

Wisconsin's Billion-Dollar Tax Gap

How uncollected taxes can help fill the state's budget hole

Institute for Wisconsin's Future

April 2010

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Wisconsin citizens want strong communities, reasonable state and local taxes and a revenue system in which all individuals, businesses and organizations pay a fair share. IWF's Fair and Adequate series of reports examines how the current tax system works and what changes are needed to create a fair system that adequately funds the services needed for the common good.

Executive Summary

In 2010, recovery from the recession requires better schools, better roads, better infrastructure and aid for the unemployed. However, Wisconsin faces a multi-billion dollar revenue shortfall. Almost half of that deficit would disappear if the state was not losing over one billion dollars annually to the “tax gap,” the difference between what is legally owed by taxpayers and what is actually paid.

The majority of Wisconsin citizens are conscientious, paying responsibly to keep our state, county, municipal and education systems running. Unfortunately, a substantial number of taxpayers don't.

The tax gap is defined as the difference between the amount of money that taxpayers should pay and the amount that is actually paid voluntarily and on time. Wisconsin's annual tax gap of \$1.2 billion is equal to 10% of state tax collections.

This tax gap contributes heavily to the state budget shortfall and reduces the amount of revenue available to fund vital public services and infrastructure. This in turn leads to higher state and local taxes—raising costs for the households and businesses who already pay taxes. This is double jeopardy for people who are contributing their fair share. When citizens see that some people can skip out on their tax responsibility without consequence, they lose confidence in the revenue system. For businesses, this gap in tax collections can skew profits to those who don't pay. The local retailer loses out to the Internet seller. The multinational corporation avoids tax costs that state-based businesses must pay. This imbalance distorts the market.

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This report estimates the gross tax gap (before audit enforcement activity) for Wisconsin's four largest General Purpose Revenue taxes in Fiscal Year 2009. This \$1.6 billion gross tax gap includes: the individual income tax (\$746 million), sales tax (\$536 million), corporate income tax (\$113 million), cigarette tax (\$44 million), and underpayment of taxes (\$164 million). Collections actions by the Department of Revenue recovered \$401 million, leaving a net tax gap of \$1.2 billion.

Strategies for reducing the tax gap begin with ongoing measurement and evaluation of the gap. Policymakers and the public must know how big it is, the main causes of revenue loss and steps needed to address the problem. This information ensures that legislators and state administrative officials can make sound decisions about both revenue policy and the resources required for effective administration. It is also crucial to:

- Reduce chances to evade taxes by increasing information that is required to be reported and increasing situations requiring withholding of tax on payments;
- Improve technology such as e-filing and the use of electronic databases for audits and collections;
- Increase investments in Department of Revenue resources for audits and tax collection;
- Improve online taxpayer services, communications and outreach to non-English speakers;
- Reform and simplify tax laws so they are clearer and reduce opportunities for tax evasion;
- And coordinate with partners including tax preparers to ensure competence and ethical work.

“The vast majority of Americans pay their taxes accurately and are shortchanged by those who don't pay their fair share,” said IRS Commissioner Mark W. Everson. “The magnitude of the tax gap highlights the critical role of enforcement in keeping our system of tax administration healthy.”¹

What Is the Tax Gap?

The tax gap is “the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time,” according to the federal Internal Revenue Service (IRS). “The tax gap can also be thought of as the sum of non-compliance with the tax law.”²

There are three ways a tax gap can be created:

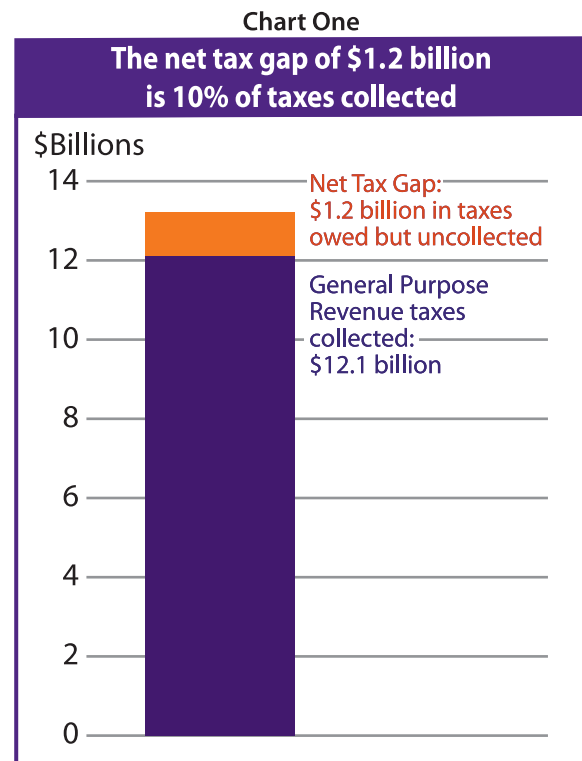
1. Underreporting— when taxpayers do not report all of their taxable income or claim more exemptions, deductions and credits than they’re entitled to;
2. Non-filing—when tax returns simply are not filed at all;
3. Underpayment—when taxpayers report the correct amount of tax due, but don’t pay the full amount.

These three items—underreporting, non-filing and underpaying—make up the gross tax gap. Enforcement actions, including audits and collection of delinquent taxes, track down some of this amount. What’s still left uncollected, after enforcement actions, is the net tax gap.

Some of the tax gap results from deliberate tax evasion, but not all of it is intentional. Taxpayers may make inadvertent mistakes or they may have misunderstandings about the kinds of income or sales that are taxable or about the deductions and credits they may claim.

