ISSUE BRIEF: Q3 2021

CLOSING AMERICA’S “TAX GAP”

A THREE-PART PLAN FOR MODERNIZING THE IRS AND COLLECTING AN ADDITIONAL $2.4 TRILLION IN TAXES OVER THE NEXT TWO DECADES

BUSINESSFORWARD FOUNDATION
1. WHAT AMERICANS OWE, MINUS WHAT THEY PAY = THE TAX GAP

2. THE SIZE OF THE TAX GAP SHOULD ALARM YOU

3. THE DISTRIBUTION OF THE TAX GAP SHOULD INFURIATE YOU

4. PART ONE: STOP ALLOWING WEALTHY TAXPAYERS TO “SELF-REPORT” THEIR BUSINESS INCOME

5. PART TWO: IMPROVE THE IRS IT SYSTEM TO BETTER TARGET THOSE WHO ARE NOT PAYING THEIR FAIR SHARE

6. PART THREE: REVERSE BUDGET CUTS THAT HOBBLED IRS ENFORCEMENT, ENCOURAGED MISREPORTING, AND LEFT IT UNABLE TO PROVIDE ACCEPTABLE CUSTOMER SERVICE

THE TOP 1% IS RESPONSIBLE FOR 28% OF THE TAX GAP

$1 IN $6 GOES UNPAID

$3.1T PAID

$600B GAP

FROM 2010-2018...

18% IRS BUDGET CUTS

1 IN 3 ENFORCEMENT EMPLOYEES LOST
We can fix what’s broken in our tax system by looking at what works. Each year, the IRS processes 253 million returns and forms in aggregate, including more than 150 million individual returns, and collects $3.5 trillion in taxes. Financial institutions produce around 3.3 billion income reports each year, and they already collect the information the IRS requires to shrink the tax gap.

Most of us earn our income in ways that are verified to the IRS. Third-party verification of wages, interest on bank accounts, and earnings on retirement savings makes it easier for us to file our returns—and harder for us to misreport.

A small portion of income is treated differently. IRS rules allow taxpayers to “self-report” business income, and there is little, if any, third-party verification of what they report, so a disproportionate amount of misreporting occurs here.

A family in the top 1% underreports 34x more income than the median-income family.

We can capture billions in unpaid taxes by focusing on this small group of taxpayers. The top 1% (by income) is responsible for 28% of the tax gap. By focusing on increased information reporting and improving IRS technology, we can more effectively target the wealthiest people who fail to pay what they owe.
WHAT THE TAX GAP MEANS TO YOU

TAXPAYERS OWED NEARLY $3.7 TRILLION IN 2019, BUT $600 BILLION WENT UNPAID

Even after the IRS enforcement activities and late payments, researches estimate that taxpayers should be paying an additional $600 billion in taxes.⁹

$600B GAP

$3.1T PAID

THE TAX GAP KEEPS GROWING AND WILL TOTAL $7 TRILLION OVER THE NEXT 10 YEARS¹⁰, LEAVING POLICYMAKERS WITH THREE BAD CHOICES:

1. RAISE TAXES...

2. CUT SPENDING ON PRIORITIES LIKE INFRASTRUCTURE, DEFENSE, AND HEALTHCARE, OR...

3. LIVE WITH HIGHER DEFICITS THAN WE SHOULD
WHEN THE IRS ALLOWS A SMALL GROUP OF AMERICANS TO SELF-REPORT THEIR INCOME, MANY OF THEM HIDE THAT INCOME

80% OF THE TAX GAP COMES FROM UNDERREPORTING INCOME

80% 

NON-FILING: AN INDIVIDUAL OR BUSINESS FAILS TO FILE A RETURN

UNDERPAYMENT: AN INDIVIDUAL OR BUSINESS FILES A RETURN, BUT FAILS TO PAY THE AMOUNT OWED ON THE RETURN

UNDERREPORTING: AN INDIVIDUAL OR BUSINESS FILES A TAX RETURN BUT INCORRECTLY UNDERREPORTS THE TAXES IT OWES

MORE THAN HALF OF BUSINESS INCOME NEVER GETS REPORTED, BECAUSE NO ONE VERIFIES WHAT TAXPAYERS SELF-REPORT

Wages and most kinds of income that low- and middle-income families earn are subject to third-party reporting. (For example, your employer, bank, and broker verifies this income to the IRS with a W2, 1099, or other form). Without third-party reporting to reference, people are more likely to underreport their income and the IRS has a harder time verifying it.

