BUDGET BULLETIN

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COMMITTEE ON THE BUDGET Republican Staff

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INFORMED BUDGETEER: WE'RRRRRE OFF TO SEE THE WIZARD

- All year, Congress has been promising American taxpayers that they will be saved from having to pay increased taxes next April because of the Alternative Minimum Tax (AMT). And all year, Congress has been looking for a way to pay for it.

- Under the paygo points of order that currently apply in the House and the Senate, all legislation that would increase the on-budget deficit is supposed to be offset over certain time periods. The 2008 budget resolutions passed by the House and the Senate, as well as the adopted conference report, have had a ready answer as to how to pay for the $55 billion cost of fending off the AMT for one year or the $240 billion in new spending from about 20 reserve funds.

- The mantra answer has been – close the **tax gap**. And if that is not enough, then close tax loopholes, tax havens, and tax shelters.

- On the opening day of Senate debate (March 20, 2007) on the 2008 budget resolution, the chairman of the Senate Budget Committee claimed that his budget "provide[s] for new measures to close the tax gap, shut tax shelters, and address the burgeoning growth of offshore tax havens." In fact, section 401 (b) (2) of the 2008 Budget Resolution conference agreement states, in a sense-of-the-Senate kind of way: "any additional revenues needed to meet the Senate's tax policy goals can be achieved by closing the tax gap, shutting down abusive tax shelters, addressing offshore tax havens, and without raising taxes."

- Of course, not only is a budget resolution incapable of accomplishing any of those things, the authors of the 2008 budget resolution did not even provide a clue as to how any of those "new measures" would actually be accomplished later.

- By statute and by definition, the budget resolution is incapable of doing anything directly about tax gaps, shelters, or havens, because the budget resolution cannot become law – it cannot compel payment of taxes.

- But a budget resolution can, if its authors choose, lay down a road map in report language regarding what legislation it expects Congress to adopt to fulfill the assumptions of the resolution. And the budget resolution can even require committees to produce reconciliation legislation that achieves a numerical instruction in the budget resolution, although the committees have the leeway to prescribe a different policy than the resolution had assumed in setting that numerical instruction. (For example, the budget resolution did instruct the HELP Committee in the Senate and the Education and Labor Committee in the House to produce reconciliation legislation that would reduce the deficit by $750 million over the 2007-2012 period.)

- Instead, the 2008 budget resolution sidestepped the power it had to issue reconciliation instructions to the Finance and the Ways and Means Committees (the committees with jurisdiction over tax law who would have to write the legislation that actually reduces tax gaps, shelters, and havens) and never stepped up to the bully pulpit that it had (through its report) to provide any legislative direction or useful advice as to how Congress could address these tax-gap issues (except in a small way on enforcement funding for the Internal Revenue Service).

- That is why the ranking member of the Budget Committee referred to the budget resolution "as the budget from the Land of Oz because somewhere behind the curtain, somebody is supposed to develop all this money."

- During the budget resolution debate, the terms "tax gap," "tax shelters," and "tax havens" were used interchangeably and collectively to try to counter the argument that there isn't "anything in that little black bag" to pay for a wide array of appetites. This *Budget Bulletin* seeks to distinguish these terms from each other and summarizes the numerical and legislative facts associated with each.

Looking Into Professor Marvel's Crystal Ball For What We Know Now ("close your eyes for a moment to be better in tune with the infinite")

- What is the tax gap? The IRS Commissioner has testified that the tax gap is "the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws." (http://budget.senate.gov/republican/hearingarchive/testimonies/2007/2007-02-14Everson.pdf)

- If any budgeteers watched the hearings held by the Senate Budget Committee and the Finance Committee, you might know that the last time the Treasury estimated the *gross* tax gap, their analysts estimated it was $345 billion in tax year 2001.
http://budget.senate.gov/republican/NewHearings&Testi2006.htm;
Feb. 14, 2007 -
http://budget.senate.gov/republican/hearingarchive/2007-02-14Everson.ram;
Jan. 23, 2007 -
http://budget.senate.gov/republican/hearingarchive/2007-01-23TaxGap.ram;
February 15, 2006 -
http://budget.senate.gov/republican/hearingarchive/2006/15feb06hearing.ram;
April 18, 2007 -
http://finance.senate.gov/sitepages/hearing041807.htm; see
http://finance.senate.gov/sitepages/hearings.htm for the webcast.

- But few know how that $345 billion breaks down into its various components. There are three main types of noncompliance with the tax law that correspond with components of the tax gap: **underreporting, underpayment, and nonfiling**, as summarized in the table below.

Most Recent Tax Gap Estimates, Tax Year 2001

Tax Gap Component - Types of Noncompliance	Gross Amount ($ billions)			Share of Total Gross Tax Gap		
Underreporting gap	**$285**			**83%**		
Individual Income Tax		$197			57%	
Business Income			$109			32%
Non-business Income			$56			16%
Credits			$17			5%
Adjustments, Deductions, Exemptions			$15			4%
Employment Tax		$54			16%	
Self-Employment Tax			$39			11%
FICA			$14			4%
Unemployment Tax			$1			0%
Corporation Income Tax		$30			9%	
Large Corp. >$10 mil			$25			7%
Small Corp. <$10 mil			$5			1%
Estate Tax		$4			1%	
Underpayment gap	**$33**			**10%**		
Individual Income Tax		$23			7%	
Corporation Income Tax		$2			1%	
Employment Tax		$5			1%	
Estate Tax		$2			1%	
Excise Tax		$1			0%	
Nonfiling gap	**$27**			**8%**		
Individual Income Tax		$25			7%	
Estate Tax		$2			1%	
Total Gross Tax Gap	**$345**			**100%**		
Less Collections from Enforcement and Other Late Payments	-$55					
Total Net Tax Gap	**$290**					

Source: IRS Office of Research, February 2006.

