The Tax Law Center NYU LAW

Written Testimony for Hearing, "Funding Our Nation's Priorities: Reforming the Tax Code's Advantageous Treatment of the Wealthy"

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Chairman Thompson, Ranking Member Smith, and distinguished members of the Committee, thank you for the opportunity to testify today. It is an honor to participate in this hearing.

The U.S. federal tax system gives income generated by wealth generous tax benefits not available to income from work. These include lower or zero rates, and the ability to delay over a lifetime or even multiple generations taxes on the income that wealth generates. Wealth includes financial assets such as stocks and bonds, real estate, personal property such as art, and ownership stakes in non-corporate businesses. The tax benefits for the income from wealth goes overwhelmingly (and sometimes exclusively) to the already very wealthy, and entrenches and exacerbates racial wealth disparities.[1] My testimony focuses on three further points:

1. **The menu of tax breaks for income from wealth leads to wasteful tax avoidance, sheltering, and even evasion.** Tax breaks on income from wealth afford the already wealthy outright tax cuts. They are also an incentive and opportunity for wealthy filers and their tax advisors to expand the coverage of these tax breaks. Wealthy filers can not only seek the lowest possible tax rate on income from their assets, but can also try to push their *labor* income into the code's preferences for "capital" income, such as by using carried interest and pass-throughs to avoid top income and payroll rates.
2. **Low- and middle-income workers have a very different experience of the tax system.** Typical workers cannot opt out of paying taxes in the year they make their income or opt into lower tax rates using complex shelters. Wealthy filers can hire teams of advisors to file their taxes, set up opaque financial arrangements, and try to outgun the IRS when they are audited.

[1] See Chuck Marr, Samantha Jacoby and Kathleen Bryant, "Substantial Income of Wealthy Households Escapes Annual Taxation Or Enjoys Special Tax Breaks," Center on Budget and Policy Priorities, November 13, 2019, https://www.cbpp.org/research/federal-tax/substantial-income-of-wealthy-households-escapes-annual-taxation-or-enjoys; Lily L. Batchelder and David Kamin, "Taxing the Rich: Issues and Options," SSRN, last updated February 1, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3452274; Chye-Ching Huang and Roderick Taylor, "How the Federal Tax Code Can Better Advance Racial Equity," Center on Budget and Policy Priorities, July 25, 2019, https://www.cbpp.org/research/federal-tax/how-the-federal-tax-code-can-better-advance-racial-equity; Dorothy Brown, *The Whiteness of Wealth: How the Tax System Impoverishes Black Americans and How We Can Fix It*, Crown, 2021.

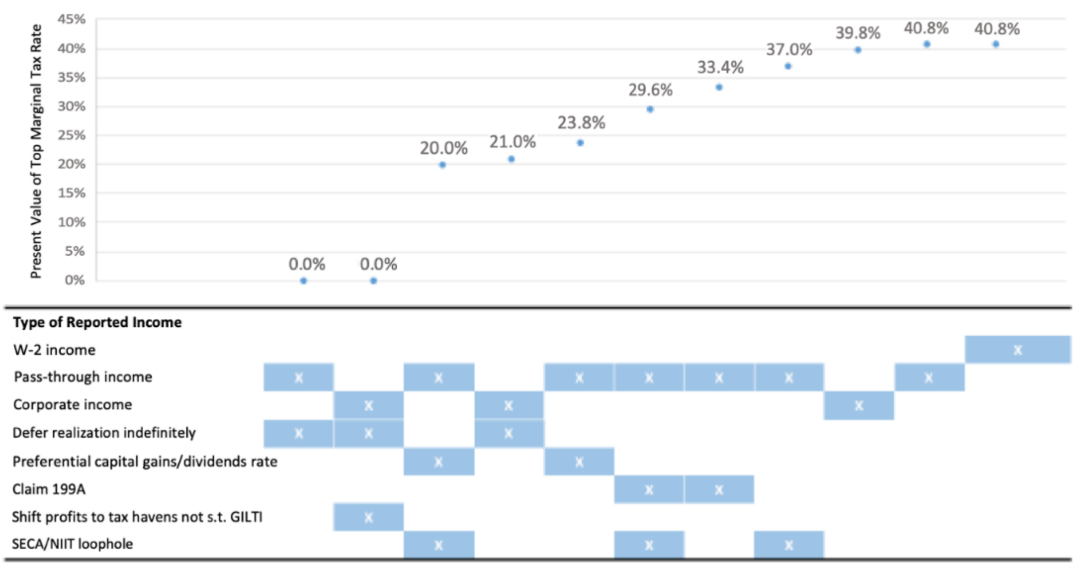
Low- and moderate-income people can struggle to file and claim tax credits for which they are eligible.

3. **Investing in workers, families, and infrastructure are higher national priorities than retaining tax breaks for income from wealth.** Permanently improving the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC), together with overdue investments in areas including basic research, infrastructure, child care, and education, would not only directly benefit families and workers, but do so in a way that helps secure shared prosperity. If lawmakers seek to offset part of the cost, two sound sources of revenue are reducing tax breaks on income from wealth and providing the IRS resources and tools to ensure that more wealthy filers comply with the law.

