I. Executive Summary and Introduction

President Biden recently proposed the American Families Plan, advancing comprehensive and necessary investments in American children and families. To help support this important agenda and increase fairness in the tax system, the President also proposed a set of tax compliance measures to foster a tax system where Americans pay the taxes they owe.

This report describes the President’s tax compliance initiatives that seek to close the “tax gap”—the difference between taxes owed to the government and actually paid. According to Treasury analysis, the tax gap totaled nearly $600 billion in 2019 and will rise to about $7 trillion over the course of the next decade if left unaddressed—roughly equal to 15% of taxes owed. These unpaid taxes come at a cost to American households and compliant taxpayers as policymakers choose rising deficits, lower spending on necessary priorities, or further tax increases to compensate for the lost revenue.

The magnitude of the tax gap means that compliance initiatives have the potential to raise substantial revenue, but these reforms also improve tax progressivity and economic efficiency. While roughly 99% of taxes due on wages are paid to the Internal Revenue Service (IRS), compliance on less visible sources of income is estimated to be just 45%. The tax gap disproportionately benefits high earners who accrue more of their income from non-labor sources where misreporting is common. Further, the tax gap imposes distortions because of the resources some expend to avoid paying taxes and the incentives created to shift economic activity into certain areas where tax liabilities can be illegally evaded.

To raise revenue, improve efficiency, and build a more equitable tax system, investments in tax compliance are of first order importance. The compliance proposals in the American Families Plan provide the IRS with the resources and information it needs to overhaul and enhance tax administration. These policy changes are integral to addressing evasion, but they also prioritize improving taxpayer service and the experience of Americans as they navigate the tax system. Taxpayers would benefit from effective communication with the IRS, access to the tax credits to which they are entitled, and competent assistance as they file their taxes.

The President’s compliance agenda has several transformational elements:

1. **Provide the IRS the resources it needs to address sophisticated tax evasion.** The first step in the President’s tax administration efforts is a sustained, multi-year commitment to rebuilding the IRS, including nearly $80 billion in additional resources over the next decade. The IRS would grow manageably (no more than around 10% annually) but also have certain funding in place to make investments with large fixed costs—like modernizing information technology, improving data analytic approaches, and hiring and training agents dedicated to complex enforcement activities. This would make up the ground that the IRS has lost over the last decade. During this time, the IRS budget fell by about 20%, leading to a sustained decline in its workforce particularly among specialized auditors who conduct examinations of high-income and global high net worth individuals and complex structures, like partnerships, multi-tier pass-through entities, and multinational corporations.

2. **Provide the IRS with more complete information.** When the IRS can verify taxpayer filings with third-party information reports, such as the W-2 forms submitted by employers to report wages, compliance rates exceed 95%. Without third-party reporting, compliance rates fall below 50% and thus lead to an inequitable asymmetry in tax collections depending on the form in which income is accrued. The Government Accountability Office (GAO) and IRS agree that strengthening third-party reporting is one of

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the most effective ways to improve tax compliance. The President’s proposal leverages the information that financial institutions already know about the accounts that they house. Financial institutions would add information about total account outflows and inflows to existing reporting on bank accounts. Importantly, there are no added requirements for taxpayers. The IRS will be able to deploy this new information to better target enforcement activities, increasing scrutiny of wealthy evaders and decreasing the likelihood that fully compliant taxpayers will be subject to costly audits. As a result, voluntary compliance will rise through deterrence as would-be tax evaders realize that the IRS has an additional lens into previously unreported income streams.

3. **Overhaul outdated technology to help the IRS identify tax evasion and serve customers.** The IRS still relies on Individual and Business File Systems that date back to the 1960s—the oldest in the federal government. The result is decades upon decades of tax administration built upon a system that is written in a programming language that is no longer taught, and where new functions are added in a patchwork rather than integrated manner. Modernization funding would allow the IRS to address technology challenges and develop innovative machine learning that can be deployed to better identify suspect tax filings, for example, by comparing returns to similarly situated taxpayers and historical filings in a way that the current IRS ecosystem does not allow. These resources would also support efforts to meet threats to the security of the tax system, like the 1.4 billion cyberattacks the IRS experiences annually. With a revitalized IRS, taxpayers would also be able to communicate with and receive guidance from the IRS in a clear, timely manner when questions arise. Further, modernized IT would help improve taxpayer service and ensure that the IRS is able to effectively and efficiently deliver tax credits to eligible families and workers, including recent expansions to the Child Tax Credit, the Earned Income Tax Credit, and the Child and Dependent Care Tax Credit proposed in the American Families Plan.

4. **Regulating paid tax preparers and increasing penalties for those who commit or abet evasion.** Taxpayers often make use of unregulated preparers who lack the training to provide accurate tax assistance. These preparers submit more returns than all other preparers combined, and taxpayers rely on their guidance, in part because of challenges in reaching the IRS in a timely manner when questions arise. In addition to the regulation of paid preparers and service improvements that would simplify tax filing, the President’s proposal includes additional sanctions for so-called “ghost preparers” who fail to identify themselves on the tax returns which they prepare.

Experts at the Treasury Office of Tax Analysis estimate that these initiatives would raise $700 billion in additional tax revenue over the next decade. This revenue is backloaded in the 10-year budget window as several of these new investments—such as hiring revenue agents capable of complex global high net-worth examinations and building the technological infrastructure to support a new information reporting regime—take years to reach their full potential. As Figure 1 shows, the revenue raised in the second decade amounts to $1.6 trillion.

These estimates are conservative because the revenue potential of additional resources for tax administration is based on return on investment (ROI) estimates from the IRS that only exist for adjustments detected through current enforcement-related activities. Benefits of other foundational shifts in tax administration that would result from this proposal—for example, overhauling and integrating IT systems and restoring trust in the IRS through timely support for taxpayers—are also unaccounted for. Moreover, although revenue estimates for increased information reporting include the effects of this regime on voluntary compliance, estimates for increased enforcement actions do not account for deterrent effects, which are generally considered qualitatively significant.
II. Defining and Measuring the Tax Gap

A well-functioning tax system requires that taxpayers make good on their tax obligations. An important measure of our tax system’s administrative effectiveness is the “tax gap”—the aggregate difference between federal taxes owed and taxes paid voluntarily and on-time. The size of the tax gap has meaningful implications for fiscal policy, while the distribution of the tax gap across income levels has important consequences for tax progressivity.

