The Tax Gap: It's Impact on Accounting Professionals and Academic Curriculum

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The Internal Revenue Service is growing increasingly concerned about the tax gap. The tax gap describes and estimates a measure of taxpayer non-compliance based on nonfiled tax returns and/or nonpayment of the correct amount of tax in a timely manner. Typically, this non-compliance is measured in three ways: non-filing of tax returns, underreporting of tax, and underpayment of tax. This paper examines tax gap data recently released by the IRS and explores the classroom implications for tax instruction, ethical issues encountered by the practitioner community, and the obligation of classroom instructors to embrace the AICPA Model Tax Curriculum.

INTRODUCTION

The enormity of the tax gap presents serious cause for concern in this time of continuous annual national deficits and economic uncertainty. This study is a descriptive investigation of the Internal Revenue Service (IRS) estimates of the tax gap and the ramifications for the accounting professional and accounting pedagogy. In order to discuss the tax gap, it is necessary to define the term. The IRS uses the term as a measure of taxpayer noncompliance with the Internal Revenue Code (IRC). This effectiveness is measured in a ratio of federal taxes actually collected and the amount of federal taxes that would be collected if taxpayers fully complied with the IRC and taxes were paid in full when due. The difference, or tax gap, represents what the IRS estimates taxpayers owe and the amount voluntarily and timely paid by taxpayers (Olson, 2009). While the change in ratio from 2001 to 2006 remains statistically insignificant, the amount in terms of dollars rose dramatically during the period (IRS, 2012). In 2001, the net tax gap stood at approximately $290 billion (Mazur and Plumley 2007) while the IRS estimates the amount for 2006 to be $385 billion (IRS 2012).

The tax gap is not a new phenomenon. Detailed research, such as the Taxpayer Compliance Measurement Program (TCMP), was conducted for tax years 1988 and earlier providing estimates of the tax gap amount. In 2001, the IRS commissioned a study, the National Research Program (NRP), to gather information relevant in explaining the causes of the tax gap and to provide recommendations necessary to reduce or eliminate it. While this investigation focuses on the individual taxpayer, it should be noted that the tax gap addresses all types of taxes owed the federal government, including income, employment, excise, and estate taxes.

TAX GAP CHARACTERISTICS

The tax gap consists of three components including nonfiling, underreporting and underpayment. Nonfiling occurs when those returns that according to IRS requirements should be filed are not filed, or are not filed on time. Underreporting of tax occurs when taxpayers fail to include all earned income as required by IRC Section 62, overstate deductions such as exemptions or exclusions not allowed, or distort income to include or increase credits not otherwise allowed. Underpayment occurs when taxpayers file their tax return but fails to pay the amount due within the time limit required by law (IRS 2005).

Since previous estimates of the tax gap were based on research conducted for the tax years 1988 or earlier, the IRS initiated the NRP program to measure individual taxpayer compliance for tax year 2001 (IRS 2005). Over the next three years, 46,000 returns from the 2001 filing year were selected for review and examination. From these returns, the NRP determined that taxpayers paid $1.767 trillion in tax obligations on time that represents compliance of about eighty-six percent (IRS 2005). However those who do not file or those who participate in the underground economy were not part of this measurement. Although it would be possible to statistically represent these missing taxpayers, the NRP elected to omit them and report only on the compliant group. Even though the federal government posted a modest surplus for 2001, these lost tax revenues cost the federal government in the short-term in the form of cash needs which were simply not available at critical times. Since 2001, the federal government has not had a budget surplus, making each year's tax gap even more critical (CBO 2012).

Who is responsible for the noncompliance? The IRS has identified what it believes to be two significant causes. One, the average taxpayer cannot understand the tax code and how to comply with the guidance. Thus, the Internal Revenue Code fails the average taxpayer because of its complexity. Two, there is significant noncompliance from self-employed individuals such as gross receipts, bad debts, and vehicle expense. According to an IRS official, information gleaned from the NRP analysis revealed underreporting of income cost the Treasury approximately $109 billion in lost income tax revenues. In contrast, overstating deductions cost the Treasury just $14 billion in lost tax dollars. Underreporting of capital gains resulted in an estimated $11 billion loss of tax revenue. Certain preliminary information from this same study suggests as little as 19 percent of actual income is reported by businesses using the cash method of accounting. Third, the IRS matching program is inept at catching unreported income from third party payers such as brokerages, flow-through entities, and 1099 payers (Dwoskin 2012; IRS 2008). In these situations, there is little or no withholding of federal taxes. Conversely, where federal taxes are withheld, over 98 percent accuracy is achieved in reporting income. In other words, third party documents such as W-2s enjoy the highest degree of reporting accuracy (IRS 2008).

