Tax gap estimate climbs to $688 billion, IRS says

The gross federal tax gap—the difference between the amount of tax legally owed to the government and the amount paid and collected on a timely basis—reached an estimated $688 billion in tax year 2021, according to a new report released by the Internal Revenue Service on October 12.
URL: https://www.irs.gov/pub/irs-pdf/p5869.pdf

The projections, which cover tax years 2020 and 2021, represent an increase of more than $192 billion from the IRS's prior estimates for tax years 2014-2016 and $138 billion from the revised projections for tax years 2017-2019, the agency said.

Elements of noncompliance

Across the three main components of the tax gap, the report shows that the gross revenue shortfall breaks down this way:

- Nonfiling, that is, tax not paid on time by those who do not file on time, amounted to $77 billion in tax year 2021, up from $41 billion in tax years 2017-2019;
- Underreporting, which reflects tax understated on timely filed returns, accounted for $542 billion in foregone collections in tax year 2021, up from $445 billion in tax years 2017-2019; and
- Underpayment, or tax that was reported on time but not paid on time, rose to $68 billion in tax year 2021, from $64 billion in tax years 2017-2019.

The net annual tax gap for tax year 2021, reflecting late payments plus amounts recouped through IRS enforcement efforts, is projected to reach $625 billion, the IRS said.

Compliance rates

The report notes that the voluntary compliance rates for tax year 2020 and 2021 tax gap held steady at roughly 85 percent.

After IRS compliance efforts are factored in, the projected share of taxes eventually paid is 86.3 percent for tax year 2021, down slightly from the 87 percent for tax years 2014-2016; however, the report attributes the decline to changes in the types of income and how that income is reported to the IRS rather than changes in taxpayer behavior.

Caveats

The IRS cautions that there are several reasons why the new estimates likely do not reflect the full extent of taxpayer noncompliance, including:

- The lack of available data to completely measure noncompliance levels in areas of the tax system such as offshore activities, digital assets and cryptocurrency, corporate income tax, income from flowthrough entities, and illegal activities;
- The lack of a reliable method for measuring taxpayer behavior related to claims for pandemic tax credits enacted on an emergency basis in 2020 and 2021;
- The level of time and training required for the IRS to develop expertise related to digital assets and other emerging issues and to complete examinations that can be used to capture the extent of that noncompliance.

The report states that "the IRS continues to actively work on new methods for estimating and projecting the tax gap to better reflect changes in taxpayer behavior as they emerge."

The report also notes that the collections shortfall associated with illegal activities is outside the scope of tax gap estimation because the government's objective is to eliminate those activities, which would eliminate any associated tax.

IRS funding a hot-button issue on Capitol Hill

Release of the latest tax gap projections comes as partisan divisions persist in Congress over the 10-year mandatory funding allocated to the IRS under the Inflation Reduction Act (P.L. 117-169) to beef up its enforcement efforts as well as modernize its information technology and improve its customer service. As enacted, the Inflation Reduction Act provided the agency with $80 billion in new funding, although roughly $20 billion of that amount will be rescinded as part of a "handshake" deal between President Biden and then-Speaker Kevin McCarthy, R-Calif., when they negotiated the Fiscal Responsibility Act (P.L. 118-5), the debt limit deal that was signed into law this past June.
URL: https://www.congress.gov/117/plaws/publ169/PLAW-117publ169.pdf
URL: https://www.congress.gov/118/plaws/publ5/PLAW-118publ5.pdf

Democrats generally have argued that the Inflation Reduction Act funds will give the IRS the resources it needs to audit the increasingly complex returns of large corporations and partnerships and ultrawealthy individuals that often have opaque sources of income and engage in highly sophisticated tax transactions. The contention among some factions of GOP lawmakers, however, is that the IRS intends to use the funds to hire an "army" of new revenue agents focused on audits of small businesses and middle-class individuals.

IRS Commissioner Daniel Werfel commented in an October 12 news release that the latest estimates "underscore the importance of increased IRS compliance efforts on key areas." The Inflation Reduction Act funding, he said, is enabling the agency to "add focus and resources to areas of compliance concern, including high-income and high-wealth individuals, partnerships, and corporations," which, in turn, will "[add] more fairness to the tax system" and "[protect] those who pay their taxes. . . ."

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