

The 'Tax Gap'

Collection and enforcement of taxes should not single out the small-business community

Given congressional interest in both revenue-reducing measures such as the Alternative Minimum Tax and concerns about the federal budget deficit, policymakers are focusing their attention on possible revenue-raising measures that would, in effect, help pay for tax cuts elsewhere. One area of interest among many is closing the so-called "tax gap."

The "tax gap" is a concept defined by the Internal Revenue Service for determining taxpayers' compliance with their federal tax obligations. The gross "tax gap" is the difference between the amount of tax that should be paid, on a timely basis, and the amount actually received by the government for a specific tax year. Thus, the "tax gap" includes both deliberate and illegal tax evasion but also non-payment that occurs for more innocent reasons; taxpayer error or simple inability to pay.

The IRS develops its "tax gap" estimates by measuring the rate of taxpayer compliance—the degree to which taxpayers fully and timely complied with their tax obligations. That rate is then used, along with myriad other assumptions, to estimate the dollar amount of taxes not timely or accurately paid. For tax year 2001, the IRS estimates nearly 17 percent of owed taxes were late or not paid at all, which translates into an estimated gross "tax gap" of \$345 billion. The IRS recovered about \$55 billion of this sum, leaving a net "tax gap" of \$290 billion.

As defined by the IRS, the "tax gap" consists of three components: nonfiling (failure to file a return), underreporting (understating income or overstating deductions), and underpayment (failure to pay reported taxes owed). The IRS argues underreporting is the largest, comprising 80 percent or \$166 billion of the total gap. The IRS claims that small businesses are responsible for \$109 billion.

Proposals to reduce the "tax gap" have included both changes in tax law and changes in IRS tax administration. The Joint Committee on Taxation has issued two reports outlining numerous legislative approaches for reducing the "tax gap." The reports contain proposals aimed at closing perceived "loopholes," as well as measures that would address non-compliance—including simplification and clarification of tax laws, increased withholding, and increased information reporting. Several of the proposals were included as revenue-raising measures in the *Tax Increase Prevention and Reconciliation Act of 2006*—including the proposal that requires all federal, state and local government entities withhold and submit to the IRS three-percent of the value of all government contracts, much like employers withhold from the pay of their employees.

President George W. Bush's fiscal year 2008 budget proposal, released Feb. 5, includes provisions for narrowing the "tax gap." Proposals to improve tax compliance (with minimum taxpayer burden) include expanding information reporting requirements, improving compliance for businesses, strengthening tax administration and expanding penalties. Specific proposals for increased reporting would require reporting on payments to corporations; basis reporting on security sales; information reporting on merchant payment card reimbursements, a certified taxpayer identification number from non-employee service providers; and increase information return penalties.

Honest small business taxpayers are especially at risk of being subjected to needless and unwarranted regulatory burdens in an attempt to capture the few "bad apples" that do not fulfill their tax obligations. Small firms could be targeted and penalized by the IRS for small and unintentional transgressions.

NSBA is fighting for the rights of honest small-business taxpayers as lawmakers continue to address the "tax gap," and has launched an initiative to increase awareness. More information is available at preventirsabuse.org.