All of this information leads a casual observer to conclude that individual taxpayers are the main culprits in this problem. Such a conclusion is in fact supported by the NRP study. Preliminary results of this study show individual underreporting makes up nearly fifty percent of the total tax gap (IRS 2008).

Working in cooperation with each other, the Administration, Congress, Treasury, and the IRS have developed a multi-step plan designed to combat the tax gap. According to the Treasury Department's Office of Tax Policy, four key principles guided the development of this plan: one, both unintentional taxpayer errors and intentional taxpayer evasion should be addressed; two, sources of noncompliance should be targeted with specificity; three, enforcement activities should be combined with a commitment to taxpayer service; and four, policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden (US Treasury 2006a; Russell 2007a).

The Treasury Department has developed sixteen proposals grouped into four key categories. These categories include: expanded information reporting; improved compliance by businesses; strengthening tax administration; and increasing penalties on tax preparers to not just include penalties from income tax returns, but also on employment, excise, exempt organizations, and estate and gift tax returns (US Treasury 2006b; Russell 2007b).

2006 TAX GAP ESTIMATES

The IRS updated the tax gap estimate based on the tax year 2006 liabilities using more recent data in all components and improved methodologies. The estimate also takes into account receipts from enforcement activities and late payments (IRS 2012). For 2006, the amount of true taxpayer liability is estimated to be $450 billion compared to the 2001 estimated liability of $345 billion. According to the IRS, the voluntary compliance rate of 83.1 percent for 2006 remains statistically unchanged from the 2001 rate of 83.7 percent (see Table 1).

TABLE 1
TAX GAP STATISTICS
TAX YEAR 2006 COMPARED TO TAX YEAR 2001
(Amounts are in billions of dollars)

	2006	2001
Estimated Total Tax	**2,660**	**2,112**
Liability Gross Tax Gap	**450**	**345**
Overall Voluntary Compliance Rate	**83.1%**	**83.7%**
Net Tax Gap*	**385**	**290**
Overall Net Compliance Rate	**85.5%**	**86.3%**
Liability Gross Tax Gap comprised of the following:		
Nonfiling Gap	**28**	**27**
Individual Income Tax	25	25
Estate Tax	3	2
Underreporting Gap	**376**	**385**
Individual Income Tax	235	197
Non-business Income	68	56
Business Income	122	109
Adjustments, Deductions, Exemptions	17	15
Credits	28	17
Corporate Income Tax	67	30
Small Corporation (assets under $10 M)	19	5
Large Corporation (assets of 10M or more)	48	25
Employment Tax	72	54
Self-employment Tax	57	39
FICA and Unemployment Tax	15	15
Estate Tax	2	4
Underpayment Gap	**46**	**33**
Individual Income Tax	36	23
Corporate Income Tax	4	2
Employment Tax	4	5
Estate Tax	2	2
Excise Tax	0.1	0.5
* Net tax gap is defined as tax liabilities, incurred in that year, that remain outstanding after IRS enforcement efforts.		
Source: Internal Revenue Service 2012		

The increase in the gap to $385 billion from $290 billion is due to an increase in tax liabilities and does not reflect a significant change in the compliance rate. The IRS estimates the net compliance rate at 85.5 percent which is statistically unchanged from the 2001 tax gap net compliance rate of 86.3 percent. However the 2006 estimated total tax ($450 billion) compared to the estimated $385 billion gap, means that 14.3 percent of the total tax liability will never be paid as compared to the 2001 estimated 18.96 percent nonpayment (IRS 2012).

As displayed in Table 1, the change in the tax gap from 2001 to 2006 was concentrated in the underreporting and underpayment forms of noncompliance. The nonfiling portion ($28 billion versus $27 billion) of the gap barely changed. The underreporting gap ($376 billion versus $285 billion) changed by 32 percent while the underpayment gap ($46 billion versus $33 billion) changed by 38 percent. Overall, the estimated tax gap increased from 2001 to 2006 by 32 percent which is slightly more than the increase in the overall tax liability (30 percent).

