

## Strengthening the Tax Base

### Written Testimony for Hearing, “Medicare Forever: Protecting Seniors by Making the Wealthy Pay Their Fair Share”

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The United States Senate Committee on The Budget  
September 27, 2023

Chairman Whitehouse, Ranking Member Grassley, and distinguished members of the Committee, thank you for the opportunity to testify.<sup>1</sup> I am the Executive Director of the Tax Law Center at NYU Law, a public interest initiative that seeks to improve the integrity of the tax system. The Center is staffed by tax lawyers with expertise in tax administration, private practice, and the tax legislative process, and our work draws on extensive networks of public interest minded tax practitioners and experts.

#### SUMMARY

#### **The federal tax base should be broadened and strengthened to more securely support the nation’s priorities.**

A building needs a strong foundation. It should be wide enough to support what’s resting on it. It should also be solid, without gaps and cracks.

The federal tax base is the foundation for the federal budget, which invests in national priorities including, social security, defense, economic security programs, benefits for veterans and federal retirees, education, transportation and healthcare – including Medicare.<sup>2</sup> But currently:

- **The federal tax base is not broad enough.** Too much income—especially of the largest corporations and highest-income individuals—is excluded. For example, certain pass-through business income is excluded from the net investment income tax (NIIT) and Self-Employed Contributions Act (SECA) taxes, allowing business owners to avoid paying their fair share of taxes, lowering both general and trust funds revenues. Exclusions from the tax base can attract wasteful and aggressive tax avoidance.
- **The federal tax base is unacceptably leaky.** Before lawmakers acted to restore the IRS’s ability to address tax compliance, it was estimated that more than \$500 billion per year would

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<sup>1</sup> This testimony draws heavily on my prior work including: [Building Back Better: Raising Revenue to Invest in Shared Prosperity](#), Testimony Before the U.S. Joint Economic Committee (October 6, 2021); [How U.S. International Tax Policy Impacts American Workers, Jobs, and Investment](#), Testimony Before the Senate Committee on Finance (March 25, 2021); [Depletion of IRS Enforcement Is Undermining the Tax Code](#), Testimony Before the House Ways and Means Committee (February 11, 2020).

<sup>2</sup> CBPP (CBPP), [Policy Basics: Where Do Our Federal Tax Dollars Go?](#) (July 28, 2022).

leak out of the “tax gap,”<sup>3</sup> with some \$100 billion each year lost to the Medicare, Social Security, and UI trust funds on account of taxes owed but not paid.<sup>4</sup> Some of this loss comes from tax avoidance overstepping the boundaries of the law into illegal tax evasion.

**Broadening the federal tax base and shrinking the federal tax gap is a sound way to raise revenues and will put the federal budget and the critical priorities it funds on a more solid and lasting foundation:**

- **Enhanced revenue can protect critical federal priorities from cuts, address long-term deficits, and finance new investments** to meet national challenges, including lifting the health and living standards of low- and moderate-income families; and supporting an aging population.
- **Well-designed measures to strengthen the tax base can support economic growth** by ensuring more resources flow to productive activity and preventing wasteful tax avoidance and evasion. Would-be tax avoiders and evaders should not gain an advantage over businesses that pay what they owe and choose to focus on their products, customers, and innovation rather than play tax games.
- **Strengthening the tax base complements proposals to raise tax rates:** each percentage point of tax would cause less economic and revenue waste from tax avoidance and evasion.
- **A stronger tax base can help both general revenues and dedicated revenue streams including the Medicare trust fund** (that has relied on general revenues from time to time).

**Three ways lawmakers can secure a broader tax base and shrink the federal tax gap are:**

1. **Reject proposals currently on the table that would increase tax cheating and non-compliance and weaken the tax base.** That means:
  - (a) **Maintain IRS base discretionary funding and do not subject IRS mandatory funding to more damaging cuts below levels agreed to in the debt ceiling deal.**
  - (b) **Do not undermine new tax compliance provisions** that will help honest filers comply with their tax obligations, help the IRS to detect tax cheating, and reduce random audits of taxpayers who have filed accurately.
  - (c) **Build on, rather than reverse, the limited base broadening in the 2017 law.** Corporate base broadeners used to offset part of the cost of permanent corporate tax cuts should take effect and continue—or if weakened, the cost should be offset with other corporate tax base broadening or rate increases. Costly provisions that narrowed the tax base in ways that encourage tax avoidance—such as the 199A pass-through

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<sup>3</sup> See Internal Revenue Service (IRS), [Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016](#), Publication 1415, 27 (August 2022) (“Tax Gap Estimates for 2014-2016”).

<sup>4</sup> For 2014 to 2016, parts of the tax gap that affected these trust funds included the \$7 billion annual self-employment tax non-filing gap; the \$82 billion annual employment tax underreporting tax gap; the \$5 billion annual employment tax underpayment gap; and the \$6 billion annual underreporting of taxable Social Security benefits. *Id.*, at 11, 20. Portions of unpaid SECA and FICA taxes, as well as the tax on taxable Social Security benefits, are directed to the Medicare Trust Fund if paid. Centers for Medicare and Medicaid Services, [How is Medicare Funded?](#) (last visited September 24, 2023); see also I.R.C. §§ 1401, 3101, 3111.

deduction and the doubled estate tax exemption—should expire on schedule. Base-protecting mechanisms such as the GILTI minimum tax should be strengthened.

2. **Address the “big three”: the non-taxation of income from extraordinarily large fortunes; the non-taxation of certain foreign profits; and pass-through taxation.** Each of these areas combines a too-narrow tax base with major non-compliance issues. For example, ensuring that all pass-through business income of high-income taxpayers is subject to either the NIIT or SECA tax and ensuring that all the revenues flow to the relevant trust funds would directly help Medicare’s finances.
3. **Choose from a large menu of big and small options to strengthen the tax base.** The Tax Law Center at NYU Law (Tax Law Center) has compiled a broader menu of options to strengthen the tax base, “[Broadening the US Federal Tax Base](#),” that the Tax Law Center has designed or analyzed in the course of our work (such as submitting on the Priority Guidance Plan and Green Book) and that we intend to update. These include closing the capital gains loophole for exchange-traded funds, strengthening the bipartisan Corporate Transparency Act’s (CTA’s) reporting requirements to ensure it more effectively addresses the most complex types of tax evasion and corruption, and extending broker reporting to high-value art transactions.

## **PART I: FEDERAL REVENUE AND THE STATE OF THE TAX BASE**

Federal tax revenue should rise. This is necessary to meet the fiscal challenges associated with an aging population, and to protect and enable investments that the nation needs to make to raise health and living standards for low- and moderate-income families; secure an innovative, dynamic, and inclusive economy; and address global challenges.

The long-run projected growth in federal spending stems primarily from the retirement of the baby boomers and the related rise in health care and retirement security costs.<sup>5</sup>

Federal revenues are currently about 18.4 percent of GDP, but CBO projects this to fall through 2025, and to rise only modestly afterwards. However, a large part of the projected rise is due to the scheduled expiration of large parts of the 2017 tax law, which some lawmakers are proposing to halt in full.<sup>6</sup> Revenues would be about 3 percent higher, as a percentage of GDP, without the two rounds of tax cuts first enacted under President Bush and then under President Trump: those tax cuts alone are enough to explain the entire projected increase in the debt-to-GDP ratio over the coming decade, as testimony explained to this Committee earlier this year.<sup>7</sup>

Revenues must rise to meet our national fiscal challenges and other priorities. Relative to the size of the economy, U.S. tax revenue is substantially lower than that of most other Organisation for Economic Co-operation and Development (OECD) countries.<sup>8</sup> Revenue measures can be paired with responsible policies to contain cost growth across the federal budget, like the

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<sup>5</sup> Congressional Budget Office (CBO), [The 2023 Long-Term Budget Outlook](#) 6 (June 2023).