I. THE MENU OF TAX BREAKS FOR INCOME FROM WEALTH LEADS TO WASTEFUL TAX AVOIDANCE, SHELTERING, AND EVEN EVASION

The federal tax code's many tax breaks for income from existing wealth mean that high-wealth filers are taxed at a wide range of rates depending on how they report their income. Tax rates on income from the ownership of corporate stock, other business interests, real property, and other assets can all be far below the top rates on labor income – and as low as zero percent. The following figure from a recent study summarizes some of the rates available to wealthy filers:[2]

Present Value of Top Marginal Tax Rate by Type of Reported Income



[2] Batchelder and Kamin, *supra* note 1, Chart excerpted from Figure 2. Others include §1400Z (Opportunity Zones), §1202 the exclusion for certain capital gains from small business stocks, and the many other provisions discussed comprehensively here: U.S. Senate Budget Committee, "Tax Expenditures: Compendium of Background Material on Individual Provisions," S. Prt. 116-53, December 1, 2020, https://www.govinfo.gov/content/pkg/CPRT-116SPRT42597/pdf/CPRT-116SPRT42597.pdf.

This array of rates and preferences gives high-wealth filers opportunities and incentives to: (1) get their income from wealth the *best* possible tax treatment out of a large menu; and (2) shelter their *labor* income so that it too gets the tax breaks intended for "capital" – and in doing so avoid the progressive top tax rates on salaries.

Only filers with substantial resources and access to skilled tax advice can choose to use these often-complex arrangements. Such tools are not available to low- and moderate-income workers, who are taxed at ordinary rates, and pay taxes in real time, as they earn their wages and salary.

Some of these arrangements are lawful but exploit instances where the tax law's treatment of a form of income does not match the economic reality of how the income was made. The prospect of large tax savings can also invite some wealthy filers and their tax advisers to push the boundary of what is lawful, and, in some cases, step over the line into tax evasion. The IRS can sometimes shut down unlawful tax shelters, but others invariably pop up. Curtailing the tax breaks that attract shelters in the first place is the better cure.

Several illustrations of how tax subsidies for income from wealth can spur avoidance (or worse):

Capital gains tax rates and step-up basis

There is a long history of tax shelters and avoidance exploiting tax breaks on capital gains (income from assets that grow in value). Currently, the top tax rate on capital gains is far lower than the top tax rate on salaries.[3] The rate on capital gains accumulated over a lifetime can be effectively *zero percent* if a person holds onto the assets that grew in value until death (known as "stepped-up basis").[4] Professor Leonard Burman explains:

> "A whole industry of tax planners devotes their considerable skills to converting high-taxed ordinary income into lightly taxed, or untaxed, capital gains. This saves high-income people billions of dollars in taxes and represents a giant waste of economic resources."[5]

Whenever there has been a lower rate on capital gains than on labor income, wasteful shelters have emerged to exploit the gap. The best approach to curbing these shelters is the one partially taken by the 1986 tax reform: curbing the tax break itself.

The 1986 tax reform was prompted in part by a boom in tax shelters that led Congress to conclude, "it had become increasingly clear that taxpayers were losing faith in the Federal income tax system."[6] Many of these tax shelters exploited the difference between higher ordinary income tax rates and lower-taxed capital gains to protect current ordinary income from tax – and

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[3] A top capital gains rate of 20% plus the 3.8% net investment income tax for high-income filers versus 37% plus 3.8% in Medicare payroll taxes for high earners.
[4] See written testimony of Harry L. Gutman for this hearing.
[5] Leonard E. Burman, "Biden Would Close Giant Capital Gains Loopholes—At Least For the Rich," Tax Policy Center, April 28, 2021, https://www.taxpolicycenter.org/taxvox/biden-would-close-giant-capital-gains-loopholes-least-rich.
[6] Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986 (H.R.3838, 99th Congress; Public Law 99-514)," JCS-10-87, May 4, 1987, https://www.jct.gov/publications/1987/jcs-10-87/.

convert it into capital gains taxed later at a lower rate.[7] The result was an incentive to "invest" in wasteful ventures that produced economic losses – because they generated tax savings that were even more valuable for filers. This is why the tax shelters "involved a wide variety of products hardly crucial to the national economy, including such things as jojoba beans and chinchilla farms."[8] The 1986 tax reform under President Reagan sought to stamp out these shelters, most importantly by equalizing the top capital gains and ordinary income rate at 28 percent.[9] When the rates diverged again, new shelters and planning arrangements emerged to exploit the gap.[10] Some include:

- **"Basket options:**" These were an arrangement hedge funds and high net worth individuals commonly used from the late-1990s to claim that short term investments (sometimes held for just a few seconds) are eligible for long-term capital gains treatment, and therefore get a lower preferential rate for such gains.[11] As Senator McCain noted at a hearing on this scheme, "Americans are tired of seeing Wall Street firms playing by a set of rules other than those that apply to ordinary citizens."[12]
- **Carried Interest:** Managers of private investment funds (including hedge funds, venture capital funds, and private equity funds) can be paid through both "management fees" taxed at ordinary income rates and "carried interest" taxed at low capital gains rates. Managers typically choose to receive as much of their income as possible as carried interest.[13]

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[7] Leonard E. Burman, "Tax Reform and the Treatment of Capital Gains," Testimony before the House Ways and Means Committee and the Senate Finance Committee, September 20, 2012, https://www.taxpolicycenter.org/publications/tax-reform-and-tax-treatment-capital-gains/full.

[8] Michael J. Graetz, "Tax Reform 1986: A Silver Anniversary, Not a Jubilee," *Tax Notes*, October 21, 2011, http://www.taxhistory.org/www/features.nsf/Articles/066C3B71D4C8F8CA85257930006459EE?OpenDocument

[9] Leonard E. Burman, Tom Neubig, and Gordon Wilson, "The Use and Abuse of Rental Project Models," U.S. Department of Treasury: Compendium of Tax Research 1987, https://home.treasury.gov/system/files/131/Report-Compendium-1987-Part11.pdf.