The tax gap only relates to legal income. It is extremely difficult to measure the extent of illegal income—and hence the taxes that might be owed on the income, were the income to be legal. Also, government efforts are generally aimed at stopping the illegal activity itself, rather than collecting taxes on the illegal income.

The tax gap is a very different concept than that of the ‘underground economy’—transactions that escape official measurement. There is some overlap between the two, but they are different. For example, the underground economy includes illegal activity, which isn’t part of the tax gap. And the tax gap includes overstated expenses and deductions that aren’t part of the underground economy. The IRS notes: “The greatest area of overlap between these two concepts is sometimes called the ‘cash economy,’ in which income (usually of a business nature) is received in cash, which helps to hide it from taxation.”³



How Big Is Wisconsin's Tax Gap?

In Fiscal Year 2009, Wisconsin had a tax gap of \$1.6 billion. This is the estimated gross tax gap, prior to collections from enforcement activities. Collections actions by the Department of Revenue recovered \$401 million, leaving a net tax gap of \$1.2 billion. [See Chart One.] The detailed calculations that support these estimates can be found later in this report.

The gross gap of \$1.6 billion is equal to 13% of all general purpose revenue (GPR) tax collections that year. The net gap of \$1.2 billion is equal to 10% of all GPR collections. GPR taxes are the basic revenues for state operations, and include income taxes (individual and corporate) and sales taxes. Any other tax revenue the state collects is for very specific purposes, such as gasoline taxes for the state's transportation spending.

This \$1.6 billion gross tax gap includes:

- Individual income tax (\$746 million),
- Sales tax (\$535 million),
- Corporate income tax (\$113 million),
- Cigarette tax (\$44 million), and
- Underpayment of taxes (\$164 million). [See Chart Two.]

Chart Two

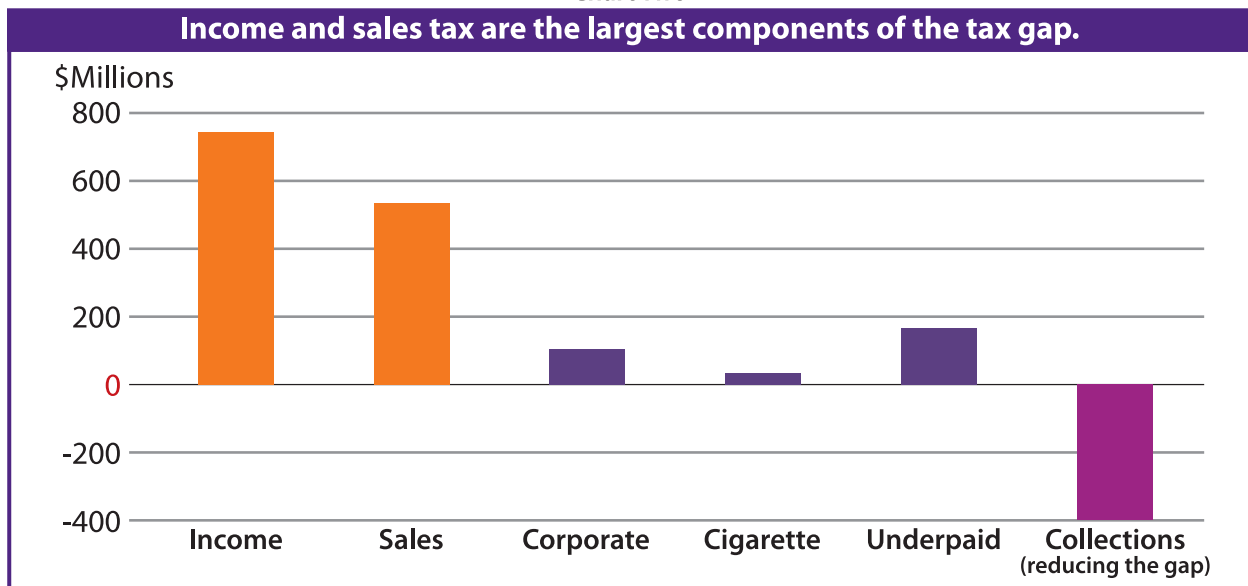
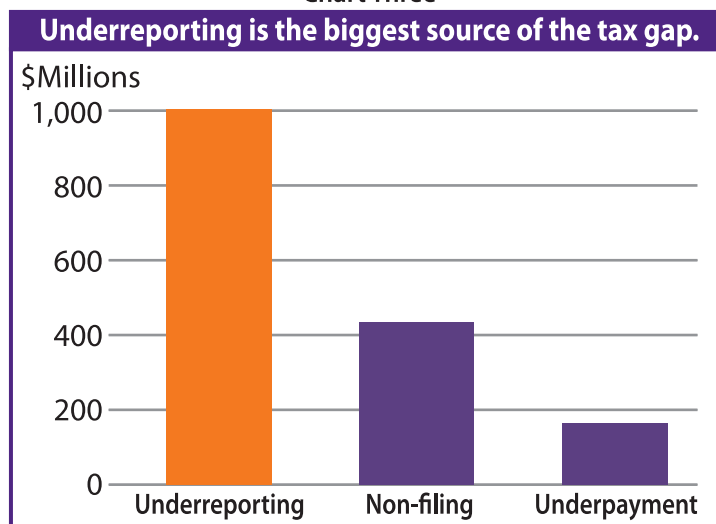


Chart Three



The taxes estimated are the four largest GPR taxes, generating 95% of collections in FY 2009. The gaps for other taxes are not likely to add substantially to the estimate. Also, the tax gap estimate is for GPR taxes only. No estimate was made for the gasoline tax or other segregated fund taxes.

