IRS has no easy way to verify independently. About 11 percent of the underreporting gap is attributable to corporate income tax, and only 0.3 percent to the estate tax.

Individual taxpayers fail to report about 63 percent of income from sources for which there is no information reporting, such as sole proprietorships. In contrast, only 7 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 with wages, only about 1 percent goes unreported.

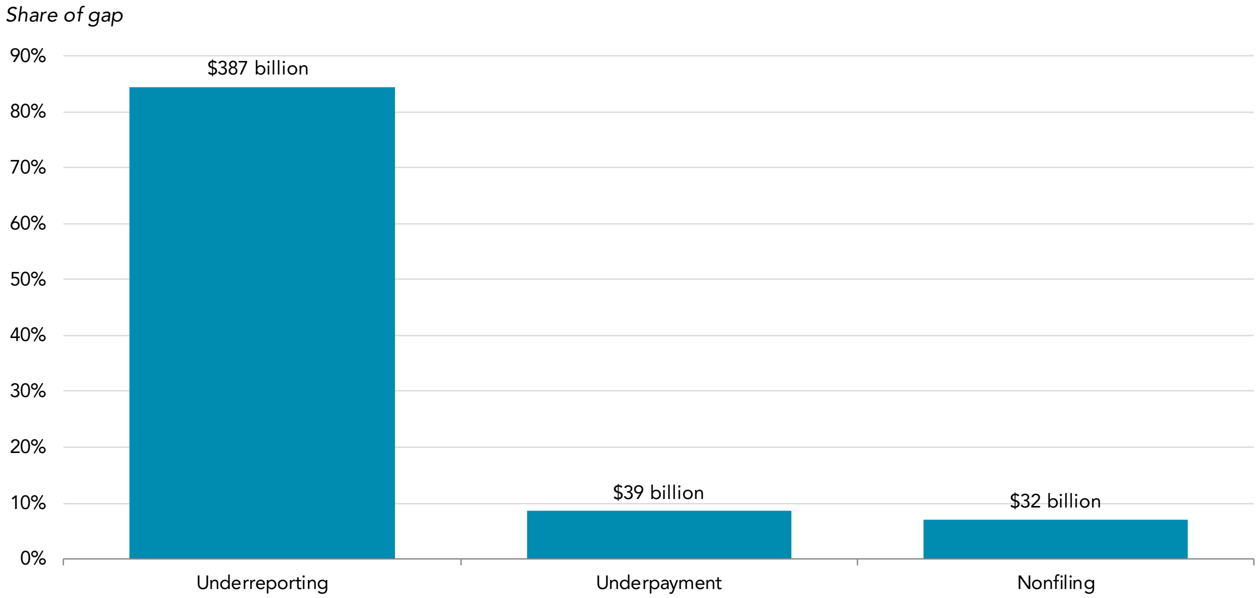
Background

What is the tax gap?

FIGURE 1

Components of the $458 Billion Gross Tax Gap

2008–10

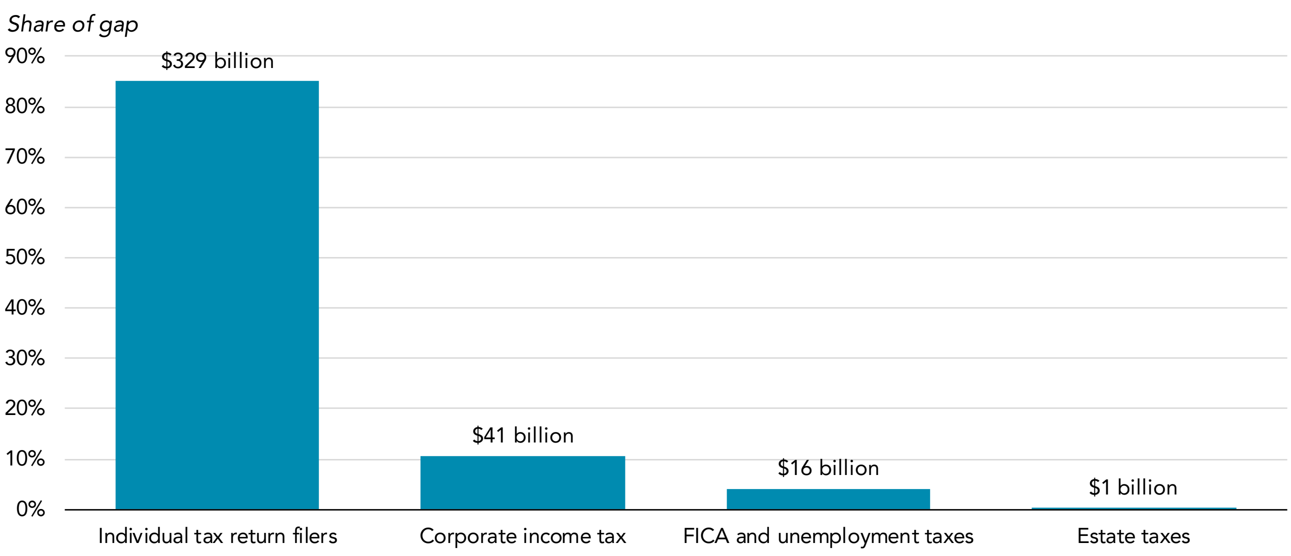


Source: Internal Revenue Service, Research, Analysis and Statistics (2016).