<sup>6</sup> *Id.* at 20.

<sup>7</sup> Brian Deese & David Kamin, *Principles for the 2025 Tax Debate*, Tax Notes (forthcoming) (manuscript at 5) (on file with author); Bobby Kogan, [The Rich Get Richer, Deficits Get Bigger: How Tax Cuts for the Wealthy and Corporations Drive National Debt](#), Testimony Before the Senate Budget Committee n.xxvi (May 17, 2023).

<sup>8</sup> See Tax Policy Center (TPC), [Fiscal Facts: Total Tax Revenue for OECD Countries](#) (June 19, 2023); TPC, [Briefing Book \(Federal Budget\): How Do U.S. Taxes Compare Internationally?](#) (May 2020).

provisions of the Inflation Reduction Act that allow Medicare to negotiate lower prices for certain drugs, which are estimated to deliver about \$25 billion in savings through 2031.<sup>9</sup> A balanced combination of revenue increases and cost control—inside the Medicare trust fund and across the budget—can protect against spending cuts that would both increase hardship and undermine the nation’s ability to secure an inclusive, sustainable, and dynamic economy.<sup>10</sup>

To increase federal revenues, addressing tax rates will need to be one part of the picture, which can include reversing some of the 2017 tax law’s deep tax rate cuts for corporations, allowing rate cuts for high-income filers to expire, and considering proposals to increase tax rates on revenue sources dedicated to the Medicare trust fund and other specific parts of the budget.<sup>11</sup>

But the tax base should be strengthened in tandem, and this is the focus of my testimony. The tax base is not broad enough and too much tax that is owed goes unpaid.

It is convenient to look at base broadening and the tax gap as separate problems, but they are deeply linked, and the line between them is not always clear-cut. Carve-outs from the tax base attract aggressive tax avoidance seeking to push even more income into the special preferences and out of the tax base. In doing so, filers can blur or even step over the boundary of the law into outright tax evasion. Meanwhile, Treasury and IRS interpretations of the tax law that are overly generous to taxpayers but that are not the best application of the law can unnecessarily widen tax breaks, shrink the tax base, and hurt public finances in doing so.

### **1. The tax base is not broad enough.**

The tax base is *what* gets taxed at the relevant tax rate schedule. The bulk of federal revenues comes from taxes on incomes (both individual and corporate) and payrolls.

Various deductions, exclusions, and other preferential treatments carve income out of the federal tax base.<sup>12</sup> These targeted tax breaks for specific types of income or filers are sometimes called “tax expenditures,”<sup>13</sup> or “spending through the tax code” because their economic and budgetary impact is like a spending program designed to subsidize a particular activity.<sup>14</sup>

Tax expenditures shrink the tax base by reducing the amount of income taxed at normal tax rates. Individual and corporate tax expenditures are estimated to cost about \$1.5 trillion (about 6

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<sup>9</sup> CBO, [How CBO Estimated the Budgetary Impact of Key Prescription Drug Provisions in the 2022 Reconciliation Act](#) 11 (Feb. 17, 2023). CBO estimates that the negotiation program will lower Part D spending by \$14 billion, Part B spending by \$9 billion, and other federal spending by \$1 billion. *Id.*

<sup>10</sup> See Paul Van de Water, [Medicare Is Not “Bankrupt.”](#) CBPP (February 13, 2023).

<sup>11</sup> See Department of the Treasury (Treasury), [General Explanations of the Administration’s Fiscal Year 2024 Revenue Proposals](#), 72-74 (March 9, 2023); U.S. Senate Committee on the Budget, [Sen. Whitehouse: We Can Protect Social Security for All Without Cutting Benefits](#) (August 12, 2023).

<sup>12</sup> See Treasury, [Tax Expenditures](#) (last visited September 24, 2023).

<sup>13</sup> TPC, [Briefing Book \(Tax Expenditures\): What Are Tax Expenditures and How Are They Structured?](#) (May 2020).

<sup>14</sup> The Congressional Budget Act of 1974 requires that a list of “tax expenditures” be included in the budget and defines them for these purposes as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” See Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344 §3(a)(3), 88 Stat. 297, 299 (1974).

percent of GDP) in FY2022,<sup>15</sup> more than the cost of Medicare and Medicaid combined, or either defense or non-defense discretionary spending.<sup>16</sup>

Tax expenditures, just like other types of federal spending, are not inherently sound or unsound policy.<sup>17</sup> But many carve-outs from the tax base are costly, fail to achieve their aims, and create new problems. Overall, the value of individual tax expenditures flows towards high-income filers that need little help or incentive to undertake the activities—such as building wealth through homeownership, education, or saving—that the subsidies are meant to support.<sup>18</sup> This makes them ineffective at achieving their purported goals while increasing income, wealth, and racial inequality.<sup>19</sup> On the business side, many business tax breaks are portrayed as benefiting “small businesses” and innovation but are in fact tilted towards large corporations that can use them for tax avoidance, giving them another unfair tax advantage over smaller and startup firms.<sup>20</sup>

Exclusions from the tax base can also attract tax avoidance, sheltering, and gaming that pulls investment away from more productive activities.<sup>21</sup>

Prominent exclusions from the federal tax base that shrink it in unproductive ways are:

- **The ability to wipe out accumulated tax on the capital gains of assets held until death.** This means large incomes of the wealthiest filers never face income tax at any rate, either during their lifetime or their heirs’ lifetimes.<sup>22</sup> Even capital gains and dividends that do face income tax get a lower tax rate than income from salaries, and combined with the complete exclusion of some capital gains from the tax base, these preferences for income from wealth are carve-outs from the individual income tax base.<sup>23</sup>

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<sup>15</sup> See Treasury, *supra* note 12; Bureau of Economic Analysis, [Gross Domestic Product, Fourth Quarter and Year 2022 \(Third Estimate\), GDP by Industry, and Corporate Profits](#) (March 30, 2023). Totals do not account for interactions.

<sup>16</sup> FY2022 outlays for Medicare, net of offsetting receipts, and Medicaid totaled \$1.3 trillion. See CBO, [The Budget and Economic Outlook: 2023 to 2033](#) 14-15 (February 15, 2023). Defense discretionary spending was \$746 billion, while nondefense discretionary spending was \$910 billion. *Id.* at 17.

<sup>17</sup> For example, the Child Tax Credit is a tax expenditure that is a powerful tool for lifting families out of poverty. See CBPP, [Policy Basics: The Child Tax Credit](#) (December 7, 2022).

<sup>18</sup> The CBO estimates that in 2019 18% of the value of major individual income tax expenditures flowed to the highest-income 1 percent of filers. See CBO, [The Distribution of Household Income, 2019](#) (November 2022). TPC estimates of individual income tax expenditures for 2022 are not aggregated. See TPC, [Individual Income Tax Expenditures \(December 2022\)](#) (December 2022). We are not aware of recently updated aggregate estimates that include effects of the Inflation Reduction Act.

<sup>19</sup> See CBPP, [Policy Basics: Federal Tax Expenditures](#) (December 8, 2020). For analysis of racial disparities in tax expenditures, see Assistant Secretary for Tax Policy Lily Batchelder & Deputy Assistant Secretary for Tax Analysis Greg Leiserson, [Disparities in the Benefits of Tax Expenditures by Race and Ethnicity](#), Treasury (January 20, 2023).