[10] Burman, *supra* note 7.

[11] U.S. Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, "Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits," July 22, 2014, https://www.hsgac.senate.gov/imo/media/doc/REPORT-Abuse%20of%20Structured%20Financial%20Products%20(Basket%20Options)%20(7-22-14,%20updated%209-30-14).pdf.

[12] U.S. Senator John McCain, "Opening Statement by Senator John McCain at PSI Hearing on Basket Options," Press Release, July 22, 2014, https://www.hsgac.senate.gov/imo/media/doc/OPENING%20-%20John%20McCain%20(July%2022%202014).pdf. The IRS identified basket options (and substantially similar transactions) as a listed transaction in 2015. See Internal Revenue Service Notice 2015-47, 2015-30 I.R.B. 76, https://www.irs.gov/pub/irs-drop/n-15-47.pdf, superseded by 2015-73, 2015-46 I.R.B. 660, https://www.irs.gov/pub/irs-drop/n-15-73.pdf.

[13] The 2017 tax law made small modifications but left the tax break largely intact. See Tax Policy Center, "What is carried interest, and how is it taxed?", last updated May 2020, https://www.taxpolicycenter.org/briefing-book/what-carried-interest-and-how-it-taxed.

- **"Swap-until-you-drop:"** Some advisors advertise the strategy of using "like-kind exchanges" plus stepped-up basis as "swap until you drop.[14] Selling or exchanging property generally triggers capital gains tax, but under the "like-kind exchange" exception in the tax code, no tax is triggered when commercial real estate is swapped for other commercial real estate.[15] Swapping one profitable investment for another can mean continually delaying tax on the gain in value of a chain of properties. If this continues until the owner passes away, stepped-up basis then wipes out capital gains tax on a lifetime of profits. The tax break supports an industry of exchange accommodators who specialize in facilitating exchanges.[16]
- **Special Purpose Acquisition Company (SPAC) sponsors:** The 2020-2021 boom in SPACs was driven primarily by financial disclosure considerations[17] and the tax treatment of SPACs is not always favorable for all participants,[18] but SPAC *founders* who set up and implement the SPAC are often not taxed at labor income rates for those activities but instead receive shares that get capital gains tax preferences.[19] If carefully planned, conversion of the founder shares can be a non-taxable transaction.[20] On conversion, the shares become public shares and are subject to the capital gains tax, meaning zero tax until realization, and a lower rate.[21]

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[14] Archer Investors, "Swap Till You Drop – How to Leave Your Heirs In Good Hands," November 11, 2019, https://www.archerinvestors.com/2019/11/11/swap-till-you-drop-how-to-leave-your-heirs-in-good-hands/.

[15] Internal Revenue Service, "Like-kind Exchanges Now Limited to Real Property," Press Release # IR-2018-227, November 19, 2018, https://www.irs.gov/newsroom/like-kind-exchanges-now-limited-to-real-property.

[16] Chye-Ching Huang, "Obscure Law Shelters Property Exchanges," New York Times, April 14, 2015, https://www.nytimes.com/roomfordebate/2015/04/14/the-worst-tax-breaks/obscure-law-shelters-property-exchanges.

[17] Jennifer Rudden, "Size of SPAC IPOs in the U.S. 2009-2021," Statista, May 5, 2021, https://www.statista.com/statistics/1178273/size-spac-ipo-usa/; For examples of SEC rules dampening SPACs, see John Coates and Paul Munter, "Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs")," SEC, Public Statement, April 12, 2021, https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs.

[18] Siri Bulusu, "Tax Traps Await Early SPAC Investors Without Ideal Timing, Luck," Bloomberg Tax, February 25, 2021, https://news.bloombergtax.com/daily-tax-report-international/tax-traps-await-early-spac-investors-without-ideal-timing-luck.

[19] Michael Stevenson et al., "BDO Knows SPACs: Tax Treatment of SPAC Founder Shares," BDO USA LLP, February 2021, https://www.bdo.com/getattachment/3c706316-54f9-4670-84b4-760be7155be0/attachment.aspx?ASSR_ARAS_BDOKnows-SPACs-Part4.pdf; SPAC sponsors generally do not have an employment or management contract with the SPAC and are not allowed to receive compensation for services. See also Ortenca Aliaj, Sujeet Indap and Miles Kruppa,"The Spac Sponsor Bonanza," Financial Times, November 13, 2020, https://www.ft.com/content/9b481c63-f9b4-4226-a639-238f9fae4dfc.

[20] For example, by issuing before events such as the SEC registration or identification of the target company. See Barry M. Weins and Christopher J. Truitt, "Tax Implications You Need to Know Surrounding SPACs Part 1," Cherry Bekaert LLP, April 6, 2021, https://www.cbh.com/guide/articles/tax-implications-you-need-to-know-surrounding-spacs/; David Herzig, "SPACs – An Income And Estate Tax Primer," Forbes, March 15, 2021, https://www.forbes.com/sites/davidherzig/2021/03/15/spacs--an-income-and-estate-tax-primer/?sh=2ca7fb6f3892. See also IRC §83(b).

[21] Devon Bodoh et al., "Cutting Edge Tax Issues with SPACs: Creative Approaches and Pragmatic Solutions," Weil, Gotshal & Manges LLP, December 2, 2020, https://www.weil.com/~/media/mailings/2020/q4/cutting-edge-tax-issues-with-spacs--creative-approaches-and-pragmatic-solutions.pdf.

