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Closing the Tax Gap Means Taxpayers Beware!

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American taxpayers are winding up their annual reckoning with the IRS. Meanwhile, House and Senate Democrats are discussing a number of new tax revenues to pay for their spending agenda, including eking out “free money” from closing the tax gap. The tax gap is the difference between what the IRS estimates it is owed and what it actually collects—purportedly around \$290 billion. Closing this tax gap is not a simple matter, nor is it cost free. The three types of proposals to close the tax gap are (1) making reporting to the IRS more extensive, (2) increasing withholding, and (3) giving the IRS more power. Each of these would be a nightmare for American taxpayers.

What is the “Tax Gap”? The tax gap is really a compliance gap, arising when taxpayers do not pay the correct amount of taxes they owe.¹ The gap is not large in relative terms—the IRS estimates about an 84 percent compliance rate.² According to the IRS, of those who underpay, 82 percent underreport their tax liability, 8 percent fail to file returns, and 10 percent underpay known tax debts.

Most of the compliance problem comes from honest taxpayers who try to comply with the tax code but are tripped up by its increasing complexity and unwieldiness. The remainder is due to tax evasion by those who knowingly break the law.³

Tax compliance is high when payments or wages are reported by a third party, such as a W-2 from an employer or a 1099 from a bank for interest earned. Compliance is the highest (nearly 99 percent) when there is also tax withholding, such as with the withholding of income and Social Security taxes from paychecks.

Compliance is lowest when there is no third party reporting, such as payments to a lawn service or hairdresser. The costs of complying with the complex tax code are already extremely high for these types of small businesses and entrepreneurs, and so further efforts to tighten the tax noose could make this burden crushing. Instead, lawmakers seeking to improve compliance should simplify the tax code so these types of businesses do not have to employ hordes of expensive lawyers and accountants just to pay their taxes.

All taxpayers, not just small businesses, face rising compliance costs. Americans spent billions of hours and an estimated \$279 billion filling out their federal income taxes last year alone.⁴ This cost is nearly as much as the tax gap itself. Still, lawmakers maintain a misplaced focus on “free” revenues from closing the tax gap. Taxpayers should be aware of what this would entail.

Increase Reporting to the IRS. As the IRS’s Nina Olson, the National Taxpayer Advocate, has stated, “No one wants to be obligated to file a document with the IRS every time he or she takes a cab ride, has someone mow their lawn, or calls a plumber to fix a broken faucet.”⁵ Yet many tax gap proposals would boost the reporting that businesses and individuals have to do to unprecedented levels.

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It is already costly and burdensome to report financial information to the IRS. In order to collect more taxes, the IRS would have to ferret out more information about income and deductions than it is already privy to. This would require foisting new layers of reporting and complexity on Americans taxpayers, an especially invasive policy given the explosion of online entrepreneurship. New reporting measures would have to:

- **Force online businesses from Amazon to eBay to comply with tortuous IRS regulations.** The 200 million people who buy and sell items on eBay and other auction Web sites should be brought into the ever expanding net of the IRS, according to recommendations by an IRS advisory committee. Even the smallest online sellers on any commercial Web site such as Craigslist would be required to apply for a tax identification number and then issue 1099s to buyers.⁶ The folly of this idea is compounded by the fact that Internet transactions often straddle the globe. Even though the IRS maintains it would track only domestic sales, enforcing this measure would be a technical nightmare, if feasible at all.
- **Turn private citizens into IRS informers** in the hunt for more information on sales from small businesses. The IRS would have to find independent sources of information on small business income. Those sources would be the small businesses' customers. For example, a family hiring a contractor to build a new room or a swimming

pool or young college student buying a new car from a family friend could be required to report those transactions to the IRS.

- **Require investment brokers to report profits from securities sales,** rather than just the sales themselves. This would impose greater costs and complexity on brokerages, further damaging Wall Street's international competitiveness.
- **Enlist state and local governments in aiding the IRS.** According to the Department of Treasury, state and local governments should open up their taxpayer records to the IRS.⁷ For example, the IRS could use data-mining tools to sift through state data and develop audit leads or use state audit reports to target IRS audits. This would impose additional bureaucracy and costs on state and local revenue departments and could compromise the autonomy of state governments.

Increase Payments Subject to Withholding.

Because compliance is highest for taxes automatically withheld by a third party, increasing payments subject to withholding would be the logical extension of increased reporting. This would turn ordinary citizens into IRS agents. All over America, each time a payment is made for services, individuals would have to figure out the correct level of taxes to withhold and send on to Washington. This would require new regulations, procedures, and forms, and the time-consuming and tedious task of complying would be fraught with error and abuse—a compliance nightmare in its own right.

1. See Rea S. Hederman, Jr., "Senate Budget Resolution Fails to Address Tax Gap Problems," Heritage Foundation *WebMemo* No. 1419, April 10, 2007, at www.heritage.org/Research/Taxes/wm1419.cfm.
2. Nina Olson, testimony before the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. House of Representatives, March 5, 2007, at www.irs.gov/pub/irs-utl/nta_testimony_houseappropriations_030507_v7.pdf.
3. Office of Management and Budget, "Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2008," February 2007, p. 192.
4. The Tax Foundation, "Total Federal Income Tax Compliance Costs, 1990-2015" October 2006, at www.taxfoundation.org/research/topic/96.html.
5. Nina Olson, testimony before the Committee on the Budget, U.S. Senate, February 15, 2006, at http://budget.senate.gov/democratic/testimony/2006/olsen_taxgap021506.pdf.
6. Internal Revenue Service, "Small Business/Self-Employed Subgroup Reports," November 16, 2006, at www.irs.gov/pub/irs-utl/2006_irpac_public_meeting.pdf.
7. Department of the Treasury, "A Comprehensive Strategy for Reducing the Tax Gap," September 26, 2006, at www.ustreas.gov/press/releases/reports/optaxgapstrategy%20final.pdf.

