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## Reducing the Tax Gap: 5 Key Points on Information Reporting

By Chuck Marr and Samantha Jacoby

The major economic recovery legislation Congress is developing will make investments to reduce child poverty, address climate change, and increase economic opportunity and security for families across the country. These investments will be paid for in part by asking wealthy people and profitable corporations to pay a fairer amount of tax. In addition, a key source of revenue will flow from collecting more of the taxes that high-income people and businesses already owe under current law. This “tax gap” — taxes owed but not collected — is now roughly \$600 billion annually with fully \$160 billion annually just from unpaid taxes of the top 1 percent, as a new Treasury report highlights.<sup>1</sup> Closing the tax gap will require, in part, more robust information the IRS can use to identify and collect those unpaid taxes.

President Biden has developed a comprehensive plan to reduce the tax gap that the Treasury Department estimates would raise \$700 billion over ten years. The plan has three interdependent components: people, computer systems, and information. A decade of deep budget cuts has led to a 30 percent reduction in the well-trained IRS audit staff needed to audit the largest corporations and the highest-income filers, leading to a sharp drop in their audit rates. The proposal provides robust funding to rebuild depleted audit staff and upgrade the IRS’s antiquated technology systems. Significantly, the House Ways and Means Committee’s legislation to raise revenue adopts the full Biden Administration \$80 billion funding proposal to rebuild the agency’s audit staff and upgrade its computer systems.

Critically, the Biden plan also provides for a set of financial reporting rules that would help the IRS identify unreported income and reduce the likelihood that wealthy households underreport their income in the first place, which the House should add as the legislative process continues. The information reporting component would raise \$460 billion — the majority of the revenue in the Biden tax gap plan — according to Treasury.

It is an integral component of the plan. As IRS Commissioner Charles Rettig recently wrote to Senator Elizabeth Warren, “increased information reporting targets underreported income, which is

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<sup>1</sup> Natasha Sarin, “The Case for a Robust Attack on the Tax Gap,” Department of the Treasury, September 7, 2021, <https://home.treasury.gov/news/featured-stories/the-case-for-a-robust-attack-on-the-tax-gap>.

the largest category of the tax gap.”<sup>2</sup> A group of his predecessors has added: “Research shows that when the IRS has access to third-party reporting, compliance rates top 95 percent. Without third-party information reporting, compliance rates are below 50 percent. Reliable information is critical to an effective and fair tax system.”<sup>3</sup>

Contrary to some confusion and misinformation, the information reporting proposal is specifically designed to impose no burdens on taxpayers, to protect privacy, and to shield people with low or moderate incomes from higher audit rates. Here are five key points to understand about the information reporting component of the plan.

## **1. It places no new burdens on taxpayers and is simple for banks to implement.**

The proposal is designed not to burden taxpayers. Taxpayers will not be required to reconcile information about their bank accounts with the information on their tax returns. This proposal could not be clearer: the taxpayer does not need to do anything.

Moreover, the additional burden on financial institutions is minimal: the information they will be required to provide the IRS is already readily available to them and will be provided to the IRS on forms they are already responsible for generating. They already are required, on 1099-INT forms, to provide taxpayers and the IRS with the amount of interest income that taxpayers receive (if more than \$10). Under President Biden’s proposal, financial institutions would add two pieces of information to 1099-INT forms: the total outflows and inflows into all accounts that exceed \$600. As we explained previously,<sup>4</sup> this is far less burdensome than some other information reporting requirements already in place, including the requirement that brokers report sale proceeds and the tax basis of assets (i.e., cost) on 1099-B forms, which are now routinely distributed to taxpayers and the IRS.

## **2. It is designed to protect privacy.**

The IRS will only see two pieces of information: annual gross account inflows and outflows, with no detail on individual transactions. There has been some confusion about this aspect of the IRS plan, in part because critics and banking lobbyists are mischaracterizing the information reporting proposal. The Independent Community Bankers Association, for instance, falsely claims that “[t]he Biden administration is proposing requiring financial institutions report to **the IRS all transactions of all business and personal accounts worth more than \$600,**” even highlighting the misinformation in bold. This assertion is false: financial institutions will provide just the two pieces of aggregated annual data described above.