The specific tactics used to get income into the capital gains rates and exclusions ebb and flow. But as long as the tax breaks continue, so will attempts to push more income into them.

Using pass-throughs to avoid and evade top rates on labor income

The 2017 tax law turbocharged incentives for high-income filers to use their ownership of "pass-throughs" to avoid taxes on high earnings.[22]

The single largest source of income for high-income and wealthy filers is via their ownership of "pass-through" businesses that do not face the corporate tax rate, but that are, in theory, taxed at owners' individual rates. Even before the 2017 tax law, many owners of S Corporations, a type of pass-through, were underreporting the share of their income from those pass-throughs that is salary for their labor services, and overstating the share that is "business profits," a maneuver to avoid the 3.8 percent Medicare payroll taxes on high salaries.[23] The 2017 tax law's "pass-through deduction" means that a high earner who reclassifies their salary as business income from a pass-through business can now cut their tax rate on that income by 11.2 percentage points.[24]

The 2017 tax law's "guardrails" to limit gaming have little coherent rationale, are complex, and invite planning to try to get the lucrative deduction.[25] The regulations implementing the deduction in some cases expanded the opportunities for planning.[26] Written comments on the proposed regulations came overwhelmingly from filers, industries or other private interests seeking more favorable tax treatment: only six out of more than 300 were from public interest-oriented individuals or groups.[27] One tax advisor told a conference of financial advisers:[28]

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[22] The law introduced many new opportunities for tax avoidance and planning. See, for example, Chuck Marr, Brendan Duke, and Chye-Ching Huang, "New Tax Law is Fundamentally Flawed and Will Require Basic Restructuring," Center on Budget and Policy Priorities, last updated August 14, 2018, https://www.cbpp.org/research/federal-tax/new-tax-law-is-fundamentally-flawed-and-will-require-basic-restructuring; Samantha Jacoby, "Potential Flaws of Opportunity Zones Loom, as Do Risks of Large-Scale Tax Avoidance," Center on Budget and Policy Priorities, January 11, 2019, https://www.cbpp.org/research/federal-tax/potential-flaws-of-opportunity-zones-loom-as-do-risks-of-large-scale-tax; David Kamin et al, "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation," *Minnesota Law Review* Vol. 103, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423; Batchelder and Kamin, *supra* note 1.

[23] This is one of myriad ways pass-through owners can avoid different top tax rates. See U.S. Department of the Treasury, Office of Tax Analysis, "Gaps between the Net Investment Income Tax Base and the Employment Tax Base," April 14, 2016, https://home.treasury.gov/system/files/131/NIIT-SECA-Coverage.pdf.

[24] See Marr, Duke, and Huang, *supra* note 22.

[25] See Marr, Duke, and Huang, *supra* note 22; Kamin et al *supra* note 22.

[26] Samantha Jacoby, "Pass Through Deduction Regulations Reflect Industry Lobbying," Center on Budget and Policy Priorities, January 30, 2019, https://www.cbpp.org/blog/pass-through-deduction-regulations-reflect-industry-lobbying.

[27] Shu-Yi Oei and Leigh Osofsky, "Legislation and Comment: The Making of the § 199A Regulations," *Emory Law Journal*, Vol. 69, No. 2, January 2019, https://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=2273&context=lsfp.

[28] Emily Horton, "Tax Planner: Drive Wealthy Clients Through 'Gaping Hole' in Tax Code," Center on Budget and Policy Priorities, May 31, 2018, https://www.cbpp.org/blog/tax-planner-drive-wealthy-clients-through-gaping-hole-in-tax-codel; Tobias Salinger, "Tax Planners See Uncertainty, Opportunity in Pass-through Deduction," Financial Planning, May 25, 2018, https://www.financial-planning.com/news/pass-through-deduction-raises-qbi-questions-in-tcja.

> This is, without a doubt, one of the biggest areas of planning that we can have under the new law. This is why, in large part, they should have just renamed the [2017 tax law] the tax professional, lawyer and financial advisor job security act of 2017. The [pass-through] deduction leaves a gaping hole in the tax code, and the goal by the end of the presentation today is to make you guys the bus drivers, or the truck drivers, to drive right through that hole with your clients.

Well-resourced filers and their tax advisors seem quite successful at fitting labor income into such "holes" in the progressive income tax drilled by tax breaks supposedly for capital income: research suggests that about three quarters of "business profits" the very wealthy receive through their pass-throughs are in fact compensation for their labor.[29]

The IRS lacks resources and tools to detect and act on non-compliance by high-wealth filers

There is a difference between lawful tax avoidance and unlawful tax evasion, but the array of tax preferences for income from wealth invites some wealthy filers to push that boundary in search of the lowest possible tax rate. It can be difficult for the IRS to hold the line, in part because high-wealth filers have further advantages, relative to wage and salary earners, in tax compliance and disputes processes:

- **Little or no independent information on income from wealth:** The IRS can verify what an employee states as wage or salary income by matching it with information from employers. For the wealthy, the IRS has no "third party" source of information to verify the source or amount of many types of their reported (or unreported) income.[30]
- **Opaque ownership:** High-wealth filers can choose to use complex webs of entities and ownership arrangements that make it difficult to understand who owns – and should pay tax on – various streams of income. Pass-through business income is supposed to show up on owners' individual tax returns to be taxed at their individual tax rates, but a recent study found that the ultimate owner of much pass-through income cannot be found using IRS data,[31] concluding "[o]ur inability to unambiguously trace 30 percent of partnership income to either the ultimate owner or the originating partnership underscores the concern that the current U.S. tax code encourages firms to organize opaquely in partnership form in order to minimize tax burdens."
- **Cuts to the IRS have benefited high-wealth people who don't pay what they owe:** Estimates from 2010 show that the top 1 percent of filers are responsible for more than a fifth of the tax gap of taxes owed but not paid,[32] while more recent estimates suggest that