Nearly two-thirds of the gross tax gap (63%), which totals about \$1.008 billion, came from underreporting. Non-filing accounted for 27% of the gross gap, or \$431 million. Underpayments were 10% of the total, or \$164 million. [See Chart Three.]

Why Is the Tax Gap Important?

The tax gap matters—a lot.

The money that is lost through the tax gap could be used to improve transit systems, ensure small classes in the early grades, provide consistent home health care for the elderly, hire enough district attorneys to boost public safety or prevent property tax hikes.

Closing the tax gap can generate substantial revenue. For example, reducing Wisconsin's net tax gap by 20% would generate \$240 million. This is the equivalent of all state spending on the Wisconsin Technical College System, the state's District Attorneys and the entire Department of Tourism. These additional funds would be particularly important as we face long-term structural deficits, high demand for support systems during the continuing recession and demands for structural improvements that pave the way for economic recovery.

The tax gap raises other issues – like fairness. If some taxpayers are not paying their fair share, others are either paying more than they should or receiving fewer services than they deserve. The tax gap imposes an unfair burden on citizens who already pay the taxes they legally owe.

The fact that many individuals and businesses step around their taxes is not a well-kept secret. The citizens shelling out for their own taxes as well as the costs of those who don't pay what they owe lose confidence in the tax system. If honest taxpayers doubt the effectiveness and fairness of the tax system, they become less willing to comply voluntarily and the gap grows.

Reducing Wisconsin's net tax gap by 20% would generate \$240 million.

The tax gap pattern is damaging to the economy by putting compliant taxpayers at an economic disadvantage to the individuals and businesses that do not pay their fair share. Wisconsin retailers who collect sales tax are at a disadvantage to out-of-state Internet and mail-order retailers who aren't required to collect the tax. Wisconsin companies that pay their required amount of taxes are at a revenue disadvantage to competitors who try to shift corporate income to states where there is no tax.⁴

The tax gap also hurts the economy by diverting private resources to finding loopholes and public resources to preventing tax avoidance practices. The tax gap occurs, in part, because of the complexities of federal and state tax laws. A substantial number of taxpayers take advantage of these complexities, sometimes legally, but also illegally, to reduce their tax liability. These strategies are not costless. Companies expend substantial dollars to lawyers and accountants for tax purposes. These expenses add to consumer costs. Tax avoidance activities also require government tax agencies to devote staff and resources to identifying and challenging questionable practices.

Strategies for Reducing the Tax Gap

The tax gap exists at the federal level and in states throughout the nation. National policymakers and state leaders are looking at ways to prevent dollars from draining out of the public coffers. The best comprehensive set of recommendations comes from a 2009 study by the U.S. Department of the Treasury⁵ which identified seven strategies for reducing the tax gap:

1. Reducing opportunities for tax evasion—primarily through additional information reporting and withholding of tax on payments. Compliance with tax laws is highest when there is reporting of payments and withholding of tax on those payments. Misreporting is lowest for wages and salaries, interest and dividends, pensions and annuities, and deductions, all items for which information is reported and, in some cases, taxes are withheld. Misreporting is highest for items with little or no information reported. The major strategy for reducing misreporting where it is the highest is finding ways to require information by persons making payments to taxpayers;
2. A commitment to research on the tax gap—discussed further in the next section;
3. Improvements in information technology, such as e-filing to simplify tax processing and decrease errors, as well as the use of electronic databases in audit and tax collection;
4. Improved compliance activities, including more resources for audit and tax collection, and more efficient use of these resources;⁶
5. Enhanced taxpayer service, including new and expanded online services, more effective communications and outreach to taxpayers who do not speak English;
6. Reform and simplification of tax laws, which would make it easier for taxpayers to understand tax laws and voluntarily comply with them and would reduce opportunities for tax evasion. In a 2007 report, the IRS stated: “The tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to tax law complexity that results in errors of ignorance, confusion and carelessness.”⁷
7. Coordination with partners and stakeholders, including tax preparers and other federal and state agencies. Federal and state agencies have long complained about incompetence and unethical standards among tax preparation professionals. In January 2010, the IRS announced it would require anyone who prepares federal tax returns to register, pass a minimum competency test and be subject to continuing education requirements and ethics rules.

Measuring the Tax Gap

The tax gap is difficult to measure—after all, it requires information that taxpayers do not provide voluntarily. Further, efforts to measure the gap can be burdensome to taxpayers. Until the late 1980s, the IRS had a Taxpayer Compliance Measurement Program, involving intensive, line-by-line audits. That program was discontinued due to concerns that the audits were too burdensome for the taxpayers involved.

After that, the IRS relied on narrower, less comprehensive approaches to measuring the tax gap, but has now initiated a National Research Program. This program consists of a statistical sampling of tax returns, supplemented by information from other data sources. By tapping into this supplemental data, the IRS can obtain much of the information it needs without contacting taxpayers. However, it will continue to contact some sampled taxpayers for information that cannot be verified through IRS or other databases. In addition, the federal tax agency has received a boost in funding that will allow it to update its tax gap estimates regularly.