The IRS periodically releases estimates of the federal tax gap. The most recent estimates, covering years 2011–2013, showed an average gross tax gap of $441 billion annually. After late payments and enforcement efforts are factored in, the net tax gap over this period is estimated at $381 billion. Extrapolating for growth in the intervening years, for tax year 2019, the gross tax gap was estimated at $584 billion, and is on pace to total $7 trillion over the course of the next decade. This is almost 3% of GDP on an annualized basis. These estimates imply a voluntary compliance rate of around 84%, and a net compliance rate of around 86%.

The tax gap has three distinct elements: taxpayers who fail to file returns in a timely manner (the “nonfiling” tax gap, around 9% of the gross tax gap); those who underreport income or overclaim deductions and credits on tax returns (the “underreporting” tax gap);

2 The voluntary compliance rate is defined as the amount of taxes paid “voluntarily and timely” divided by “total true tax,” and corresponds to the gross tax gap. The net compliance rate is higher because it is the ratio corresponding to the net tax gap, after “enforced and other late payments” are added to the numerator of this ratio. Greater enforcement efforts increase both the voluntary compliance rate and taxes collected through enforced and other late payments. Ibid.

3 The IRS tax gap report shows that average annual federal taxes owed and voluntarily paid on time for 2011–2013 were about $2,242 billion and total estimated annual tax liability was about $2,683 billion, for a voluntary compliance rate of about 84%. This rate has been relatively constant since the 1970s. Ibid.
and those who underpay taxes despite reporting obligations in a timely manner (the “underpayment” tax gap, around 11%). By far the largest contributor to the tax gap is the underreporting gap—around 80%.[4]

### Table 1: Tax Gap Estimates over Time

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Estimated Total True Tax</td>
<td>$2,683</td>
<td>$3,589</td>
<td>$3,635</td>
</tr>
<tr>
<td>Gross Tax Gap</td>
<td>$441</td>
<td>$584</td>
<td>$630</td>
</tr>
<tr>
<td>Nonfiling Tax Gap</td>
<td>$39</td>
<td>$52</td>
<td>$52</td>
</tr>
<tr>
<td>Underreporting Tax Gap</td>
<td>$352</td>
<td>$466</td>
<td>$512</td>
</tr>
<tr>
<td>Underpayment Tax Gap</td>
<td>$50</td>
<td>$66</td>
<td>$66</td>
</tr>
<tr>
<td>Voluntary Compliance Rate</td>
<td>83.6%</td>
<td>83.7%</td>
<td>82.7%</td>
</tr>
<tr>
<td>Enforced and Other Late Payments</td>
<td>$60</td>
<td>$76</td>
<td>$76</td>
</tr>
<tr>
<td>Net Tax Gap</td>
<td>$381</td>
<td>$508</td>
<td>$554</td>
</tr>
<tr>
<td>Net Compliance Rate</td>
<td>85.8%</td>
<td>85.8%</td>
<td>84.8%</td>
</tr>
</tbody>
</table>

[1] Estimates based on applying the tax gap projection technique (which assumes constant compliance rates by major component of income) to the TY 2011-2019 IRTF and BRTF data.

[2] Estimates based on adjusting compliance rates for Guyton et al. (2021) estimate that the published tax gap was understated by an annual average of $33 billion (in 2012 dollars) in underreported income from offshore wealth and passthrough entities in TY 2006-2013, then applying constant compliance rates by major component of income.

Many attempts to assess the tax gap rely on a sample of random audits that the IRS undertakes to estimate the share of unpaid taxes. The most prominent of these studies examines individual income tax returns. Such random studies are generally thought of as the “gold standard” for understanding tax evasion. However, these audits can struggle to capture the full extent of tax evasion for high-income taxpayers because sophisticated taxpayers and those who advise them are well-positioned to shield unpaid taxes from audit detection.[5] This has led some scholars to suggest that the results from studies based on IRS “National Research Program” (NRP) random audit data may not satisfactorily capture tax evasion by the very wealthy taxpayers, and that tax gap estimates are significantly understated because they do not fully reflect this sophisticated evasion.[6]

The IRS attempts to mitigate this by adjusting for income undetected by audits through “Detection Controlled Estimation” (DCE), a methodology under which detected evasion is used to estimate the magnitude of undetected evasion. DCE adjustments are intended to bring the amounts of estimated non-compliance in line with the amounts detected by the most specialized auditors. In the aggregate, these adjustments roughly triple the estimated amount of unreported income. But even DCE estimates may not fully account for the most sophisticated evasion techniques, undetected income, and unidentified emerging issues. One estimate of the

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[4] Ibid.

[5] For example, capital income accruing to offshore accounts have until recently not been subject to reporting requirements that make them easily traceable in audits. In addition, passthrough income accrues disproportionately to high earners and can be challenging to attribute to its ultimate owner.

The magnitude of this issue is shown in Table 1, which illustrates that adjusting the tax gap for passthrough and offshore evasion increases the tax gap significantly.

Research also finds that underreporting tends to rise with income when taxpayers are ranked by their total income, including the unreported amount. In part, tax evasion rises with higher incomes because higher-income taxpayers have sophisticated accountants and tax preparers who can stake out aggressive tax positions that can help shield true tax liability. And because the IRS lacks the number of specialized auditors needed to adequately detect and pursue these instances of noncompliance, the consequences of tax underpayment are perceived to be minor, and voluntary compliance rates are lower.

But the distribution of the underreporting tax gap is also a byproduct of the current information reporting regime. For some, but not all, categories of income, the IRS can crosscheck taxpayer filings because it receives information reports from third parties, like employers, and this information can be used to verify that taxpayers are accurately reporting income and deductions. When taxpayers know that their tax information is being reported to authorities, their voluntary compliance rate increases.