<sup>20</sup> See [How to \(Not\) Support Small Businesses Through the Tax System](#), The Tax Law Center at NYU Law (Tax Law Center) (June 9, 2023).

<sup>21</sup> This effect can be described as a reduction in “allocative efficiency.” For a review of the empirical literature suggesting that allocative efficiency effects can be more substantial than supply-side impacts in the context of individual income tax reform, see William Gale & Andrew A. Samwick, [Effects of Income Tax Changes on Economic Growth](#), Brookings Institution (February 1, 2016).

<sup>22</sup> See Huang, [Building Back Better](#), *supra* note 1 at 10 (October 6, 2021).

<sup>23</sup> See, e.g., Congressional Research Service (CRS), [Tax Expenditures: Compendium of Background Material on Individual Provisions](#) 5, U.S. Senate Committee on the Budget (December 2022). Note that these numbers consider only permanent tax expenditures reported in FY2020.

- **Large amounts of foreign income of large multinationals are entirely or partially exempt from the US tax base.** The 2017 tax law set up an international tax framework that affords complete exemptions<sup>24</sup> and zero or low rates to certain foreign income of US multinationals, meaning that it faces rates far below the 21 percent top domestic corporate tax rate.<sup>25</sup> Even with the requirement that some of those profits face a minimum level of tax under the new global intangible low-taxed income (GILTI) regime, these exclusions and reduced rates amount to a tax break on multinationals’ foreign profits worth some \$45 billion annually.<sup>26</sup> This is the largest corporate tax expenditure.<sup>27</sup> The US tax base also excludes specific types of foreign income including from foreign oil and gas extraction.<sup>28</sup>
- **Holes in payroll taxes and the “Medicare tax” on unearned income.** The Affordable Care Act enacted the “unearned income Medicare contribution” or NIIT to ensure that high-income filers—who earn most of their income from wealth rather than from wages and salaries—faced tax rates on their income comparable to the Medicare payroll tax rates faced by wages and salary earners. The 3.8 percent NIIT rate is the same as the 2.9 percent combined employee and employer Medicare payroll tax faced by all earners plus the 0.9 percent high-earner Medicare rate on wage and salary income. The NIIT means that most high-income taxpayers pay a 3.8 percent tax on income above \$200,000 for a single filer or \$250,000 for a married couple, either through employment taxes (FICA or SECA) or through the NIIT. FICA and SECA revenues flow to the Medicare trust fund, but NIIT revenues currently do not.

The NIIT somewhat reduces incentives for high-income filers to try to convert their salary and wages into other types of income in order to avoid FICA and SECA. The NIIT was originally intended to apply to all forms of income not covered by those employment and self-employment taxes,<sup>29</sup> but lawmakers left large gaps in this tax base that allow high-income filers to avoid facing any payroll tax or NIIT when their income flows through certain pass-through businesses.<sup>30</sup> Specifically, high-income filers who own limited partnerships or S corporations and are actively involved in the business can avoid both the NIIT *and* the additional 0.9 percent high-earner Medicare tax.<sup>31</sup>

There are many other large and small ways that the tax base has been shrunk. Many appear explicitly in tables and analyses of tax expenditures or revenue raising options prepared by congressional and administration estimators, such as the 1200-page compendium that the

<sup>24</sup> See Kimberly Clausing, [Profit Shifting Before and After the Tax Cuts and Jobs Act](#), 73 National Tax Journal 4, 11 (2020).

<sup>25</sup> Huang, *How U.S. International Tax Policy Impacts American Workers, Jobs, and Investment*, *supra* note 1 at 2.

<sup>26</sup> See Joint Committee on Taxation (JCT), [Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026](#) 32 (December 22, 2022).

<sup>27</sup> See *id.*

<sup>28</sup> See I.R.C. § 907; see also Huang, *How U.S. International Tax Policy Impacts American Workers, Jobs, and Investment*, *supra* note 1 at 3.

<sup>29</sup> See Jason Furman (@jasonfurman), X (formerly known as Twitter) (October 28, 2021, 12:13 PM), <https://twitter.com/jasonfurman/status/1453756934985850889>.

<sup>30</sup> See Karen C. Burke, [Exploiting the Medicare Tax Loophole](#), 21 Fla. Tax Rev. 2 570, 606 (September 22, 2017).

<sup>31</sup> For full analysis of gaps in the bases of these taxes, see CRS, [The 3.8% Net Investment Income Tax: Overview, Data, and Policy Options](#) (June 30, 2023); Treasury Office of Tax Analysis, [Gaps Between the Net Investment Income Tax Base and the Employment Tax Base](#) (April 14, 2016).

Congressional Research Service prepared for this Committee in December 2022.<sup>32</sup> Others are not as visible, because they flow from questionable regulatory decisions,<sup>33</sup> are smaller or hard to estimate, raise difficult methodological questions, or are newly emerging.<sup>34</sup> Part II.2 returns to this broader set of options.

## 2. The tax base is too leaky.

Before the enactment of the Inflation Reduction Act (IRA), the “tax gap” of federal taxes owed under law but not paid amounted to \$496 billion annually from 2014 to 2016,<sup>35</sup> an estimated \$540 billion annually between 2017 and 2019,<sup>36</sup> and approximately \$7 trillion over the coming decade.<sup>37</sup> About 28 percent of the individual income tax underreporting gap is attributable to the highest-income one percent of filers.<sup>38</sup>

These leaks directly deplete the Medicare trust fund. Taxes owed, but not paid, to the Medicare, Social Security, and Unemployment Insurance trust funds total some \$100 billion each year (IRS estimates do not currently divide this impact between the funds).<sup>39</sup>

A striking example of potential tax non-compliance leading to losses from the trust funds is currently before the courts. The IRS announced a campaign in 2018 to examine arrangements where individual partners have “inappropriately claimed to qualify as ‘limited partners’ not

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<sup>32</sup> CRS, *supra* note 23.

<sup>33</sup> Regulatory decisions can show up in the estimate of a broader tax expenditure, but not be separately listed.

<sup>34</sup> For example, tax expenditure estimates do not regularly attempt to estimate payroll tax expenditures, or focus on the payroll tax implications of provisions that are also individual income tax expenditures. Difficulties involved include considering and estimating the tax expenditure on benefit eligibility (especially in Social Security). *See* JCT, JCX-22-22, [Estimates Of Federal Tax Expenditures For Fiscal Years 2022-2026](#) 4 n.8 (2022); CBO, [The Distribution of Major Tax Expenditures in 2019](#), 33-34 (October, 2021). This has the somewhat counterintuitive effect that provisions like the NIIT, which policymakers consider primarily as a measure to address the payroll tax base issues, are counted as “negative” tax expenditures for the income tax. It also means that measures used to plug holes in the base via an alternative default tax base (such as the Corporate Alternative Minimum Tax (CAMT)) can be treated as “negative” tax expenditures, but carve-outs from the alternative tax base (such as the exclusion of depreciation from the CAMT base) are not. Finally, some effects that are arguably tax expenditures can appear when new business and technology developments do not fit neatly into the default tax rules. For example, the current exclusion of digital assets from the “wash sale” rules, *see* Taylor Cranor & Mike Kaercher, [Congress Should Extend Wash Sales Rules to Digital Assets](#), Tax Law Center (April 17, 2023), is arguably a departure from the normal tax base but one that has only become evident as the market for digital assets has developed.

