



October 22, 2021

WHAT YOU NEED TO KNOW ABOUT Tax Gap

PRO POINTS

- **By all estimates, the IRS doesn't collect hundreds of billions of dollars that it's owed by taxpayers each year.** The difference between collections and how much is owed is known as the tax gap, and policymakers are eager to narrow it.
- **The IRS says it doesn't have the resources it needs to better chase tax cheats.**
- **Perhaps more than ever, the tax gap is playing a key role in a political debate, as Democrats seek to use increased tax collections to help pay for President Joe Biden's domestic agenda.**

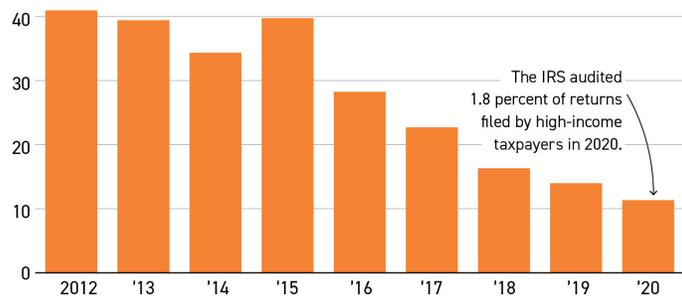
HOW WE GOT HERE

The IRS periodically issues official estimates of the tax gap, most recently saying that the tax gap for 2011, 2012 and 2013 was about \$381 billion per year when accounting for the agency's enforcement efforts and other late payments.

In essence, the agency found that taxpayers are sending them \$5 out of every \$6 owed, voluntarily and on time.

Audits of high-income individuals have fallen since 2012

IRS AUDITS OF TAXPAYERS WITH MORE THAN \$1 MILLION IN TOTAL POSITIVE INCOME, THOUSANDS



Source: TRAC-IRS

But even the IRS brass believes that figure doesn't tell the whole story. IRS Commissioner Chuck Rettig got a lot of attention over the spring, by personally estimating that the tax gap now could be as high as \$1 trillion a year.

Other projections, from the Treasury Department and the economists Larry Summers and Natasha Sarin (who subsequently joined Treasury in the Biden administration), found tax gap figures somewhere in the middle of the official and unofficial IRS estimates — more in the \$600 billion or a bit higher range.

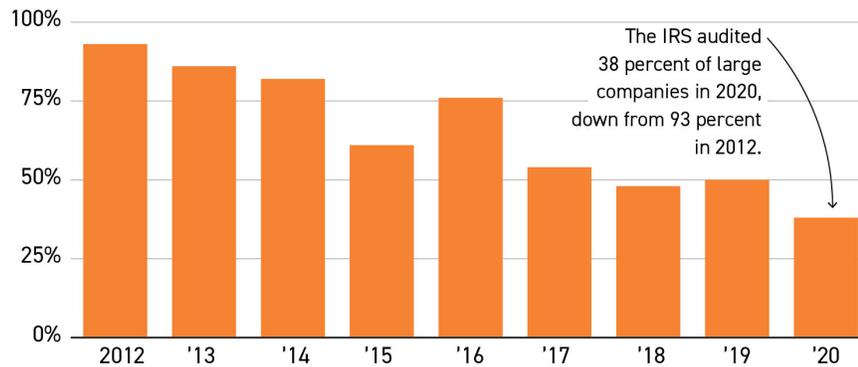
One big reason for that higher estimate, Rettig told the Senate Finance Committee, was the explosion in virtual currencies — practically an afterthought for the IRS during the last period when the agency estimated the tax gap, but now a market worth a couple trillion dollars.

Rettig also said that the rich are looking to stashing more income offshore and relying on more opaque business structures, while companies or individuals low-balling their income to the IRS has long been the key driver in decreased IRS collections.



Audits of large corporations fell significantly from 2012 to 2020

IRS AUDITS OF COMPANIES WITH MORE THAN \$20 BILLION IN ASSETS



Source: TRAC-IRS

But he also argued that the IRS was “outgunned” and needed more resources to battle taxpayers who were deliberately shorting the Treasury.

