# “Income Tax Compliance and the Black-White Wealth Gap”

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## Abstract

The purpose of this research is to examine the anatomy of discriminatory tax compliance outcomes and to assess the magnitude of their economic impact on the Black-White wealth gap. We find that proprietorships have a long and consistent history as the most noncompliant of the three major classes of individual income taxpayers: (1) wage and salary earners; (2) recipients of property income from corporations (mainly interest and dividends); and (3) operators of proprietorships and partnerships. Black American income taxpayers are highly underrepresented among proprietorships and overrepresented among wage earners. Consequently, Black Americans experience relatively lower levels of after-tax, disposable income, which contributes to the Black-White wealth gap.

## 1.0 Introduction

1.1 The U.S. Government has detailed historical knowledge of income tax compliance differences between various sources of income. Wage and salary earners know that information returns precede their tax filing with the Internal Revenue Service (IRS), and they respond with high-level compliance. Because shareholders are the residual claimants for corporate income, corporate employees have little incentive to misreport corporate income. The IRS also receives information returns for partnerships; therefore, noncompliance on partnership income is constrained. However, the IRS receives no information returns for income earned by operators of proprietorships, and this class of income taxpayers is the least compliant.

1.2 In order to practice fairness, should not the government enforce compliance evenhandedly vis-à-vis the three main classes of income taxpayers: (1) Wage and salary earners; (2) recipients of property income from corporations; and (3) operators of proprietorships and partnerships? If it does not, then is government discriminating? Finally, if discrimination is occurring, does it impact mainly a class of taxpayers in which Black Americans are disproportionately represented (i.e., wage earners)? If so, then tax compliance discrimination could be an important contributor to the Black-White wealth gap.[1]

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## 2.0 Material and methods

2.1 This research flows mainly from existing statistics on tax compliance; from efforts by the U.S. national accountants (the U.S. Department of Commerce, Bureau of Economic Analysis (BEA)) to prepare comprehensive estimates of gross domestic income; from examination and interpretation of the "equal protection" clause of the U.S. Constitution; and from computations of hypothetical tax liabilities using 2009 U.S. Federal Income Tax Returns.

2.2 U.S. Government information on the history and current state of tax compliance is primarily the product of the Statistics of Income (SOI) Division of the Internal Revenue Service (IRS), U.S. Department of the Treasury.[2] The statistics provide evidence that the proprietorship class of income taxpayers has a long history of being the most noncompliant of the three major classes of income taxpayers.

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[1] See Oliver and Shapiro (2006) for an extensive analysis of the Black-White wealth gap.

[2] For details on SOI tax statistics and IRS operations, budgets and compliance, visit; http://www.irs.gov/taxstats/compliancestats/article/0,,id=131661,00.html.

2.3 BEA uses SOI's findings in its preparation of gross domestic income, and reflects the value of misreporting on its National Income and Product Account (NIPA) reconciliation tables.[3] For example, NIPA Table 7.18 reports that 2008 wages and salaries of $6,141.8 billion was adjusted by $91.1 billion (1.5%) to account for income misreporting. NIPA Table 7.14 reports that 2007 proprietorship and partnership net profits (less losses) of $626.5 billion was adjusted by $494.6 billion (78.9%) to account for misreporting. Finally, NIPA Table 7.16 reports that 2006 corporate total receipts less deductions of $1,900.3 billion was adjusted by $300.0 billion (15.8%) to account for misreporting.

2.4 The "equal protection" clause in the 14th Amendment to the U.S. Constitution requires that the U.S. Government ensures equal protection for each of its citizens. However, equal protection should not be misconstrued to mean "equal treatment." There is no constitutional provision for equal treatment. Is it reasonable that citizens should expect laws and regulations to be applied equally and without bias? Equal treatment would go a long way toward producing equal outcomes. Certainly, failure by a U.S. Government agency—in this case the IRS—to create equal outcomes for different classes of taxpayer citizens may be viewed as discriminatory.

2.5 To show the disparate outcomes that result from the U.S. Government's uneven enforcement of tax compliance for the three main classes of income taxpayers, we first provide the following information about all U.S. and Black-owned firms:

- 2.5.1 According to the Table 728 of the U.S. Census Bureau (2010) *Statistical Abstract*, there were 18.9 million proprietorships, 2.2 million partnerships, and 5.3 million corporations in 2002.
- 2.5.2 According to Table 1 of the U.S. Census Bureau (2006) report on *Black-Owned Firms*, there were 1.2 million Black firms of all types in 2002.
- 2.5.3 For 2002 and across the three main types of business establishments (proprietorships, partnerships, and corporations), Black firms comprised just 4.5 percent of all U.S. firms. Average (mean) sales and receipts of Black firms ($74,018) was just 8.7 percent of the average receipts for all U.S. firms ($852,960). Blacks were significantly underrepresented in number and in the value of average receipts because they accounted for 13% of the population in 2002.[4]

2.6 Considering the relatively small number of Black firms and the small value of their receipts in the context of tax noncompliance, what are the tax implications for Black Americans? In response to this question, we make the following assumptions and perform the following computations for individual taxpayers that derive income from the three major classes of firms:

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[3] For an early and thorough analysis of BEA's use of SOI tax compliance data, see Parker (1984).
[4] The population percentage is from the U.S. Bureau of the Census (2003).

