Introduction

The Franchise Tax Board has one of the most effective tax audit, collection, and filing enforcement systems in the United States and yet conservative estimates show California loses more than $6.5 billion a year to tax cheating. More troubling, though, is how much it has grown over the last 20 years.

It is more than just a state problem. The Internal Revenue Service estimates that the federal tax gap is approximately $255 billion annually.

These unpaid taxes lead to fiscal crises, budget imbalances, and a chronic struggle between proponents of increased revenues (taxes) and reduced spending (cuts).

We prepared the following list of Frequently Asked Questions to provide an understanding of the "tax gap."

What is the “tax gap?”
The “tax gap” is the difference between what is legally owed and what is voluntarily paid.

How much is it?
In California, it is estimated to be about $6.5 billion annually.

What is being done about it?
We rely on a combination of enforcement programs, and education and outreach efforts to curtail tax cheating.

• We are using technology, new data sources, and strategic partnerships with other governmental agencies to better detect and enforce the tax laws.
  
  For example, sharing information from other state agencies, such as the “New Employee Registry” with the Employment Development Department, allows us to identify and garnish wages of delinquent taxpayers soon after they start a new job.
  
  FTB has automated its filing enforcement activities to increase tax compliance in a less intrusive manner. The FTB's Filing Enforcement Program contacts 600,000 individual nonfilers annually, and brings in $400 million in revenue. About 30,000 corporate nonfilers are contacted each year, resulting in $30 million in revenue.
  
  • We have an aggressive program in place to detect and prosecute tax cheats. We share information with the IRS and other states that assist in the identification and prosecution of suspected tax cheats. We annually receive more than 160 million income records from third parties such as banks, employers, state departments, the IRS, and other sources. In the area of abusive tax shelters, we have entered into strategic partnerships with the IRS and other states to share leads and technical information about these shelters.
  
  • Education and outreach is a central theme in our activities. FTB and other state agencies educate individuals and businesses about their income tax filing responsibilities. We work with tax practitioners, providing them with updates and resources to provide answers to questions they have in preparing returns and representing their clients.
  
  • In 1999-2000, FTB net assessments from audit activities totaled $1.1 billion. In the same period, more than $1.8 billion was collected through automated and manual collection activities.
  
  Among the tools used by FTB's collection program:
  
  • Notices mailed to individuals and businesses
  • Levies on bank accounts
  • Garnishments on wages
  • Liens filed

What elements make up the tax gap?
Of the $6.5 billion tax gap, the largest segment of the tax gap – 80 percent – is made up of taxpayers that either underreport income or overdeduct expenses.

Sole proprietors* make up the highest percentage rates of personal income tax underreporting (percentage of proprietors who underreport):

Antique dealers.......................................................60-70%
Restaurants...............................................................55-65%
Used car dealers......................................................45-55%
Auto repair businesses ..........................................40-50%
Landscaping ............................................................35-45%


Individuals that do not file tax returns represent about 10 percent (about $650 million) of the tax gap problem. The remaining 10 percent (about $650 million) is estimated to represent those taxpayers that have underpaid their reported taxes owed.
Individual nonfilers identified:

Wage earners ................................................................. 43%
Self-employed ............................................................... 39%
Filed federal return ....................................................... 10%
Mortgage interest ............................................................ 4%
Real estate sales ............................................................. 3%
Partnership income ....................................................... 1%

Top five industries for nonfilers (% of nonfilers):

Health services ........................................................... 10.4%
Business service ........................................................... 9.6%
Personal services ........................................................... 9.6%
Real estate ...................................................................... 7.6%
Engineering/accounting ............................................ 7.4%

There is a huge problem of underreporting when it comes to businesses. Certain businesses process transactions for relatively small amounts that are usually paid in cash. Examples would be the barber, cosmetology, and restaurant industries. The majority of these daily receipts can sometimes be in the form of cash. To keep the cash undetected they fail to record the cash transactions in their books, or keep separate books. Money orders or cashier's checks are used to pay bills, and large dollar items are purchased with cash.

The percentage rates of corporate underreporting breaks down this way (percentage of all income received but not reported, by industry):

- Services (includes doctors, lawyers, hotels, etc.).......................... 32%
- Retail trades................................................................. 25%
- Finance (includes insurance and real estate)................................ 23%
- Mining ........................................................................ 20%
- Transportation (includes communications and utilities)........... 20%
- Construction ................................................................ 20%

What about the underground economy from illegal activities?

Whether it is income from prostitution, illicit drug sales, gambling, or embezzlement it is virtually impossible to quantify the extent of financial activity going on. Nevertheless, all income is taxable, including income from illegal activities.

How can you measure the tax gap?

It's very difficult. FTB has some sources of information that are useful. First, we look to trends identified by the IRS and make assumptions of how they apply to California. Second, FTB relies on three key areas of tax administration to help measure and improve tax compliance: filing enforcement; audit; and collection activities.

How much does it cost us?

It costs the honest taxpayer nearly 20 percent more in taxes because of tax cheating.

How does it affect me?

The effects of the tax gap can impact the residents of the state in several ways:

- Fewer government services
- Higher taxes
- Increased deficit

How does it affect California business?

Businesses that pay their fair share of taxes are put at a competitive disadvantage when going through the bid process. By paying cash, employers can evade their obligations to make payroll deductions for income tax, workers' compensation insurance premiums, and Social Security contributions. Paying wages in cash also makes it easier for the employees to evade taxes, and child support since there is no record of their wages reported to the taxing authorities. Failure to make these governmentally mandated payments gives unscrupulous employers an unfair competitive advantage over employers who comply with the laws.

What can I do to help reduce the tax gap?

If everyone knew how much tax cheating cost them in terms of underfunded educational programs, out-of-date infrastructure and the negative impact of the decline in civic duty, less cheating would occur. Speak with your families, friends, neighbors, and co-workers. Let them know that it's not only the government that gets hurt when cheating happens. We all pay the price. Tax cheating is not a victimless crime.