House taxwriters explore causes of and cures for the 'tax gap'

Members of the House Ways and Means Committee gathered May 9 for a hearing to discuss the factors contributing to the "tax gap" – or the difference between federal taxes owed and paid on a timely basis – and what might be done to reduce it.

Measuring revenue shortfall and compliance rates

The Internal Revenue Service periodically assesses the size and composition of the tax gap, as well as the overall taxpayer compliance rate. The agency’s most recent estimates were released in May of 2016 and were presented as averages for the 2008-2010 timeframe. That analysis pegged the gross tax gap at $458 billion (on average), roughly in line with the IRS’s penultimate estimate – for 2006 – that figured a gross gap of $450 billion. The net tax gap – that is, the tax gap reduced for late payments and collections through enforcement activities – averaged $406 billion over the three years examined in the most recent analysis.

URL: https://www.irs.gov/pub/irs-soi/06rastg12overw.pdf
Those figures are then compared to overall tax liabilities to arrive at the compliance rate – which averaged 81.7 percent (gross) and 83.7 percent (net) from 2008-2010. These compliance rates – both gross and net – were down about 2 percent from the 2006 analysis, which the IRS attributed to changes in its estimation methodology rather than shifts in taxpayer behavior.

In terms of its composition, the vast majority of the gross tax gap in the most recent analysis – $319 billion – came from owed but unpaid individual tax liabilities. Employment taxes ($91 billion) and corporate taxes ($44 billion) accounted for nearly all of the remaining shortfall. More than 80 percent of the gross gap is attributable to underreporting of income, with far smaller contributions to the gap stemming from underpayments of tax and nonfiling of returns.

Unsurprisingly, compliance rates are quite high with respect to sources of income – such as employee wages – that are separately reported to the IRS and withheld on by employers. On the flip side, noncompliance is comparatively high for income that is not subject to third-party reporting – such as self-employment income.

The IRS is expected to release an updated estimate of the tax gap this summer covering 2011-2013.

An overview that discusses how the tax gap is measured and the economics of tax compliance was prepared in conjunction with this hearing by the Joint Committee on Taxation staff.

URL: https://www.jct.gov/publications.html?func=startdown&id=5185

**Enforcement issues**

Ways and Means Committee Chairman Richard Neal, D-Mass., opened the hearing decrying the state of the IRS’s enforcement budget, as well as the focus of its audit efforts.

"Insufficient IRS funding creates incentives for some taxpayers to take aggressive tax positions,” Neal said. "Well-advised taxpayers, including multinational companies and high-income taxpayers, have the incentives and the resources to do just that."

Neal noted that the numbers of IRS exam personnel and revenue officers have declined by about 40 percent over the past seven years, and that the overall audit rate now stands at less than one-half of 1 percent.

At the same time, though, Neal argued that the agency is focusing too much on the returns of low-income taxpayers, including Earned Income Tax Credit recipients.

"Many question why the IRS is using its limited resources in this manner rather than deploying them on high-income taxpayers and corporations where the return is greater per hour of a revenue agent’s time,” Neal said.

However, reflecting the continuing partisan divide on budget issues generally and IRS funding in particular, ranking Republican Kevin Brady of Texas posited that the IRS should better target its current resources rather than ask for additional funds.

“"The truth is that the IRS budget has been stable over the last several years and any cuts by Congress were made only when compared to an all-time budget high,” Brady said.

In fact, devoting extra enforcement dollars to the IRS has been discussed by both parties in recent months.

The Trump administration, in its fiscal year 2020 budget plan submitted to Congress in March, proposed an additional investment of $15 billion over 10 years in IRS enforcement activities, which it predicted would yield $47 billion in otherwise uncollected revenue over that timeframe.

Similarly, a budget bill dealing with the so-called “sequester” caps on discretionary spending that was advanced by House Budget Committee Democrats last month – but not taken up on the floor due to unrelated intraparty divisions – would have granted the IRS an extra $400 million and $750 million for enforcement over the next two fiscal years.
‘Gig’ economy workers and the tax gap

Several members on both sides of the aisle – as well as witness J. Russell George, the Treasury Inspector General for Tax Administration, or TIGTA – spent much of their allotted time discussing the effect on the tax gap of payments to workers in the so-called “gig” economy, which generally refers to business generated by online platforms that bring together service providers and customers (for example, ride-sharing and e-commerce platforms).

According to George, current rules generally only require businesses to report payments (on Form 1099-K) to service providers utilizing their platforms if the payments total at least $20,000 and stem from at least 200 transactions. Even then, those service provider payments may not have federal taxes withheld from them.