For example, a regular taxpayer could have to:

- Withhold taxes from the plumber or electrician who makes repairs in the home;
- Obtain a W-4 from the babysitter down the street before enjoying a night out;
- Report the name, date of birth, address and taxpayer identification number of dry cleaners or hairdressers;
- Withhold taxes from doctors and lawyers; and
- Comply with all the new paperwork and financial burdens required by tax withholding.

These types of policies have been tried before, though not to such extremes. In the mid-1990s, the IRS sought to crack down on landlords in the Section 8 voucher rental housing program. These landlords had to report their taxpayer identification information to the housing authority. If their information was deemed inaccurate by the IRS—a frequent occurrence—the housing authority had to withhold a portion of the rental payment—irrespective of the landlord's costs—and forward it to the IRS. This led to an immense waste of housing authorities' resources and yielded little in results. Some landlords threatened to evict their low-income tenants because they didn't want to deal with the IRS. If government-regulated housing authorities had to struggle to comply with the IRS in its crackdowns, ordinary Americans would have little chance.

Increase the Power of the IRS. The IRS has the charge to collect and enforce the federal tax code, and extending its power seems an obvious step toward increasing compliance. But giving the IRS more power could infringe on personal liberties that Americans cherish and stifle economic growth. In the tax gap debate, the IRS often couches measures to close the tax gap in euphemistic generalizations that no one could object to such as “improve research,” “improve compliance activities,” “invest in IT,” and “improve tax payer service.” However,

none of these phrases captures the reality of a more powerful IRS.

Investigations into abuses by the IRS a decade ago revealed an overzealous agency with staff, from agents to executives, free to gratuitously impose highly punitive measures on taxpayers. IRS agents anonymously testified that they had repeatedly seen senior IRS staff and executives “violate or ignore Internal Revenues Manual procedures and Treasury regulations simply because they wanted to punish a taxpayer.”⁸

Closing the tax gap could cause a resurgence in these kinds of abuses. Proposals currently being discussed would:

- **Increase the number of auditors and audits.** It is often suggested that simply adding more auditors to the IRS's army would increase compliance. However, the IRS's enforcement budget has been increased by 50 percent since 2000, with little effect on revenues collected.⁹ Virtually every major corporation in America already has full-time IRS agents on site auditing its financial records. Individual Americans should not have to face anything near that level of government scrutiny of their personal lives. IRS Commissioner Mark Everson has acknowledged that “we will never be able to audit our way out of the tax gap.”¹⁰
- **Allow the IRS to obtain details on personal credit card transactions.** The IRS would compare records from credit card holders obtained from credit card companies with income records from businesses and then audit any business with large discrepancies. This process would be ripe for abuse. Even if these efforts would yield some small number of tax evaders, the IRS should not have such extensive power to poke and prod into Americans' private affairs.
- **Increase IRS penalties** by expanding existing penalties on tax preparers and creating a new

8. William W. Beach, “Increasing IRS Tax Collection Powers Threatens More IRS Abuse: The New Congress Moves to Close the ‘Tax Gap,’” February 27, 2007, at www.heritage.org/Research/Taxes/wm1373.cfm.

9. Daniel J. Mitchell, “The Tax Gap Mirage” Cato Institute, March 2007, at www.cato.org/pubs/tbb/tbb_0306-44.pdf.

10. Mark Everson, testimony before the Committee on the Budget, U.S. Senate, February 14, 2007, at <http://budget.senate.gov/republican/hearingarchive/testimonies/2007/2007-02-14Everson.pdf>.

penalty for filing erroneous refund claims. IRS penalties are already steep. Increasing penalties further would likely have only a marginal effect on compliance.

Simplify to Increase Compliance and Revenues. As Treasury Secretary Henry Paulson noted, “When I look at what needs to be done, I concluded that there is not a pot of gold to pay for AMT, to balance the budget, whatever, unless we sign on for specific reporting provisions, increased reporting that I would recommend against.”¹¹ In other words, most measures are too invasive and costly to consider. Paulson’s trepidation should be weighed heavily by lawmakers. A better approach would be to simplify the tax code by reducing rates and broadening the tax base by getting rid of the myriad of deductions and loopholes that now plague the system.

At 17,000 pages, the tax code is incredibly complex, leading to many compliance problems, and

every year Congress inserts more complicating loopholes and special interest provisions into it. Efforts to close the tax gap through enforcement would only add to this complexity. As international experience has shown, higher tax complexity and higher burdens result in more taxpayer mistakes and evasions.

Conclusion. Legislators who view the tax gap as a pot of gold to pay for their spending agendas have misplaced faith in the IRS. Taxpayers should know what increased IRS enforcement would mean to them, from burdensome reporting to a loss of personal privacy. Efforts to raise compliance would have a negative impact on economic growth, individual freedom, and the burden of tax compliance. The best mechanism to reduce the tax gap is to reform the current overcomplicated tax system.

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11. Henry M. Paulson, Jr., Secretary, U.S. Department of the Treasury, testimony before the Finance Committee, U.S. Senate, February 6, 2007, at <http://finance.senate.gov/sitepages/hearings.htm>.