<sup>35</sup> IRS, *supra* note 3, at 11. This is the “gross” tax gap for the most recent years available. The net tax gap, subtracts the amount of the tax gap the IRS anticipates will be recovered and was \$428 billion annually between 2014 and 2016. *Id.* IRS estimates may understate the true amount of tax non-compliance because they cannot account for certain types of sophisticated avoidance and evasion. *See* [IRS Updates Tax Gap Estimates: New Data Points the Way Toward Enhancing Taxpayer Service, Compliance Efforts](#), IRS-2022-192 (October 28, 2022) (“IRS Updates Tax Gap Estimates”).

<sup>36</sup> IRS, *supra* note 3, at 27. The net tax gap over the same period is estimated at \$470 billion annually. *Id.*

<sup>37</sup> Treasury, [The American Families Plan Tax Compliance Agenda](#), at 3 (May 2021).

<sup>38</sup> Andrew Johns & Joel Slemrod, *The Distribution of Income Tax Noncompliance*, 63 Nat’l Tax J. 397, 406 (2010); Jason DeBacker et al., [Tax Noncompliance and Measures of Income Inequality](#), Tax Notes Federal 7-8 (February 16, 2020). Estimates of the total tax gap and the share attributable to the highest income filers vary and are difficult to make given limited sightlines of the IRS into some major categories of non-compliance (including offshore income, digital assets, and income held through complex layers of entities). *See* Daniel Reck et al., Washington Center for Equitable Growth, [Tax Evasion at the Top of the U.S. Income Distribution and How to Fight It](#) (March 22, 2021); IRS Updates Tax Gap Estimates, *supra* note 35.

<sup>39</sup> *See supra* text accompanying note 4.

subject to SECA tax.”<sup>40</sup> This illustrates how a tax base that is not broad enough can invite wasteful tax avoidance as filers try to push their income out of the base—and how aggressive tax avoidance can then also blur or overstep the line into unlawful tax evasion. Currently, Point 72 Asset Management, a hedge fund founded and owned by billionaire Steve Cohen, is challenging a tax assessment on \$344 million of earnings for failing to pay SECA.<sup>41</sup> The case is one of several objections to assessments arising from the IRS campaign.<sup>42</sup>

A decade of damaging cuts to IRS enforcement funding beginning in 2010 left the IRS unable to adequately fulfill its basic function of upholding the tax law and ensuring that filers pay what they owe. Before the recent IRA, the IRS lost about 40% of its auditors, including those experienced enough to review the most complex returns of large businesses and high net worth individuals.<sup>43</sup> At some sites, the IRS even lacked basic supplies, such as pens and staplers.<sup>44</sup> Under resourcing also hampered the IRS’s ability to do the research needed to understand the root causes of the tax gap and new emerging areas of non-compliance, including offshore tax evasion and tax evasion involving digital assets.<sup>45</sup>

To rebuild and transform taxpayer service and ensure that high-income filers and large corporations pay more of the taxes they already owe, the IRA provided the IRS an additional \$80 billion to be spent through the end of 2031. CBO estimated that this funding would raise a *net* \$180.4 billion between 2022 and 2031 by simply collecting more tax revenue that is already owed under the law. This is a rare example of spending that pays for itself many times over.

The debt limit deal undermined this effort. If implemented, it will result in \$21.39 billion in cuts to IRA funding and *add* to deficits by a net of some \$20 billion over the next ten years in increased tax non-compliance.<sup>46</sup>

It would be a mistake to think that because the IRS has some ability to change the timing of its spending of IRA money so that cuts are accounted for on the “back end” that the damage to its ability to improve tax compliance and service will not be felt far earlier.

The reason that lawmakers provided the IRA money as a mandatory stream over a decade was to enable transformational projects—IT upgrades and systems modernization, hiring and training

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<sup>40</sup> [Large Businesses and International Active Campaigns](#), IRS (September 15, 2023). The IRS has paused the campaign while these cases are being concluded. See Kristen A. Parillo, [IRS Pauses New Audits Under SECA Campaigns](#), Tax Notes (September 26, 2023).

<sup>41</sup> Miles Weiss, [Steve Cohen Fights a \\$10 Million Tax Bill to Derail an IRS Plan](#), Bloomberg News (August 18, 2023).

<sup>42</sup> See Respondent’s Motion for Partial Summary Judgment, [Soroban Capital Partners LP v. Comm.](#), No. 16218-22 (T.C. March 1, 2023); Petition for Readjustment of Partnership Items Under Code Section 6226, [Denham Capital Management LP v. Comm.](#), No. 9973-23 (T.C. June 21, 2023).

<sup>43</sup> See Chuck Marr et al., [Rebuilding the IRS Would Reduce the Tax Gap, Help Replenish Depleted Revenue Base](#) (December 16, 2022).

<sup>44</sup> Alan Rappeport, [Decades of Neglect Leave I.R.S. in Tax Season ‘Chaos’](#), New York Times (March 4, 2022); see also Michael Kaercher & Chye-Ching Huang, [Cracks in the System: The Consequences of Underfunding the IRS](#), Tax Law Center (April 15, 2022).

<sup>45</sup> See Treasury Inspector General for Tax Administration, [Actions are Needed to Improve the Completeness, Development, and Review of IRS Tax Gap Estimates](#) 6 (March 23, 2023).

<sup>46</sup> Thalia Spinrad & Chye-Ching Huang, [Impact of House and Senate IRS Funding Proposals](#), Tax Law Center (July 18, 2023).



expert staff, and dramatic improvements to taxpayer services<sup>47</sup>—that need multiple years of funding to plan and execute well, and some confidence of continued funding. By cutting some 27% of the IRA funding, the deal moves forward a cliff in IRS funding to FY2030 or sooner.<sup>48</sup>

A nearer cliff may cause the IRS to commit to less ambitious transformation. As it approaches, it will be impossible for the IRS to responsibly hire or plan for multi-year projects as though the funds will continue, and the IRS will be forced to slow or reduce compliance and service improvements. The IRS cannot move faster to compensate: its workforce and systems are depleted, limiting how quickly it can hire and train new staff without taking existing staff off frontline activities and harming service and compliance. House proposals to cut IRS funding even below the levels agreed to in the debt ceiling deal would worsen the damage.<sup>49</sup>

Some lawmakers are also proposing to undo or undermine the statutory tools the IRS will need to focus on the most egregious non-compliance rather than random audits of honest and accurate filers.<sup>50</sup> New bipartisan “third party” information reporting requirements on digital asset brokers will allow those who invest in digital assets to track their income and comply with their tax filing obligations. And new information reporting applying to the corporations that run online peer-to-peer payment platforms will increase voluntary compliance by helping gig workers and others who use these platforms to track and report income. These measures can help discourage the use of payment platforms or digital assets to hide income and evade taxes.<sup>51</sup> They can also help the IRS to steer its audit and other compliance activity away from audits of accurate filers and towards those who try to deliberately evade taxes on income generated through online payment platforms or digital assets.<sup>52</sup> These measures should be implemented, not weakened.

## PART II: FORGING A STRONG TAX BASE

Lawmakers can strengthen the tax base in four key ways.

**1. First, do no harm by rejecting proposals that will increase tax non-compliance and shrink the tax base.** That means:

**(a) Maintain IRS base discretionary funding and do not subject IRS mandatory funding to more damaging cuts below levels agreed to in the debt ceiling deal.** The US Senate Committee on Appropriations has passed a proposal setting IRS base funding for FY2024 at a nominal freeze.<sup>53</sup> This is \$1.8 billion below the level requested by the President’s Budget and

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<sup>47</sup> Chuck Marr, Samantha Jacoby & Jabari Cook, [Success of the IRS Rebuilding and Tax Gap Reduction Effort Depends on Sufficient Funding Through Annual Appropriations](#), CBPP (December 7, 2022).