George argued this lack of third-party reporting and withholding of tax at the source of payment breeds widespread noncompliance.

“This creates a more complicated tax situation for individuals who, in many cases may not understand the tax obligations of their activities, such as the possible obligation to pay self-employment tax,” George said.

Lawmakers discussed several potential remedies to the situation, such as requiring reporting and withholding on payments to gig economy workers – even if just on a worker-voluntary basis – or reducing the thresholds that determine when a Form 1099-K must be filed.

“TIGTA recommended to the IRS that the agency develop a strategic plan to address tax administration in the gig economy and the IRS agreed on its importance,” Rep. Brady noted. “We believe that Congress must be involved in these discussions, as well.”

International tax

Chairman Neal noted that the true tax gap may be even larger than the official estimate because it does not attempt to incorporate revenues lost to illegal activities, as well as international tax noncompliance.

On the international front, Rep. Lloyd Doggett, D-Texas, discussed the No Tax Breaks for Outsourcing Act (H.R. 1711), a bill he recently introduced that, among other things, would repeal the 50 percent deduction against Global Intangible Low-Taxed Income (GILTI) under tax code section 250, do away with the provision that excludes from GILTI a 10 percent return on tangible foreign assets, and eliminate the 20 percent haircut on foreign tax credits under the GILTI regime.

Doggett asked witness Ken Wood, a transfer pricing expert and former IRS associate chief counsel (International), whether the bill would cut down on tax avoidance in the international space.

Wood responded that eliminating deferral – something that in a sense Doggett’s bill would move toward by increasing the amount of foreign income currently taxable in the US – would “go a long way” toward addressing Doggett’s concerns.

Other issues

Witness James McTigue, Jr., director of strategic issues at the Government Accountability Office argued in favor of several other actions that Congress could take to reduce the tax gap, including expanding the IRS’s so-called “math error” authority which enables the agency to correct certain types of errors on tax returns without initiating a formal audit, and enhancing electronic filing. Expanding required electronic filing by corporations, for example, could enable the IRS to better focus its resources by cutting down on examinations of compliant taxpayers, McTigue argued.

McTigue also suggested that the IRS should be granted authority to regulate paid tax preparers – a change that has proven controversial among some stakeholders. Such a provision was included in the Trump administration’s fiscal year 2020 budget blueprint but was left out of IRS reform legislation (H.R. 1957) that cleared the House earlier this year and has since stalled in the Senate because of some lawmakers’ concerns about a provision that would codify the IRS’s Free File program.
House retirement bill hits speed bump

A bipartisan retirement savings bill that cleared the House Ways and Means Committee early last month and was thought to be on a fast track for passage by the full House now faces delays because of a provision that would allow individuals to use funds in section 529 education savings accounts to cover costs associated with home schooling.

The Setting Every Community Up for Retirement Enhancement Security (SECURE) Act of 2019 (H.R. 1994) is aimed at making it easier for smaller businesses to offer tax-qualified retirement savings plans to their employees, encouraging individuals to participate in retirement plans, and promoting savings for certain nonretirement expenses. House Majority Leader Steny Hoyer, D-Md., had hoped to bring the bill to the floor this week, but progressive Democrats in the House raised concerns about the section 529 provision based on comments from the National Education Association and the American Federation of Teachers.

The measure still has significant support, and those watching the process expect Hoyer will bring it to the House floor as soon as the week of May 13, but it might not receive expedited consideration and will likely be amended before final passage.

In the Senate, Finance Committee Chairman Charles Grassley, R-Iowa, and ranking Democrat Ron Wyden of Oregon unveiled their own retirement legislation – dubbed the Retirement Enhancement and Savings Act (RESA) of 2019 (S. 972) – in early April. That measure, which is a modified version of legislation that Wyden and then-Finance Chairman Orrin Hatch, R-Utah, introduced in 2016, may reach the Senate floor in the coming weeks. RESA is broadly similar to the House’s SECURE Act, although there are some notable differences between the two that would have to be reconciled if each measure clears its respective chamber as currently written. (For prior coverage, see Tax News & Views, Vol. 20, No. 13, Apr. 5, 2019.) RESA does not include the home schooling provision that is bogging down the House bill.

Finance Committee schedules hearing on retirement savings issues

In other news, the Senate Finance Committee announced this week that it will hold a hearing on May 14 to discuss “Challenges in the Retirement System.”