2.6.1 We assume that the three taxpayers have the following actual sources of taxable income: Taxpayer 1 has income from employment ($50,000 in wages); Taxpayer 2 has property income in the form of distributions from corporations ($25,000 in interest income and $25,000 in ordinary dividend income); and Taxpayer 3 has entrepreneurial net income ($50,000 from a proprietorship).

2.6.2 We assume that the three taxpayers report the following adjusted gross income to the IRS, which is consistent with a U.S. Department of the Treasury (2007) study for tax year 2001.[5] Taxpayer 1 reports 98.8% of the wages—the employer transmits a W-2 information return to the IRS. Taxpayer 2 reports 96.35% of the interest and dividend income—the distributing corporations provide Forms 1099-INT and 1099-DIV information returns the IRS. Taxpayer 3 reports 42.9% of the proprietorship net income to the IRS—the IRS receives no information return from the proprietorship.

2.6.3 We compute tax liabilities for the three taxpayers using IRS Form Schedule 1040.

## 3.0 Theory and computation

3.1 Why have differing levels of income tax compliance evolved and why are varied compliance requirements imposed? First, different classes of taxpayers are associated with differing capacities to lobby (rent seek) the U.S. Congress to shape the outcomes that are desired. Whereas many corporations have the resources to lobby congress directly for favorable tax provisions, lone non-corporate firms may not possess such capacity.[6] However, many small entrepreneurs form associations and pool resources to lobby Congress for favorable tax provisions or to minimize enforcement of tax laws.

3.2 Second, technological developments enable the IRS to enforce tax compliance through differing requirements. For example, government regulation of a relatively small number of corporations that were large employers with large receipts initially enabled paper reporting to the IRS of employee wages and salaries and interest and dividend distributions. Today this reporting occurs electronically, and these information return reporting requirements have been extended to proprietorships and partnerships.

3.3 Although the technology is available to impose greater compliance on proprietorships and partnerships, the U.S. Government has not required that these firms report sales and/or receipts automatically and electronically. Just as corporate firms include computerized and automated systems for reporting receipts (especially in retail establishments), a similar type of system could be operationalized for proprietorships

[5] The U.S. Department of the Treasury (2007) reports the following "net misreporting percentages" for 2001: Wages, salaries, and tips – 1.2%; interest and dividend income - 3.6% and 3.7%, respectively; and nonfarm proprietor income – 57.1%.

[6] Corporate employees serve as the agents of shareholders, who require that net income is optimized. This is achieved by corporate lobbying of Congress for favorable tax provisions. For corporations, fully legal and favorable tax provisions replace illegal income misreporting as a method for ensuring that shareholders receive optimal income from investment.

and partnerships to report to the IRS. Admittedly, small firms could configure two cash registers: One “on the books” and one “off the books.” Unfortunately, such reporting requirements would constitute only a partial solution to the tax compliance problem. The problem of accurate reporting of expenses would remain.

3.4 We compute income tax liabilities for the aforementioned three taxpayers. For simplicity we assume that all three taxpayers are single, were born after 1950, have no other sources of income, do not itemize deductions, and misreport their income at the rates identified by the U.S. Department of the Treasury (2007). We use standard methods for computing tax exemptions and tax liabilities.

4.0 Results/Discussion/Conclusion

4.1 Table 1 provides the results of our tax liability calculations:

Table 1.—Tax Liability Calculations for Three Taxpayers

| Categories | Taxpayer 1 | Taxpayer 2 | Taxpayer 3 |
|---|---|---|---|
| Actual adjusted gross income/net income | $50,000 | $50,000 | $50,000 |
| Reported adjusted gross income/net income | $49,400 | $48,175 | $21,450 |
| Standard deduction | $5,700 | $5,700 | $5,700 |
| Personal exemption | $3,650 | $3,650 | $3,650 |
| Table income | $40,050 | $38,825 | $12,100 |
| Tax liability | $6,194 | $5,894 | $1,394 |
| Disposable income | $43,806 | $44,106 | $48,606 |

4.2 Table 1 reveals that Taxpayer 3 risks misreporting income and walks away with a $4,800 lower tax liability and higher disposable income than Taxpayer 1. This outcome is likely to prevail as long as Taxpayer 3 maintains an accounting system that is consistent with tax reporting, and as long as that tax reporting is consistent with norms that are reflected by proprietorships that operate in the same or similar industries and in locations with comparable characteristics.

4.3 The higher level of disposable income for Taxpayer 3 is substantial and can be wealth expanding. Assuming that Taxpayer 3 is White and Taxpayer 1 is Black, a head-to-head comparison shows that Taxpayer 3 is in a much better financial position than Taxpayer 1 on an after-tax basis. If this type of outcome is pervasive and persistent over time, it clearly helps explain how and why the Black-White wealth gap exists and persists. In a report on the 2007 *Consumer Finance Survey*, Bucks *et al* (2009) report that median White household net worth was $170,400 compared with $27,800 for non-White households.[7] This $142,600 net worth or wealth gap would be accounted for in a little less than 30 years based on the hypothetical outcomes that are highlighted in Table 1.

[7] Black households are included in this latter category and they reflect even lower median net worth.

## 5.0 References


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