<sup>48</sup> Thalia Spinrad & Chye-Ching Huang, *supra* note 46; Chye-Ching Huang, Thalia Spinrad, & Kathleen Bryant, [Debt Ceiling Deal’s Cuts to IRS Funding Bring the IRS Funding Cliff Closer: Appropriators Should Not Compound Harm](#), Tax Law Center (June 28, 2023). Moreover, House bills have proposed to rescind all of the remaining IRA funds and thus would, if enacted, move the funding cliff up to FY2024. *Id.*

<sup>49</sup> Thalia Spinrad & Chye-Ching Huang, *supra* note 46.

<sup>50</sup> Grace Henley et al., [Undermining Information Reporting Requirements for “Gig” Companies and Other Online Platforms Would Hurt Honest Filers, Cost Revenue, and Reward Tax Evaders](#), Tax Law Center (June 12, 2023); Michael Kaercher & Taylor Cranor, [Taxing Digital Assets: What’s at Stake?](#), Tax Law Center (August 4, 2022).

<sup>51</sup> Grace Henley et al., *supra* note 50; Chye-Ching Huang, [U.S. Will Likely Lose Billions Due to Unacceptably Long Delay for Digital Asset Reporting Requirements](#), Tax Law Center (August 24, 2023).

<sup>52</sup> Grace Henley et al., *supra* note 50; Kaercher & Cranor *supra* note 50.

<sup>53</sup> Chuck Marr & Samantha Jacoby, [Bipartisan Senate Action Passes Minimal Test for IRS Funding While Multiple House Republican Bills Fail](#), CBPP (July 20, 2023).

does not keep pace with inflation. This will require more repurposing of IRA funds just to fill the hole in the base levels of operations that further IRS transformation would then build on.<sup>54</sup> This is far less damaging, however, than the House proposals that would effectively result in the rollback of all IRA funding.<sup>55</sup>

**(b) Do not undermine new tax compliance provisions that will help honest filers comply with their tax obligations and will help the IRS detect tax cheating while reducing random audits of compliance taxpayers.** This means rejecting proposals to repeal or weaken 1099-K information reporting for third-party settlement organizations (requiring online marketplaces and “gig” platforms to provide information reporting to document business transactions over \$600) and section 6045 cryptocurrency broker reporting.<sup>56</sup>

**(c) Build on, rather than reverse, the limited base broadening included in the 2017 law.** The 2017 tax law included some base broadening measures, such as the elimination of business expense deductions for entertainment, and limitations to individual tax expenditures including itemized deductions.<sup>57</sup> Its phase-ins and sunsets mean decisions must be made about what parts of the law to retain, fix, and let expire.<sup>58</sup> In general, lawmakers should retain and build on sound measures that broadened the federal tax base—but let expire or scale back costly, inefficient and regressive provisions that shrank the tax base.<sup>59</sup> For example:

- **Corporate base broadening measures in the 2017 tax law should be allowed to take effect and strengthened.** For example, the 2017 tax law introduced a stronger limitation on deducting interest expenses to 30 percent of adjusted taxable income for businesses with gross revenue over \$29 million annually.<sup>60</sup> If this new limitation were reversed, and full expensing for R&E were restored in tandem, certain businesses would again be able to both claim deductions for investments *and* be able to deduct more of their interest costs on their borrowing. That combination would be especially valuable for the leveraged buyout (“private equity”) industry that relies on being able to load up acquired companies with debt.<sup>61</sup> It would also be valuable for large multinational corporations that avoid taxes by making large

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<sup>54</sup> Spinrad & Huang, *supra* note 46.

<sup>55</sup> *Id.*

<sup>56</sup> Kaercher & Cranor, *supra* note 50; Mike Kaercher & Taylor Cranor, [IRS Issues Sound Guidance on Taxation of Cryptocurrency Consistent with TLC’s Recommendations](#), Tax Law Center (June 21, 2023).

<sup>57</sup> See CRS, R45092, [The 2017 Tax Revision \(P.L. 115-97\): Comparison to 2017 Tax Law](#) (2018) (providing a summary of TJCA’s provisions, including base broadeners).

<sup>58</sup> If all of the net tax cuts set to expire in 2017 are made permanent without any offsets, they will cost roughly \$3.5 trillion over the next decade, representing roughly 1% of GDP. Households in the 95th-99th percentiles would reap the largest benefits and the top 1% would disproportionately benefit. Deese & Kamin, *supra* note 7, at 5. The Tax Law Center and other experts have written about how these tax cuts should be addressed more broadly. See Huang, *Testimony*, *supra* note 1; Chuck Marr, [2025 Tax Debate Begins, Offers Opportunity for Course Correction](#), CBPP (March 7, 2023); Deese & Kamin, *supra* note 7.

<sup>59</sup> Huang, *Testimony*, *supra* note 1; Marr, *supra* note 58.

<sup>60</sup> The limitations on deducting interest expense under section 163(j) went into effect in 2018. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13301, 131 Stat. 2054, 2117-21. The requirement to amortize research and experimental expenditures went into effect in 2022. *Id.* at § 13206, 131 Stat. 2111-13. There are also exceptions for certain expenses. See section 163(j)(5). Some lawmakers are proposing to reinstate a weaker limitation on interest expenses based on EBITDA. Doug Sword, [Senate, House Backers Try to Push 163\(j\) Relief Into Limelight](#), Tax Notes (September 15, 2023).

<sup>61</sup> Michael Kaercher, [American Ingenuity: Promoting Innovation Through the Tax Code](#), Testimony for the Committee on Small Business, Subcommittee on Economic Growth, Tax, and Capital Access (June 6, 2023).

interest payments to their foreign affiliates.<sup>62</sup> Undoing the limitation on interest deductions for large businesses would also further increase the federal tax system’s tilt towards financing investments with debt rather than equity.<sup>63</sup> Innovation can be more effectively supported through other policies.<sup>64</sup>

If Congress decides that it nevertheless wishes to reverse part of the 2017 tax law’s corporate base broadening, it should trade off a reduced base with a higher rate or other base broadening. That was the trade reflected in the 2017 tax law, and given revenue needs, undercutting the base without other base broadening or raising rates is an unacceptable combination.

Part II.2 also discusses how the GILTI minimum tax should be strengthened to protect the corporate tax base.

- **Provisions that shrank the tax base in ways that give large tax cuts to wealthy filers and encourage tax avoidance should expire.<sup>65</sup> These include:**
  - **The section 199A “pass through” deduction**, a special lower rate on most income earned through pass-through business entities. If kept in place, it will cost \$700 billion over 2026-2035.<sup>66</sup> More than half of its value goes to the highest-income one percent of filers, and a full quarter goes to the highest-income one out of every thousand tax filers.<sup>67</sup> Despite supposed guardrails, tax advisors have called section 199A a “gaping hole” in the code.<sup>68</sup> It is “the very worst kind of tax policy, picking winners and losers haphazardly in a complex tax provision, and then generating significant incentives for people to rearrange their businesses to try to get on the right side of the line.”<sup>69</sup> The deduction did not provide any boost in economic activity in the two years following its enactment, research suggests.<sup>70</sup>
  - **The doubled exclusion from estate and gift taxes.** The 2017 tax law doubled the amount that a wealthy couple can pass tax-free to their heirs from \$11 million to \$22 million (adjusted for inflation). Extending this would cost \$125 billion between 2026 and 2033.<sup>71</sup> The doubled exclusion potentially *more than* doubles the amount of

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<sup>62</sup> *Id.*

<sup>63</sup> See Treasury, [Effective Marginal Tax Rates \(EMTRs\) on new investment under Current Law and Policy](#) (November 2021). Analysts across the political spectrum have recognized this tax tilt towards debt financing as a problem, and some have proposed even stronger limitations on interest deductibility. See American Compass, [Rebuilding American Capitalism: A Handbook for Conservative Policymakers](#) 58 (2023) (proposing eliminating deductions for interest expense).