Measuring the tax gap may be even more difficult for state tax agencies, with fewer resources available to them than the IRS. Only a few have published studies recently—California, Idaho, Minnesota and New York.⁸ A recent announcement by the Minnesota Department of Revenue indicates just how difficult tax gap measurement can be. Minnesota DOR found, while updating its individual income tax gap study done for tax year 1999, that the methodology was flawed and the resulting estimates were not reliable.⁹ Yet, there are good reasons for federal and state tax agencies to devote resources to estimating the tax gap and sharing their findings with policy makers and the general public.¹⁰

Consistent monitoring of the tax gap ensures that revenue agencies, policy makers and citizens know how serious the problem is. Research groups provide reasonable estimates, but only a tax agency like the IRS or the Wisconsin Department of Revenue has access to the taxpayer records and other data sources that permit careful measurement of the tax gap. Further, measuring the gap should not be a one-time exercise. The gap should be measured periodically—such as every five years—in order to identify whether it is increasing or decreasing.

Periodic tax gap reviews show the main sources of the tax gap, identify strategies for reducing the gap and evaluate strategies underway. For instance, tax gap studies can point to problematic areas of tax law or regulations, identify potential targets for taxpayer service and education, and suggest law and rule changes that will promote compliance.

Tax gap studies help to target enforcement methods—identifying the kinds of taxpayers and activities that should be audited and the strategies that will facilitate collection from delinquent taxpayers. This research can also help tax administrators and policy makers understand the limits of enforcement. The tax gap cannot be closed completely. Trying to do so would require record-keeping and reporting that is too costly and, more importantly, is more intrusive than is acceptable.

Consistent overview of the tax gap can help to reassure the vast majority of taxpayers that policy makers care about fairness are working actively to rebalance the revenue system so every player contributes their share. That will increase confidence in the tax system.

Wisconsin's annual tax gap of \$1.2 billion is equal to 10% of state tax collections.

Simply put, measuring the tax gap is good government. Tracking revenue loss clarifies the size and causes of the problem, identifies ways to address it, allocates appropriate resources to enact those strategies, and evaluates whether these actions are effective in reducing the gap. It is the first necessary step in treating taxpayers fairly.

Tax Gap Estimates in Detail

The following sections describe the tax gap estimates and their methodologies in detail. For the individual income and sales taxes, both underreporting and non-filing were estimated. The corporate income tax estimate is for underreporting only, while the cigarette tax estimate is for non-filing only. The underpayment gap is the total for all taxes.

Individual Income Tax

Tax Gap estimate: Wisconsin had an underreporting gap of \$578 million and a non-filing gap of \$168 million in Fiscal Year 2009. The combined gap of \$746 million was equal to about 12% of actual income tax collections that year.

Most of the income tax gap involves business income. In its most recent study of the tax gap, the IRS notes: "Well over half of the individual underreporting gap came from understated net business income (e.g., unreported receipts and overstated expenses)."¹¹ Business income is only 8% of Wisconsin income, but responsible for 57% of the underreporting tax gap. This income includes the earnings of sole proprietors, farmers and owners of partnerships, S corporations and trusts and estates, and rents and royalties.

Methodology: This report is based on a 2007 Internal Revenue Service estimate of the federal individual income tax gap for tax year 2001.¹² **The IRS study uses the word “misreport” to cover the various kinds of taxpayer behavior that constitute the tax gap.**

Table One shows the misreporting percentages from the 2007 IRS report that were used in estimating the Wisconsin individual income tax underreporting gap. We applied these misreporting percentages to amounts of Wisconsin income, exemptions, deductions and credits in 2007, to estimate misreporting on Wisconsin returns. The misreported amounts were multiplied by the state's average marginal tax rate in 2007 of 5.36% to determine the Wisconsin underreporting gap.¹³ The estimates for tax year 2007 were adjusted to Fiscal Year 2009 collection levels.

Table 1

| Misreporting Percentage for Components of Income, and Exemptions and Deductions | | |
|---|-------------------------|--------------------------------|
| Income, Exemption or Deduction | Misreporting Percentage | Estimated Tax Gap (\$millions) |
| Wages and salaries | 1% | \$56 |
| Interest income | 4% | \$10 |
| Dividend income | 4% | \$8 |
| Capital gains | 12% | \$34 |
| Business income | 57% | \$191 |
| Farm income | 72% | \$13 |
| Rents and royalties | 51% | \$30 |
| Pass-through entity income (a) | 18% | \$93 |
| Pensions and annuities | 4% | \$25 |
| Other gains (b) | 64% | \$15 |
| Alimony income | 7% | \$1 |
| Unemployment compensation | 11% | \$4 |
| Other income | 64% | \$58 |
| Adjustments to gross income (c) | -21% | -\$19 |
| Exemptions | 5% | \$10 |
| Deductions | 5% | \$3 |
| Credits | (d) | \$45 |

(a) Income from partnerships including limited liability companies, S corporations, estates and trusts, and real estate mortgage investment conduits.

(b) Gains from sale of assets other than stocks, bonds and other capital assets; these gains are generally reported on federal Form 4797.

(c) Adjustments are subtractions from gross income to determine adjusted gross income. The percentage is negative because the largest adjustment is for self-employment tax. When self-employed persons underreport their earnings, it reduces their Social Security and Medicare self-employment tax as well as their income tax. It also reduces the deduction for self-employment tax they may claim as an adjustment on the income tax return.

(d) The federal misreporting percentage for credits was 26%, but our estimates used the percentage for wages for the married couple credit and the percentage for deductions for the school property tax and itemized deductions credits, as explained in the text.