For ordinary wage and salary income, where employers share a Form W-2 with both employees and the IRS (as well as automatically withhold income taxes), compliance is very high, with only an estimated 1% misreporting rate. As Figure 2 shows, compliance drops off with a decline in third party information reporting. For income subject to substantial information reporting, but not withholding, estimated misreporting rates are 5%. For income subject to some limited information reporting, misreporting rises to 17%. In stark contrast, for opaque income sources that accrue disproportionately to higher earners—like proprietorship income and rental income—misreporting is estimated to be 55%. The IRS and GAO have identified increased information reporting as one of the best ways to improve taxpayer compliance because providing the IRS with a lens into opaque income sources both improves enforcement activities and encourages voluntary compliance by taxpayers who perceive that the IRS has information necessary to pursue them should they not meet their tax obligations.

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Although less is known about the distribution of the nonfiling and underpayment tax gaps, a recent Treasury Inspector General report highlights the importance of high-income nonfilers as contributors to the tax gap. The report notes that since 2010, the estimated number of high-income non-filers has risen by nearly 50% as a resource-constrained IRS lacked the ability to pursue all of these cases. Between 2014–2016, the Inspector General’s report identified nearly 900,000 high-income nonfilers, of which 400,000 cases (44% of cases) were never investigated due to resource constraints. Of these 400,000 cases, 300 of the most egregious evaders cost the federal government $10 billion in unpaid tax liabilities over this period.

The IRS is already working to address this issue: In 2018, it established a program to pursue all high-income nonfilers for tax years from 2016 through 2019, and it intends to select all high-income nonfiling cases for enforcement action for tax years 2020 and beyond.

### III. IRS Challenges with Compliance

Given the current magnitude of the tax gap in the United States, large compliance initiatives will have benefits that far exceed costs. One illustration of the large potential return on these resource investments is provided by the IRS, which estimates that $1 spent on tax enforcement typically yields at least $4 in direct revenue (for example, increased tax payments collected from high-income filers).

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**Figure 2: Misreporting by Income Category**

- **Income Subject to Information Reporting and Withholding**: Includes wages and salaries.
- **Income Subject to Information Reporting**: Includes pensions and annuities, unemployment compensation, dividend income, interest income, and taxable Social Security benefits.
- **Income Subject to Some Information Reporting**: Includes partnership/S corp income, capital gains, and alimony income.
- **Income Subject to Little or No Information Reporting**: Includes nonfarm proprietor income, other income, rents and royalties, farm income, and Form 4797 income.

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10  A high-income nonfiler is any nonfiler with total income greater than or equal to $100,000.

11  TIGTA, 2020. “High-Income Nonfilers Owing Billions of Dollars Are Note Being Worked by the Internal Revenue Service,” 2020-30-015. Since 2020, the IRS has committed to a new strategy for handling non-filing cases and aims to prioritize those involving high-income taxpayers (see Eric Hylton, “How the IRS Prioritizes Compliance Work on High-Income Non-Filers Through National and International Efforts,” CL-20-08, IRS.)
The direct increase in additional tax revenue that the IRS is able to collect from compliance efforts does not include the indirect effects of greater enforcement activities, as evidence suggests that taxpayers are more likely to be compliant in the presence of visible, robust enforcement efforts.

Technology (and, in theory, the ability to detect tax evasion) has developed significantly in recent years. In the late 1990s, only about 10% of individual income tax returns were filed electronically and the vast majority of the IRS’s enforcement activities focused on returns filed on paper. The Internal Revenue Service Restructuring and Reform Act of 1998 helped change this by setting an ambitious goal of reaching an 80% electronic filing rate over the course of the decade following 1998. The IRS furthered the transition away from paper returns by providing electronic filing options for all of the major tax filing categories, and by 2011, the electronic filing rate for individual income tax returns was 78% and continued to rise to 93% in 2019. For business returns, the electronic filing rate has more than doubled (from 33% to 70%) since 2011.

Enhanced electronic filing should help the IRS improve compliance in an efficient manner. In addition to reducing processing burden, data from electronically filed returns are easier to match against data contained on third-party information returns, prior year’s returns, and similarly situated returns to help identify the most productive tax returns to audit. This work can also help avoid unnecessary, costly and burdensome audits of compliant taxpayers. Yet, tax compliance has not improved. This is because the IRS operates outdated systems and lacks the ability to fully take advantage of the benefits of more modern technology due to its resource constraints. Further, noncompliance has been exacerbated by enhanced opportunities to shield income from tax liability, and even from audits. These opportunities are particularly available for those in the top end of the income distribution who can avoid taxes through sophisticated strategies such as offshoreing, creating complex partnership structures, or moving taxable assets into the crypto economy.

12 IRS estimates. For direct enforcement agents and associated staffing, the ROI is much higher. The IRS provides a range of ROI estimates for different types of activities, informed by how collections have risen historically across categories. These range from 2 to 11, and increase over time as new initiatives become more productive. IRS, 2020. “Congressional Budget Justification & Annual Performance Report and Plan.” Publication 4450 (Rev. 2-2020).
13 GAO, 2019. “Multiple Strategies are Needed to Reduce Noncompliance: Statement of James R. McTigue, Jr., Director, Strategic Issues.”
14 The difficulty of tracking down offshore income is why some countries have adopted amnesty agreements that incentivize individual taxpayers to voluntarily disclose foreign wealth. These tend to increase tax revenue, reflecting a large gap between true taxable income and what is taxed. Langenmayr, Dominika, 2017. “Voluntary Disclosure of Evaded Taxes—Increasing Revenue, or Increasing Incentives to Evade?” Journal of Public Economics, 151: 110-125.
A. Consequences of Technology Shortfalls

Due in part to the IRS’s reliance on outdated technological platforms, the compliance benefits of the transition to electronic tax return filing have yet to be fully realized. Without adequate technology, the IRS is unable to make use of 21st century data analytic approaches to verify the accuracy of taxpayer filings.

The IRS’s core tax processing system for over 150 million individual tax returns and $1.2 trillion in annual revenue—known as Individual Master File (IMF)—is written in programming languages that date back to more than half a century ago, making IMF among the oldest IT systems in the federal government.15 Designed in 1962, IMF is one of the highest risk systems in the Federal government, exposing a major weakness to the IRS’s ability to administer and collect taxes. (The system for processing business tax returns is similarly antiquated.) Annual changes have been made to the system since its development to address tax code changes and to improve processes and, where possible, to update the underlying hardware. The result today is decades of tax law written in a programming language that is no longer taught, a data platform that is highly complex to maintain, and an outdated system with a limited number of employees supporting it—about half of whom are eligible to retire.