PROFESSIONAL PERSPECTIVE

Many proposals have been made to close or reduce the tax gap. Proposals have been made by the IRS, Treasury, the National Taxpayer Advocate, legislators, the AICPA and others. For example, the American Institute of Certified Public Accountants (AICPA) supports the Senate Finance Committee to identify constructive means to close the tax gap to collect billions of dollars in lost revenue (AICPA 2007a). The National Taxpayer Advocate recommends three major strategies to close the gap. The strategies include (1) fundamental tax simplification, (2) expand third-party reporting to include non-wage income, and (3) improve IRS compliance activities to balance taxpayer service and enforcement (Olson 2007).

Tax compliance measures were included in the President's 2009 revenue proposal including: 1099K reporting payments to corporations, 1099b reporting security sales, merchant payment card information reporting and increase information return penalties. Together these revenue proposals are estimated to generate $35 billion in revenue to close the tax gap (Nellen 2008).

During the AICPS's 125th anniversary celebration, AICPA president Melancon indicated that tax reform and simplification are concerns of the organization. He expressed belief that technology would have a significant impact on tax preparation. He also noted that there are current proposals for the IRS to keep track of all income and transactions and simply send a tax bill to the taxpayer as a means to reduce the tax gap. Although in the short-term, Melancon admitted that the gap might increase if revenue transactions went unreported (Cohn 2012).

Given rising healthcare costs, the baby boom generation entering retirement, and federal spending on Medicare, Medicaid and Social Security programs growing, and the tax gap will only increase and have serious ramifications for the federal budget. Consideration and enactment of tax gap reduction proposals must continue and be successful. As many of the proposals impact tax guidance, it is also imperative that the accounting profession and academic tax curriculum keep pace with any federal tax code reform.

PROFESSIONAL RESPONSIBILITY

The debate over to who the tax professional owes their allegiance is at the forefront. Does the tax professional owe a greater responsibility to the tax system or to the client? Significant criticism and proposed reforms seem to target the tax professional as, if not the main culprit, at least a contributing culprit as a cause of the tax gap. Whether due to a lack of understanding of the tax code and its subsequent misapplication, or to a lack of adherence to professional standards and codes conduct, the tax professional is squarely in the eyes of the administration, Congress, US Treasury, and the IRS. In situations where conflict arises, does the tax professional owe their loyalty to the client or the system? When more than one legitimate interpretation of the tax code exists or where tax law is unclear, the tax professional has to make a choice as to how to proceed. The duty to inform the client of the alternatives

and the consequences attached to each never disappears. The tax professional is somewhat constrained by rules promulgated by the Treasury Department.

Until recently, Internal Revenue Code Section 6694 imposed a standard on tax preparers which required a tax preparer to avoid taking positions which had a less than one chance in three of being sustained on its merits. In 2007, that standard was changed to require a good faith belief that the position has a realistic possibility of being sustained (IRS 2007). This standard now incorporates language similar to preponderance of evidence rules used in a courtroom, where a judgment is to be made based on a belief a position is more likely than not to be accepted or sustained.

Past Commissioners of the Internal Revenue Service, Roscoe Egger and Mark Everson both argued that tax practitioners have a primary responsibility to the tax system (Egger 1982; Everson 2004). The AICPA takes the position that tax practitioners have a responsibility to be fair and honest in their dealings with the IRS and should instill in their clients confidence in the tax system. However, no taxpayer is under any obligation, moral or legal, to pay more taxes than legally owed. In *Gregoy v. Helvering* (1934), Judge Learned Hand declared many years ago that there is nothing sinister in arranging one's affairs as to keep taxes as low as possible Judge Hand also indicated that everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more tax than the law demands (Chirelstein, 1968). .