Source: Internal Revenue Service, U.S. Department of the Treasury, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, August 2, 2007.

As Table 1 shows, misreporting percentages are relatively small for wages and salaries, interest and dividends, pensions, alimony income, exemptions and deductions. They are a bit larger for unemployment compensation, capital gains, income from partnerships and other pass-through entities, and adjustments to gross income. The percentages are much larger for farm income, sole proprietor income, rents and royalties, gains on sales of assets other than capital assets, and miscellaneous income.

Wisconsin's largest source of income (after deductions, adjustments and exemptions) is wages and salaries, accounting for 77% of the total. But these earnings account for only 10% of the tax gap. By contrast, business income is only 8% of Wisconsin income, but responsible for 57% of the underreporting tax gap. This income includes the earnings of sole proprietors, farmers and owners of partnerships, S corporations and trusts and estates, and rents and royalties.

One important reason why the tax gap associated with business income is so high is the lack of information reporting and payment of tax when a business receives income or pays an expense—in contrast to reporting and tax withholding for wages and salaries. Employers withhold taxes from the wages they pay to their workers and report to tax agencies the amount of pay the workers received and the amount of taxes withheld. There is no similar reporting for business income and expenses, and that creates an opportunity for reporting too little income and/or too much expense.

However, lack of reporting is not the only reason the underreporting gap attributable to business income is so high. Another is the complexity of tax laws that make it hard for businesses to know what kinds of income are taxable and what kinds of expenses they may deduct. Those complicated laws lead to honest mistakes on tax returns.

There is also a lack of information on many kinds of miscellaneous income, which accounts for only 1% of total income but 13% of the underreporting gap.

Investment income (interest, dividends and capital gains) generates 10% of total income and accounts for 9% of the underreporting gap. Retirement income (pensions, annuities and distributions from individual retirement arrangements) are 8% of income and provide 4% of the gap. Social Security income is not included because Wisconsin exempts all Social Security benefits, beginning in 2008.

The IRS notes: "Well over half of the individual underreporting gap came from understated net business income."

Offsets to income (statutory adjustments, deductions and personal exemptions) reduce the underreporting gap by 1%. The effect on the tax gap is negative because of the deduction allowed for self-employment tax. Underreporting of earnings by the self-employed reduces their Social Security and Medicare self-employment tax as well as their income tax, and it also reduces the deduction they may claim on their federal and state income tax returns for self-employment tax. Since the deduction, which reduces income tax, is underreported, the tax gap is reduced.

The 8% underreporting gap for tax credits includes only the three largest credits: the school property tax credit, the itemized deductions credit and the married couple credit. The next largest credit is that for taxes paid to other states.¹⁴ The underreporting gap associated with this credit is likely to be small, and could even be negative. The remaining credits are small and unlikely to have a large impact on the tax gap.

In addition, the estimates for credits are not based on the misreporting percentage for federal tax credits, which was 26%. Instead, the 1% misreporting percentage for wages was used for the married couple credit, since wages make up most of the base for that credit. For the school property tax credit and the itemized deductions credit, the 5% misreporting percentage for deductions was used. The bases for these two credits—property taxes (also rent) for one and medical expenses, mortgage interest, charitable contributions and miscellaneous expenses for the other—are expenses for which taxpayers may claim itemized deductions for federal tax purposes. Further, for the school property tax credit, we applied the misreporting percentage only to credits of taxpayers claiming less than the \$300 maximum credit. Once property taxes exceed \$2,500, there is no benefit from over-reporting.

Income tax changes in the 2009-2011 state budget will affect the tax gap in years after Fiscal Year 2009, but not by much. For example, the budget reduced the exclusion of capital gains on assets held for more than one year from 60% to 30% of those gains. That will increase the tax gap by about \$20 million. The budget also created a fifth tax bracket with a rate of 7.75% for high-income individuals; previously the top rate was 6.75%. The higher rate will increase the tax gap by about \$10 million.

The Internal Revenue Service also estimated the federal individual income tax non-filing gap in its 2007 report. This gap was about 2% of actual collections, and if the same percentage applies for Wisconsin, its non-filing gap is \$168 million in FY 2009.

Sales Tax

Tax Gap estimate: There is a sales tax¹⁵ underreporting gap of \$317 million. This is the gap attributable to retailers underreporting the amount of their sales of taxable goods and services. The sales tax non-filing gap is estimated to be \$35 million; this results from retailers failing to file sales tax returns with the state. There is also an additional \$7 million tax gap for other taxable purchases from sellers not required to collect the tax, aside from Internet and mail-order sales.

The tax gap from sales to Wisconsin consumers by out-of-state Internet retailers and mail-order companies is estimated to be \$177 million. This includes \$83 million on Internet purchases by businesses, \$42 million on Internet purchases by households and \$52 million on catalog purchases.

After combining all the categories of sales tax gap, Wisconsin's sales tax gap in FY 2009 was an estimated \$536 million, equal to 13% of collections.

Methodology: Wisconsin's sales tax underreporting and non-filing gaps were estimated using a study prepared for the Minnesota Department of Revenue for the year 2000.¹⁶ From this study, we determined that Minnesota's sales tax underreporting gap was 7.8% of actual collections in 2000; the sales tax non-filing gap was 0.9%; and the gap on out-of-state transactions other than Internet and catalog sales was 0.2%. These percentages were applied to Wisconsin's Fiscal Year 2009 sales tax collections to generate estimates for these three components of the sales tax gap.