The IRS’s legacy computing infrastructure cannot keep pace with the preferences of today’s taxpayers for instantaneous data access, real-time interactions, and other customer-centric services. The cost to operate the IRS’s current technology ecosystem continues to increase as well. The GAO has pointed out that the use of such an antiquated systems is more costly for the IRS than replacing with modern technology since “procurement and operating costs associated with this [programming] language will steadily rise, because

fewer people with the proper skill sets are available to support [it]."\textsuperscript{16} Outdated technology is a problem that extends beyond the 1960s Master File architecture. As of the end of 2020, 30\% of software in use was “aged”, meaning behind the most up-to-date version.\textsuperscript{17}

Without the resources to modernize its underlying technological infrastructure the IRS is required to layer new IT systems on top of an obsolete base infrastructure.\textsuperscript{18} The result is a patchwork approach that poses a threat to the stability of the tax system. As the National Taxpayer Advocate warned, “By analogy, the IRS has erected a 50-story office building on top of a creaky, 60-year-old foundation, and it is adding a few more floors each year. There are inherent limitations on the functionality of a 60-year-old infrastructure, and at some point, the entire edifice is likely to collapse.”\textsuperscript{19} To illustrate the danger, in the peak of the 2017 tax filing season, the IRS system crashed on the day of the filing deadline and forced a last-minute national federal tax filing extension.\textsuperscript{20} An added risk exposure caused by outdated technology is that it is ill-suited to meet new and expanding challenges. The IRS defends against approximately 1.4 billion sophisticated cyberattacks annually as criminals seek access to a significant volume of sensitive taxpayer data which would be better protected by more modern infrastructure.\textsuperscript{21}

The limitations of outdated technology are well understood by Treasury and the IRS. The Taxpayer First Act of 2019 included a push to modernize information technology and move toward rebuilding IRS computer systems and implementing machine learning approaches to help give tax enforcement agents a clearer picture of the most suspect filers.\textsuperscript{22} The ability to make progress on these efforts will be dependent on a sustained, timely multi-year budget commitment to cover the large fixed costs associated with transitioning away from legacy systems toward a modern, integrated platform.

In addition to hindering compliance efforts, IRS technological deficiencies have broad consequences for taxpayer service as well. The National Taxpayer Advocate reports that the IRS has struggled to provide adequate and reliable customer service. For example, the IRS had the resources to answer only 29\% of the 100 million telephone calls received in FY 2019, and during many months of the COVID-19 pandemic, the combination of resource constraints and a shift to remote operations further complicated service efforts and reduced service levels.\textsuperscript{23}

**B. Budget Shortfalls Worsening over Time, Leading to a Decline in Enforcement Activity**

The magnitude of the U.S. tax gap is the byproduct of many factors, including long-term IRS resource constraints. Since the early 2000s, the IRS budget as a share of GDP has been trending downward.\textsuperscript{24} This decline masks the severity of the funding shortfall because the pressure for enforcement resources due to a growth in sophisticated evasion opportunities is rising even more rapidly than GDP. Examples of advanced evasion techniques include the use of foreign bank accounts to shield income from IRS scrutiny and

\begin{itemize}
  \item \textsuperscript{16} Ibid.
  \item \textsuperscript{17} IRS, 2021. “Information Technology Annual Key Insights Report.” Publication 5453 (3-2021).
  \item \textsuperscript{18} IRS, 2021. "IRS, Treasury Disburse 25 Million More Economic Impact Payments Under the American Rescue Plan," IR-2021-77.
  \item \textsuperscript{19} National Taxpayer Advocate, 2018. “Annual Report to Congress 2018.”
\end{itemize}
the adoption of international, intra-company dealings that shift income solely for tax purposes but can be made to appear legitimate in ways challenging for the IRS to detect.

Over this same time period, there has been a rise in complex business structures, such as partnerships, which also require significant efforts by IRS agents to obtain a complete understanding of interrelated business activities. Partnership income as a share of total income grew from less than 5% to more than 35% since 1990. More than 4.2 million partnership returns were filed in calendar year 2018, which is more than double the number of corporate returns filed the same year; however, the IRS audited only 140 of these returns.\textsuperscript{25} Examining these returns is resource-intensive for the IRS because many partnerships use tiered organizational structures where multiple levels of domestic and sometimes foreign business entities combine to obscure the ultimate beneficiaries of the business operations. Some recent research suggests that 30% of partnership income cannot unambiguously be traced to the ultimate owner.\textsuperscript{26}

The IRS, like all federal agencies, is best suited to provide the services Americans deserve when it has the resources it needs to do so. At present, IRS funding deficiencies have directly resulted in an inability for the IRS to meet its mission of administering a fair and effective tax system.

Despite preexisting needs to modernize outdated systems and to detect increasingly complex evasion, the last decade shows a decrease—rather than an increase—in IRS resources. In real terms, the IRS’s overall budget declined by 18.5% between FY 2010 and

\begin{itemize}
\item 25 This translates to an audit rate of less than 0.00004%. Similarly, just 397 of the 4.8 million S-corporation returns were audited. IRS Statistics of Income, 2019. “Table 17a: Examination Coverage and Recommended Additional Tax After Examination, by Type and Size of Return,” IRS Databook.
\end{itemize}
FY 2021. The IRS’s enforcement budget decreased by 15% over this time period, leading to a 20% decline in the IRS workforce. These losses have been most significant for revenue officers who collect taxes (50% decrease) and revenue agents who audit complex returns (35% decrease). Today, the IRS has fewer auditors than at any time since World War II. As experienced employees have retired, the IRS has been unable to replace departing workers with new revenue officers and with agents of comparable training and skills necessary to pursue the most complicated noncompliance cases.

Consequently, the share of audited returns has declined by nearly 45% between 2010–2018. There has also been a contemporaneous steep decline in audit rates across all filing categories. The share of corporate income tax, individual income tax, estate tax, and employment tax returns examined by auditors have all dropped in the last decade.