- Note that not all of the tax gap remained permanently uncollectible in 2001 – the IRS estimates it was able to collect $55 billion of what was legally owed (including fines and penalties), albeit late. As a result, the net estimated tax gap in

2001 – the amount that was owed and never collected – was $290 billion, not $345 billion (therefore, we don't have to figure out a way to collect the difference between $345 billion and $290 billion – the Treasury has already collected it).

- The **underreporting gap** ($285 billion in 2001) is the amount of tax that is owed (but not paid voluntarily and on time) by taxpayers who do file their returns on time but do not fully report their tax obligations. Underreporting can be intentional (due to cheating) or unintentional (due to ignorance); the IRS' estimates of the tax gap do not quantify how much underreporting is due to cheating vs. incomprehensible tax law.

- Underreporting accounts for more than four-fifths of the total gross tax gap, with underreporting of individual income the largest culprit. This makes sense, since individual income taxes accounted for about half of all federal tax receipts in 2001.

- About 55 percent of the individual underreporting gap ($109 billion) came from understated net business income (unreported receipts and overstated expenses), while another 28 percent ($56 billion) came from underreported non-business income such as wages, tips, interest, dividends and capital gains. The remainder of the individual income tax underreporting gap is due to overstated subtractions (such as deductions, exemptions and credits) from income.

- Underreporting of employment taxes is a direct effect of underreporting individual income. For example, if a small business owner understates his income for income tax purposes, he will also be understating his income for employment tax purposes.

- IRS guesses that underreporting of corporation income ($30 billion) makes up less than 10 percent of the total tax gap. However, recent testimony and reports from the Treasury Inspector General for Tax Administration place little confidence in the estimates of the amount of noncompliance with the corporate income tax, since such estimates are essentially artifacts from the most recent audits that were last done more than 20 years ago in the mid-1980s.
  http://www.finance.senate.gov/hearings/testimony/2005test/072606mm.pdf
  http://www.treas.gov/tigta/auditreports/2006reports/200650077fr.pdf

- The **underpayment gap** ($33 billion) accounts for 10 percent of the total tax gap, and is the only piece of the tax gap that is known as an actual amount. The underpayment gap is the amount of tax that is reported on returns filed on time, but not paid voluntarily or on time for some reason.

- The largest piece of the underpayment gap is from owed, but not fully paid, individual income taxes. According to an IRS representative, most of the underpayment gap is eventually collected (the exact percentage is not known), but it can take up to 10 years because of court challenges and appeals. Some of the underpayment gap is never collected because the IRS cannot find the delinquent taxpayer (due to death, no forwarding address or name change).

- The **nonfiling gap** ($27 billion) is 8 percent of the total tax gap. The nonfiling gap is tax that is owed, but not paid voluntarily and on time by taxpayers who do not file required returns. The nonfiling gap is net of any tax paid by or on behalf of these taxpayers before the due date of the return, for example, through withholding.

What Is Anyone Actually Doing About The Tax Gap Here in Kansas Besides Dreaming About More Money "Somewhere, Over the Rainbow"?

- As part of its 2008 budget request, the Administration sent up 16 proposals to reduce the tax gap. Of these, the Joint Committee on Taxation (JCT) estimated that 12 of them would collectively increase revenue by $5.7 billion over the 2008-2012 period (see table below), while the other four proposals would have negligible or no effect.

PROPOSALS IN THE PRESIDENT'S 2008 BUDGET TO REDUCE THE TAX GAP
(in billions of dollars as estimated by JCT)

	2008-2012
Require information reporting on merchant payment card reimbursements	3.34
Expand broker information reporting	0.80
Require information reporting on payments to corporations	0.59
Require basis reporting on security sales	0.49
Increased information return penalties[a]	0.17
Modification of collection due process procedures for employment tax liabilites[b]	**0.17**
Require a certified taxpayer ID number from contractors	0.07
Expand preparer penalties	**0.03**
Require increased information reporting for certain government payments for property and services	0.03
Create an erroneous refund claim penalty	**0.03**
Permit disclosure of prison tax scams[a]	c
Make repeated willful failure to file a tax return a felony	c
TOTAL	5.72

NOTE: Items in **bold** indicate proposals already enacted in 2007 supplemental, P.L. 110-28; details may not add due to rounding
a. These are proposals that have passed the Senate, but have not been enacted
b. The enacted version was modified to raise $0.163 billion instead of $0.173 billion.
c. less than $50 million.
Source: http://www.house.gov/jct/s-2-07.pdf

- So far, Congress has already enacted (in May 2007 in the Iraq supplemental) three of these proposals, which are estimated to increase revenue by $0.2 billion over the next five years. These three proposals will achieve only 3.5 percent of the total additional revenues that would come in if all the President's proposals were enacted.

- While Congress has partially advanced some of the less lucrative of the remaining proposals, it abandoned them before sending them to the President for what would have been a certain signature. Further, Congress has totally ignored the top four proposals that would do the most among the President's proposals to reduce the tax gap. Together, these four proposals account for $5.2 billion, or 91 percent, of the additional revenue under the President's tax-gap proposals.

MAKE SURE TO READ ON TO THE PART 2 CONTINUATION OF THIS *BULLETIN* IN NO. 6b