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Wendy Walker • Sep. 16, 2019

A recent inversion in the yield curve, historically a sign that a recession is on the way, has experts talking about a downturn and companies preparing for one.

One aspect of an economic slowdown companies are prone to overlook involves taxes. Recessions tend to widen the tax gap, essentially the difference between how much taxpayers owe and how much they actually pay. An increase in the tax gap would almost assuredly lead to more severe IRS enforcement of tax reporting compliance, which would have ramifications for both companies and individual

Committee's May report determined that the increase in the tax gap in the last recession was not due to a drop in the voluntary compliance rate, or VCR, of taxpayers. Most taxpayers were still willing to pay what they owed.

So, what did cause a widening of the gap? Tax reporting, or lack thereof, played a critical role. The Committee report suggests that 84 percent of the tax gap for the periods of 2008-2010 was attributed to underreporting of income, most of which is subject to little or no tax information reporting, mostly from self-employment. It's the type of income reported on Forms 1099.

Tax information reporting by companies, therefore, will be critical to narrowing the tax gap in the next recession. Evidence suggests that taxpayer compliance rates hover around 82 percent when income is reported to the IRS on an information return. Taxpayers pay taxes on reported income. They're less likely to pay taxes on income the IRS doesn't know exists. In need of revenue, the IRS will very likely focus even more on enforcing reporting regulations during a recession than it does when the economy is strong.

Tax information reporting enforcement during an economic downturn

One potential avenue the IRS could take for keeping the tax gap minimal, as mentioned specifically in the Committee's report, would be to focus on 1099-K reporting. Third-party settlement organizations such as ride-share and home-share services use the 1099-K to report payments to service providers.

The IRS is somewhat handcuffed by the high threshold for reporting a 1099-K, currently set at $20,000 and 200 transactions per year. But if Congress decides to lower the threshold, as some states already have, the result would be a revenue boon for the IRS and could provide a major boost for closing the tax gap during a recession.

Self-employment income of the type reported on the 1099-K has grown rapidly since

compliance with crypto tax regulations.

Significant gaps in reporting of crypto gains and losses could be contributing upwards of $25 billion a year to the tax gap, and the IRS has already promised forthcoming guidance to help enforce compliance. Like ride-share drivers, crypto asset owners could find some new forms in the tax information they receive in January. In turn, crypto trading exchanges will almost certainly have to deal with significant increases in reporting volume.

Of course, in a pinch for revenues, the IRS is likely to step up enforcement of 1099 reporting in general, including the 1099-MISC and, as soon as it comes into use, the 1099-NEC. Increased backup withholding enforcement, launched by IRS in July this year is already targeted at the 1099-MISC and will continue to grow as the program expands to add more Forms 1099 to the penalty process.

Preparing for tax in a period of recession

Making sure that tax reporting processes are centralized and automated should be a priority for companies in preparing for a recession. Spikes in form volume could catch unprepared companies off guard and leave them vulnerable to reporting errors and penalties. During a recession, when every penny is precious, expensive nuisance costs such as IRS penalties are the last expenses a company wants to incur.

Moreover, recessions inevitably lead to a reduction in headcount. Those without centralized and automated reporting processes will very likely suffer from inefficiency, leading to reporting delays and errors, and ultimately to penalties. Hiring and paying experienced professionals to react to and implement regulatory changes will not be financially feasible, so finding alternative methods to track and implement changes to mandates is critical to avoiding risk.

A strong economy presents an opportunity to get tax information reporting under

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