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Treasury Releases the American Families Plan Tax Compliance Agenda

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President Biden's tax compliance proposals evidence a comprehensive plan providing IRS funding for enforcement activities. The proposals for substantial and sustained investment in the IRS—if effectuated—would allow the IRS to strengthen and grow its workforce and technological capabilities, likely resulting in a marked uptick in enforcement activity for many types of taxpayers.

The U.S. Treasury Department recently released a report (the "Treasury Report") providing a set of tax compliance proposals intended to "increase fairness in the tax system and foster a tax system where Americans pay the taxes they owe" and that seek to close the "tax gap" (the difference between taxes owed and those actually paid). The tax compliance initiatives were released in conjunction with President Biden's recent proposals in the American Families Plan and were also further described in the Biden Administration's tax proposals provided in the General Explanations of the Administration's

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Fiscal Year 2022 Revenue Proposals (the "Green Book").[1] See KPMG's analysis of the tax proposals in the Green Book: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget.

According to the Treasury Report, the annual gross tax gap reached nearly $600 billion in 2019 and is on pace to total approximately $7 trillion, cumulatively, over the next decade (roughly equal to 15 percent of taxes owed). Treasury views these compliance initiatives as potentially raising substantial revenue, while also improving tax progressivity and economic efficiency. The initiatives appear to be aimed at improving compliance on "less visible" sources of income. The Treasury Report notes that roughly 99 percent of taxes due on wages are paid to the IRS, but in comparison, compliance rates on "less visible" sources of income are estimated to be just 45 percent.

Assuming legislation implementing the tax compliance proposals is enacted, the Treasury Report asserts that the proposals would provide the IRS with resources and information to enhance tax administration by:

- Increasing the IRS's resources to pursue noncompliant taxpayers and better serve compliant taxpayers
- Overhauling antiquated technology to help the IRS leverage 21st century data analytics tools
- Leveraging information that financial institutions already collect to shed light on taxpayers misreporting income from opaque categories
- Regulating paid tax preparers and increasing penalties for those who intentionally commit malfeasance

The Treasury Office of Tax Analysis estimates that these initiatives would shrink the tax gap by about 10 percent, raising $700 billion in additional tax collections, net of investments in those initiatives, over the next ten years, and $1.6 trillion during the decade after that.

Background: Reversing the Declining Enforcement Trend

IRS enforcement efforts have been trending downward for two decades, according to the Treasury Report. The report blames the magnitude of the tax gap, among other factors, on long-term IRS resource constraints and the growth of sophisticated evasion opportunities such as the use of foreign bank accounts and international intra-company dealings that "shift income solely for tax purposes but can be made to appear legitimate in ways challenging for the IRS to detect." In addition, the Treasury Report points to a rise in "complex business structures, such as partnerships," remarking that the tiered structure and levels of domestic and foreign entities "combine to obscure the ultimate beneficiaries of the business operations." Examining the returns of entities in these complex structures is resource-intensive for the IRS, the Treasury Report indicates.

[1] Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021).

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According to the Treasury Report, the IRS examined only 140 partnerships in FY2018, out of more than 4 million partnership returns filed, an audit rate of .00004 percent.

KPMG Observation*: The Treasury Report's focus on partnerships continues a trend that began with the Government Accountability Office Report of 2013,*[2] *which revealed the lack of audit coverage of large partnerships in comparison to large corporations, and which led to the enactment of a new centralized partnership audit regime under the Bipartisan Budget Act of 2015. The provisions of the Bipartisan Budget Act relating to the centralized partnership audit were scored at approximately $9.3 billion over the fiscal-year 2016 – 2025 budget cycle,*[3] *indicating the expectation that the new rules would improve IRS efforts to audit, assess tax, and collect tax from partnerships. The trend of focusing on partnership compliance and enforcement has continued with heightened required reporting for partnerships, including mandatory reporting on the basis of tax capital, the introduction of Schedules K-2 and K-3 to report partnership international items, and multiple other additions to Form 1065, including regarding transfers of partnership interests. In addition, the IRS's Large Business and International division has added compliance campaigns relating to partnerships, including those relating to sales of partnership interests and self-employment taxes. The Treasury Report appears to reflect the shifting Treasury and IRS attitudes in favor of more aggressive partnership tax enforcement. For a discussion of this developing trend, see Greg Armstrong, Ossie Borosh, Tom Greenaway, and Tom Kane*, IRS Partnership Enforcement Ramps Up*, Daily Tax Report (Nov. 30, 2020).*

Restoring IRS Resources—Hiring Initiatives, Modernizing IT

The President's compliance agenda as described in the Treasury Report prioritizes restoring the IRS's enforcement capability by undertaking a sustained, multi-year commitment to "rebuilding" the IRS, spending almost $80 billion on IRS priorities during the course of the next decade. This investment would go toward hiring new, specialized enforcement staff, modernizing information technology, and investing in taxpayer service. The report emphasizes that the increased resources would boost the IRS's enforcement efforts for those with the highest incomes without raising audit rates for those earning less than $400,000 in "actual income" as compared to recent years.

The proposed increase in IRS resources would be implemented through two components, both allocated over ten years: a $72.5 billion mandatory stream of funds and a $6.7 billion "integrity allocation." The proposal contains year-by-year estimates of resources, details specific activities supported by the funds, and is designed to enable 10 percent annual budget growth.

The integrity allocation would, among other things, support the hiring and retention of at least 5,000 new enforcement personnel. The mandatory funds would be directed toward revitalizing IRS exams of large corporations, partnerships, and global high-wealth and high-income individuals.

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[2] U.S. Gov't Accountability Office, Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency, at 13 (2014) (GAO-14-732).