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<sup>2</sup> Charles Retting, Letter to Senator Elizabeth Warren, Department of the Treasury, August 27, 2021, <https://www.warren.senate.gov/imo/media/doc/Warren%20et%20al%20response%20to%20Warren%20082721.pdf>.

<sup>3</sup> Lawrence Gibbs *et al.*, “Five former IRS commissioners: Biden’s proposal would create a fairer tax system,” *Washington Post*, May 4, 2021, [https://www.washingtonpost.com/opinions/five-former-irs-commissioners-bidens-proposal-would-create-a-fairer-tax-system/2021/05/04/c4ee8346-acfc-11eb-ab4c-986555a1c511\\_story.html](https://www.washingtonpost.com/opinions/five-former-irs-commissioners-bidens-proposal-would-create-a-fairer-tax-system/2021/05/04/c4ee8346-acfc-11eb-ab4c-986555a1c511_story.html).

<sup>4</sup> Chuck Marr, “Biden Financial Reporting Requirement an Integral Part of Plan to Address Tax Gap,” Center on Budget and Policy Priorities, July 12, 2021, <https://www.cbpp.org/blog/biden-financial-reporting-requirement-an-integral-part-of-plan-to-address-tax-gap>.

Further, under the proposal, the IRS will not share any information with financial institutions. This is one of the central reasons why, although the proposal is intended to target the non-compliance of only high-income people, it applies broadly to all accounts with a balance of more than \$600, rather being limited to accounts held by people with total *incomes* above a certain level. Currently, banks don't know a person's total income, and it would be an invasion of privacy for the IRS to be required to tell banks whether an individual's total income meets a threshold. (Instead, as discussed below, the plan has a separate protection that would prevent the IRS from increasing audit rates on filers below \$400,000.)

This is designed to protect taxpayers' privacy.

IRS employees face incarceration and steep fines for breaching filer privacy, which is part of the IRS's strong and decades-long record of taxpayer privacy protection.<sup>5</sup> The proposal also provides funding to invest in technology upgrades that would increase data security and should reassure taxpayers that their information will be protected.

### 3. It advances racial equity.

President Biden's IRS plan is specifically designed to correct an inequity that has developed in IRS audits. Without the staffing or information needed to target its audits, the IRS focuses on the simpler returns of low-income taxpayers. Today, a low-income person claiming the Earned Income Tax Credit (EITC) is about as likely to be audited as a person in the top 1 percent. That's despite EITC claims representing just 6 percent of the tax gap, while the top 1 percent is responsible for more than 26 percent. Audit rates have recently fallen for the EITC, but they have fallen *far more* for high-income people, primarily because as its budget shrank, the IRS lost more audit staff with the expertise to audit the complex returns of high-income people. As a result, the most highly audited counties in the country are now predominantly Black, rural counties in the deep South.<sup>6</sup>

Under President Biden's plan, the IRS would receive additional resources to hire and train audit staff who would be equipped to conduct the complicated audits of very high-income and high-wealth people — those who are disproportionately responsible for the tax gap, and who are overwhelmingly white.<sup>7</sup> While audit rates for high-income filers would increase under the proposal, it specifies that “[a]udit rates will not rise relative to recent years for those with less than \$400,000 in actual income.”<sup>8</sup>

The information reporting proposal would also help address a related inequity, by giving the IRS information and tools that it can use to prevent and detect non-compliance among wealthy people, which it has long had for low- and moderate-income workers. The IRS already has income

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<sup>5</sup> ProPublica recently ran stories based on taxpayer information, but multiple law enforcement agencies are investigating how that taxpayer information became public, and potential criminal charges await any IRS employee involved.

<sup>6</sup> Paul Kiel, “It’s Getting Worse: The IRS Now Audits Poor Americans at About the Same Rate as the Top 1%,” ProPublica, May 20, 2019, <https://www.propublica.org/article/irs-now-audits-poor-americans-at-about-the-same-rate-as-the-top-1-percent>.

<sup>7</sup> This is due to historical and continuing racial bias and discrimination, which have systematically reduced opportunity for households of color.

