U.S. DEPARTMENT OF THE TREASURY

Investing in the IRS and Improving Tax Compliance

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A well-functioning tax system requires that all taxpayers pay what they owe. An unfortunate characteristic of the current system, however, is an asymmetric adherence to tax law by the nature of income received. While roughly 99% of the taxes due on wages are remitted to the Internal Revenue Service, compliance across other forms of income is substantially less, as the IRS has difficulty verifying whether income from opaque sources is properly reported. Noncompliance is concentrated at the top of the distribution: A recent study found that the top 1 percent failed to report 20 percent of their income and failed to pay nearly $175 billion in taxes owed annually.

Lower levels of compliance not only impact tax progressivity, but they also lower tax revenue and deteriorate our nation's fiscal position. Left unaddressed, this tax gap— the difference between taxes owed to the government and taxes actually paid—will total about $7 trillion over the course of the next decade. This massive gap in revenue means policymakers must choose between higher taxes elsewhere in the tax system, lower spending on fiscal priorities, or rising budget deficits.

The tax gap has many underlying causes, chief among them being insufficient resources. Budget cuts over the past decade have resulted in an agency that lacks the capacity to address sophisticated tax evasion efforts. Over this period, audit rates for taxpayers making over $1 million in income have fallen by almost 80 percent.

A robust and sustained investment in the IRS is necessary to ensure it can do its job of administering a fair and effective tax system. The IRS requires more resources to conduct investigations into underreported income and to pursue high-income taxpayers who evade their tax liability through complex schemes. It requires 21st century technology to unpack complex tax returns and track income across various opaque sources. And, it requires access to better information so that the agency can target its efforts at the most egregious offenders, while helping compliant taxpayers avoid unnecessary and costly audits. This investment will also put the IRS in a position to provide taxpayers with timely answers to questions.

These considerations provide the basis for a series of proposals in the American Families Plan that overhaul tax administration and provide the IRS the resources and information it needs to address tax evasion. All told, these reforms will generate an additional $700 billion in tax revenue over the course of a decade, net of the investments made. Specifically, the tax administration reforms will:

- **Provide the IRS the resources it needs to stop sophisticated tax evasion**. Over the last decade, a declining IRS budget has deprived it of the resources it needs to effectively enforce our nation's tax laws. After accounting for inflation, the IRS budget has fallen by about 20 percent, and its workforce has been depleted, with the number of complex revenue agents (who are dedicated to high-end evasion and large corporate cases) falling by 35 percent. As a result, IRS audits have fallen across the board, and particularly for the highest earners.

  The IRS has made clear that it needs additional resources to pursue costly tax evasion. These are not easy cases to resolve; the average investigation of a high-wealth individual takes two years to complete and often requires the IRS to commit substantial resources. Moreover, the lack of adequate investment in compliance has significant revenue consequences. Indeed, several hundred taxpayers who committed the most egregious form of evasion—failing to file taxes all together—cost the federal government $10 billion over a period of just three years.

  A key component of this initiative is the provision of a sustained, multi-year stream of funding. Altogether, the proposal directs roughly $80 billion to the IRS over a decade to fund an array of priorities—including overhauling technology to improve enforcement efforts, which is more effectively implemented with the assurance of a consistent funding stream. This investment will also facilitate the IRS hiring and training auditors to focus on complex investigations of large corporations, partnerships, and global high-wealth individuals. The President's proposal directs that additional resources go toward enforcement against those with the highest incomes, rather than Americans with actual income of less than $400,000.

- **Provide the IRS with more complete information**. When the IRS has information from third parties, income is accurately reported, and taxes are fully paid. However, high-income taxpayers disproportionately accrue income in opaque sources—like partnership and proprietorship income—where the IRS struggles to verify tax filings. As a result, up to 55 percent of taxes owed on these less visible income streams is unpaid, with disproportionate levels of non-compliance for those at the top of the income distribution.

GAO and IRS research confirm that providing the IRS a mechanism for cross-checking the accuracy of such tax filings is a proven way to improve compliance. This reform aims to provide the IRS information on account flows so that it has a lens into investment and business activity—similar to the information provided on income streams such as wage, pension, and unemployment income.

Importantly, this proposal provides additional information to the IRS without any increased burden for taxpayers. Instead, it leverages the information that financial institutions already know about account holders, simply requiring that they add to their regular, annual reports information about aggregate account outflows and inflows. Providing the IRS this information will help improve audit selection so it can better target its enforcement activity on the most suspect evaders, avoiding unnecessary (and costly) audits of ordinary taxpayers.

- **Overhaul outdated technology to help the IRS identify tax evasion**. Elements of IRS IT systems are antiquated and make it difficult for the IRS to identify those who are not paying their taxes and to help those who want to comply. The President's proposal provides the IRS much-needed resources to modernize its technological infrastructure. Leveraging 21st century data analytic tools will enable the IRS make use of new information about income that accrues to high-earners and will help revenue agents unpack complex structures, like partnerships, where income is not easily traced.
- **Improve taxpayer service and deliver tax credits**. A well-functioning tax system requires that taxpayers be able to interact with the IRS in an efficient and meaningful manner. Inadequate resources often mean that IRS service agents are unable to provide taxpayers timely answers to their tax questions. Service enhancement will improve the ability of the IRS to communicate with taxpayers securely and promptly. Importantly, the proposal also includes the necessary resources to ensure that the IRS effectively and efficiently delivers tax credits to families and workers, including newly expanded Child Tax Credits and Child and Dependent Care Tax Credits.
- **Regulate paid tax preparers**. Taxpayers often make use of unregulated tax preparers who lack the ability to provide accurate tax assistance. These preparers submit more tax returns than all other preparers combined, and they make costly mistakes that subject their customers to painful audits, sometimes even intentionally defrauding taxpayers for their own benefit. The President's plan calls for giving the IRS the legal authority to implement

safeguards in the tax preparation industry. It also includes stiffer penalties for unscrupulous preparers who fail to identify themselves on tax returns and defraud taxpayers (so called "ghost preparers").

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