FIGURE 2

Components of the $387 Billion Underreporting Gap

2008-10



Source: Internal Revenue Service, Research, Analysis and Statistics (2016).
FICA = Federal Insurance Contributions Act

Background

What is the tax gap?

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Background

Q. What does the IRS do and how might it be improved?

A. The IRS administers the federal tax laws that the Congress enacts.

The Internal Revenue Service (IRS) administers the federal tax laws that Congress enacts. IRS performs three main functions—tax return processing, enforcement, and taxpayer service. In addition, the IRS conducts criminal investigations and oversees tax-exempt organizations and qualified retirement plans. The IRS budget and workforce have been shrinking, even as the tax law has become more complex and the agency has taken on new tasks.

IRS ACTIVITIES

Slightly over 40 percent of the IRS's $11.5 billion budget in 2017 went to enforcement (figure 1). About 84 percent of the enforcement budget was for examinations of taxpayer returns (audits) and collections. IRS spent the remainder on criminal investigations and regulatory activities, including monitoring tax-exempt organizations and qualified retirement plans.

About 36 percent of the budget funded operations support, including information technology, services, facilities, and organizational support. Another 21 percent supports taxpayer services, including prefiling taxpayer assistance and education and filing and account services. Finally, another 3 percent went to business systems modernization to upgrade information and technology services. These percentages have remained roughly stable in recent years.

THE DECLINE IN SPENDING AND WORKFORCE AND WHY IT IS A PROBLEM

The total IRS budget has been shrinking in real terms in recent years. Between 2010 and 2017, spending on the IRS declined by 15 percent from $13.6 billion to $11.5 billion in 2017 dollars. Over a longer time frame, IRS employment dropped by over 30 percent, from 112,000 full-time equivalents in 1995 to less than 77,000 in 2017 (figure 2).

While IRS resources have shrunk, the agency's workload has increased. With the taxpayer population increasing, the IRS must process more returns, administer more deposits and refunds, and expend more resources to keep taxpayers compliant. Changes in the economy and society have created other challenges for tax enforcement and compliance. These include the globalization of corporate activity, an increase in the share of income taxed through partnerships and other pass-through entities, and changes in family structure. The latter changes have made it harder for IRS to determine whether taxpayers are entitled to tax benefits based on complex criteria, including household living arrangements, family relationships, and support tests.

A major source of increased workload has been the IRS's expanded role in adminstering social programs. The IRS today manages a wide range of benefits for low- and middle-income families and families with children. These include the earned income credit, the child credit, the child and dependent care credit, tax subsidies