<sup>64</sup> See Kaercher, *supra* note 61.

<sup>65</sup> See Huang, *Testimony*, *supra* note 1; Marr, *supra* note 58; Deese & Kamin, *supra* note 7.

<sup>66</sup> Chuck Marr & Samantha Jacoby, [The Pass-Through Deduction is Tilted Heavily to the Wealthy, Is Costly, and Should Expire as Scheduled](#), CBPP (June 8, 2023).

<sup>67</sup> TPC, [Tax Benefit of the Deduction for Qualified Business Income, Baseline: Current Law, Distribution of Federal Tax Changes by Expanded Cash Income Percentile, 2022](#) (December 29, 2022).

<sup>68</sup> Emily Horton, [Tax Planner: Drive Wealthy Clients Through “Gaping Hole” in Tax Code](#), CBPP (May 31, 2018).

<sup>69</sup> Samantha Jacoby, [Repealing Flawed “Pass-Through” Deduction Should Be Part of Recovery Legislation](#), CBPP (June 1, 2021) (quoting David Kamin). Similarly, former JCT Chief of Staff Edward Kleinbard called it “Congress’ worst idea ever.” *Id.*

<sup>70</sup> Lucas Goodman, et al., [How Do Business Owners Respond to a Tax Cut? Examining the 199A Deduction for Pass-Through Firms](#) 1-4 (National Bureau of Economic Research, Working Paper No. 28680, 2022).

<sup>71</sup> CBO, [Budgetary Outcomes Under Alternative Assumptions About Spending and Revenue](#) Table 1 (May 2023).

money it allows wealthy individuals to pass on tax-free. Individuals can make lifetime gifts of assets to donees, and those assets may appreciate over the donee's lifetime—and such gifts are also key to some of the most complex tax avoidance techniques used to push large fortunes out of the transfer tax base.<sup>72</sup>

- **Individual base broadening should be strengthened.** The 2017 tax law made changes to the individual income tax structure, including a doubled standard deduction, additional limits on certain itemized deductions, and paring back the Alternative Minimum Tax (which was originally intended as a broader backstop to the too-narrow normal tax base).<sup>73</sup> These interacting changes limited the cost of itemized deductions but made some (such as the mortgage interest deduction) even more concentrated on the highest-income filers, and so likely less effective and efficient at achieving their purported policy aims.<sup>74</sup> The limitation on the State and Local Tax Deduction (SALT) has also been implemented in a way that encourages states to support their high-income filers to engage in aggressive and complicated tax avoidance using pass-through entities to avoid the cap, reducing its effectiveness and creating new disparities between types of businesses, filers, and states.<sup>75</sup> Depending on how lawmakers address expiring individual tax provisions more broadly, they may have an opportunity to improve the individual tax base in ways that reduce wasteful avoidance, raise revenues, and make any retained tax preferences more efficient and effective.

**2. Address three glaring areas that combine a tax base that isn't broad enough with major tax non-compliance: (a) the non-taxation of income from extraordinarily large fortunes; (b) the non-taxation of certain foreign profits; and (c) pass-through taxation.**

**(a) Ensure income from extraordinarily large fortunes faces at least some tax and reduce preferences for income from wealth over work.** Much of the income generated by wealth is currently carved out of the US tax base. Income from wealth can entirely disappear from the federal income tax base if it comes from assets (such as stocks and bonds) that have grown in value but have not been realized (e.g., sold) during the lifetime of the owner.<sup>76</sup> Combined with exclusions and other holes in the estate and gift taxes, this can allow income from extraordinary fortunes to not be included in the US tax base over decades, lifetimes, and generations.<sup>77</sup> Other carve-outs for income from wealth include tax rates as low as zero percent.<sup>78</sup> This array of tax

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<sup>72</sup> See, e.g., Jesse Drucker & Maureen Farrell, *A Lavish Tax Dodge for the Ultrawealthy Is Easily Multiplied*, New York Times (December 28, 2021); Barbara Bryniarski, *Helping a Client Benefit from an Intentionally Defective Grantor Trust*, Tax Adviser (November 11, 2021).

<sup>73</sup> See CRS, *supra* note 57, at 8-19.

<sup>74</sup> See Howard Gleckman, *The TCJA Shifted the Benefits of Itemized Deductions to Higher-Income Households*, Forbes (October 16, 2018); TPC, *Briefing Book: How did the TCJA change the standard deduction and itemized deductions?* (May 2020).

<sup>75</sup> The 2017 tax law includes a \$10,000 limitation on SALT deductions. Certain states have created “workarounds” by allowing partnerships and S corporations to pay state income taxes on behalf of partners or owners. See Richard Rubin, *The SALT Cap Has a \$20 Billion Hole*, Wall Street Journal (August 27, 2023). This could be addressed with guidance or legislation. See Daniel Hemel, *The Passthrough Entity Tax Scandal* 26-28 (New York University Law and Economics Research Paper, No. 23-01, 2023).

<sup>76</sup> See Harry L. Gutman, *Taxing Gains at Death*, Tax Notes Federal (January 11, 2021).

<sup>77</sup> See Lily L. Batchelder & David Kamin, *Taxing the Rich: Issues and Options* 3-7 (February 1, 2020) (unpublished manuscript).

<sup>78</sup> *Id.* at 6.

benefits for income from wealth goes overwhelmingly (and sometimes exclusively) to the already very wealthy and entrenches and exacerbates racial wealth disparities.<sup>79</sup>

There are many ways to bring more income from wealth into the US tax base.<sup>80</sup> A key priority should be ensuring that income from the gain in assets faces at least some income tax, and various proposals to address this problem are superior to current law.<sup>81</sup> For example, President Biden's proposal to treat unrealized capital gains as taxable income for the wealthiest people in the country would raise \$437 billion over 2024-2033.<sup>82</sup>

**(b) Ensure that less of the foreign income of large US multinationals escapes the US tax base.** The cost to the public of subsidizing the foreign profits of US multinationals is about \$60 billion annually.<sup>83</sup> That subsidy takes the form of excluding some of that income entirely from the US tax base and from lower tax rates on foreign profits (between zero and 10.5 percent) compared to the 21 percent tax rate on domestic profits.<sup>84</sup> This invites US multinationals to try to siphon profits out of the US tax base and out of the tax bases of other countries where they have customers or do business, and into low-taxed “tax haven” countries like Ireland and Bermuda. Multinationals report about 56% of their income in major tax havens, about the same share as they did before the 2017 tax law.<sup>85</sup>

Multinational tax non-compliance is usually less about outright tax evasion than corporations trying to use regulations and the courts to stretch the boundaries of their ability to move profits out of the US tax base, and an understaffed IRS can have limited ability to push back.<sup>86</sup>

Lawmakers can adopt reforms to include more of the foreign profits of US multinationals in the tax base. A key way would be to build on the GILTI provisions of the 2017 tax law. GILTI takes a sound basic approach of attempting to ensure that foreign profits of US multinationals are included in the US tax base by having to face at least some minimum level of tax. GILTI provided the blueprint for the 15 percent minimum tax that is now at the heart of the deal to address multinational tax avoidance by 143 countries and jurisdictions including the US.<sup>87</sup>

But the GILTI rate is too far below the tax rate on profits earned in the US, and, due to flaws in its design, the regime excludes too much foreign income that which leads to the perverse

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<sup>79</sup> See *id.*; Chuck Marr, Samantha Jacoby & Kathleen Bryant, [Substantial Income of Wealthy Households Escapes Annual Taxation Or Enjoys Special Tax Breaks](#), CBPP (November 13, 2019); Chye-Ching Huang & Roderick Taylor, [How the Federal Tax Code Can Better Advance Racial Equity](#), CBPP (July 25, 2019); Dorothy Brown, *The Whiteness of Wealth: How the Tax System Impoverishes Black Americans and How We Can Fix It* (2021).