Table 2: Audit Rates, 2010 vs. 2018

<table>
<thead>
<tr>
<th>Filer Category</th>
<th>Percent Audited 2010</th>
<th>Percent Audited 2018</th>
<th>Percent Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Filers</td>
<td>0.93%</td>
<td>0.51%</td>
<td>-45.39%</td>
</tr>
<tr>
<td>Individuals</td>
<td>1.11%</td>
<td>0.59%</td>
<td>-46.30%</td>
</tr>
<tr>
<td>EITC recipients</td>
<td>2.39%</td>
<td>1.41%</td>
<td>-41.10%</td>
</tr>
<tr>
<td>With annual income over $1 million</td>
<td>8.36%</td>
<td>3.23%</td>
<td>-61.35%</td>
</tr>
<tr>
<td>$1 million - $5 million</td>
<td>6.67%</td>
<td>2.21%</td>
<td>-66.87%</td>
</tr>
<tr>
<td>$5 million - $10 million</td>
<td>11.55%</td>
<td>4.21%</td>
<td>-63.55%</td>
</tr>
<tr>
<td>$10 million +</td>
<td>18.38%</td>
<td>6.66%</td>
<td>-63.76%</td>
</tr>
<tr>
<td>Corporations</td>
<td>1.39%</td>
<td>0.88%</td>
<td>-36.54%</td>
</tr>
<tr>
<td>With assets over $20 billion</td>
<td>97.99%</td>
<td>49.29%</td>
<td>-49.70%</td>
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<tr>
<td>Employment</td>
<td>0.21%</td>
<td>0.14%</td>
<td>-33.63%</td>
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<tr>
<td>Estates</td>
<td>10.12%</td>
<td>8.60%</td>
<td>-15.01%</td>
</tr>
<tr>
<td>With assets over $5 million</td>
<td>24.31%</td>
<td>18.71%</td>
<td>-23.07%</td>
</tr>
</tbody>
</table>

Source: IRS Statistics of Income Databook. Audit rates by annual income are imputed from Table 9b; all other data are from Table 9a.

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The decreases in audit rates are most pronounced for highly complex audits performed by experienced agents. Among individual taxpayers, audits of taxpayers with income over $1 million have fallen by over 60% between 2010–2018, with the audit rate decreasing from 8.4% to 3.2%.  

Audit coverage for large corporations has been cut in half over the last decade, as coverage for companies with $20 billion or more in assets decreased from 98% in FY 2010 to around 50%. This is the result of staff attrition and budget stringency, which both diminish the resources that the IRS can dedicate to auditing high-income taxpayers and large corporations. During the past 10-year period, global high wealth examinations have taken roughly two years on average to complete and have averaged around 284 hours per return. The same is true for partnerships, where audits average around 333 hours per return. In contrast, routine field audits of less complex taxpayers average approximately 40 hours per return.  

In order for the IRS to appropriately focus enforcement scrutiny on high-income taxpayers and the businesses they own—which research has shown is a primary source of the tax gap—it’s budget must be replenished. IRS agents cannot simply be assigned to global high wealth, partnership, or large and complex business examinations without the requisite skills, training, and experience to analyze returns that are highly complex: For large corporations, the average number of pages per tax filing has risen from slightly under 4,000 to nearly 6,000 since FY 2012.  

The vast majority of taxpayers timely file their returns and pay the tax liabilities they owe. However, declining examination coverage has real consequences. There is a direct correlation between the number of audits that the IRS is able to perform and the revenue that the IRS collects from examinations. In addition, if certain compliant taxpayers come to believe that there is little to lose or much to gain from underpaying tax liabilities, overall compliance levels will decline. Visible enforcement efforts can help keep taxpayers compliant.  

Falling revenue due to fewer audits imposes added real costs passed on to non-evaders. In the long run, either taxes must be raised on compliers or government expenditures must be limited. The lack of enforcement thus leads to a de facto punitive tax on compliant taxpayers as those who pay their fair share will have their taxes increased or government services reduced because evaders are not paying. The costs can be particularly high for compliant direct competitors of tax evaders. Evasion opportunities essentially impose an even greater tax on compliant taxpayers because direct competitor businesses who abide by the tax laws are put at a competitive disadvantage. As taxes rise to meet revenue needs, this disadvantage is made more pronounced since only law-abiding taxpayers bear the burden of tax changes.  

The consequences of these shortfalls have been exacerbated by expanding responsibility, as these consequential budget cuts have been matched with calls for the IRS to take on new functions. While these new functions are related to the IRS’ core mission of tax administration, the increased workload spreads limited resources even more thinly. Indeed, many parts of the Affordable Care Act  

31 Ibid.  
32 Ibid.  
33 IRS data.  
34 Ibid.  
36 Ibid.  
are administered through the IRS. And recently, the IRS has been pivotal in facilitating support for American families in the COVID-19 pandemic: For example, it has administered three rounds of Economic Impact Payments, most recently sending out over 160 million payments totaling nearly $400 billion within weeks of the American Rescue Plan’s passage.38 The IRS also has been charged by Congress with providing periodic advance payments of the Child Tax Credit for the first time in history, and proposals in the American Families Plan call on the IRS to administer credits that provide expanded support for families, childcare, and low-income individuals in the coming years.

C. Inequities in Tax Enforcement

Although the tax code redistributes income in a way that mitigates racial and income inequality, it also can function in ways that exacerbate it.39 Indeed, research has highlighted ways in which aspects of tax policy can advantage upper-income taxpayers, while also identifying aspects that burden low-income individuals. In addition, scholars have increasingly focused on aspects of the tax code that disadvantage Black and Hispanic families in particular.40

IRS enforcement efforts can have similar effects. Recently, a stream of research has begun to identify disparities in tax enforcement activities.41 Historically, this inquiry has been complicated by the absence of data on taxpayers’ race or ethnicity.42

The Biden Administration recently launched an Equitable Data Working Group that seeks to address these data limitations across federal datasets. At the same time, the Treasury Department is currently undertaking research to study the relationship between the tax code and racial inequities. This multi-year project will require close engagement between federal agencies and those in the research and advocacy communities.

Over the last decade, a reduction in resources available to the IRS exacerbated inequities in predictable ways. In particular, diminished resources made it difficult to maintain a cadre of the most specialized auditors, which in turn depressed audits rates for high-income taxpayers relative to those in the lower part of the income distribution. Indeed, although audits of those claiming the Earned Income Tax Credit (EITC), have fallen by around 40% since 2010, income tax audits of those earning $10 million or more annually have fallen by closer to 65% (See Table 3). While it is true that audit rates generally rise with income levels so that high earners are audited with a greater probability than those of low or moderate income, the level differences mask a significant shift in the trend.