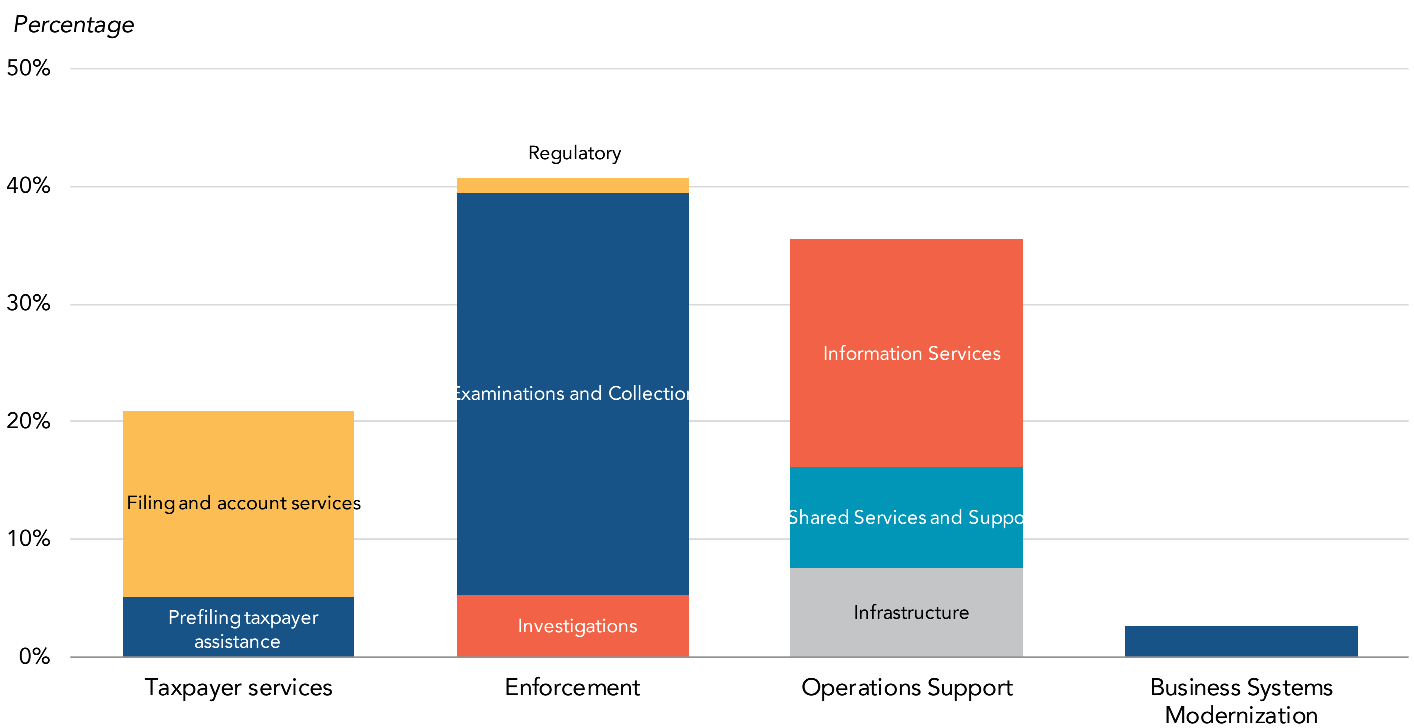
Background

What does the IRS do and how might it be improved?

for higher education, and premium subsidies under the Affordable Care Act. When Congress creates new programs for the IRS to administer, it often does not provide additional funding to administer them.

The 2017 Tax Cuts and Jobs Act presents the IRS with new challenges. IRS will need to write new regulations to administer provisions that are ambiguous and sometimes contradictory. Some provisions that appear to be especially difficult are the new 20 percent deduction for income from pass-through businesses and the complex new international tax provisions. Congress is considering a supplemental appropriation to help IRS administer the new tax law, but that additional funding will not reverse the long-term decline in the IRS budget.

FIGURE 1
IRS Budget Shares by Activity
Fiscal year 2017



Source: Internal Revenue Service, Statistics of Income Division. Data Book, 2017. Table 28. "Costs Incurred by Budget Activity, Fiscal Years 2016 and 2017."

Background

What does the IRS do and how might it be improved?

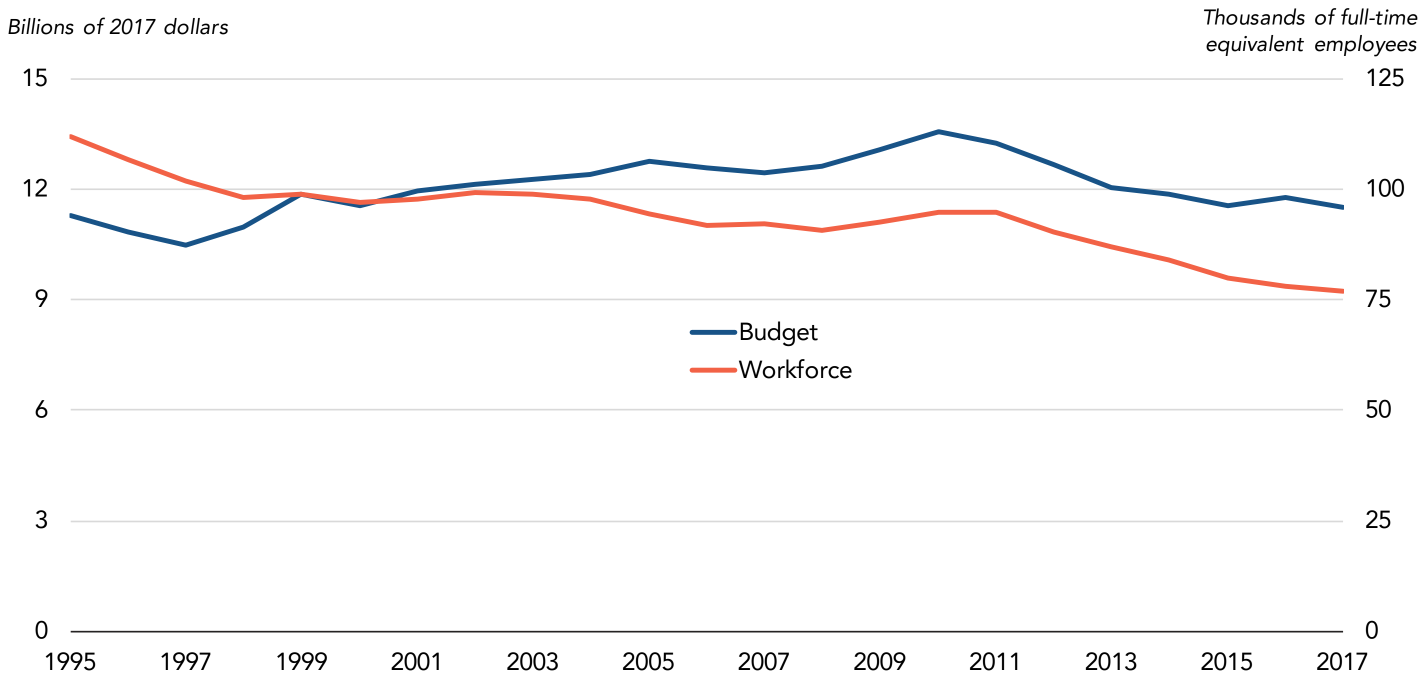
WHAT CAN BE DONE?