<sup>80</sup> See Batchelder & Kamin, *supra* note 77.

<sup>81</sup> See Huang, *Building Back Better*, *supra* note 1, at 9-10.

<sup>82</sup> Treasury, *supra* note 11 at 82, 214.

<sup>83</sup> CRS, *supra* note 23, at 43.

<sup>84</sup> See *id.*, at 43-45; Jane G. Gravelle, CRS, IF11943, [GILTI: Proposed Changes in the Taxation of Global Intangible Low-Taxed Income](#) 1 (2021). The GILTI rate is scheduled to increase to 13.125% in 2026. Gravelle, *supra*, at 1.

<sup>85</sup> Kimberly Clausing, [Testimony Before the US Senate Committee on the Budget](#) (April 18, 2023); Wendy Edelberg, Chye-Ching Huang & Rose Jenkins, [Six Economic Facts on International Corporate Taxation](#), The Hamilton Project (June 2022).

<sup>86</sup> See, e.g., Jesse Drucker & Jim Tankersley, [How Big Companies Won New Tax Breaks From the Trump Administration](#), New York Times (December 30, 2019); Joseph Walker & Richard Rubin, [Amgen Fights IRS over \\$10.7 Billion Tax Bill](#), Wall Street Journal (August 1, 2022).

<sup>87</sup> OECD, [Members of the OECD/G20 Inclusive Framework on BEPS](#) (June 9, 2023).

outcome that it can make the US the least attractive place to locate investments or profits from a tax perspective.

The US can plug these holes in its tax base by strengthening GILTI and other parts of its international tax regime, through such proposals as those in the Biden Administration's budget that would raise over \$1 trillion between 2024 and 2033.<sup>88</sup> That would also bring the US into compliance with the Inclusive Framework deal that the EU, Japan, and other major trading partners are moving to implement.<sup>89</sup> If the US does not ensure that this income is subject to some minimum inclusion in tax base then, under the global agreement, other countries will, and will enjoy the benefit of that revenue.<sup>90</sup> There is no reason for the US to give up revenue that it could instead use to meet national priorities.

Reducing multinationals' ability to shift profits offshore can also help create a fairer competitive environment for US businesses that are unable or unwilling to use tax avoidance as a business strategy. Instead of sinking resources into a tax-avoidance arms race, companies will be able to focus more on customers, products, and innovation.

**(c) Close holes in passthrough regimes.** Over 50 percent of business profits now flow through “pass-through” entities rather than through corporations subject to the corporate income tax.<sup>91</sup> Research has found that over 60 percent of pass-through income earned by individuals flows to the top 1 percent of filers.<sup>92</sup> There are many deliberate and accidental holes in the tax base specifically involving pass-throughs that should be plugged. Repealing section 199A and addressing the pass-through workarounds in the SALT cap is discussed above.

The President's FY2024 budget proposes to close the holes in the Medicare payroll taxes and NIIT, raising \$306 billion over ten years.<sup>93</sup> Another proposal in the President's budget would increase the rate on Medicare payroll, self-employment, and NIIT taxes for filers with incomes over \$400,000 from 3.8 to 5 percent, raising \$344 billion over ten years.<sup>94</sup> The proposal would also dedicate all NIIT revenues to the Medicare trust fund.<sup>95</sup>

Lawmakers can also address other problems with partnerships—a form of pass-through controlling more than \$30 trillion in assets and vastly outnumbering public firms.<sup>96</sup> Partnership

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<sup>88</sup> Treasury, *supra* note 11 at 211.

<sup>89</sup> David Kamin, Rebecca Kysar, & Chye-Ching Huang, *A (Less Rocky) Path Forward on International Corporate Tax Reform*, Tax Law Center (December 16, 2022); Ernst & Young, *Japan Enacts 2023 Tax Reform Bill Including Legislation to Implement IIR to Align with OECD BEPS 2.0 Pillar Two* (March 30, 2023).

<sup>90</sup> Kimberly A. Clausing, *The Revenue Consequences of Pillar 2: Five Key Considerations*, Tax Notes (July 24, 2023).

<sup>91</sup> Author's calculations using IRS, *Corporation Income Tax Returns Complete Report* 1-3 (2019); IRS, SOI Tax Stats – Partnership Statics by Entity Type [Table 9b](#); IRS, SOI Tax Stats – Nonfarm Sole Proprietorship Statics, [Business Receipts, Selected Deductions, and Net Income](#); IRS, SOI Tax Stats - Individual Income Tax Returns Complete Report (Publication 1304), [Table A](#), Row 57 (2019).

<sup>92</sup> See Michael Cooper et al., *Business in the United States: Who Owns It, and How Much Tax Do They Pay?*, 30 *Tax Policy and the Economy* 91, 94 (2016). *But see* Natasha Sarin, Treasury, *The Case for a Robust Attack on the Tax Gap* (September 7, 2021) (suggesting that 35 percent of corrected partnership and S-Corporation income flows to those with a corrected adjusted gross income of \$500,000 and over).

<sup>93</sup> Treasury, *supra* note 11 at 214. *See also* Paul N. Van de Water, *President Biden's 2024 Budget Would Strengthen, Improve Medicare*, CBPP (May 3, 2023).

<sup>94</sup> Treasury, *supra* note 11 at 214.

<sup>95</sup> *Id.* at 75-76.

<sup>96</sup> Emily Black et al., *The Spiderweb of Partnership Tax Structures* 1 (February 24, 2023) (unpublished manuscript).

taxation currently combines complexity, inconsistency in the system, and optionality. That means leeway for large partnerships to choose what revenue and expenses are counted by the partnership and how they are allocated between different partners. Reforms could seek to move results closer to economic reality, reduce known inconsistencies, and reduce optionality in ways that would make the regime more administrable.<sup>97</sup>

Passthroughs are also a key source of tax non-compliance, thought to account for \$130 billion of unpaid owed taxes annually in the most recent tax gap estimates, a full 26 percent of the tax gap, and more than three times as large as corporate tax noncompliance.<sup>98</sup> IRS and academic research assumes that the share of the tax gap attributable to pass-throughs is about as concentrated among high-income filers as reported pass-through income.<sup>99</sup> But recent research suggests that passthrough tax evasion may be especially underestimated for high-income filers because of the difficulty the IRS currently has tracing partnership income to its true owners.<sup>100</sup>

Some partnerships are owned through circular structures of partnerships owning partnerships owning other partnerships,<sup>101</sup> or partnerships that "resemble 'spiderwebs' with groups of related entities and clusters of overlapping partners."<sup>102</sup> So, "complexity of partnership structures makes them an apt vehicle for business tax planning."<sup>103</sup> Addressing non-compliance within this sector is therefore important for addressing tax under-reporting.

