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Avoiding Taxes Is Easy, When You Own a Business

TAX REPORT | **LAURA SAUNDERS**

Trump and Biden have something in common: It's hard to audit them.

For people who want to lowball their taxes, it helps to own a business. That can offer strategies for reducing what you owe Uncle Sam—and make you far harder to audit.

This has long been the case, but it's in the news again in a big way for President Trump, and a far smaller one for his opponent, former Vice President Joe Biden.

The tax spotlight is on Mr. Trump because the New York Times recently reported that it has obtained and analyzed years of his tax-return data despite his refusal to release it. The Times raised questions about his tax compliance, and Mr. Trump derided its reporting but provided no details. The Times's report hasn't been independently verified.

Mr. Biden, who has released years of returns, has been called out for employing a tax move the Obama administration wanted to end. In 2017 and 2018 he avoided as much as $500,000 of payroll taxes by minimizing the wages his business paid to himself and his wife. On the 2019 return the payroll tax avoidance shrank to less than $10,000.

The Biden campaign has said the salaries earned by the Bidens "are reasonable and were determined in good faith." Other presidential candidates have used the same tax-minimizing strategy.

As different as Mr. Trump and Mr. Biden are, as business owners they have something in common: It's difficult for the Internal Revenue Service to audit them. Proposals are now surfacing to make it easier.

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on reasonable compensation and avoid IRS scrutiny.

Yet even if a business owner flouts the law in this area, the IRS may not challenge it. Unlike with, say, some tax shelters, a win in a compensation dispute may not help the agency prevail in other cases because each is so specific.

Other business-income issues posing challenges for IRS auditors are legal expenses, valuations, personal use of business property and compensation paid to family members. These areas have come up in reports on Mr. Trump's and his family's taxes, and each likely requires a deep, labor-intensive dive into a business's records.

The IRS is also short-staffed. According to a Congressional Budget Office study released in July, To understand what's in play, start with the "tax gap"—the IRS's estimate of taxes it thinks are owed but not paid. Overall it will be at least $600 billion this year, according to updates of the latest IRS data by former IRS Commissioner Charles Rossotti and others. That's more than all individual income taxes paid by the lowest-earning 90% of filers, says Mr. Rossotti, who is an adviser to Carlyle Group on technology investments.

According to the IRS, the single largest element of the tax gap is individual income taxes owed but not paid by owners of closely held businesses. Mr. Rossotti calculates that 11 million of the highest-income business owners account for about 30% of the overall tax gap, or about $200 billion of lost revenue this year.

Why is the tax gap so high for these filers? For one thing, their returns differ from those of taxpayers with income mostly from wages, retirement- plan payouts, dividends and the like. These types of income are reported to the IRS by entities such as employers or financial firms, and the agency's computers will likely catch a discrepancy if the individual filer omits income. The IRS estimates that 5% or less of this income goes unreported.

By contrast, business owners determine how much income they report to the IRS, often with little independent corroboration. This makes it easier to lower—or outright cheat on—taxes. The agency estimates that up to 55% of business income is unreported or misreported.

"For business owners, a tax return can be an opening bid with the IRS," says Michael Graetz, a former Treasury Department official now teaching at Columbia University's law school.

Often these taxpayers and their advisers have to make judgment calls. For example, owners of pass-through firms like Mr. Biden and Mr. Trump typically must divide their business income between the portion that's their pay—with Social Security and Medicare taxes due—and the portion that doesn't incur these taxes. Many owners want to lower pay to save on taxes, while tax preparers push for higher pay to the number of revenue agents handling complex enforcement fell by 35%, to about 9,000, between 2010 and 2018. Audits, especially of high-income taxpayers, dropped as well.

Given the U.S.'s growing budget deficit, there are calls to reduce the tax gap by increasing IRS enforcement funding. The CBO study estimated that a $20 billion investment could raise $61 billion of revenue over a decade, while University of Pennsylvania economist Natasha Sarin and former Treasury Secretary Lawrence Summers say the return on a $100 billion investment would be $1.1 trillion over a decade. Mr. Rossotti envisions a far higher return: $1.6 trillion over a decade on a $64 billion investment that includes major new technology. His detailed proposal to achieve this, which he says he has been mulling since he was IRS commissioner, would require 11 million business owners to give bank-account information to the IRS and reconcile the account with their tax returns. This and other measures would give the agency a strong head start in finding unreported business income, he says. The bank-account requirement would apply to businesses owned by individuals with more than $25,000 of gross revenue, exempting about 70% of owners. Mr. Rossotti estimates it would increase these owners' tax-prep time by 20%, or about 90 minutes.

As welcome as extra revenue would be, the future of this and other enforcement proposals is far from certain. Congress has reduced IRS funding and backed off past compliance efforts that owners of closely held businesses called burdensome.

Mr. Rossotti thinks the time is ripe for new IRS enforcement: "Politicians have tax plans, but shouldn't we collect the taxes already on the books?"

comply with unclear laws

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