A Finance Committee aide told Tax Notes this week that the hearing is expected to address issues outside the scope of the RESA legislation. One possible topic of discussion is a pending retirement savings bill from Senate taxwriters Rob Portman, R-Ohio, and Ben Cardin, D-Md., that updates legislation (S. 3781) they introduced in the last Congress.

Witnesses scheduled to appear include Lynn Dudley, senior vice president of global retirement and compensation policy for the American Benefits Council; Oregon State Treasurer Tobias Read; Joan Ruff, board chair of the AARP; and Joan Tibbetts, vice president of retirement for the Principal Financial Group.

House taxwriters split over how to expand paid family and medical leave benefits

There was bipartisan agreement at a May 8 House Ways and Means Committee hearing that lack of access to paid family and medical leave benefits makes it more difficult for businesses to retain qualified employees and creates
economic uncertainty for workers – particularly those at the lower end of the income scale – who are facing personal health issues or family caregiving responsibilities.

But taxwriters split along party lines when the discussion turned to how to make those benefits available more widely: Democrats called for enacting a national mandate that would be funded by employment taxes while Republicans favored working through the tax code to provide incentives to encourage more businesses to offer paid leave and encourage individuals to save for family-life expenses.

**National mandate**

Ways and Means Committee Democrats touted the Family and Medical Insurance Leave (FAMILY) Act (H.R. 1185), sponsored by Rep. Rosa DeLauro, D-Conn., as a model for a nationally mandated paid family and medical leave policy. That measure, which was introduced in March, would provide up to 12 weeks of partial wages – 66 percent wage replacement, capped at $4,000 a month – to workers who need to take time off from their jobs to address a serious personal or family health issue, care for a newborn or newly adopted child, care for an injured service member, or address family issues related to the deployment of a service member. Benefits would be portable as workers change jobs and would be available to "traditional" employees as well as individuals who have multiple jobs or are self-employed.

URL: [https://www.congress.gov/bill/116th-congress/house-bill/1185/text?q=%7B%22search%22%3A%5B%22%5C%22family+act%5C%22%5D%7D&r=3&s=1](https://www.congress.gov/bill/116th-congress/house-bill/1185/text?q=%7B%22search%22%3A%5B%22%5C%22family+act%5C%22%5D%7D&r=3&s=1)

The leave program would be funded through a 0.4 percent payroll tax on wages that would be split evenly between employees and employers. An independent trust fund within the Social Security Administration would be created to collect the dedicated payroll taxes and administer benefits.

H.R. 1185 has been referred to the Ways and Means Committee, but Chairman Richard Neal, D-Mass., has so far not announced plans to hold a mark-up. A Senate companion measure (H.R. 463) is sponsored by New York Democrat – and 2020 presidential hopeful – Kirsten Gillibrand.

**GOP objections:** Republicans on the panel generally chafed at the notion of a one-size-fits-all federal program and pointed to what they saw as design flaws in the FAMILY Act.

Ways and Means ranking Republican Kevin Brady of Texas argued in his opening statement that the income from a new employment tax would be insufficient to sustain the level of benefits promised under the FAMILY Act.

"The true cost of a family leave mandate is up to $1 trillion in the first decade, according to the American Action Forum. And it could go higher in the future. This could force an average worker making $50,000 a year to pay more than $58,000 in higher payroll taxes and lower wages over their work career whether they ever use the program or not," he said. (Witness Rachel Greszler of the Heritage Foundation said in her prepared testimony that the FAMILY Act would increase an individual's payroll taxes by an average of $1,000-$2,000 a year.)

Brady and other Ways and Means Republicans also contended that payroll taxes are by nature regressive, and several Republicans questioned the wisdom of adding a new program to the Social Security system when the existing Social Security trust fund is already facing an insolvency crisis. In response to a question from Rep. Tom Reed, R-N.Y., the ranking member on the Social Security Subcommittee, Greszler noted that if the proposed FAMILY Act program cannot sustain the promised level of benefits, future generations would be left to deal with the shortfall.

Two of the witnesses at the hearing who were invited by Democratic taxwriters came from states that either have implemented or are in the process of implementing a paid family and medical leave program.

Ways and Means Republican Vern Buchanan of Florida asked one of those witnesses, Washington State Employment Security Department Commissioner Suzan LeVine, whether a program like the one envisioned in the FAMILY Act would work better at the state level, with the federal government providing some funding assistance.

LeVine replied that leaving the issue to the states would result in uneven availability of benefits.

