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Americans Underpay Taxes by \$345 Bln, IRS Says (Update1)

Feb. 14 (Bloomberg) -- Americans cheat on their taxes to the tune of about \$345 billion a year and \$290 billion of that goes uncollected by the government, the U.S. Internal Revenue Service said.

The IRS released new data today based on its random audits of 46,000 tax returns for 2001 that pinpoint its estimate of the so-called "tax gap." The agency previously had described the gap as a range between \$312 billion to \$353 billion.

The \$345 billion gross tax gap is nearly equal to Bush administration projections for the budget deficit, which the Office of Management and Budget estimates will reach \$354 billion in the fiscal year that begins Oct. 1.

"The magnitude of the tax gap highlights the critical role of enforcement in keeping our system of tax administration healthy," IRS Commissioner Mark Everson said in a statement. Everson is scheduled to testify before the Senate Budget Committee on the uncollected revenue tomorrow.

The IRS collected \$2 trillion in revenue in fiscal year 2004, including \$717 billion in payroll taxes used to fund the Social Security and Medicare retirement programs. That means the uncollected revenue represents a noncompliance rate of 16.3 percent.

Everson said most of the noncompliance occurs in business sectors where there isn't automatic reporting of transactional information to the IRS, such as sole proprietors. For example, sole proprietors who report their income and claim business deductions on Schedule C underpay their taxes by about \$68 billion.

Corporations

The IRS is unable to determine what percent of the underpayments are due to willful noncompliance with the tax laws and how much is attributable to confusion created by the complicated tax system, Everson said. The IRS's estimate also incorporates outdated projections of underpayments by corporations, so the actual tax gap is likely higher than \$345 billion, he said.

The Bush administration has requested \$89 million in new funding to improve enforcement efforts at the IRS in the coming fiscal year.

Everson said that wouldn't allow the IRS to conduct more audits. Instead, he said, the IRS will use the results of the study to better focus its efforts and better "target" areas of noncompliance with the law when conducting audits.

Policy Changes

The Bush administration also has called for five policy changes it says would reduce the tax gap. They include taking steps to ensure employment taxes are paid by companies that use independent contractors leased by employment agencies, requiring additional information reporting, and holding professional tax preparers more accountable for the returns they handle on behalf of clients. These steps would recover about \$3.5 billion over a 10-year period, the Treasury Department estimated.

The administration also proposed paying private debt collection agencies a 25 percent commission to go after uncollected revenue, a policy criticized by the National Treasury Employees Union, which represents IRS workers.

Colleen Kelley, the union's president, said studies show it's more efficient to use IRS employees to go after the revenue.

`` The tax debt privatization program doesn't make any sense, either in terms of economics or efficiency," she said.

Montana Senator Max Baucus, the top Democrat on the Finance Committee, which oversees the IRS, called the administration's proposals for reducing the tax gap ``weak."

Tax Shelters

Baucus said the administration should embrace stronger Senate proposals to more clearly define when tax transactions lack economic substance, a key feature of an illegal tax shelter.

`` If we closed the tax gap, America could stop borrowing and our budget deficits could disappear," Baucus said. `` The federal government is failing the millions of Americans who patriotically pay their fair share of taxes when it fails to act aggressively here."

The IRS isn't the only government agency suggesting that Americans are paying less in taxes than they should.

In December, the Commerce Department said Americans avoided paying taxes on a record \$1 trillion in income in 2003. The department's Bureau of Economic Analysis shows the gap between true income and the amount Americans reported on income-tax filings has increased 35 percent between 2000 and 2003, a period when tax rates were falling. In the previous four decades, the gap has increased when taxes were raised and contracted when rates were lower.

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