**To sum up, lawmakers can improve the pass-through tax base and tax compliance in three main ways:**

**(a) Remove pass-through tax breaks and clean up underlying rules.** As noted above, lucrative tax breaks for pass-throughs as well as complex underlying rules may not only lead to revenue lost directly, but also encourage aggressive tax avoidance that can step over into non-compliance as filers search for these tax savings.

**(b) Ensure the IRS continues to have the resources needed to increase the number and quality of audits on partnerships and other pass-throughs.** Increasing the coverage and quality of both operational and research audits can help both the IRS and lawmakers to understand other steps needed to secure the pass-through tax base. IRA funding has already enabled the IRS to establish a special work unit to focus on large and complex pass-throughs.<sup>104</sup>

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<sup>97</sup> For some examples of approaches to partnership reform, see [Press Release, US Senate Committee on Finance, Wyden Unveils Proposal to Close Loopholes Allowing Wealthy Investors, Mega-Corporations to Use Partnerships to Avoid Paying Tax \(September 10, 2021\)](#); Monte A. Jackel, [Is It \(Finally\) Time? Reforming Subchapter K](#), Tax Notes Today Federal (March 29, 2021).

<sup>98</sup> IRS, *supra* note 3, at 11.

<sup>99</sup> John Guyton et al., [Tax Evasion at the Top of the Income Distribution](#) 28 (National Bureau of Economic Research, Working Paper No. 28542, 2021). This may understate the percentage of the pass-through tax gap attributable to the one percent, as noncompliance may be higher at the top of the income distribution. *Id.*

<sup>100</sup> See Guyton et al., *supra* note 99, at 26.

<sup>101</sup> Corey Husak, [The Sources and Size of Tax Evasion in the United States](#), Center for Equitable Growth (May 14, 2021).

<sup>102</sup> Black et al., *supra* note 96 at 2.

<sup>103</sup> *Id.* at 5.

<sup>104</sup> Press Release, IRS, [IRS to establish special pass-through organization to help with high-income compliance efforts; new workgroup to blend current employees and new hires to focus on complex partnerships, other key areas](#) (September 20, 2023).

**(c) Improve tools for understanding and addressing pass-through non-compliance, including closing holes in information reporting.** Not only are pass-through regimes often complex, but much of the income that flows through pass-throughs is not subject to information reporting. Lawmakers can provide the IRS with information reporting tools that encourage voluntary compliance and allow the IRS to identify the most egregious forms of tax evasion using pass-throughs. One option is to strengthen the bipartisan Corporate Transparency Act (discussed below).

**3. Choose from a large menu of big and small options to address problematic avoidance/non-compliance.** The Tax Law Center has compiled several dozen options to strengthen the tax base that we have either designed or analyzed in “[Broadening the US Federal Tax Base](#).” The Tax Law Center’s development and analysis of these options draws on the deep tax practice, tax administration, and research expertise of our staff, and our networks of public interest minded tax lawyers, accountants, researchers, and market actors. We have proposed or analyzed these base broadening options in the course of our work to date including submitting proposals for consideration in the Green Book and the regulatory Priority Guidance Plan. Examples of base-broadening options included in this compilation<sup>105</sup> are:

- **Improving the bipartisan Corporate Transparency Act to identify tax evasion and other criminal activity using pass-throughs.** Lawmakers took a sound bipartisan step by enacting the CTA in response to the Panama Papers leak, which highlighted the use of shell companies to hide wealth from tax and law enforcement agencies. The CTA establishes a registry of the ultimate owners of certain entities that is available to the IRS and other regulators. The registry covers many corporations and LLCs but does not currently include most general partnerships, trust arrangements, or other entities with no state filing requirement. The most egregious tax evasion linked with corruption, sanctions evasion and other criminal activities is likely to flow towards the pass-throughs and other entities left in the shadows, unless lawmakers act. The Tax Law Center has proposed paths forward.<sup>106</sup>
- **Repealing the tax exemption for in-kind redemptions of exchange-traded funds (ETFs):** Under section 852(b)(6), if an ETF or other regulated investment company distributes appreciated securities or other property, no gain recognition is required. Section 852(b)(6) allows deferral and even complete avoidance of tax on gains in ways that investors investing independently and even through mutual funds cannot achieve. This allows for extreme forms of tax avoidance such as “heartbeat trades,” in which investment banks partner with ETFs to cycle large stock portfolios into funds and then quickly out of them using in-kind redemptions to avoid capital gains tax. The flow of funds into ETFs is driven disproportionately by high-net-worth individuals. Congress should repeal the exemption in section 852(b)(6) for regulated investment companies that allows them to distribute

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<sup>105</sup> Many other compilations of potential base broadening options include Treasury’s “Green Books,” tax reform proposals, and CBO’s “Budget Options.” Ours focuses on options that the Tax Law Center has developed or analyzed recently in consultation with other experts and includes links to relevant Tax Law Center publications such as our Priority Guidance Plan submissions and analyses of proposed legislation.

<sup>106</sup> Sophia Yan, [How Strengthening the Corporate Transparency Act Can Help the IRS Follow the Money](#), Just Security (April 12, 2022); Sophia Yan, [Budget Represents a Missed Opportunity to Promote Corporate Transparency Act Reforms](#), Tax Law Center (April 19, 2023); Tax Law Center, [Comment Letter on Beneficial Ownership Information Reporting Requirements](#) (February 7, 2022).



appreciated property in kind to a redeeming shareholder without realizing capital gains. JCT estimates that closing this loophole would raise \$205 billion over 10 years.<sup>107</sup>

- **Applying the wash sale rules to digital assets:** Investors can currently use wash sales to harvest losses on digital assets without changing their investment portfolio. Long-standing rules in section 1091 prevent taxpayers from engaging in wash sales to harvest losses on stocks and securities. However, lawmakers have not modified section 1091 to apply to digital assets. Congress should close the loophole that allows digital asset investors to access this aggressive tax planning practice. Extending the wash sale rules to digital assets, along with other changes, including addressing related party transactions in the wash sale rules, would raise \$23.5 billion over 10 years.<sup>108</sup>
- **Extending broker reporting to high-value art and antiquities transactions:** The opaque art and antiquities market facilitates tax and sanctions evasion and money laundering.<sup>109</sup> Under section 6045, brokers must provide information reporting on the gross proceeds of and gain or loss on dispositions of certain assets, including stocks, securities, and digital assets. It does not, however, currently apply to art and antiquities.<sup>110</sup> The Tax Law Center proposes that Congress extend broker reporting to art and antiquities to address their role in enabling tax evasion.

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<sup>107</sup> Sam Potter, Katherine Greifeld & Elaine Chen, [ETF Industry Risks Losing Key Tax Edge as Democrat Whets Knife](#), Bloomberg (September 14, 2021).

<sup>108</sup> Treasury, *supra* note 11 at 218.

<sup>109</sup> See, e.g., Graham Bowley, [As Money Launderers Buy Dalis, U.S. Looks at Lifting the Veil on Art Sales](#), New York Times (June 19, 2021); Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, [The Art Industry and U.S. Policies that Undermine Sanctions](#) 35-37 (July 27, 2020).

<sup>110</sup> Section 6045 gives the Secretary of the Treasury sufficient authority to require brokers to report the gross proceeds of transactions involving art and antiquities, but the Secretary has not exercised that authority. See 6045(a).