Trust, but Verify

by David Cay Johnston

Full Text Published by taxanalysts®

David Cay Johnston is a former tax reporter for *The New York Times*. He is also the author of two books about taxes: *Free Lunch* and *Perfectly Legal*.

* * * * *

New data, not yet published by the IRS, establish beyond a doubt that America has two income tax systems, separate and unequal. One system effectively taxes people with wages, while the other system is a sieve of untaxed income for investors and business owners.

The data show that 99 percent of wages people report on their income tax returns matches what employers list in verification reports. In contrast, the share of actual income from capital gains and business, which is not independently verified, is much less. Only about half of Schedule C profits show up on tax returns. And the new IRS data show that only 88 percent of capital gains is reported, a figure that almost certainly understates reality by a substantial degree.

Table 1. Net Misreported Percentages for Selected Line Items by Reported AGI and True AGI[a]

	Wages, Salaries, and Tips		**Capital Gains**		**Schedule C Income**	
AGI	**Reported AGI**	**True AGI**	**Reported AGI**	**True AGI**	**Reported AGI**	**True AGI**
No adjusted gross income	12%	-39%	34%	-15%	101%	-17%
$1 under $5,000	13%	3%	35%	-9%	90%	-16%
$5,000 under $10,000	9%	4%	18%	-18%	78%	15%
$10,000 under $15,000	6%	3%	59%	5%	76%	26%
$15,000 under $20,000	4%	2%	26%	8%	75%	38%
$20,000 under $25,000	3%	1%	22%	22%	74%	45%
$25,000 under $30,000	2%	3%	41%	3%	70%	48%
$30,000 under $40,000	1%	2%	25%	19%	69%	56%
$40,000 under $50,000	1%	1%	53%	17%	61%	58%
$50,000 under $75,000	1%	1%	23%	22%	57%	62%
$75,000 under $100,000	1%	1%	28%	17%	45%	61%
$100,000 under $200,000	#	1%	17%	18%	32%	62%
$200,000 under $500,000	#	1%	11%	24%	21%	55%
$500,000 under $1,000,000	#	1%	4%	18%	23%	58%
$1,000,000 under $2,000,000	*#	*#	#	10%	21%	52%
$2,000,000 or more	*#	*#	#	1%	19%	53%
Total	**1%**	**1%**	**12%**	**12%**	**57%**	**57%**

[table continued]

Total Income	**Tax After Refundable Credits**

AGI	Reported AGI	True AGI	Reported AGI	True AGI
No adjusted gross income	96%	-9%	99%	67%
$1 under $5,000	53%	2%	99%	74%
$5,000 under $10,000	38%	5%	92%	63%
$10,000 under $15,000	29%	4%	76%	43%
$15,000 under $20,000	22%	5%	62%	35%
$20,000 under $25,000	20%	5%	53%	24%
$25,000 under $30,000	17%	6%	42%	22%
$30,000 under $40,000	11%	7%	29%	19%
$40,000 under $50,000	10%	7%	25%	16%
$50,000 under $75,000	7%	8%	17%	15%
$75,000 under $100,000	5%	9%	12%	14%
$100,000 under $200,000	6%	13%	11%	18%
$200,000 under $500,000	8%	20%	12%	22%
$500,000 under $1,000,000	4%	21%	5%	21%
$1,000,000 under $2,000,000	2%	16%	3%	16%
$2,000,000 or more	1%	11%	2%	11%
Total	**11%**	**11%**	**18%**	**18%**

[a] Based on results from the Tax Year 2001 NRP Individual Reporting Compliance Study, adjusted for income not detected during audits.
* Based on fewer than 10 observations.
** Based on fewer than 3 observations.
# Rounds to zero.
Source: Tax Year 2001 Individual Income Tax Underreporting Gap Estimates by Selected Levels of True and Reported AGI.

The new data on taxpayer compliance, which the IRS provided to me ahead of official government publication, comes from the National Research Program Individual Reporting Compliance Study for 2001. Think of it as the successor to the old taxpayer compliance measurement program, known as the audits from hell because the unlucky selected for examination had to substantiate every line on their tax returns. The new system picked 46,000 taxpayers and asked them to verify only a few items on their returns.