[29] Matthew Smith, Danny Yagan, Owen Zidar, and Eric Zwick, "Capitalists in the Twenty-First Century," The *Quarterly Journal of Economics*, Vol. 134, Iss. 4, 2019, http://ericzwick.com/capitalists/capitalists.pdf.
[30] Internal Revenue Service, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011–2013," Publication 1415 (Rev. 9-2019), September 2019, https://www.irs.gov/pub/irs-pdf/p1415.pdf.
[31] Michael Cooper *et al*., "Business in the United States: Who Owns It and How Much Tax Do They Pay," U.S. Department of the Treasury, Office of Tax Analysis, October 2015, https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-104.pdf.
[32] Andrew Johns and Joel Slemrod, "The Distribution of Income Tax Noncompliance," *National Tax Journal*, Vol. 63, No. 3, September 2010, https://assets.documentcloud.org/documents/5219189/The-Distribution-of-Tax-Noncompliance.pdf.

share could be far larger.[33] Yet cuts to the IRS have caused audit rates for the top 1 percent of filers to fall by more than 70 percent since 2010, becoming a shrinking share of all audits.[34]

Even when faced with obvious forms of tax noncompliance by the wealthy, the IRS is stretched too thin to follow up. A Treasury Inspector General for Tax Administration report published last year found the IRS had not followed up with more than 879,000 high-income households that simply did not file a tax return but owe an estimated $45.7 billion in unpaid tax. The top 100 non-filers alone owe an estimated $9.9 billion.[35] Just as starkly, the Department of Justice recently laid charges alleging that CEO Robert T. Brockman concealed $2 billion in capital gains income using offshore accounts. The fraud and tax evasion alleged is brazen: simply hiding and not reporting income, without even trying to claim a veneer of legality. Yet this was a "decades-long" scheme that only just resulted in charges.[36]

Much tax non-compliance by some of the very wealthy is far subtler than simply hiding income from the authorities. Instead, "Such taxpayers tend not to steamroll tax laws; they employ complex, highly refined strategies that seek to stretch the tax code to their advantage," one ProPublica investigation illustrated.[37] When faced with complex tax planning that may overstep the line into evasion, the IRS can be out-gunned by high-wealth filers and their advisors. Severely depleted by decades of cuts, the IRS lacks enough staff with the technical expertise to determine true tax liability and prevail in a dispute. Indeed, the IRS' Global High Wealth Industry Group, created in 2009 to audit

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[33] John Guyston, Patrick Langetieg, Daniel Reck, Max Risch, and Gabriel Zucman, "Tax Evasion at the Top of the Income Distribution: Theory and Evidence," NBER Working Paper 28542, March 2021, https://www.nber.org/papers/w28542.

[34] Calculations use data from: Internal Revenue Service, "IRS Data Book Table 17a: Examination Coverage and Recommended Additional Tax After Examination, by Type and Size of Return, Tax Years 2010–2018," last updated October 22, 2020, https://www.irs.gov/statistics/soi-tax-stats-examination-coverage-and-recommended-additional-tax-after-examination-by-type-and-size-of-return-tax-years-2010-2018-irs-data-book-table-17a. The top 1% includes all filers with adjusted gross income of $500,000 and above. Table 17a includes both in-process and completed audits, so figures are subject to change as new audits are opened for recent tax years. The figure cited above is for Tax Year 2015, the most recent year outside the normal statute of limitations for tax returns filed on time.

[35] Treasury Inspector General for Tax Administration, "High-Income Nonfilers Owing Billions of Dollars Are Not Being Worked By The Internal Revenue Service," TIGTA Report # 2020-30-015, https://www.treasury.gov/tigta/auditreports/2020reports/202030015fr.pdf.

[36] U.S. Department of Justice, "CEO of Multibillion-dollar Software Company Indicted for Decades-long Tax Evasion and Wire Fraud Schemes: Allegedly Used Secret Swiss and Bermudian Bank Accounts in Scheme to Conceal Approximately Two Billion Dollars of Capital Gains Income", Press Release, October 15, 2020, https://www.justice.gov/opa/pr/ceo-multibillion-dollar-software-company-indicted-decades-long-tax-evasion-and-wire-fraud; Similarly, see Shirsho Dasgupta, "Document leak reveals scope, audacity of Russian banking billionaire's alleged IRS ripoff," McClatchy DC Bureau, August 18, 2020, https://www.mcclatchydc.com/news/investigations/article244763002.html.

[37] Jesse Eisinger and Paul Kiel, "The IRS Tried to Take on the Ultrawealthy. It Didn't Go Well." ProPublica, April 5, 2019, https://www.propublica.org/article/ultrawealthy-taxes-irs-internal-revenue-service-global-high-wealth-audits.

the complex returns of very wealthy filers, did not receive the resources it had planned for, hampering its efforts. [38]

Only the already wealthy can enjoy outright tax breaks on wealth, choose to try to expand the coverage of these tax breaks, and maneuver through the audits and disputes with the IRS to protect those advantages. Ninety percent of the wealthiest 1 percent of households are white, while white households are 65 percent of all households. If current trends continue, it will take the median Latino family over 2,000 years just to match the *current* wealth of the median white household, and Black families will *never* catch up with white families' current level.[39] Due to the private discrimination and policy choices that create these disparities, households of color are especially likely to face barriers preventing them from building wealth. Tax advantages that go overwhelmingly and sometimes exclusively to the highest-wealth households entrench and exacerbate these disparities.