<sup>8</sup> Department of the Treasury, “The American Families Plan Tax Compliance Agenda,” May 2021, <https://home.treasury.gov/system/files/136/The-American-Families-Plan-Tax-Compliance-Agenda.pdf>.

information for people who earn their income through wages and salaries via the W-2 forms their employers provide to the IRS. But many wealthy people receive most of their income from more opaque sources, such as sales of assets and business transactions, which often face no similar third-party reporting on their incomes. The proposal would address that imbalance by providing the IRS with new information to help it uncover unreported income for which there is little or no third-party information such as a W-2.

Some have asserted that the information reporting proposal would discourage people of color from becoming banked.<sup>9</sup> This assertion is based on a misleading and incomplete characterization of the proposal. Such critiques further ignore the fact that the economic recovery package creates many new potential pathways for households of color to become banked, including the monthly and fully refundable Child Tax Credit, which can be directly deposited to bank accounts. More fundamentally, the revenue raised by the information reporting proposal would finance economic recovery policies to expand economic opportunity and security among people with low incomes.

#### **4. Its low account threshold will prevent gaming.**

Because the information reporting proposal is designed to increase IRS enforcement on high-income people who are not paying all of the taxes they owe, some policymakers argue that accounts below a certain level — for instance, with flows or balances below a \$250,000 threshold — should be exempted from new information reporting. This may have some intuitive appeal, but it would undermine the proposal and eliminate much of the potential revenue.

Setting a high account threshold would create opportunities for tax evasion. High-income people could distribute their money among multiple accounts, so each account would fall below the reporting requirement threshold, and they could thereby continue to avoid detection of their tax evasion.

The proposed structure, which includes all accounts above \$600, limits this type of gaming, so the IRS can collect more revenue from high-income tax cheaters.

#### **5. More robust information reporting is strongly in the interests of honest taxpayers and business owners.**

The information reporting requirement would have a positive effect on honest taxpayers, who would likely face reduced audit risks under it. That's because, rather than relying largely on random audits, the IRS would have better information with which to detect tax evasion and could better target its audits against high-income tax cheats. As the Congressional Budget Office recently wrote, the proposal “might reduce the burden on compliant taxpayers by allowing the IRS to better target noncompliant ones and to reduce the number of audits that resulted in no change in tax assessment.”<sup>10</sup>

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<sup>9</sup> Letter to Senate Leader Chuck Schumer, House Speaker Nancy Pelosi, Senate Minority Leader Mitch McConnell, and House Minority Leader Kevin McCarthy, Independent Community Bankers of America, July 12, 2021, [https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-congress/icba-minority-bank-council-letter-re-bank-account-reporting-proposal.pdf?sfvrsn=6b430517\\_0](https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-congress/icba-minority-bank-council-letter-re-bank-account-reporting-proposal.pdf?sfvrsn=6b430517_0).

<sup>10</sup> Phill Swagel, “The Effects of Increased Funding for the IRS,” Congressional Budget Office, September 2, 2021, <https://www.cbo.gov/publication/57444>.

The proposal could also increase a sense of trust and fairness because filers would know that more of their fellow taxpayers will be paying more of the tax they owe.

It would also benefit honest business owners, who are put at an unfair disadvantage by business owners who cheat on their taxes. The largest share of the tax gap is from the underreporting of business income that is supposed to show up on individual tax returns. Policymakers can support honest business owners by adopting more robust information reporting rules.

## Conclusion

In their letter endorsing the Biden Administration's information reporting proposal, a bipartisan group of former Treasury Secretaries summarized the benefits to strengthening information reporting:<sup>11</sup>

We are convinced that better information-reporting requirements can be designed that will permit significant increases in revenue collection without imposing any burden at all on taxpayers and imposing no significant increase in regulatory burdens across the economy. Relying on financial institutions to relay some basic information about account holders is a sensible way forward.

The economic recovery package should include this important information reporting requirement. Doing so would ensure higher tax compliance, raise revenue from high-income people who currently do not pay much of the taxes they owe, and help to fund critical investments that would reduce poverty, broaden opportunity, improve health coverage, address climate change, support workers, and narrow gaping racial disparities that continue to plague the nation.

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<sup>11</sup> Timothy Geithner *et al.*, "We Ran the Treasury Department. This Is How to Fix Tax Evasion." *New York Times*, June 9, 2021, <https://www.nytimes.com/2021/06/09/opinion/politics/irs-tax-evasion-geithner-lew-paulson-summers-rubin.html>.