"We need every state to be involved," LeVine said. "Where you’re located shouldn’t determine whether you have access” to paid family and medical leave.
Expanded tax incentives

In rejecting a new federal mandate, Ways and Means Republicans argued that it would be more efficient to expand access to paid family leave by building on incentives already in the tax code. Ranking member Brady and several other GOP taxwriters noted that their 2017 tax cut legislation (P.L. 115-97, known informally as the Tax Cuts and Jobs Act or TCJA) provides a temporary credit under section 45S to qualifying employers that offer paid family and medical leave to their employees and also includes family-friendly provisions, such as an increased child tax credit, that put more money in workers’ pockets.

Brady more broadly credited the TCJA with creating an economic boom that “is encouraging even more businesses to provide expanded benefits for their workers like paid family and medical leave.”

Permanent section 45S credit: Brady’s chief recommendation for expanding paid family and medical leave benefits was to make the section 45S tax credit permanent. (The credit is currently scheduled to expire at the end of this year.)

“No member of Congress should support taking away this valuable tax incentive if we’re serious about expanding access to paid leave,” he said.

That sentiment was widely shared among the panel’s GOP members as well as the Heritage Foundation’s Rachel Greszler – although Greszler also noted in response to a question from Rep. Mike Kelly, R-Pa., that the TCJA credit provided a “windfall” to businesses that were already providing paid family and medical leave to their employees before the TCJA was enacted.

Tax-preferred savings options: Some Ways and Means Republicans also discussed ways to allow workers to tap into tax-preferred savings plans to help cover family caregiving expenses.

Mike Kelly raised the possibility of allowing individuals to make penalty-free withdrawals from retirement plans – an idea that Greszler laid out in her prepared testimony. They noted that the Setting Every Community Up for Retirement Enhancement Security (SECURE) Act of 2019 (H.R. 1994), a bipartisan retirement savings bill that cleared the Ways and Means Committee in April and is expected to be brought to the House floor by the end of this month, already includes a provision that would allow penalty-free withdrawals of up to $5,000 (per individual) from an IRA or qualified retirement plan to cover expenses associated with the birth or adoption of a child and permit recontributions of withdrawn amounts. (Kelly is one of the sponsors of the SECURE Act.)

In exchanges with Kelly and with Republican Jackie Walorski of Indiana, Greszler also suggested that Congress could pass legislation authorizing tax-preferred Universal Savings Accounts that could be funded with after-tax contributions, with interest accumulating tax-free and withdrawals permitted at any time and for any reason. House Republicans approved Universal Savings Accounts as part of the “Tax Cuts 2.0” plan they advanced last year while they still controlled the chamber, but the legislation was never taken up in the Senate. (For prior coverage, see Tax News & Views, Vol. 19, No. 32, Sep. 28, 2018, and Tax News & Views, Vol. 19, No. 30, Sep. 14, 2018.)

Dem concerns: Democrats, for their part, argued that providing tax incentives would do little to expand the availability of paid leave programs.

Rep. Lloyd Doggett, D-Texas, asked Pronita Gupta of the Center for Law and Social Policy whether she has observed an increase in the number of employers offering paid family leave since the section 45S credit was enacted as part of the Tax Cuts and Jobs Act in 2017.

Gupta replied that most US workers still have no access to paid leave programs and that relying on business-oriented tax policy to expand those benefits “is not enough.”

Democratic taxwriter Ron Kind of Wisconsin cautioned that allowing individuals to tap into retirement funds to pay for family caregiving expenses would run the risk of jeopardizing their future retirement security. Kind, who is one of the
sponsors of the SECURE Act, stated that Congress should “resist the temptation” to expand the list of permissible reasons for making penalty-free retirement-account withdrawals.

Rep. Don Beyer, D-Va., commented that Universal Savings Accounts would be of limited use to individuals facing significant medical or caregiving expenses given the relatively low interest rates being offered on most deposit accounts.

Democratic Rep. John Larson of Connecticut was skeptical about the GOP’s argument that tax incentives would spur more employers to offer paid leave benefits because they would have the flexibility to design programs that make the most sense for their business and their employees.

In many cases, ‘flexibility’ is construed as “the flexibility to do nothing,” he said.

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**Senate Budget chief won’t seek re-election in 2020**

Senate Budget Committee Chairman Mike Enzi, R-Wyo., announced May 4 that he will not see re-election to the Senate in 2020. The four-term senator has chaired the Budget panel since 2015 and was responsible for shepherding a budget resolution through the committee in 2017 that authorized a 10-year, $1.5 trillion net tax cut that could move through Congress under fast-track budget reconciliation protections. That tax-and-spending blueprint, which was subsequently approved by the full Senate and adopted in the House, paved the way for passage and enactment in late 2017 of the GOP’s massive tax cut legislation known informally as the Tax Cuts and Jobs Act or TCJA (P.L. 115-97).