II. LOW- AND MIDDLE-INCOME WORKERS HAVE A VERY DIFFERENT EXPERIENCE OF TAX FILING AND AUDITS THAN HIGH-WEALTH FILERS

Typical workers cannot opt out of paying taxes annually or opt into lower tax rates using complex schemes. And while the wealthy can hire teams of professional accountants and lawyers to file their taxes, low- and moderate-income people often struggle to find resources that would help them file and claim tax credits for which they are eligible. The IRS lacks staff to answer more than about a quarter of its calls from people seeking help with their taxes.[40] Only 2.3 percent of filers can access the IRS sponsored Volunteer Income Tax Assistance program and Tax Counseling for the Elderly program,[41] whose volunteers have a 94 percent accuracy rate, the best of any tax preparer type.[42] But many low- and middle-income filers used paid preparers who don't have professional credentials and don't currently have to meet any minimum standards showing they know the tax rules, exposing filers to the risk of error and audits.[43]

Nevertheless, in stark contrast with wealthy filers' opaque sources of income, tax compliance on wage and salary income is above 95 percent, because that labor income is subject to robust information reporting and withholding.

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[38] *Id*.

[39] See Huang and Taylor, *supra* note 1, Brown, *supra* note 1;.

[40] Erin M. Collins, "Introductory Remarks by the National Taxpayer Advocate," National Taxpayer Advocate, December 31, 2020, https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20_Introduction.pdf.

[41] "Fiscal Facts," Tax Policy Center, May 3, 2021, https://www.taxpolicycenter.org/fiscal-fact/number-vita-tce-returns-ff-05032021.

[42] Internal Revenue Service, "VITA/TCE Quality Review Refresher," Publication 5299, https://www.irs.gov/pub/irs-pdf/p5299.pdf.

[43] John Wancheck, "IRS Needs Authority to Regulate Tax Return Preparers," Center on Budget and Policy Priorities, May 5, 2021, https://www.cbpp.org/blog/irs-needs-authority-to-regulate-tax-return-preparers.

Audit rates on low- and moderate-income filers have fallen since 2010 due to cuts in IRS enforcement funding – but by far less than the drop in audit rates on the highest-income filers.[44] Audit rates for EITC filers are now about the same as for the top 1 percent of filers, even though the top 1 percent of filers contribute far more to the tax gap.[45] The disconnect between the steep cuts to audit rates of wealthy individuals and the outsized contribution of some to the tax gap has also led to stark geographic and racial patterns. A former IRS economist and researcher estimates that the most highly audited areas of the country are now rural, southern counties that have predominantly Black residents.[46]

While high-income filers and large businesses can hire lawyers and accountants to challenge an audit, the vast majority of audited low-and moderate-income filers have no professional representation.[47] The prior Taxpayer Advocate has suggested that many low- and moderate-income filers who were audited were denied their claims for tax credits such as the EITC and CTC when they were in fact eligible.[48] The Taxpayer Advocate suggests that many of these households cannot navigate the daunting audit process, such as figuring out what documentation is required to prove their family circumstances.[49] But there have been no studies to determine how many filers denied their credits on audit would in fact be able to claim them if they were given help.[50] Research also finds that audits appear to deter low- and moderate-income workers from claiming their tax credits in future years, even when they appear to be eligible.[51]

III. INVESTING IN WORKERS, FAMILIES, AND INFRASTRUCTURE ARE HIGHER NATIONAL PRIORITIES THAN RETAINING TAX BREAKS FOR INCOME FROM WEALTH

In large part due to tax subsidies for income from wealth, the highest-income one percent of households currently receive about a fifth of the value of federal income tax breaks.[52] The U.S.

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[44] Chye-Ching Huang, "Depletion of IRS Enforcement Is Undermining the Tax Code," Testimony before the House Ways and Means Committee, February 11, 2020, https://www.cbpp.org/research/federal-tax/depletion-of-irs-enforcement-is-undermining-the-tax-code#_edn20%20.
[45] See Internal Revenue Service, *supra* note 30.
[46] Kim M. Bloomquist, "The Tax Gap: Holding Steady or Missing in Action?" *Tax Notes*, October 28, 2019, https://www.taxnotes.com/tax-notes-federal/information-reporting/tax-gap-holding-steady-or-missing-action/2019/10/28/2b1p7.
[47] See National Taxpayer Advocate, Nina E. Olson, Hearing Before the House Committee on Oversight and Government Reform, April 17, 2018, https://www.irs.gov/pub/irs-utl/National%20Taxpayer%20Advocate%20Testimony-OGR%20IRS%20Oversight%20Hearing-4-17-2018.pdf.
[48] Taxpayer Advocate Service, Internal Revenue Service, "Earned Income Tax Credit, Making the EITC Work for Taxpayers and the Government," Special Report to Congress, Vol. 3, 2020, https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/JRC20_Volume3.pdf.
[49] *Id*.
[50] *Id*.
[51] John Guyton, Kara Leibel, Dayanand S. Manoli, Ankur Patel, Mark Payne and Brenda Schafer, The Effects of EITC Correspondence Audits on Low-Income Earners, NBER Working Paper 24465, December 2019, https://www.nber.org/papers/w24465.
[52] See Marr, Jacoby, and Bryant, *supra* note 1.