Inequities in enforcement are not solely the result of a reduction in the number of audits of high-income taxpayers. Rules and regulations governing tax procedures can advantage well-resourced and corporate taxpayers who have access to tax experts in ways lower-income taxpayers do not. For instance, wealthy taxpayers often rely on tax opinions provided by advisors to avoid penalties and have their representatives negotiate terms to obtain more favorable outcomes.43


39 For example, until recently, the vast majority of children living in poverty were ineligible for the Child Tax Credit (CTC). Because of the concentration of poverty in minority communities, this meant that although three-quarters of white and Asian children were eligible for the full CTC, only about half of Black and Hispanic children were. Goldin, Jacob and Katherine Michelmore. "Who Benefits from the Child Tax Credit?” National Tax Journal, forthcoming. The Biden Administration’s reforms are focused on redressing this inequity.


41 Work by former IRS economist Kim Bloomquist points out that the five counties with the highest audit rates are predominantly African-American, rural counties in the South. Bloomquist, Kim M. “Regional Bias in IRS Audit Selection.” Tax Notes Federal, March 4. A number of other promising research projects are underway.


It is important to note that the President’s compliance proposals are designed to ameliorate existing inequities by focusing on high-end evasion. Audit rates will not rise relative to recent years for those with less than $400,000 in actual income. This focus is justified by the composition of the tax gap, which accrues disproportionately to those at the top of the distribution, who earn income in opaque categories like partnership and proprietorship income, where misreporting rates are high. While the impact on racial disparities from future enforcement efforts remains to be seen and will be the byproduct of a broader set of policy initiatives, the Biden Administration’s commitment to racial equity was a key factor in the design of the current proposal.

For these reasons, investments in tax compliance do more than raise revenue to fund necessary investments or improve our fiscal position. They also work to address inequities by increasing the share of IRS enforcement attention that is focused on high-income noncompliers. Further, improvements in taxpayer services and other enhancements to tax administration such as the tighter regulation of tax preparers can decrease disparities in the treatment of different groups of taxpayers.

IV. The President’s Compliance Proposals

The President’s proposals would overhaul tax administration in the United States to create a more equitable tax regime. These proposals, taken as a whole, would generate revenue from taxes that are owed but not paid and through improved voluntary compliance. Increased funding for the IRS would also improve how taxpayers are served by the IRS—making sure that all taxpayers are able to take advantage of the tax benefits to which they are entitled and are able to communicate effectively and efficiently with the IRS when questions arise.

The compliance initiative has several elements, including:

- increasing the resources of the IRS to pursue noncompliant taxpayers and better serve the vast majority who are fully compliant;
- leveraging information that financial institutions already collect to shed light on those taxpayers who misreport income derived from opaque categories;
- overhauling antiquated technology to help IRS leverage 21st century data analytic tools; and
- regulating paid tax preparers and increasing penalties for those who intentionally commit malfeasance.

While it will take time and substantial effort to achieve these goals, even modest progress would translate into a substantial increase in revenue. Treasury’s Office of Tax Analysis estimate that over the next decade, these changes would shrink the tax gap by about 10%, raising $700 billion in additional tax collections over the next 10 years net of investments. The revenue raised is even larger in the second decade after enactment at about $1.6 trillion. Revenue raised is backloaded in part because investments in the IRS often take several years to reach their ultimate payoff.
In addition to raising substantial revenue, investments in tax compliance would improve the efficiency and fairness of the tax code. Evasion imposes economic distortions because the resources taxpayers expend to implement and hide income from tax authorities create no social benefits. Tax evasion also can shift economic activity into certain areas like proprietorship or cash-based businesses due to their evasion advantage. In addition, the same tax rates raise more revenue once evasion is made more difficult, and economic distortions caused by disparate tax treatments of honest versus evasive businesses, among other examples, would be decreased. Further, the tax code will be fairer when it no longer benefits opaque sources of income relative to wage labor. In sum, effectively tackling tax evasion can decrease the amount of resources expended on underpaying tax liabilities, limit distortions, and encourage more socially responsible behavior.

The uneven distribution of the tax gap implies that evasion contributes to after-tax income inequality. Prior empirical evidence demonstrates that the tax gap can be tied disproportionately to people in the top end of the income distribution, and recent research emphasizes the importance that income misreporting has for understanding income inequality trends. Further, asymmetric compliance rates between labor wage income and more opaque sources of income, especially for high-income earners, has important horizontal and vertical equity implications. As such, the fairness and progressivity of the tax code can be enhanced through more equal compliance rates that ensure those with high incomes pay what they owe.

NOTE: Estimates outside the 10-year budget window are subject to greater uncertainty which is reflected through the dotted line.
A. Restoring IRS Resources

The first step in the President’s efforts to restore IRS enforcement capability is a sustained, multi-year commitment to rebuilding the IRS. This involves spending nearly $80 billion on IRS priorities over the course of the decade including hiring new specialized enforcement staff, modernizing antiquated information technology, and investing in meaningful taxpayer service—including the implementation of the newly expanded credits aimed at providing support to American families. Importantly, the additional resources will go toward enforcement against those with the highest incomes, and audit rates will not rise relative to recent years for those earning less than $400,000 in actual income.

The President’s proposal includes two components: a dedicated stream of mandatory funds ($72.5 billion over a decade) and a program integrity allocation ($6.7 billion over a decade). These mechanisms provide for a sustained, multi-year commitment to revitalizing the IRS that will give the agency the certainty it needs to rebuild.

The IRS proposal includes year-by-year estimates of the additional resources that will be directed toward the agency as well as the specific activities that these resources would support. The design ensures that the IRS is able to absorb and usefully deploy additional resources over the entire 10-year horizon and keeps budget growth manageable at around 10% per year.

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<th>Table 3: IRS Proposal and Revenue Raised, 2022–2031</th>
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46 The congressional budget resolution allows for additional appropriations to the IRS in the form of multi-year commitments to fund “program integrity” activities that are estimated to save more than they cost, as is the case with IRS enforcement efforts.
The $6.7 billion program integrity allocation allows for increases in base discretionary funding for boosting effective enforcement of taxpayer compliance. This effort will support the hiring and retention of at least 5,000 new enforcement personnel.