MISREPORTING BY INCOME CATEGORY

<table>
<thead>
<tr>
<th>Type of Income</th>
<th>Net Misreporting Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages &amp; Salaries</td>
<td>1%</td>
</tr>
<tr>
<td>Pensions and Annuities, Unemployment Compensation, Interest Income, Dividend Income, Capital Gains, and Alimony Income</td>
<td>5%</td>
</tr>
<tr>
<td>Partnership/ S Corp Income, Capital Gains, and Alimony Income</td>
<td>17%</td>
</tr>
<tr>
<td>Nonfarm Proprietor Income, Other Income, Rents, Royalties, Farm Income, and Form 4797 Income</td>
<td>55%</td>
</tr>
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</table>

WHO VERIFIES:

- Employers
- Employers, Government, Banks
- Financial Institutions
- No One
THE SCALE OF THE TAX GAP SHOULD ALARM YOU

THE ANNUAL TAX GAP IS MORE THAN THE AMOUNT PAID BY THE BOTTOM 90% IN TAXES EVERY YEAR

THE BOTTOM 90% MAKE LESS THAN $151,935

$440B
ANNUAL TAXES PAID BY THE BOTTOM 90%

$600B
ANNUAL TAX GAP

WE COULD USE THE EQUIVALENT MONEY TO INVEST IN THE U.S. AND OUR WORKERS

Unpaid taxes could fund critical investments in infrastructure, child care, and education that would improve our workforce and economy in the long run.

THE ANNUAL TAX GAP COMPARED TO THE COSTS OF CRITICAL LONG-TERM INVESTMENTS

TRANSPORTATION INFRASTRUCTURE (OVER 10 YEARS)
$621B

ANNUAL TAX GAP
$600B

CHILD CARE AND PAID LEAVE (FOR 10 YEARS)
$450B

WATER AND POWER INFRASTRUCTURE (OVER 10 YEARS)
$211B

UNIVERSAL PRE-K (FOR 10 YEARS)
$200B
THE DISTRIBUTION OF THE TAX GAP SHOULD INFURIATE YOU

THE TOP 1% ACCOUNTS FOR 28% OF THE TAX GAP
THE TOP 5% ACCOUNTS FOR 53%
THE TOP 10% ACCOUNTS FOR 64%

EACH COLUMN REPRESENTS 1% OF TAXPAYING HOUSEHOLDS IN U.S.

TAX GAP DISTRIBUTION BY INCOME PERCENTILE

TAXPAYER IN TOP 1% VS. MEDIAN TAXPAYER
EARNs 12X MORE
UNDERREPORTS 34X MORE

TOP 1%
HOW BUDGET CUTS HOBBLED IRS ENFORCEMENT AND CUSTOMER SERVICE

CONGRESS CUT 18% OF THE IRS BUDGET FROM 2010-2018, WHICH HURT HIRING AND TRAINING

Fewer agents: From 2010 to 2018, the IRS lost 1 in 3 enforcement employees.22

The IRS has roughly the same number of employees today as it did in 1970 - even though the population has grown by 62%.

1970
1 IRS EMPLOYEE PER 2,961 PEOPLE23

2020
1 IRS EMPLOYEE PER 4,368 PEOPLE24

THE IRS CANNOT KEEP UP WITH ADVANCED EVASION TECHNIQUES

Understanding the interrelated business activities of partnerships and other complex businesses makes auditing them expensive and time-intensive. As a result, very few partnership returns are audited.

THE IRS FAILED TO PURSUE NEARLY HALF OF HIGH-INCOME NONFILERS - THE LOWEST HANGING FRUIT

900,000 high-income individuals never filed a tax return. Due to a lack of resources, 400,000 (44%) of these nonfilers were never even investigated.28

TREASURY INSPECTOR GENERAL’S REPORT, DATA ON NONFILERS (2014-2016)

4.2 MILLION PARTNERSHIP RETURNS WERE FILED IN 2018 BUT ONLY 140 OF THESE WERE AUDITED (0.00004% AUDIT RATE)25

AVERAGE ROUTINE FIELD AUDIT27
2 DAYS

AVERAGE PARTNERSHIP AUDIT26
14 DAYS

NOTE: EACH DAY IS 24 HOURS OF AUDIT TIME

NONFILERS, INVESTIGATED
44%

NONFILERS, NEVER INVESTIGATED
56%
ALL THREE REFORMS WILL WORK IN TANDEM TO IMPROVE SERVICE AND INCREASE VOLUNTARY COMPLIANCE

With additional information, employees are better able to distinguish tax evaders from taxpayers, reducing audits on the compliant and encouraging evaders to start paying their taxes.

Improved technology that can utilize the new information reporting regime to more accurately identify tax evasion.

RESULT:
A LEVEL PLAYING FIELD AND BETTER CUSTOMER SERVICE

Staff who can utilize 21st century channels of communication to resolve issues quickly and efficiently.
PART ONE: CREATE THIRD-PARTY REPORTING FOR OPAQUE BUSINESS INCOME

VERIFICATION EXISTS FOR MOST INCOME ALREADY
- Your employer verifies your wages.
- Your bank verifies your interest earnings.
- Your broker verifies your earnings on your 401(k).
- Social Security verifies your benefits.
- Companies like eBay verify what you earn using their services.
- But no one verifies business income.
- Which is why more than half of all business income is not reported to the IRS.