[3] Joint Comm. on Tax'n, Estimated Revenue Effects of the Tax Provisions Contained in H.R. 1314, The "Bipartisan Budget Act Of 2015," Scheduled For Consideration By The House Of Representatives On October 28, 2015, JCX-135-15 (Oct. 28, 2015) (Fiscal Years 2016 - 2025 [Millions of Dollars]).

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***KPMG Observation**: A significant effort likely would be required to assimilate the projected growth (10 percent per year) at the same time the IRS is reconfiguring its enforcement structure in order to achieve the integration and efficiencies it described in its Taxpayer First Act ("TFA") implementation plans. In the near term, the effort required to implement a new TFA-inspired enforcement structure while simultaneously accomplishing major new hiring could strain current enforcement capabilities. Experienced personnel could be diverted from their current roles to implement new TFA processes and assist in the hiring, training, and coaching of new enforcement personnel.*

The mandatory funds would underwrite other important IRS priorities, including supporting a broad initiative to modernize the IRS's IT infrastructure. Specifically, $6 billion of the mandatory funds would be dedicated to modernizing IT with an objective of providing a more comprehensive view of enforcement case information and taxpayer data and real-time processing. Funds would support an effort to deploy new analytical techniques, developing machine learning capabilities to enable the IRS to identify tax returns for compliance review. The proposed investment in modernizing IT would include $4.5 billion directed toward implementing a new information reporting regime. Finally, the report explains that the President's proposal is intended to enable improved taxpayer communication with the IRS and would include additional dedicated customer service representatives to aid taxpayers with various, newly expanded credit programs.

Information Reporting

The Treasury Report describes the next step of the compliance agenda, increased information reporting, as "shining light on opaque income streams, including proprietorship and partnership business income." In so doing, the Treasury Report references a range of empirical data that it indicates demonstrate higher compliance rates as a result of third-party information reporting of taxpayer income. The Treasury Report points out that current reporting requirements for gross receipts exists for only certain types of revenue but there is no reporting requirement for deductible expenses. The President's proposal requires information reporting on financial accounts in order to increase the visibility of gross receipts and expenses. According to the Treasury Report, the absence of this information reporting is the reason why the tax gap for partnership, S corporation, and proprietorship income is reportedly estimated at around $200 billion annually.

The proposed new reporting regime would be built on the framework that already exists for financial institutions to report interest income on Form 1099-INT. Specifically, the proposed new annual return would report gross inflows and outflows on all business and personal accounts from financial institutions, including bank, loan, and investment accounts. An exception would be carved out for accounts below a certain de minimis gross cash flow threshold.

The Treasury Report specifies that other similarly situated accounts, such as payment settlement entities, would also be covered by the proposed new regime and be required to report gross receipts and gross purchases. The regime would be designed to also cover foreign financial institutions and crypto asset exchanges and custodians. It is also envisioned that, like the rules applying to cash transactions, businesses that receive crypto assets with a fair market value of more than $10,000 would have to report those transactions.

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According to the estimates of the Treasury Department's Office of Tax Analysis, the proposed increase in information reporting would raise $460 billion over the next decade. While it may be possible to challenge some of the underlying estimates that support the new information reporting proposal, it is apparent that the IRS views enhanced information reporting—especially when applied to S corporations, partnerships, and proprietorships—as an important component of the overall effort to enhance compliance among those entities. The Treasury Report also explains that the additional information reporting would enhance the effectiveness of enforcement measures by the IRS being better able to target its enforcement resources.

KPMG Observation: *The Treasury Report references the lack of information reporting relating to partnership income notwithstanding the fact partnerships provide the IRS with Schedules K-1 annually. These schedules contain detailed information of each partner's allocable share of partnership income and expenses. Although the Treasury Report appears to include in "opaque income streams" partnership business income, the Treasury Report contains an illustrative chart that places partnership income, as well as S corporation income, capital gains, and alimony income, in the category of "income subject to some information reporting" with a 17 percent rate of misreporting, as compared with the 55 percent rate of misreporting that data shows for proprietorship income. See Treasury Report, Figure 2: Misreporting by Income Category.*

Also of note, this new reporting requirement would apply to foreign financial institutions. Since 2014, foreign financial institutions around the globe have been reporting information relating to accounts held by U.S. persons pursuant to the Foreign Account Tax Compliance Act ("FATCA"). Whether the reporting is done directly to the IRS, or to the tax local authorities that exchange the information with the IRS, the data (including account balances) is received by the IRS annually. Significantly, the definition of financial institution is much broader under FATCA, including collective investment vehicles and certain insurance companies. Thus, it is unclear what additional information these financial institutions could provide to enhance U.S. taxpayer compliance.

Regulating Tax Preparers and Other Compliance Proposals

The Treasury Report also mentions other administration proposals that are intended to complement the enhanced enforcement and information reporting initiatives. One proposal would provide the IRS the authority to regulate and establish minimum competency standards for all paid tax preparers. Other proposals include permitting the IRS to require payment recipients to certify their taxpayer identification numbers to payers issuing third-party information reports and imposing unpaid corporate tax liability on shareholders in specified tax shelter cases.

Conclusion

The proposals in the Treasury Report evidence a comprehensive plan to provide sustained funding to the IRS and enable the heightened enforcement detailed in the report. The agenda's proposals for substantial and sustained investment in the IRS, if effectuated, would allow the IRS to strengthen and grow its workforce and technological capabilities, likely resulting in a marked uptick in enforcement activity for many types of taxpayers.

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***KPMG Observation**: The Treasury Report does not discuss the impact of the increasing complexity of new provisions and regulations on compliance. Although increased enforcement may influence taxpayer attitudes and behavior, reduction of complexity may also enhance taxpayers' ability to voluntarily comply.*

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