The tax gap imposes an unfair burden on citizens who already pay the taxes they legally owe.

Applying the percentages derived from the Minnesota study to Wisconsin is reasonable if the states have similar sales tax bases and if the behavior of sales taxpayers—the retailers who collect and remit the tax—are similar. Except for clothing, which Minnesota exempts and Wisconsin taxes, the two states tax similar goods and services.¹⁷

The remaining part of the sales tax gap involves purchases by a Wisconsin resident from a retailer located in another state, for instance over the Internet or by mail order.¹⁸ Federal law prohibits states from requiring these out-of-state sellers to collect sales tax. Therefore, it is very difficult to enforce this tax, particularly on households, so it accounts for a large portion of the sales tax gap.

The tax-gap estimate from sales to Wisconsin consumers by out-of-state Internet retailers and mail-order companies was derived using the methodology outlined in a 2006 Wisconsin Department of Revenue (DOR) report.¹⁹ The DOR estimates were updated using more recent data, through 2007, on electronic commerce and catalog sales from the U.S. Bureau of the Census. The estimates were projected out to Fiscal Year 2009 using smaller growth rates than those used by DOR because of the economic recession that began in 2008.

The state's February 2009 budget adjustment act took a major step toward narrowing the tax gap attributable to e-commerce and catalog sales by adopting the Streamlined Sales and Use Tax Agreement (SSUTA), effective October 1, 2009.²⁰ The states that are part of this agreement—Wisconsin is the 23rd—agree to simplify and modernize their sales tax laws and administrative procedures to encourage remote sellers to voluntarily collect the tax on sales to in-state consumers. Currently, about 1,100 retailers are voluntarily collecting the tax. In addition, participating states hope to persuade Congress to require remote sellers to collect the tax for states that have adopted the agreement.

States participating in the SSUTA adopt uniform definitions for certain kinds of goods and services—each state still determines whether those goods and services are taxable, but how they are defined is the same in all states. Participating states also streamline administration through automated systems that make it easier for retailers to figure what is taxable and how much tax is owed.

The initial fiscal impact of adopting the SSUTA is small—a net gain of about \$3 million a year—but the long-term impact could be substantial if Congress requires Internet and catalog sellers to collect taxes for states taking part in the agreement.

Corporate Income Tax

Tax Gap estimate: Wisconsin's corporate income tax gap is estimated at \$113 million.

Methodology: Estimating the corporate income tax gap is extremely difficult, even for tax agencies like the Internal Revenue Service and state revenue departments, because corporate tax laws and the economic behavior of large, often global corporations are very complicated. Nonetheless, because the corporate income tax is Wisconsin's third largest GPR tax source, it is important to get some indication of the size of this tax's gap.

The 2007 IRS study provided an estimate of the federal corporate underreporting tax gap, but not the non-filing gap.²¹ The IRS admitted that its estimate was “weak” because it was based on research done in the 1980s. However, we use it here because it is the only estimate available and because, even if it is way off, it only changes the gross tax gap slightly—overstating or understating the corporate tax gap by 75% changes the overall tax gap estimate by plus or minus 5%.

The IRS report showed a corporate underreporting gap equal to 18% of actual federal corporate tax collections. If Wisconsin had a similar gap in Fiscal Year 2009, when its corporate tax collections were \$630 million, its tax gap would be \$113 million.

One major difference between federal and Wisconsin corporate tax law needs to be considered. For federal tax purposes, related corporations report their income and expenses on a single, consolidated return. Prior to 2009, related corporations filed as separate entities—filed separate tax returns—in Wisconsin. Some large, multistate and multinational corporations took advantage of Wisconsin's separate-entity reporting requirement to move income to entities located outside the state to avoid paying Wisconsin tax.

For example, some corporations transferred income-earning assets to a subsidiary in Nevada, which does not have a corporate income tax. They claimed that Wisconsin could not tax the income on those assets because the Nevada subsidiary had no business presence here. And dividends paid by the subsidiary to the Wisconsin parent were not taxed because Wisconsin allows a deduction for dividends received from a related corporation. Other corporations put trademarks and similar intangible assets in a holding corporation in Delaware, which does not tax income from intangibles, and claimed a deduction on their Wisconsin tax returns for royalties paid to that Delaware subsidiary, often reducing their Wisconsin income to \$0.²²

Whether or not separate entity reporting contributed to the tax gap depended on the legality of this activity. If it was legal under Wisconsin law, it did not add to the tax gap; if it was illegal tax evasion, it did increase the gap.

The budget adjustment bill enacted in February 2009 eliminated separate-entity accounting and required combined reporting for related corporations.²³ This change reduced the tax gap by making it more difficult for large corporations to set up subsidiaries for the sole purpose of evading taxes. It also made for a fairer tax: corporations are more likely to be taxed on their profits from economic activity attributable to Wisconsin.

It is crucial to invest in additional resources for audit and delinquent tax collections, taxpayer service and information technology.

Cigarette Tax

Tax Gap estimate: Wisconsin's cigarette tax gap is estimated at \$44 million.

Methodology: A report prepared for the Minnesota Department of Revenue for cigarette sales in 2007 offered several estimates of the cigarette excise tax gap for that state, ranging from 2% to 8%.²⁴ Using the higher percentage, Wisconsin's cigarette tax gap could be as much as \$44 million.