raises less revenue at all levels of government, relative to the size of its economy, than most other developed countries.[53] The U.S. also invests less in areas such as reducing child poverty, securing paid leave, and other investments that support economic opportunity and mobility.[54]

Relative to other developed economies, U.S. intergenerational mobility is low, income and wealth inequality is high.[55] These inequalities are also heavily skewed by race, due to historic and current barriers to full economic opportunity for people of color.[56] So, "[t]o an unusually large extent in the U.S., economic disparities between individuals reflect the luck of one's birth and systemic discrimination, not hard work."[57] Low- and moderate-income households have faced decades of near-stagnant wages, and the COVID-19 recession has now dealt a heavy blow to the incomes of low-wage workers and workers of color.[58]

Lawmakers are now considering making investments to build a stronger and more inclusive economy that improves the living standards of low- and moderate-income families. These investments should include making permanent the historic changes to tax provisions for workers and families that were conceptualized in the House Heroes Acts, enacted in the American Rescue Plan, as Chairman Neal's Building an Economy for Families Act proposes.[59] The bill would permanently extend a stronger EITC that reduces the number of low-paid workers who are currently taxed into or deeper into poverty by the federal tax code. And it also proposes to make permanent historic reductions in child poverty achieved by the American Rescue Plan's CTC

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53 Briefing Book, "How Do US Taxes Compare Internationally?" Updated May 2020, Tax Policy Center, https://www.taxpolicycenter.org/briefing-book/how-do-us-taxes-compare-internationally.

54 OECD, "Data: Family Benefits Public Spending," last visited, May 9, 2021, https://data.oecd.org/socialexp/family-benefits-public-spending.htm; OECD, "Social Expenditure Update 2019: Public Social Spending is High in Many OECD Countries," January 2019, https://www.oecd.org/social/soc/OECD2019-Social-Expenditure-Update.pdf.

55 Gary Solon, "Cross-Country Differences in Intergenerational Earnings Mobility," *Journal of Economic Perspectives*, Vol. 16, No. 3, Summer 2002, https://pubs.aeaweb.org/doi/pdfplus/10.1257/089533002760278712; OECD, "United States: Tackling High Inequalities Creating Opportunities for All," June 2014, https://www.oecd.org/unitedstates/Tackling-high-inequalities.pdf.

56 See Huang and Taylor, *supra* note 1, Raj Chetty, Nathaniel Hendren, Maggie R. Jones, and Sonya Porter, "Race and Economic Opportunity in the United States: An Intergenerational Perspective," Quarterly Journal of Economics, Vol. 135, Iss. 2, May 2020, https://academic.oup.com/qje/article/135/2/711/5687353.

57 Batchelder and Kamin, *supra* note 1.

58 Chad Stone, "Jobs Recovery Still Long Way Off, Especially for Low-Wage Workers and Workers of Color," Center on Budget and Policy Priorities, February 5, 2021, https://www.cbpp.org/blog/jobs-recovery-still-long-way-off-especially-for-low-wage-workers-and-workers-of-color; Chuck Marr, Brandon DeBot, and Emily Horton, "How Tax Reform Can Raise Working Class Incomes," Center on Budget and Policy Priorities, October 13, 2017, https://www.cbpp.org/research/federal-tax/how-tax-reform-can-raise-working-class-incomes; Jane. G. Gravelle, "Wage Inequality and the Stagnation of Earnings of Low-Wage Workers: Contributing Factors and Policy Options," Congressional Research Service, February 5, 2020, p. 2, https://crsreports.congress.gov/product/pdf/R/R46212; Opportunity Insights Economic Tracker, last visited May 9, 2021, https://tracktherecovery.org/.

59 House Ways and Means Committee Chairman Richard E. Neal, "Chairman Neal Unveils Groundbreaking Proposal to Reshape the American Economy," Press Release, Apr 27, 2021, https://waysandmeans.house.gov/media-center/press-releases/chairman-neal-unveils-groundbreaking-proposal-reshape-american-economy.

expansions while locking in the more modest, temporary improvements in the CTC enacted in the 2017 tax law.[60]

These tax credit improvements benefit low-and moderate-income workers and families directly. The American Rescue Plan's expansions to the CTC will lift 4.1 million children out of poverty and cut the child poverty rate by over 40 percent.[61] 27 million children – including about half of all Black and Latino children – will receive the full CTC for the first time because their parents were paid too little to qualify for the full credit under prior law.[62] The EITC expansion will extend much-needed income support to over 17 million adults without children working in critical, but low-paid jobs such as cashiers, janitors and truck drivers.[63]

Permanently improving tax credits for workers and families, along with investing in priorities including basic research, infrastructure, childcare, and education, would not only directly benefit families and workers, but also do so in a way that helps secure shared prosperity. For example, research suggests that expanding economic security for children in low- and moderate-income families can help ensure that children who have talent for innovation and entrepreneurship have opportunities to fully realize those abilities.[64]

If lawmakers choose to offset part of the cost of these investments, or a legislative path that requires any cost after ten years to be fully offset, two sound sources of revenue would be:[65]

Reducing tax breaks from wealth

For example, President Biden has proposed equalizing the top capital gains and income tax rates for filers with incomes above $1 million. The proposal would also require all capital gains accrued during life to face some capital gains tax – even though that tax could still be able to be delayed for long periods. The plan would limit the use of like-kind exchanges to delay paying taxes until either property is sold for cash, gains are realized, or death. The proposal also states that it will include measures to prevent wealthy filers from using entities to avoid payroll taxes.