The IRS has faced declining or stagnant funding for a decade or more now, and Rettig has said more resources could help the agency go after tax dodgers. He also has hinted that the agency could use what has become a controversial part of the Democrats’ revenue-raising proposals — better reporting from banks and other third parties.

Still, taxpayer advocates worry about chalking up so much of the tax gap to evasion or willful tax avoidance, stressing that overlooks factors like inadvertent tax errors, frequently caused by a complex tax code.

WHAT'S NEXT

There are two main reasons that Democrats are pushing new proposals to help the IRS close the tax gap.

First, they believe that boosting tax collections and keeping the IRS suitably funded is a good idea in and of itself.

Second, Democrats are struggling to come up with the revenue needed to pay for a large social spending package, even as their ambitions have fallen from an approximately \$6 trillion measure to something perhaps a third or a quarter of that size.

Biden included two measures to increase tax collections when he rolled out his domestic agenda. The first would boost IRS funding by some \$80 billion, allowing the agency to hire tens of thousands of new staffers who could help go after tax cheats.

Democratic lawmakers appear to be united behind that plan, which has made it a consistent central plank in the party’s revenue-raising agenda.

The second idea, however, has run into more problems. That proposal would force banks, credit unions and maybe other financial institutions to give the IRS a yearly total of inflows and outflows on certain accounts.



Under Biden's original proposal, banks would have had to give the IRS information on any account with at least \$600 a year in combined withdrawals and deposits. But just this week, Democrats settled on a far higher threshold, \$10,000, and are also seeking to exempt wage income and Social Security benefits to focus the reporting requirements more on the better off.

Still, it's no sure thing that proposal would make it into a big tax-and-spend package. Republicans, never huge fans of the IRS, have mounted an aggressive offense against what they view as an unwarranted violation of people's privacy, while the financial services industry says the idea is fatally flawed and couldn't work at any account threshold.

And yet, Democrats have good reason to see if they can get the reporting requirements into their final bill — for starters, other tax-raising proposals that seemed simpler, like raising the top individual and corporate rates, might not have the needed support within the party.

POWER PLAYERS

- **IRS Commissioner Chuck Rettig:** The IRS chief's assertion that the tax gap could be as big as \$1 trillion a year garnered a lot of attention, and Rettig has made boosting tax collections a priority for the agency. Meanwhile, Democrats have pointed to how Rettig got the job — he was nominated by former President Donald Trump — to make their case that the proposed increased reporting requirements are a mainstream idea. But Republicans have not been happy with how Rettig and his team have handled the news outlet ProPublica's obtaining tax records of the very rich, making the commissioner's tax gap efforts even more difficult.
- **Senate Finance Chair Ron Wyden and House Ways and Means Chair Richard Neal:** The two Democrats most responsible for raising revenue for the Democrats' social spending package have taken somewhat different approaches to the proposed reporting requirements in recent weeks. Wyden announced the higher reporting threshold, which was endorsed by the Treasury Department, with Sen. Elizabeth Warren (D-Mass.). But Neal said he wanted to see more details on the proposal, even after he was the one who announced in September that lawmakers and the administration were trying to make the proposal more focused on the rich.
- **Treasury Secretary Janet Yellen:** Yellen and key members of her staff have become more aggressive in selling the need for increased reporting in recent weeks, noting that banks already inform the IRS when accounts earn at least \$10 a year in interest. Treasury also casts the current set-up as fundamentally unfair — workers have their wages reported on W-2 forms, while the IRS can know far less about a private business owner's income. If Democrats are successful in passing new reporting requirements, Treasury could easily have lots of regulatory work to do to flesh out the measure.
- **Senate Minority Leader Mitch McConnell:** Republicans increasingly are making the reporting requirement proposal a centerpiece of their case that Democrats are overreaching with their thin congressional majorities. McConnell has written opinion pieces for newspapers back home blasting the proposal and frequently brings it up on cable news interviews. Some Republicans even have said that the Democrats' idea would allow the IRS to check individual transactions in people's bank accounts, though both Democrats and independent analysts have said that's not the aim of the proposed program.