The study is the first time in 20 years that we have statistically reliable estimates of tax cheating, rather than back-of-the-envelope tax gap estimates that Congress made necessary in 1995 by banning any more audits to verify every line on a tax return. Unfortunately, the new data also suffer from some flaws, including reliance on documents from taxpayers that may not be reliable.

IRS officials, who according to policy are not allowed to be identified, acknowledge that one weakness in the new data is that they rely on what taxpayers say is their basis, not a forensic examination of that evidence. Still, this is a significant breakthrough in understanding incomes and adds to the evidence of official favoritism to those at the top.

The IRS analyzed the statistics in an innovative way, looking not just at income classes by reported adjusted gross income levels, but also reanalyzing the same classes by "true" AGI levels. It is a revealing approach for which honest taxpayers owe a debt of gratitude in part to Joel Slemrod, the University of Michigan business school professor who has advised the IRS Statistics of Income Division on how to extract nuggets of insight from its mountains of data.

The data show large gaps between reported and true income for several groups. People with negative incomes appear to be a big problem, but get little audit attention because it is assumed they do not owe taxes. The data suggest this would be a fruitful area for SOI to examine further, especially by developing panel data tracking the same people who show up annually (full-time real estate professionals) or often (partnership investors, shell and bust-out company con artists).

The data also reveal problems, other than wage reporting, in the upper middle class, those in the six-figure income brackets.

The data reveal that the reported capital incomes of those in the middle class, from $40,000 to $75,000 or so, are distorted by people who fail to report their true income and thus appear to have far less income than they actually earned. This also appears to explain a seemingly bizarre report by the Joint Committee on Taxation last year that said that measured by dollars, most capital gains cheating was by people in the 10 percent and 15 percent tax brackets. Many of these people, the "true" AGI data suggest, should be in the 25 percent and higher brackets with at least six-figure incomes.

Table 2. Share of Item Specific Tax Gap for Selected Line Items by Reported AGI and True AGI[a]

	Wages, Salaries, and Tips		Capital Gains		Schedule C Income	
AGI	**Reported AGI**	**True AGI**	**Reported AGI**	**True AGI**	**Reported AGI**	**True AGI**
No adjusted gross income	1%	**	3%	**	5%	**
$1 under $5,000	2%	#	1%	**	4%	**
$5,000 under $10,000	6%	1%	#	*#	7%	#
$10,000 under $15,000	9%	2%	5%	#	7%	#
$15,000 under $20,000	10%	4%	2%	#	7%	#
$20,000 under $25,000	10%	3%	1%	1%	6%	1%
$25,000 under $30,000	8%	6%	3%	#	6%	1%
$30,000 under $40,000	11%	10%	3%	1%	9%	3%
$40,000 under $50,000	9%	8%	12%	1%	8%	4%
$50,000 under $75,000	11%	17%	10%	6%	15%	12%
$75,000 under $100,000	10%	11%	16%	6%	7%	11%
$100,000 under $200,000	7%	21%	21%	18%	10%	29%
$200,000 under $500,000	3%	13%	17%	32%	6%	23%
$500,000 under $1,000,000	#	3%	4%	19%	2%	8%
$1,000,000 under $2,000,000	*1%	*1%	#	11%	1%	4%
$2,000,000 or more	*#	*#	1%	4%	1%	4%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

[table continued]

	Total Income		Tax After Refundable Credits	
AGI	**Reported AGI**	**True AGI**	**Reported AGI**	**True AGI**
No adjusted gross income	6%	**	5%	#
$1 under $5,000	3%	#	3%	#
$5,000 under $10,000	4%	#	5%	1%
$10,000 under $15,000	5%	#	7%	2%
$15,000 under $20,000	6%	1%	7%	3%
$20,000 under $25,000	7%	1%	7%	2%

$25,000 under $30,000	6%	1%	6%	2%
$30,000 under $40,000	8%	3%	8%	4%
$40,000 under $50,000	8%	3%	8%	4%
$50,000 under $75,000	12%	10%	12%	10%
$75,000 under $100,000	7%	9%	7%	9%
$100,000 under $200,000	12%	23%	12%	21%
$200,000 under $500,000	11%	23%	10%	20%
$500,000 under $1,000,000	2%	10%	2%	9%
$1,000,000 under $2,000,000	1%	6%	1%	5%
$2,000,000 or more	1%	10%	1%	8%
Total	**100%**	**100%**	**100%**	**100%**

[a] Based on results from the Tax Year 2001 NRP Individual Reporting Compliance Study, adjusted for income not detected during audits.
* Based on fewer than 10 observations.
** Based on fewer than 3 observations.
# Rounds to zero.
Source: Tax Year 2001 Individual Income Tax Underreporting Gap Estimates by Selected Levels of True and Reported AGI.