These proposals to reduce or eliminate select tax breaks on wealth would raise substantial revenue to invest in more productive priorities such as children, workers, research, and infrastructure. Such proposals would also be a significant step toward curtailing some of the

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[60] See Chuck Marr, Kris Cox, Stephanie Hingtgen, Katie Windham, and Arloc Sherman, "American Rescue Plan Act Includes Critical Expansions of Child Tax Credit and EITC," Center on Budget and Policy Priorities, March 12, 2021, https://www.cbpp.org/research/federal-tax/american-rescue-plan-act-includes-critical-expansions-of-child-tax-credit-and.

[61] *Id.*

[62] *Id*.

[63] *Id*.

[64] See Wesley Tharpe, Michael Leachman, and Matt Saenz, "Tapping More People's Capacity to Innovate Can Help States Thrive," Center on Budget and Policy Priorities, December 9, 2020, https://www.cbpp.org/research/state-budget-and-tax/tapping-more-peoples-capacity-to-innovate-can-help-states-thrive; John Van Reenen, "Innovation and Human Capital Policy," NBER Working Paper 28713, April 2021, https://www.nber.org/system/files/working_papers/w28713/w28713.pdf.

[65] Adequate taxation of corporate income, which overwhelmingly accrues to high-wealth filers, would be another sound reform: Chye-Ching Huang, "How U.S. International Tax Policy Impacts American Workers, Jobs, and Investment," Testimony before the Senate Committee on Finance, March 25, 2021, https://www.finance.senate.gov/imo/media/doc/Huang%20testimony%2003220221%20rev.pdf.

current wasteful planning and sheltering activity that costs revenue and undermines the integrity of the tax system.

But from a broader perspective, these proposals are modest in that they leave intact many other tax benefits for income from wealth. For example, wealthy filers would still benefit from the value of being able to delay paying taxes until either gains are realized or death, which could be decades in some cases, a benefit worth some hundreds of billions over ten years.[66] Regressive tax breaks for the wealthiest owners of pass-through businesses, which encourage gaming to avoid income taxes, would also be left in place – another obvious source of revenue if more is needed.[67] The continuing tax policy conversation should include review and reform of various remaining tax breaks on wealth if they are not addressed in the near term.

Those seeking to protect tax breaks on income from wealth often argue – contrary to evidence– that they deliver broad-based economic benefits.[68] And they often fail to mention the economic drain from unproductive tax shelters. As Professor Burman noted of capital gains shelters:[69]

> [S]helter investments are invariably lousy, unproductive ventures that would never exist but for tax benefits. And money poured down these sinkholes isn't available for more productive activities. What's more, the creative energy devoted to cooking up tax shelters could otherwise be channeled into something productive...Bottom line: low rates for capital gains are as likely to depress the economy as to stimulate it.

Ensuring the IRS has the resources and tools to ensure more wealthy filers pay taxes owed

The Administration also proposes to restore adequate resources to the IRS so that it can ensure that more high-wealth filers and corporations pay taxes that they owe. I have had the honor of testifying before this Committee that providing the IRS a predictable, mandatory stream of funding for tax compliance is a sound way to raise revenue by collecting taxes already owed. It would also benefit honest filers and businesses who pay their taxes. Raising revenue has broad societal benefits. The IRS can use improved resources together with new tools to better target audits and reduce unnecessary audits and the stress and burden that accompany them.[70]

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[66] See Jane Gravelle, "Mark-to-Market Taxation of Capital Gains," Tax Policy Center, https://www.taxpolicycenter.org/sites/default/files/mark-to-market_taxation_of_capital_gains.pdf; Batchelder and Kamin, *supra* note 1; the value would vary depending on the details of the proposal to end step up basis and updated interest rate projections.

[67] For further examples of options to address capital income tax preferences, see Chye-Ching Huang, "Funding Our Nation's Priorities: Reforming the Tax Code's Advantageous Treatment of the Wealthy," Testimony before the House Ways and Means Committee, Subcommittee on Select Revenue Measures, May 12, 2021; Batchelder and Kamin, *supra* note 1; Lily Batchelder, "Leveling the Playing Field Between Inherited Income and Income from Work Through an Inheritance Tax," Brookings, January 28, 2020, https://www.brookings.edu/research/leveling-the-playing-field-between-inherited-income-and-income-from-work-through-an-inheritance-tax/#:~:text=The%20Proposal,individuals%20receiving%20the%20largest%20inheritances.

[68] See Burman, *supra* note 5.

[69] Leonard E. Burman, "Under the Sheltering Lie," *Marketplace* Commentary, December 20, 2005, http://www.taxpolicycenter.org/publications/template.cfm?PubID=900918.

[70] See Huang, *supra* note 45. See also Chye-Ching Huang, "How Biden Funds His Next Bill: Shrink the $7.5 Trillion Tax Gap," New York Times, March 10, 2021, https://www.nytimes.com/2021/03/10/opinion/deficits-taxes-biden-infrastructure.html.

The Administration has also put forward a sound proposal that would allow the IRS to verify sources of income disproportionately made by the wealthy – similar to the tools already used to verify wage and salary income.[71] To reduce another source of non-compliance in a way that would benefit low-and moderate-income filers, the Administration plan also adopts a bipartisan proposal to ensure that unenrolled paid preparers meet minimum standards of competency.

Such steps would help address disparities in the tax code, promote economic opportunity, and improve the integrity of the American tax system, while raising revenue to support investments in national priorities.

Thank you for the opportunity to offer this testimony.

[71] *Id*.