The IRS is a complex and unwieldy bureaucracy that cannot easily transform into a modern high-tech organization. Some measures, however, could improve tax administration. Congress could enact legislation to simplify the tax law, as the National Taxpayer Advocate and some reform commissions have proposed. Congress could increase funding to reverse recent budget cuts and prevent a steep drop in the agency's enforcement presence. More funds for enforcement could more than pay for themselves in increased revenue collections. Congress could also give the agency more flexibility in personnel management and additional resources to help modernize their information technology, including relaxing existing pay ceilings for top technology personnel.

FIGURE 2

IRS Budget and Workforce

Fiscal year 1995–2017



Source: Internal Revenue Service, Statistics of Income Division. Data Book, 2017. Table 29. "Collections, Costs, Personnel, and US Population, Fiscal Years 1988–2017."

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Internal Revenue Service, Statistics of Income Division. *Data Book, 2017*. Table 28. "Costs Incurred by Budget Activity, Fiscal Years 2016 and 2017"; and Table 29. "Collections, Costs, Personnel, and US Population, Fiscal Years 1988–2017."

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Background

Q. What is a tax shelter?

A. Tax shelters are ways individuals and corporations reduce their tax liability. Shelters range from employer-sponsored 401(k) programs to overseas bank accounts.

The phrase "tax shelter" is often used as a pejorative term, but a tax shelter can be a legal way to reduce tax liabilities. Someone who thinks a feature of the tax code giving taxpayers the ability to reduce taxes is not a good idea might label it a shelter. Someone else might call that feature of the tax code an incentive. And as the esteemed jurist, Learned Hand, explained: "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury."

Individuals and corporations can reduce their final tax liabilities by allocating some portion of their incomes to tax shelters. Although they are classically associated with wealthy households and corporations who use anonymous Swiss bank accounts, tax shelters are more accessible and widespread than the usual association may suggest. For example, employer-sponsored 401(k) programs and individual retirement accounts are widespread and accessible ways individuals can "shelter" some of their income from taxation.

ABUSIVE TAX SHELTERING

But a tax shelter also may be defined narrowly, as a transaction or strategy that generates tax benefits unintended by the Congress or the IRS. Often a tax shelter relies on a literal interpretation of a statute to achieve a result that is "too good to be true." Professor Michael Graetz once defined a tax shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid."

The Internal Revenue Service makes a distinction between tax sheltering (which encompasses legal forms of reducing tax liability, like retirement plans) and "abusive" tax sheltering (including tax evasion, which is illegal). One example of an abusive tax-sheltering scheme is the use of trusts to reduce tax liability by overclaiming deductions or even by hiding income and assets from taxation.

EFFECTS

Tax shelters are generally beneficial if considered from the individual or firm perspective. And tax shelters may also be desirable from an overall societal perspective. That is because the erosion of the tax base may be an acceptable loss for largely beneficial tax shelters (such as charitable contributions). Of course, some tax shelters have little to no social benefits or are even harmful.

Background

What is a tax shelter?

TAX HAVENS

"Tax havens" are a specific means of tax sheltering. A tax haven is a locality—be it a state, country, or region—that often has a lower corporate or personal income tax rate. Tax havens may also have other properties that make storing assets or income there desirable, such as bank secrecy laws, or ease of incorporation (for forming shell companies), or lack of transparency for business operations.

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