This detail is significant because it suggests that the share of capital incomes -- gains, dividends, and interest -- going to the middle class and the poor is inflated in the standard SOI tables. If so, then the huge income gains going to those at the top in the past quarter-century are understated.

Now, how do we have two systems, separate and unequal?

Congress treats Americans who work for wages, claim deductions for spouses and children, collect interest and dividends, and withdraw from pension and retirement savings accounts the way Ronald Reagan said we should treat the Soviets on arms reduction: Trust, but verify.

Congress does not trust this vast majority of citizens to report their incomes honestly and, with good reason, demands verification by employers, banks, brokerages, and mutual funds, Congress also requires Social Security numbers for all dependents.

Business owners and investors are another story. Congress trusts them to fully and accurately report their revenues, their profits, and their capital gains and not to charge personal expenses as tax-deductible expenses.

For these favored citizens, there is no independent reporting, except for capital gains, in which only the amount realized at sale is reported and the individual is trusted to accurately report basis. Except for requiring audits, which are rarely performed today compared to two decades or more ago, Congress assumes that these taxpayers keep their books the same way Rome's vestal virgins retained their privileged status.

Predictably, taxpayers are no more virtuous than those vestal leaders who partied with some of the politically powerful while officialdom looked the other way. Such willful blindness is an eternal problem for the governed.

Tax unfairness clearly builds disrespect for government and can be seen as a subsidy of the richest among us financed by those further down the income ladder -- a subsidy the Bible describes as "evil."

An opportunity to end this unfairness is at hand, thanks to the big-spending ways of the Bush administration, which came into office with a nine-figure budget surplus and promised, but never delivered, fiscal restraint.

Fairness has chance to arise again because a great revenue hunt will have to begin once a new administration takes office.

The pressure to end this divide between the wage slaves and the ownership class should be intense in the wake of the news that next year's budget deficit is expected to reach a record $482 billion. Next year our government will spend $15,000 more every second than it levies in taxes, an amount almost identical to what Tax Foundation data show is the average annual income shown on tax returns for the bottom half of taxpayers in recent years. Interest on just next year's budget deficit will cost far more than running the IRS.

The current trend cannot continue, unless Americans are willing to look back on $4-a-gallon gasoline as a bargain and to give up on imported goods of all kinds because of the fast-weakening dollar.

Both presidential candidates have promised to weed out waste and abuse, a perennial promise by politicians and a central point of Republican candidate John McCain's economic promises. Now if political reporters on the campaign planes would just ask hard questions about taxes and spending instead of hunting for gaffes, the next president and Congress could be pressured to weed out officially enabled tax cheating for business owners and investors through verification and withholding, which encourages tax return filing.

"The takeaway point is that withholding and information reporting make all the difference," said Slemrod.

The professor does not believe the data indicate that the traditional SOI reports understate income inequality in a significant way. The problem I see is that to believe the new IRS data, you have to believe that among those with $2 million or more of "true" AGI, 99 percent of capital gains is reported correctly. Given that this group gets more than half of all reported capital gains, and given its access to sophisticated advice on how to minimize such gains, the 99 percent estimate is hard to swallow.

Jay Soled, a Rutgers University business professor and an expert on capital gains cheating, came to the same view after I showed him the new data. "The big numbers have to be at the top," Soled said. "We know the vast amount of cap gains are earned by high-income taxpayers, who use real property 1031 exchanges and partnership interests and who own limited liability companies and S corporations and have vast opportunities" to overstate basis and thus artificially understate gains.

Your thoughts? E-mail me at JohnstonsTake@tax.org.