REQUIRE FINANCIAL INSTITUTIONS TO VERIFY INFLOW/OUTFLOW DATA ON BUSINESS ACCOUNTS TO THE IRS
- They already collect this data.
- They already send reports — like interest on 1099s — on these accounts to the IRS.
- They collectively produce 3.3 billion of these forms/year.

THE BURDEN OF THE NEW REPORTING REGIME WILL NOT FALL ON TAXPAYERS
- Taxpayers do not collect or share any additional information themselves. Their financial institutions do all the work.

THE PAYOFF IS HUGE
- Unreported business income becomes more transparent — just like wages and other income. In 10 years, the Treasury estimates the proposal will result in an additional $460 billion.²⁹
- Ultra-high earners disclose more income, pay their fair share.
- IRS audits are more targeted and efficient — and compliant taxpayers face lower audit risk.

1099

$0
PART TWO: MODERNIZE IRS SYSTEMS

DEPLOYING NEW ANALYTICAL TECHNIQUES WILL ULTIMATELY LEAD TO FEWER AUDITS

When the IRS audits someone that has paid what they owe, the result is a “no change” audit. The rate of no change audits ranges from an average of 11% for individual taxpayers to 50% for some corporations.29

By using better technology and machine learning, the IRS can conduct a more informed audit process that reduces the burden on compliant taxpayers.

“...The IRS is going to be much smarter with respect to the way that it does its enforcement activities in ways that are going to decrease taxpayer burdens quite meaningfully.”

- NATASHA SARIN
  DEPUTY ASSISTANT SECRETARY FOR ECONOMIC POLICY,
  U.S. DEPARTMENT OF TREASURY29

INVESTMENTS IN BETTER TECHNOLOGY MORE THAN PAY FOR THEMSELVES

Technology that can utilize more information would increase productivity and more effectively target real evasion. Already, programs that the IRS has created to help automate the process have yielded higher returns on investment than manual audits.

| MANUAL EXAMINATION32 | COST $3,716 M | REVENUE $15,017 M | 4X ROI |
| REFUND SCREENINGS33 | COST $419 M | REVENUE $6,510 M | 15.5X ROI |
| AUTOMATED DATA MATCHING34 | COST $208 M | REVENUE $5,364 M | 25.8X ROI |
PART THREE: REPAIR, RESTAFF, AND RETRAIN THE IRS

HIRE SPECIALIZED STAFF TO AUDIT HIGH-INCOME BUSINESSES WITH OPAQUE INCOME

As the number of partnerships and sophisticated businesses grow, the IRS needs more specialized enforcement staff to keep up. With more specialized staff and better technology, the IRS can more effectively examine the returns of corporations, partnerships, and global high-wealth individuals - which are the most time consuming to audit but contribute disproportionately to the tax gap.

PARTNERSHIP INCOME AS A SHARE OF TOTAL INCOME\(^{15}\)

IMPROVE TAXPAYER SERVICES

To improve taxpayer services, the IRS must hire more dedicated customer service representatives and implement new technology that makes communication easier and faster. Taxpayers should not have to spend time and money to resolve issues that arise from mistakes or misunderstandings.

THE IRS WAS ABLE TO ANSWER ONLY 29% OF THE 100 MILLION CALLS RECEIVED IN 2019.\(^{36}\)
As part of the American Families Plan, the White House proposed increasing the IRS budget by 6% annually over the next ten years - which would generate $700 billion in the first decade, and $1.6 trillion in the next decade.\textsuperscript{37}

**THE ROI FROM IRS MODERNIZATION IS MASSIVE AND WILL GROW OVER TIME**

**REVENUE RAISED FROM COMPLIANCE INITIATIVES (2022-2040)\textsuperscript{38}**

- **IMMEDIATE ROI:** EACH $1 SPENT ON ENFORCEMENT COLLECTS AT LEAST $4 IN NEW REVENUE
- **MID-TERM ROI:** DETERRENCE WILL INCREASE VOLUNTARY COMPLIANCE

<table>
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<tr>
<th>Year</th>
<th>Estimated Revenue ($, Billions)</th>
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<tr>
<td>2022</td>
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<tr>
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<tr>
<td>2038</td>
<td>$575</td>
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<tr>
<td>2040</td>
<td>$2,315</td>
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**CUMULATIVE TOTAL REVENUE:**
- Immediate ROI: $1,238
- Mid-term ROI: $1,078
- Cumulative Total Revenue: $2,315
REFERENCES
7. Ibid.
8. Ibid.
10. Ibid.
12. Ibid.
19. Ibid.
23. Ibid.
28. Ibid.
29. Ibid.
30. Ibid.
33. Ibid.
34. Ibid.