The mandatory funds are allocated over a 10-year horizon. They provide enforcement resources, including a significant investment in revitalizing the IRS’s examination of large corporations, partnerships, and global high-wealth and high-income individuals. Mandatory funds are also directed toward other important IRS priorities. For example, nearly $6 billion is dedicated to IT modernization. Modernization funding will allow the IRS to address core technology challenges and transform IRS provision of meaningful taxpayer services and tax enforcement efforts. Tax processing technology today is supported by an inefficient and inflexible batch processing architecture that delays the provision of tax administration data to IRS systems, employees, and taxpayers. Modernized technology will allow the IRS to make data more easily available for service and enforcement purposes and to move toward near real-time tax processing. The existing case management system supported by more than 60 different components could be integrated to provide a more comprehensive view of enforcement case information and taxpayer data and near real-time tax processing. The result would be a more interactive tax processing experience that will allow for an improved taxpayer experience and for the IRS to focus resources on redressing noncompliance.

Additional IT tools will help support a staff capable of deploying new analytical techniques; investing in developing machine learning capabilities will enable the IRS to leverage the information it collects to better identify tax returns for compliance review. The proposed IT investment includes $4.5 billion to implement a new information reporting regime. New resources would also support efforts to meet imminent threats to the security of the tax system, like cyberattacks.

Revitalizing the IRS requires more than building up the IRS’s enforcement efforts and technological systems. Revitalization also demands a renewed commitment to meaningful taxpayer service. The President’s proposal will enable taxpayers to communicate with the IRS securely and efficiently, and the IRS’s new workforce would include additional dedicated customer service representatives ready to assist taxpayers as they navigate newly expanded programs like the Child Tax Credit, the Child and Dependent Care Tax Credit, and the Earned Income Tax Credit.

Because the expansion in the IRS’s budget is phased in over a 10-year horizon, each year the IRS’s workforce should grow by no more than a manageable 15%. By the end of the decade, however, the IRS’s budget would be roughly 40% above 2011 levels in real terms as a result of this proposal. This is a sizable increase, but a necessary one given that the IRS’s responsibilities have grown dramatically over the intervening period. Yet even with this increase, the IRS budget would still not return to early 1990s levels as a share of gross collections.

The IRS estimates the marginal return on investment (ROI) for most of its enforcement activity based on historical tax enforcement data. Average ROIs for the mandatory and program integrity allocations are shown in Table 3 above. The Office of Tax Analysis’ revenue estimate for the IRS funding proposal is projected based on these ROI estimates. Total additional revenue generated from the $80 billion increase in the IRS budget over 10 years is estimated to be around $320 billion during this horizon, which suggests roughly a 4-to-1 ROI.

These numbers are conservative because IRS ROI estimates are only available for the subset of enforcement investments, and not technology or service improvements that are likely to improve compliance. As a result, revenue estimates do not take into account increases in enforcement efficiency or taxpayer compliance that will arise from non-enforcement investments such as the benefits

47 This calculation assumes that the IRS discretionary budget over time will approximately resemble the real resource levels indicated by the FY 2022 discretionary budget request.
of widespread use of machine learning technologies. Further, these estimates do not account for increases in voluntary compliance attributable to improvements in taxpayer service. For example, when taxpayer questions are answered in a timely manner, taxes tend to be paid more accurately plus the fact that an effective system of tax administration increases taxpayer trust and compliance.\(^{48}\)

Further, because standard IRS methodologies focus on enforcement cases and the associated revenue and costs, they are not capable of arriving at an ROI for large-scale IT investments. Although researchers understand that the potential of better IRS technology to improve collections efforts is sizable, these gains are difficult to attribute in revenue estimation.

Moreover, these estimates do not take into account the deterrent effects associated with different types of enforcement activities which are generally considered to be quite significant.\(^{49}\) More recent empirical work provides a way to start to try and understand the importance of the indirect effects in understanding the revenue potential of compliance initiatives. A recent peer-reviewed study found, for example, that increased income reported in the five to eight years following a random audit is about 1.5 times the audit revenue.\(^{50}\)

Another peer-reviewed study noted that in-person collection visits raise as much revenue from firms that share a tax preparer with the visited firm as they do from the visited firm itself.\(^{51}\) Although more research is needed to arrive at a better understanding of the magnitude of deterrent effects, revenue estimates that fail to include noncompliance deterrence are conservatively low.

For the purposes of the Office of Tax Analysis’ estimation, revenue is counted when it accrues to the IRS, and a collection stream for enforcement revenue is built into these estimates: For example, even for an audit closed in FY 2022 with adjustments, collections will be realized over time. This is part of the reason why revenue from this proposal is backloaded in the traditional 10-year budget window. Further, estimates incorporate the fact that new hires take several years to reach their full potential. Revenue estimates also assume a declining marginal return for enforcement activity as the level of enforcement rises. Revenue generated reaches its steady state shortly after the end of the 10-year horizon, and the backloaded nature of additional tax collections results in a second-decade revenue estimate that is more than twice as large as the first (See Figure 5).

B. Increased Information Reporting

The second step in the compliance agenda involves shining light on opaque income streams, including proprietorship and partnership business income. Bolstering information reporting is regarded by the IRS and GAO as one of the best ways to increase the overall compliance rate,\(^{52}\) and existing empirical evidence confirms that introducing third party reporting requirements is effective.\(^{53}\)

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49 A longstanding Treasury estimate suggests that the deterrent effects of compliance activities are likely at least three times as large as the direct effects. IRS, 2018. “Budget in Brief FY 2019.”


Previous changes to information reporting shed light on the significant potential of such efforts but also on pitfalls that can arise when reporting requirements are imprecisely designed. It is important to implement comprehensive information reporting regimes, as partial reforms can simply shift tax evasion into other areas.\textsuperscript{54} Further, financial institutions house a lot of valuable information, and indeed already provide third-party reports to the IRS. Leveraging this information—rather than introducing new requirements for taxpayers\textsuperscript{55}—is a proven way to improve compliance.\textsuperscript{56}

The President’s proposal requires information reporting on financial accounts to increase the visibility of gross receipts and expenses to the IRS. Today, business income is subject to limited information reporting. Current reporting of gross receipts exists for only certain types of revenue, and there is no information reporting on deductible expenses. This is why the tax gap for partnership, S-corporation, and proprietorship income is estimated at around $200 billion annually with the net misreporting percentage for certain income categories exceeding 50%.

