Improving Tax Information Infrastructure

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The information reported on tax returns makes tax enforcement and inequality measurement possible. However, important holes remain in U.S. tax information infrastructure. This document lists reporting requirements and other changes that would substantially improve tax enforcement on high earners and large businesses, as well as substantially improve measurement of income, wealth, savings, and capital formation at the micro-level.

Business and trust ownership reporting requirements should apply to all sizeable businesses and trusts. Balance sheet reporting requirements already apply to most business entities and should be extended to all sizeable businesses and trusts. The wealth of the bottom 99% and racial inequality could be measured well with some modest additional information reporting.

We group our proposed changes into ten categories.

1. Ownership of C-corporations. Each year, sizeable private C-corporations (such as those with at least $250k in total assets or receipts, as in current balance sheet reporting requirements) should be required to list their owners and ownership stakes. Public C-corporations should be required to report owners with large stakes (1%+). This reporting could be done on a new schedule of Form 1120 that parallels the existing reporting requirement of ownership of officers (Form 1120, Schedule E).

Ownership reporting for C-corporations would bring C-corporations in line with S-corporations and partnerships (which already effectively report ownership on Schedule K-1) and is vital for tax enforcement and inequality measurement. Partnerships are often owned by corporations, and the lack of C-corporation ownership makes it challenging to trace ownership chains. Moreover, top income and wealth are likely to migrate to C-corporate form if the corporate tax rate remains substantially below top individual tax rate, which will exacerbate tax enforcement challenges under current reporting requirements.

Ownership reporting by taxpayers should be complemented by third-party information returns. All public companies and most large private companies have their stock ownership registered with the Depository Trust Company (DTC). The DTC should be required to file a new information return to the IRS that reports ownership of all its registered businesses. For the 4,400 public corporations, brokerage houses already report Form 1099-B for transactions of stock and should be required to report end-of-year holdings as well.

C-corporations have multiple classes of stock with complex rules, so a true accounting of value is difficult. However, our proposed reporting requirements would get Treasury most of the way.

2. Ultimate owners of partnerships. S-corporations and partnerships report ownership information on Schedule K-1. The K-1 system enables comprehensive enforcement and measurement of S-corporation owners, who must be U.S. individuals and are therefore easy to trace. In contrast, the K-1 system enables only limited enforcement and measurement of partnership ownership, because partnerships can be owned by foreigners and by business entities including other partnerships.

The holes in partnership reporting are large, as partnerships have developed opaque pyramidal structures that are often sandwiched with foreign entities or C-corporations. Cooper et al. (2016) show that 30% of partnership income cannot be uniquely attributed to owners. The problems documented by Cooper et al. and our solutions are two-fold.

First, 20% of partnership income is listed on K-1s as accruing to taxpayers whom the IRS cannot actually identify, most of whom are believed to be unidentified corporate owners and foreign owners. To address this first problem, the IRS should reject Schedule K-1 returns with a U.S. owner EIN that does not generate a match to the IRS's EIN database and should also require basic information (country and entity type) on foreign owners.

Second, another 10% of partnership income is earned in circular ownership structures: e.g., Partnership A partially owns Partnership B which partially owns Partnership C which partially owns Partnership A. Circular structures hide ultimate ownership (because ultimate ownership cannot be uniquely assigned to the individual partnerships) and may also hide income from taxation. To address this second problem, circular partnership ownership should trigger an automatic audit. More ambitiously but with historical precedent, partnership distributions to partnership owners could be assessed a small tax, similar to the intercorporate dividend tax in the 1930s that reduced the prevalence of C-corporate pyramids. Either approach would discourage opaque structures that obstruct tax enforcement and inequality measurement.

3. Balance sheets of private businesses incorporated abroad. Such businesses, even if they have US owners, are currently not required to report balance sheets to the IRS. As an example, Cayman Islands hedge funds currently provide no entity-level reporting, which creates a major statistical, tax, and regulatory loophole.

Following the existing model of foreign trusts with US beneficiaries, foreign private businesses with ultimate US owners should be required to report balance sheets to the IRS. Foreign businesses that are >90% owned by non-US taxpayers or have total assets below $250k could be exempted. The others should be required to report balance sheets just like domestic private businesses.

4. Balance sheets and beneficiaries of large trusts. Significant wealth at the top runs through trusts. Therefore, all sizeable trusts – those with assets above $1m or income above $20k, roughly the top 25% largest trusts – should be required to report their balance sheets and ultimate beneficiaries. Foreign trusts and trusts with any charitable purposes already report their balance sheets, just like all non-profit organizations.

5. Balance sheet line items. Business and trust balance sheets report market values of securities but only the book value of depreciable and depletable assets such as real estate or intangible assets. The IRS should add lines for reporting the market values of such assets as well.

Taxpayers should have to decompose the “Other current assets” line into marketable bonds, marketable equities, and non-marketable assets (namely private equities). Taxpayers should also have to decompose the “Other investments” line into other partnerships and other corporations.

6. Accounts balances. The IRS should extend the balance reporting requirement that already exists for IRAs (on Form 5498) and mortgages (on Form 1098) to other tax-preferred savings vehicles such as 401(k)s, regular taxable accounts such as mutual funds and brokerage accounts (which currently trigger Form 1099-DIV), and interest-bearing accounts (deposit and savings accounts which currently trigger Form 1099-INT). For 401(k)s, balance reporting would help enforcement of required distributions for those above age 70, which is the reason that IRAs already have this reporting requirement. For regular taxable accounts, balance reporting would help enforcement of the income tax as large accounts with small incomes would raise a flag. FATCA already imposes balance reporting requirements on foreign accounts for this reason.

7. Basis for purchase of assets. Whenever securities such as corporate shares are traded, the IRS should require that an information return be filed not only for the seller (as currently exists for capital gains tax purposes with Form 1099-B) but also for the buyer. The buyer’s information return would list the asset’s basis and would therefore aid capital gains tax enforcement down the line. Combined with account balances, this reporting would also allow to estimate savings and consumption at the micro-level; data on savings and consumption are very important but very limited in the US.

8. Real estate values and property taxes. There is no current information reporting for property taxes paid, which makes it difficult to enforce the property tax deduction for itemizers. The IRS should require local governments to file a new information return listing property tax paid, assessed value, and estimated market value for real estate. Monitoring real estate wealth is important to assess the financial security of American families.

9. Debt. Credit bureaus should report annual information returns listing debt at the end of the year by categories: mortgage debt, student debt, credit card debt, other debt. Alternatively, credit bureaus should share their information with the IRS so as to match debt to individual tax filers. Monitoring debt is critical to assess the financial security of American families.

10. Race. Measuring racial inequities in income and wealth require information on taxpayer race. However, the IRS currently does not collect race information. The Social Security Administration should be required to share its race information with the IRS. The information on pension wealth, real estate wealth, and debt is crucial to monitor the racial wealth gap.