The tax professional's responsibility to instill in his clients confidence in the tax system must begin with the attitude of the tax professional. There can be no tolerance for clients who wish to abuse the tax system, even if just a little bit. Much of what taxpayers think they know about tax law stems from conversations they have with other, equally uninformed people. They incorporate these practices into their own practices, perpetuating the problems. Taxpayers act without seeking advice from their tax professional and expect the tax professional to correct or resolve the problems the taxpayer creates for them self. However, if the tax professional is weak and dependent on each and every client he has, the greater the likelihood the tax professional will find some way to work around the problems caused by these uninformed clients. By establishing strong ideals with the beginning interview, clients can then decide if this is the right tax professional for them. Changing learned behavior is not easy, so accepting a client who has not had the prior benefit of a tax professional presents some risks. Only after the passage of time, and by observing how a client adapts to advice, will a tax professional be able to decide whether to continue with a client or drop the client.

CLASSROOM DILEMMA AND PERSPECTIVE

Given that those who aspire to become a professional tax accountant must be exposed to the tax code and its implication, all of the issues swirling around the tax gap are ripe for classroom consideration. The AICPA Model Tax Curriculum (MTC) provides guidance for designing the tax component of the accounting curriculum so that the AICPA's vision and its tax section's mission can be maximized (Dennis-Escoffier et al 2009). The AICPA first developed the MTC in 1996 and modified it in 1999. A joint task from comprised of the American Taxation Association (ATA) and AICPA members completely revised the curriculum guidance in 2007 to focus on learning outcomes. The MTC's recommendations are intended to adequately prepare students for entering the accounting profession, and to aid in the design and assessment of accounting curricula that will serve to attract students to careers in taxation. The primary objective of the tax component of the accounting curriculum is that students understand the role of taxation in economic decision making and financial reporting. Among the various learning outcomes set forth in the MTC, two are of particular note: one, the ability to draw supportable conclusions regarding tax issues by using research skills to identify and evaluate strengths, weaknesses, and opportunities; and two, the ability to appreciate the professional and ethical obligations for tax service providers. The MTC places a high degree of importance in the development of decision making and ethical behavior (Dennis-Escoffier et al 2009).

The revised MTC (AICPA 2007b, 2) sets forth that the primary objective of the accounting curriculum tax component is that students understand the role of taxation in economic decision making

and financial reporting. The MTC achieves this object via a series of learning outcomes that the student should master before entering the accounting profession. These outcomes include the following.

- Comprehend the rationale for tax laws
- Apply analytical reasoning tools to assess how taxes affect economic decisions
- Analyze how taxes affect financial reporting
- Develop a fundamental understanding of the components of taxable income
- Draw supportable conclusions regarding tax issues
- Communicate tax conclusions and recommendations
- Appreciate the professional and ethical obligations
- Hone interpersonal skills

The MTC specifies that the learning outcomes can be accomplished with a variety of means including undergraduate or graduate courses, tax or nontax courses, in-class or out-of-class activities, as well as face-to-face as well as online or hybrid electronic classes. Whichever delivery means or curriculum design is employed to achieve these outcomes must be evaluated to assure that the desired outcomes are attained. In the classroom, the professor's responsibility is to prepare students to recognize and adhere to the obligations set forth by the state board, state society, AICPA, and the US Treasury. The tax and nontax courses have an obligation to instruct students to recognize what constitutes income, what must be included and what can be excluded within the income recognition, what represents deductions, and what can be claimed as tax credits. These recognitions come from the rigorous investigations of practice and the examination of case history. Additionally and of equal importance is the academic's obligation to instruct and guide students to recognize what constitutes fraud, tax evasion or tax avoidance. The concept of reducing a taxpayer's taxable income to the lowest possible amount by practicing tax avoidance is at the heart of the tax classroom approach.

CONCLUSION

This descriptive investigation explores the IRS tax gap estimates and its ramifications for the accounting professional and the accounting pedagogy. The growth in the tax gap estimate from 2001 to 2006 is concentrated in the underreporting and underpayment forms of noncompliance which account for more than nine out of ten tax gap dollars. Although the IRS has initiated several initiatives to address the tax gap, they have not significantly impacted the estimated gap between the amount taxpayers owe and what they pay. The accounting professionals pay a major role in explaining to taxpayers their tax obligations and demystifying the tax code especially with regard to how taxes affect financial reporting.

The revised MTC highlights the academics' role in society and advocates learning outcomes to help student who aspire to become professional accountants to understand their unique contribution and obligation to the profession. Professional tax accountants are responsible for the effective administration of our tax system by promoting integrity and ethical dealings between the taxpayer and the federal government.

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