In 2007, Minnesota's tax per pack, \$1.49175, was much higher than Wisconsin's, \$0.77. And Wisconsin is only a short drive from Minnesota's largest population center, Minneapolis-St. Paul. In 2010, the roles are reversed. Wisconsin's rate of \$2.52 per pack is higher than Minnesota (\$1.56), Illinois (up to \$1.13 including local taxes), Iowa (\$1.36), and Michigan (\$2.00).²⁵

Higher cigarette tax rates are an incentive for smokers to buy from neighboring states where rates are lower or over the Internet. The differences between Wisconsin's current rate and those in Minnesota, Illinois and Iowa are even larger than the difference between Minnesota's and Wisconsin's rates in 2007. Those larger differences could mean a larger cigarette tax gap than the 8% of collections we estimate.

Underpayment Gap

Tax Gap estimate: The underpayment tax gap is estimated at \$164 million.

Methodology: Underpayment is the amount not paid by taxpayers who filed their returns and properly calculated their tax liability. This component is estimated from Wisconsin Department of Revenue data on delinquent taxes and Audit Bureau assessments and collections.

In Fiscal Year 2009, \$558 million in new delinquencies were added to the delinquent tax roll. However, this amount includes two items that must be subtracted out to arrive at an estimate of underpayment: interest, penalties and fees, and assessments by the Audit Bureau that were not collected. These uncollected assessments are not included because they are part of the underreporting and non-filing gaps.

The portion of the new delinquencies attributable to interest, penalties and fees is not available. It is likely to be relatively high because interest and penalty rates on delinquent taxes are high: regular interest of 12% or delinquent interest of 18% and negligence penalties up to 25%. Assuming that interest, penalties and fees account for 40% of the new delinquencies, 60% of the \$558 million, or \$335 million, is tax.

In Fiscal Year 2009, the Audit Bureau issued assessments or reduced refunds on tax returns by \$418 million, and had collections totaling \$247 million. The difference between these amounts gives an estimate of uncollected assessments of \$171 million. Subtracting uncollected assessments from \$335 million in new delinquent tax gives an underpayment tax gap estimate of \$164 million.

Wisconsin's Efforts to Reduce the Tax Gap

In the absence of major efforts to close the tax gap, it continues to grow along with the increased cash flows of a growing economy. Closing it is crucial, because it is an important source of revenue not dependent on new or higher taxes.

In recent years, Wisconsin policymakers took various steps to reduce the tax gap. These include:

- Increased funding for tax auditors and for revenue agents who collect delinquent taxes, offsetting at least in part some of the staff reductions the Department of Revenue has experienced in recent years;
- Adoption of the Streamlined Sales and Use Tax Agreement, an important step in addressing the tax gap resulting from sales to Wisconsin residents by out-of-state Internet and mail-order sellers;
- Enactment of combined reporting, which reduces opportunities for both illegal tax evasion and legal but unproductive tax avoidance by corporations subject to the state income tax;
- Internet posting of the names of and other information about delinquent taxpayers who owe substantial amounts of tax to the state;
- Expansion of programs to collect tax and other debts by offsetting tax refunds and other payments;
- And creation of a voluntary disclosure program, allowing taxpayers who have not filed required returns to fulfill their obligations without incurring penalties.

Recommendations

Wisconsin still has a major tax gap: \$1.6 billion due to underreporting, nonpayment of taxes and failure to file returns. Tax audits and delinquent tax collections reduce this amount by \$400 million, but a \$1.2 billion gap remains.

The policies outlined above were implemented to help reduce the gap. These were crucial beginnings. But given the size of the current tax gap, additional steps should be taken.

1. **Bolster Department of Revenue capacity.** In 2009, the state legislature approved funding for the Department of Revenue to fill positions that had been cut in previous budget years. However, the backlog of cases, the reduced staffing levels in the Department and the delay in upgrading technology resources caused by many years of funding cuts require additional investments to address capacity issues. To make a significant difference in curbing revenue losses, it is crucial to invest in additional resources for audit and delinquent tax collection, taxpayer service, and information technology.
2. **Simplify tax laws.** Wisconsin's tax structure is too complicated. The basic tax form has doubled in size over the past 20 years. Wisconsin's 'basic' form for individuals was one page long in 1987 with four schedules on a second page. The instructions were 23 pages. By 2008, Form 1 was three pages and the instructions were 46 pages.²⁶

The main reason these tax forms are now so much longer is the proliferation of new exemptions, deductions and credits which have caused income tax laws to grow much more wordy and complicated. This is a problem because it makes compliance with tax laws more difficult and more costly for taxpayers of all kinds. It makes oversight more difficult and more costly for state agencies. It creates more opportunities for unscrupulous taxpayers to game the system. It makes it more difficult for lawmakers to understand the impact of the tax changes they implement.

The solution to the problems of tax complexity is to begin simplifying the tax code by reducing and rationalizing the number of exemptions, deductions and credits. One approach is to require mandatory sunset dates on all tax exemptions, which would require each to be examined and re-instated only if the benefit overrides the cost. And until the thicket of tax breaks is cleared, there should be a legislative moratorium on all new breaks.

3. **Monitor the Tax Gap on a regular basis.** This would help expose trends and new areas that need special attention. It is vital for elected officials, state managers, local leaders and the public to be informed about the size of the tax gap. In addition, tax gap oversight can determine the main reasons that revenue is being lost which indicates the kind of policies needed to alleviate the problem. This kind of consistent research provides legislators and state administrative officials with information necessary for sound decision making about both revenue policy and the resources required for effective administration.

