Background

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.

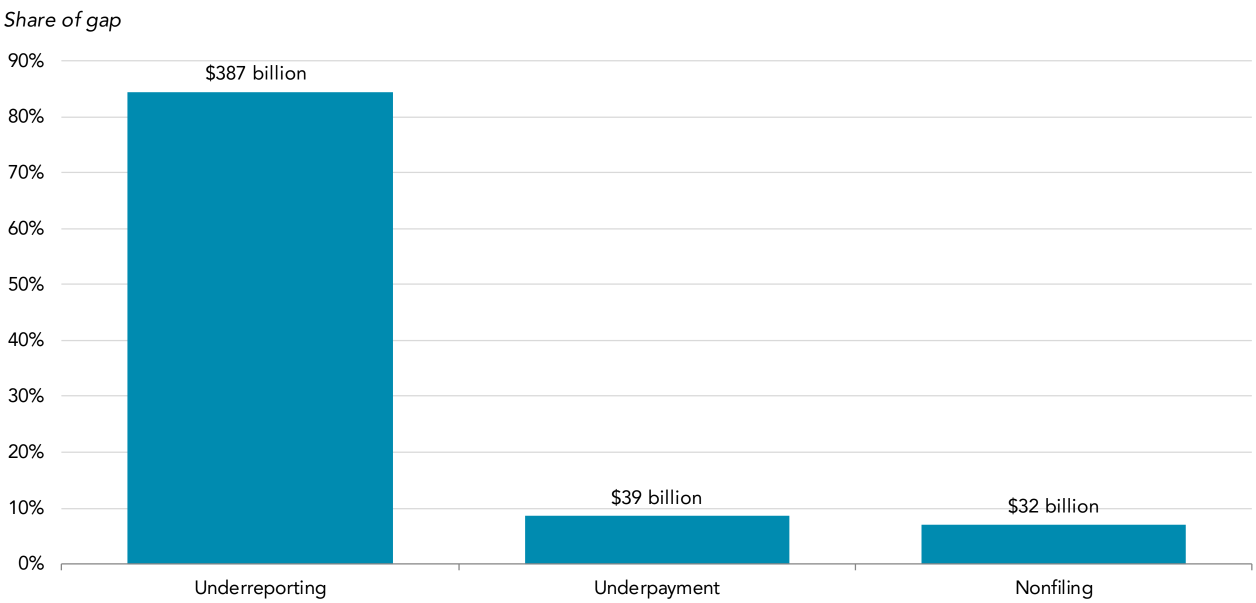
Background

What is the tax gap?

FIGURE 1

Components of the $458 Billion Gross Tax Gap

2008–10

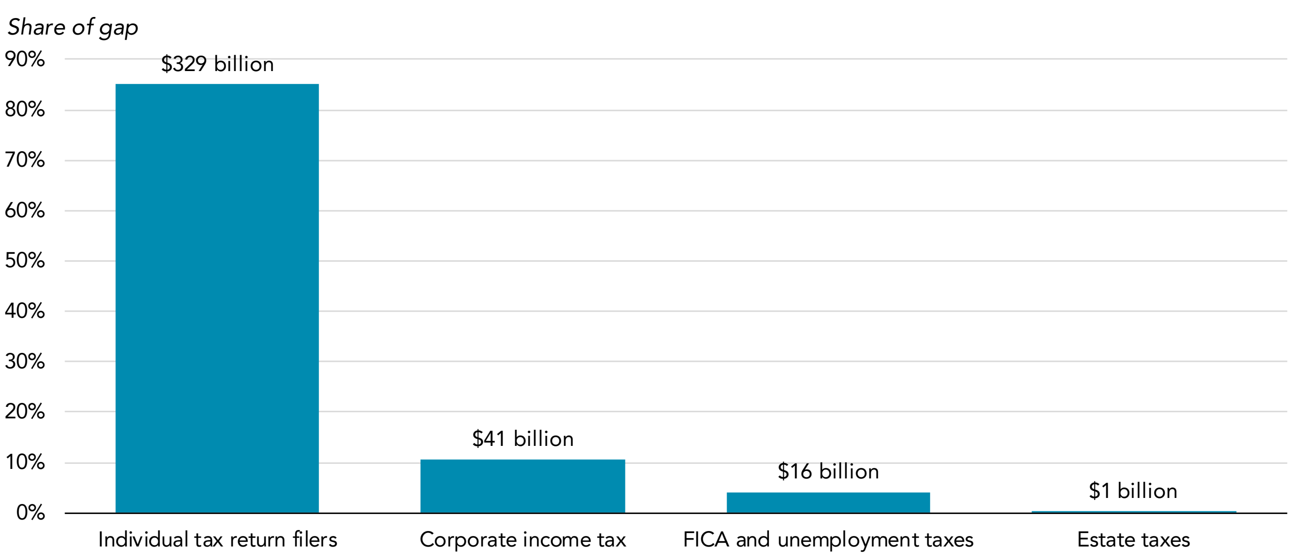


Source: Internal Revenue Service, Research, Analysis and Statistics (2016).

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?

Data Sources

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Further Reading

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