Tax Tips You Can Use

	The "Tax Gap" By Kathleen Crawford, EA LTC #27851-C First Published in the Jacksonville Review Oct&Nov 2007 Updated August 2020

Each year the IRS commissioner reports to Congress on the tax system and one area that she or he discusses is the "Tax Gap". The next two articles will discuss aspects of the tax gap.

The tax gap is the tax money that was actually paid compared to the amount that should have been paid to the federal government. Sometimes this number includes only the amount paid on time and sometimes it includes the amounts paid on time, paid late, and paid after collection efforts. The tax gap has three components: Non-filers or taxpayers who don't file a tax return for some period; people who file but do not pay the full amount of tax owed; and taxpayers who under-report their income or over-report their expenses. The IRS did a study in 2001 by auditing a number of people and determined that the tax gap was about $345 Billion dollars for that year. The IRS estimates that even after collection efforts, they collect only 86% of what should be paid in taxes.

The tax gap affects us all because our tax rate (or deficit) could be 14% lower if 100% of people paid the taxes that were due, and also the IRS has stepped up its efforts to collect more of the taxes due causing more paperwork for everyone. As most people know, each year taxpayers receive more tax information statements from banks, mortgage companies, brokerage firms and other companies.

Non-filers are estimated to cause about 10% of the tax gap. These are people who chose not to or are prevented from filing a tax return at all. The IRS knows about a lot of these people because banks report interest to their social security number or brokerage firms report stock dividends or sales or companies report wages. The IRS has stepped up its efforts to prepare its own tax returns for these people. If the taxpayer is getting a refund, the computer just moves on. The reality is that if the taxpayer wants to make a donation to the treasury and leave their tax year open for audit, so be it. However if the computer thinks that the taxpayer owes money after its conservative calculation then it sends a tax bill. Unless the taxpayer responds with other information or an actual tax return, the bill becomes final and collectible.

The second part of the tax gap, about 5%, are taxpayers who file their tax returns, but don't pay the full amount due on the return. I have seen taxpayers who have stacked up tax debts for years before the IRS descends upon them. One of my instructors wondered aloud why anyone would think that the biggest, most powerful debt collector in the history of the world would pass them by, but people do think that the IRS will not come looking for them. If a taxpayer is known to owe money, they are the easiest target to help lower the tax gap. In recent years, the IRS has added many agents to go after these known tax debts, including additional personnel in the Medford office.

The biggest portion of the tax gap is made up of taxpayers who do not report all of their income or report more than their legitimate expenses. This category makes up almost 85% of the tax gap. Many people will wonder how a taxpayer can report less income than he receives. Most of the time it is the self employed who under-report. For example, a repairman is paid in cash and ‘forgets’ to put the amount in his records. Or a contractor fails to send out 1099’s to her subcontractors, so a subcontractor decides not report that income. Another type of income under-reporting is personal loan interest. If I loan my friend money and he pays me interest, that interest is income to me just like bank interest. How many people know to report this income? A third type of unreported income is the gain on sale of assets. The profit on the sale of personal items is taxable income, so that coin collection sold on ebay may generate taxable income to be reported.

The IRS has several methods to find these people. The first method affects many taxpayers. The rules for 1099 reporting are being tightened so that more 1099’s will be required. The various “1099” forms are the way that a business can report amounts paid to other individuals and businesses, so that the IRS will know about them. The fines for failing to issue 1099’s are being raised and enforced. In my practice, I have just seen the first penalty letter for late filing of 1099’s.

Another way that unreported income and over reported expenses are found is during an audit. In an audit, the IRS will look at bank deposits for the year. If a taxpayer’s deposits are above the income listed on the tax return, then the taxpayer failed to report income, unless he has an explanation for the difference. The IRS will also look at some aspects of life style. If the taxpayer claims to have made $2000 last year and has a new $50000 car in the driveway, there needs to be some explanation.

The IRS is three times more likely to audit a self-employed person than a taxpayer who works for wages because of the possibly of under-reported net income. Audits are not always random. I recently helped a taxpayer with a small audit. She received a letter that her large subcontract expense was being disallowed. The taxpayer had not filed 1099's for her subcontractors. We submitted the bookkeeping records to show that the expense was legitimate. But before the records were accepted, we had to submit cancelled checks, names, addresses and social security numbers, where available, for each subcontractor. My client's tax return was accepted, but guess who will get audited next.

The IRS is tightening income reporting rules and increasing audits because Congress wants the Tax Gap narrowed. When tracking income and expenses for your tax return, this is important to keep in mind.

The Jacksonville Tax Lady LLC (OR License #13695) is located in beautiful, historic Jacksonville at 610 N. Fifth Street across from the Pony Espresso. Kathleen and Angela can be reached at 541-899-7926.