At the federal level, the Internal Revenue Service is devoting additional resources to tax gap measurement, and the state might be able to piggyback on those efforts. Wisconsin could also explore collaboration with other states. Measuring the gap, and sharing the findings with policy makers and citizens, would have paybacks in more efficient allocation of enforcement resources, increased voluntary compliance and greater public confidence in the tax system.

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Footnotes

¹ Internal Revenue Service, U.S. Department of the Treasury, "IRS Updates Tax Gap Estimates," IR-2006-28, Feb. 14, 2006. Available at: <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>.

² Internal Revenue Service, U.S. Department of the Treasury, "The Tax Gap," available at: <http://www.irs.ustreas.gov/newsroom/article/0,,id=158619,00.html>.

³ Internal Revenue Service, U.S. Department of the Treasury, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, August 2, 2007, p. 6.

⁴ Wisconsin took significant steps toward addressing both of the problems by adopting the Streamlined Sales and Use Tax Agreement and by requiring combined reporting for corporate income taxpayers in 2009 Wisconsin Act 2, the budget adjustment law enacted in February 2009. These changes are discussed in the later sections of this report on the sales and use tax and corporate income tax gap estimates.

⁵ U.S. Department of the Treasury, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance*, July 8, 2009. Others making similar recommendations include: California Legislative Analyst's Office, *California's Tax Gap*, February 2005; Idaho Tax Commission, *Idaho's Tax Gap, 2009: Estimating Idaho's Tax Gap and Developing Strategies to Reduce It*, November 2009; U.S. Government Accountability Office, *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, April 14, 2005. The GAO has also issued several reports in recent years on specific aspects of the tax, such as charitable contributions made in cash, losses reported by sole proprietors, S corporations, and rental real estate reporting. These are available at the GAO's website: <http://www.gao.gov/index.html>.

⁶ The Wisconsin Department of Revenue received \$11.84 million and 31 positions for enhanced enforcement of tax laws in the state's 2009-2011 budget. The Institute for Wisconsin's Future encouraged these additional resources in *Investing in Revenue: How Wisconsin Can Profit by Using the Minnesota Model for Closing the Tax Gap*, January 2009 (available at: http://www.wisconsinfuture.org/publications_pdfs/tax/investinginrevenue.pdf).

⁷ Internal Revenue Service, U.S. Department of the Treasury, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, August 2, 2007, p. 6. The Institute for Wisconsin's Future identified the growing complexity of Wisconsin's tax laws in *Simplifying Wisconsin Taxes: How a Proliferation of Tax Credits, Deductions and Exemptions Has Complicated the Tax System*, May 2009 (available at: http://www.wisconsinfuture.org/press_release_pdfs/simplifying_taxes.pdf).

⁸ The studies are listed in the bibliography.

⁹ See the notice at: http://www.taxes.state.mn.us/taxes/legal_policy/other_supporting_content/tax_gap_study.pdf.

¹⁰ The case for measuring the tax gap is made in: Internal Revenue Service, *Reducing the Tax Gap*; U.S. Department of the Treasury, *Update on Reducing the Federal Tax Gap*; U.S. Government Accountability Office, *Tax Compliance: Reducing the Tax Gap*; and Michael Mazerov, "What States Can Do to Reduce Their Tax Gaps".

¹¹ *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, p. 12.

¹² IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*.

¹³ The average marginal tax rate shows the amount of tax on additional income: the tax on an additional \$100 is \$5.36. Since misreported income is additional income, the average marginal tax rate is the appropriate rate to use. This rate was applied to misreported income, exemptions and deductions, but not misreported credits, since the amounts eligible for credit have already been multiplied by a credit rate to give the credit that is subtracted from tax.

¹⁴ This credit is equal to the amount of taxes paid by Wisconsin residents on wages, salaries or other income earned in another state. By providing a credit for these other states' taxes, Wisconsin ensures that the earnings are not taxed twice.

¹⁵ Technically, in Wisconsin as in other states, it is called the "sales and use tax." The most important distinction is that a sales tax is applied to in-state purchases, while a use tax is for out-of-state purchases that would have been subject to the sales tax if purchased in Wisconsin. This report uses the more common phrase "sales tax."

¹⁶ American Economics Group, Inc., *Minnesota Sales and Use Tax Gap Project: Final Report*, November 19, 2002.

¹⁷ This conclusion is based on a review of tax exemption reports prepared by the revenue departments in the two states and a survey on the sales taxation of services prepared by the Federation of Tax Administrators, available at: <http://www.taxadmin.org/fta/pub/services/services.html>. See Minnesota Department of Revenue, Tax Research Division, *Tax Expenditure Budget, Fiscal Years 2010-2013*, February 2010 (available at: http://www.taxes.state.mn.us/taxes/legal_policy/other_supporting_content/2010_tax_expenditure_links.pdf), and Wisconsin Department of Revenue, Division of Research and Policy, *Summary of Tax Exemption Devices*, February 2009 (available at: <http://www.revenue.wi.gov/ra/09sumrpt.pdf>).

¹⁸ Again, technically this tax on out-of-state purchase is called a use tax.

¹⁹ Wisconsin Department of Revenue, "Fiscal Effect of E-Commerce and Other Remote Sales," October 23, 2006.

²⁰ Additional information about the agreement can be found in Wisconsin Legislative Fiscal Bureau, *Summary of Budget Adjustment Provisions: 2009 Wisconsin Act 2*, February 23, 2009. The Department of Revenue has information on the Streamlined Sales and Use Tax Agreement at: <http://www.revenue.wi.gov/sstp/index.html>.

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