

## THE INDIVIDUAL INCOME TAX GAP AND ACCOUNTS RECEIVABLE

### The Tax Gap

Several years ago the Internal Revenue Service developed the concept of the tax gap as a way to measure voluntary federal income tax compliance.

- The **gross tax gap** is the difference between taxes owed (the “true” tax liability) and taxes paid voluntarily and timely for any given tax year.
- The **net tax gap** is the gross tax gap minus taxes collected through various IRS enforcement programs for the same tax year.

Both gross and net individual income tax gaps consist of three main components: nonfiling, underreporting and underpayment.

- The **nonfiling** gap is the amount of tax liability owed by taxpayers who do not voluntarily and timely file returns.
- The **underreporting** gap is the amount of tax liability not voluntarily reported by taxpayers who do file returns.
- The **underpayment** tax gap is the amount of tax liability individuals report on returns but do not pay voluntarily and timely.

IRS’s latest estimates of the gross individual income tax gap for tax year 1992 (the most recent year for which figures are available) range from \$93 to \$95 billion. The estimated total “true” individual income tax liability is between \$550 and \$552 billion for tax year 1992.

This means the overall individual **noncompliance rate** is about 17 percent. Conversely, the **voluntary compliance rate**, as measured by tax gap research, is about 83 percent. That is, 83 percent of taxes owed are paid voluntarily by taxpayers. While the rate of tax noncompliance has remained fairly stable over the last 20 years, the dollar value of the noncompliance rate has risen sharply.

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## **Accounts Receivable**

As these tax gap estimates indicate, the vast majority of taxpayers pay the taxes they owe voluntarily and on time. Out of fairness to the millions of Americans who meet their tax obligations, the IRS has a compliance program to collect overdue taxes from those who do not.

However, we do not treat all noncompliant taxpayers the same. We know that in some cases taxpayers are able to comply with the tax law but for some reason are unwilling to do so. On the other hand, we also realize that some taxpayers who owe overdue taxes would like to comply with the law but are unable to pay the taxes they owe because of serious hardship. (Taxpayers in this kind of situation have accounts that we consider "Currently Not Collectible"; see below.)

Like any business, the IRS maintains an **accounts receivable inventory**, money that is owed the business -- in this case the federal government.

It is important to understand what makes up the total amount of the IRS accounts receivable inventory. When a taxpayer either does not file a return or files an inaccurate return, we make an assessment -- that is, send a bill -- based on the tax laws. In sending these bills, we do not consider ultimate collection potential. If we did not make such assessments, it would seriously undermine our voluntary tax system. It would also be unfair to those taxpayers who do file timely and accurately.

We record these unpaid assessments -- plus ever-increasing interest and penalties related to the unpaid taxes -- as accounts receivable. We keep them on our books for as long as they are legally collectible -- 10 years, as prescribed by law. Thus, unlike private businesses, the IRS's accounts receivable cannot be simply written off as uncollectible.

At the end of FY 1996, IRS's gross accounts receivable inventory was \$216.3 billion, of which 30 percent, or about \$65 billion, reflected accrued interest and penalties.

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## Components of the Accounts Receivable Inventory

The IRS's gross accounts receivable inventory for compliance purposes is divided into two components: Currently Not Collectible and Active Accounts Receivable.

- **Currently Not Collectible Accounts** are those that IRS Collection employees, after carefully reviewing specific facts and circumstances, determine that taxpayers cannot currently pay. We can make this determination for a number of reasons, including personal hardship.

At the end of FY 1996, \$105.8 billion -- nearly half of the gross receivable total -- was classified as Currently Not Collectible. Over 70 percent of that amount (or \$75 billion) is not collectible either because the tax is owed by a defunct corporation; the taxpayer is in bankruptcy; we are unable to locate the taxpayer; or the taxpayer is under such a hardship that he or she cannot pay the amount owed.

- **Active Accounts Receivable** are accounts that are potentially collectible and that continue to be pursued through normal collection activities: first, a series of notices and telephone contacts; then installment agreements and offers in compromise; and ultimately as a last resort, liens, levies and seizures.

At the end of FY 1996, \$110.5 billion of gross accounts receivable, a little over 50 percent, made up this component .

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