

Tax Gap (And what to do if you find yourself there)

By

Brett Hersh, EA, MBA

The tax gap is the difference between taxes owed to the US Treasury and taxes actually paid by taxpayers. The tax gap is estimated to be 300 billion dollars annually. The IRS believes that two-thirds of the tax gap (\$200,000,000,000) is caused by individuals who: 1) do not file their tax returns, 2) properly file but do not pay tax due with the return, and 3) those who under-report income on the returns they file. Eighty percent (\$160,000,000,000) of this “individual” tax gap results from sole proprietors’ (those filing schedule C) under-reporting business income.

In my experience, the vast majority of individual noncompliance is not caused by intentional misstatement or willful neglect. The first component, failure to file, is often explained by circumstances beyond the taxpayer’s control - such as a health issue or family crisis. Procrastination, another common reason for not filing, is much more profound when taxes are owed. Procrastination leads to a missed deadline. The inaction that led to missing the deadline then turns into fear of IRS reprisal. More years of non-filing followuntil the IRS finally catches up. The second component of the individual tax gap, filing a return but not paying the tax due, is most commonly caused by the individual’s financial circumstances, not refusal to pay.

Most under-reported business income is explained by two factors: the complexity of the tax code and the fact that many sole proprietors handle their own accounting. Sole proprietors who handle their own accounting often overlook (or do not understand) 1099 reporting requirements. Many also prepare their own tax returns or utilize a less-than-knowledgeable tax preparer.

So, now that we’ve discussed the financial forces and geological underpinnings that form the tax gap; what should you do if you find yourself lost in the tax gap? Here are a few bits of direction that may help you navigate through to a more pleasant location.

First: Do not panic. Being lost in Tax Gap is a serious situation. More often than not, however, it is not as dire as most believe. Keep your cool and keep things in perspective. Most tax delinquencies are settled more easily than you may anticipate. Also remember that every step you take is accompanied by rights, options, and opportunities. Un-filed returns can be filed. Erroneous returns can be amended. Income and deductions can be substantiated. Payment plans can be established. Under certain circumstances, the amount you owe can be negotiated and reduced.

Second: Do not wait. The tax gap has no tolerance for placing one's head in the sand. Hiding an IRS notice in a drawer may help you avoid it, but it does not delete your file from the IRS database. Maybe you don't have the money to pay the bill or don't understand what the notice means. Perhaps you are delirious and think the IRS will lose track of you if you stand very still and quiet. After all, you tell yourself, the amount you owe is but a proverbial grain of sand in the tax gap. The IRS must have larger nuggets to reap. Unfortunately, this delusion is seldom the case. The collection of past due taxes is an escalating process. As you procrastinate, penalties and interest mount, and your rights and options may be diminished. Navigating out of the tax gap requires action.

And finally, don't go it alone. Consider hiring a competent, professional guide who speaks the IRS language and understands their procedures. A professional representative can investigate the legitimacy of IRS claims and explain your situation to IRS representatives. Tax professionals have the expertise to correct errors and find missed deductions that may reduce the total tax due. They can also investigate your personal circumstances, financial status, and ability to pay and help formulate a strategy that will satisfy the IRS without causing you, your family or your credit rating undue hardship.

In this article we have discussed the federal tax gap and offered some ideas to consider if you find yourself in it. These ideas may also apply to navigating your way out of your state's tax gap, although the approach may be a bit different. If you should need any assistance, as always, feel free to contact our office or consult with a qualified tax professional.

Brett Hersh is the owner HBS Tax. He can be reached at (304) 267-2594. If you would like regular updates on important tax changes and planning strategies, please sign up for the HBS Tax Newsletter at HBSbusiness.com.