Budget reconciliation rules allow certain designated legislation to win passage in the Senate by a simple majority vote rather than the three-fifths supermajority – 60 votes – normally required to clear procedural hurdles in that chamber. Reconciliation was essential to Senate passage of the TCJA, since the GOP controlled only 52 seats in that chamber in 2017 and the legislation did not receive any Democratic support.

In addition to chairing the Budget Committee, Enzi sits on the Senate Finance Committee and supported legislative efforts to require on-line retailers to collect state and local sales and use taxes on “remote” sales. He sponsored the Marketplace Fairness Act, which generally would have authorized any state to require remote sellers to collect and remit sales and use taxes on remote sales sourced to that state. (The measure cleared the Senate in 2013 but was never taken up in the House.) And he applauded the US Supreme Court’s decision in *South Dakota v. Wayfair, Inc., et. al.*, which overturned the physical presence rule for purposes of sales and use tax nexus that was established in its previous decisions in *Quill* (1992) and *National Bellas Hess* (1967). Enzi notes in a policy statement on his Senate web site that he was “glad the Court realized the importance of closing this gaping loophole in our tax law that denied states the right to enforce their own laws.”

In a speech announcing his retirement, Enzi said he plans to spend the rest of his term focusing on “budget reform to get control of our national debt” as well as small-business initiatives.

**CBO midyear update: Little change in debt, deficit outlook**

Enzi’s retirement news and his comments about the national debt came just two days after the Congressional Budget Office (CBO) released a midyear update of the debt and deficit outlook over the next decade that showed little change from the bleak 10-year projections the agency published in January of this year.

**URL:** https://www.cbo.gov/system/files/2019-05/55151-budget_update_0.pdf


**Baseline debt and deficit projections:** The latest CBO report projects that the federal budget deficit will reach $896 billion in current fiscal year 2019, exceed $1 trillion each year beginning in 2022, and reach $1.3 trillion in 2029. Relative to the size of the economy, the deficits that CBO projects would average 4.3 percent of gross domestic product (GDP) over the 2020 – 2029 period, well above the 2.9 percent average over the past 50 years. CBO’s
midyear estimate of the deficit for 2019 is about the same as it was in January, and projected deficits over the 2020 – 2029 period are about 2 percent less than CBO projected in January – mainly a function of technical changes in the agency’s estimation methodologies since that time, rather than the effects of enacted legislation.

Federal debt held by the public is projected to grow from 78 percent of GDP in 2019 to 92 percent in 2029, down slightly from the nearly 93 percent projected in January. This would mark the largest share since 1947 and more than twice the 50-year average.

**Extending 2017 tax cuts, lifting sequester caps would worsen outlook:** As it did in January, CBO cautions in the midyear update that its baseline revenue and spending projections assume, among other things, that the tax relief provisions affecting individuals, estates, and passthrough entities that were enacted in the Tax Cuts and Jobs Act are allowed to expire as scheduled after 2025, and that “sequester” caps on discretionary spending (that is, annual appropriations) take effect as currently scheduled in 2020.

Under an “alternative fiscal scenario” in which the 2017 tax cuts are extended, temporary tax “extenders” provisions are renewed, certain Affordable Care Act taxes that Congress has previously acted to postpone are instead repealed, and the sequester caps do not take effect as scheduled, deficits would increase by $4 trillion over the 10-year budget window and debt held by the public would spike to 105 percent of GDP by the end of 2029 – just 1 percentage point below the highest percentage ever recorded (106 percent of GDP in 1946), CBO says.

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**Ways and Means to look at climate change – but not through the tax lens**

House Ways and Means Committee Chairman Richard Neal, D-Mass., announced this week that there will be a full committee hearing on May 15 on “The Economic and Health Consequences of Climate Change.”

A committee aide told Politico that a carbon tax is “not the focus” of the hearing but that the committee will instead explore “climate change generally” and its intersection with other issues within the Ways and Means’ purview, such as health and trade. However, discussion of a carbon tax, which could take a variety of forms, is likely to come up.

A concern for some Democrats, including senior Ways and Means Democrat Ron Kind of Wisconsin, has been the potentially regressive nature of levying new fees on emissions; but concepts such as returning the fees to households in the form of a dividend seek to address this challenge.

Witnesses for the session had not been announced as of press time.

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