Third party information reporting is already provided on primary income streams for the vast majority of Americans, such as wage, pension, and unemployment income. The President’s proposal would help make tax administration more equitable by subjecting financial flows, especially those that accrue disproportionately to those at the top of the income distribution, to third-party reporting as well.

The new reporting regime would build from the framework of the Form 1099-INT reports that taxpayers already receive from financial institutions when they earn more than $10 in interest from a bank, brokerage, or other financial institution. Financial institutions would simply report additional data on the financial accounts of these existing information returns. Specifically, the annual return would report gross inflows and outflows on all business and personal accounts from financial institutions, including bank, loan, and investment accounts but carve out exceptions for accounts below a low de minimis gross flow threshold.\textsuperscript{57}

Other accounts that are similarly situated to financial institution accounts would also be covered under this new reporting regime—for example, payment settlement entities would also be required to report gross receipts and gross purchases. The reporting regime would also cover foreign financial institutions and crypto asset exchanges and custodians.

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\textsuperscript{54} For example, the introduction of Form 1099-K provided the IRS and taxpayers with information about businesses’ sales by payment card and other electronic means. As a result, taxpayers increased reported receipts by up to 24% once they began to believe that the IRS could conceivably verify gross receipts. However, many business taxpayers appeared to offset this change with simultaneously increased reported expenses. Slemrod, Joel et al., 2017, “Does Credit Card Information Reporting Improve Small-Business Tax Compliance?” Journal of Public Economics, 149. See also Adhikari, Bibek et al., 2020. “Information Reporting and Tax Compliance,” AEA Papers and Proceedings, 110.

\textsuperscript{55} As part of the Affordable Care Act, a new provision was introduced which would have required businesses to send Form 1099 information returns for all purchases of goods and services over $600. It was set to go into effect in 2012 but repealed six months prior to enactment because of a concern about the burden imposed on small businesses. National Taxpayer Advocate, 2010. “Fiscal Year 2011 Objectives Report to Congress.”

\textsuperscript{56} For example, in the international sphere, the Foreign Account Tax Compliance Act (FATCA) was enacted in 2010 to help combat tax evasion by those with offshore accounts. Although it is difficult to draw full conclusions given the nascentness of these efforts, research suggests that financial institutions play an important role in providing information to the IRS that encourages increased compliance. De Simone, Lisa, Rebecca Lester, and Kevin Markle, 2020. “Transparency and Tax Evasion: Evidence from the Foreign Account Tax Compliance Act (FATCA).” Journal of Accounting Research 58(1). This is in part attributable to amnesty programs that were implemented around the same time as new reporting requirements and precipitated a significant increase in self-reported foreign dealings. Johannesen, Niels, et al., 2020. “Taxing Hidden Wealth: the Consequences of US Enforcement Initiatives on Evasive Foreign Accounts,” American Economic Journal: Economic Policy 12(3).

\textsuperscript{57} The proposal preserves significant flexibility for the Secretary and the IRS to design the new reporting requirements in the way that will be most effective for tax compliance efforts.
These new reporting requirements would come with no additional reconciliation requirement for taxpayers. For already compliant taxpayers, the only effect of this regime is to provide easy access to summary information on financial accounts and to decrease the likelihood of costly “no fault” examinations once the IRS is able to better target its enforcement efforts. For noncompliant taxpayers, this regime would encourage voluntary compliance as evaders realize that the risk of evasion being detected has risen noticeably.

To arrive at a revenue estimate for the impact of a comprehensive information reporting regime, the Office of Tax Analysis began with an estimate of the tax gap for business income which included Schedule C proprietorship income, Schedule E rent and pass-through income, and small corporation income as well as the portion of the employment tax gap associated with business incomes. This tax gap estimate was then reduced to reflect the expected increase in voluntary compliance once taxpayers realize that the IRS has a lens into business income. The revenue estimate added two assumptions: first, a reduction in the steady state share of the tax gap due to increased voluntary compliance as taxpayers react to increased information reporting; and second, a gradual increase of voluntary compliance that phases in over time.

The revenue estimates assume that the bank reporting proposal will become effective for tax year 2023, building in implementation time for the IRS and for financial institutions. The Administration would concurrently seek out ways to reduce any new burden on financial institutions associated with this information reporting requirement.

This additional information reporting would also enhance the effectiveness of enforcement measures, as it will provide a proxy measure for a taxpayer’s potential income position, and suspect account flows could help the IRS better target its enforcement activities. This would benefit compliant taxpayers, whose risk of costly no-fault audits would decrease as the IRS better targets enforcement actions.

According to the Office of Tax Analysis, the increase in compliance that would result from this new reporting regime is estimated to raise $460 billion over the next decade.

**Challenges of Cash and Virtual Currencies**

For a new information reporting regime to shed light on previously opaque income sources effectively, it is imperative to prevent business income from being shielded from reporting requirements. This is why the new Form 1099 reports would also be required from payment services providers so that businesses cannot shift out of traditional financial institutions to other kinds of platforms and avoid making their income visible to the IRS.

Another concern is that an information reporting regime will shift taxpayers toward a greater use of cash. Although information reporting may push some taxpayers to transact more in cash to avoid the reporting, it is unlikely that a substantial share of the business tax gap will move to cash-based transactions. Businesses already have incentives to use cash as much as possible to avoid detection via bank statements obtained in an audit, but there are practical barriers—such as security risks and the difficulty of spending large amounts of cash for certain transactions—to expanding the use of cash without depositing it in a bank account.

Still another significant concern is virtual currencies, which have grown to $2 trillion in market capitalization. Cryptocurrency already poses a significant detection problem by facilitating illegal activity broadly including tax evasion.

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59 Early work suggested the significance of the challenges posed by the rise of virtual currencies: “To the extent that cryptocurrencies continue to gain momentum; we could reasonably expect tax evaders—who traditionally executed their tax-evasion techniques through the use of offshore bank accounts in tax-heaven jurisdictions—to opt out of traditional tax havens in favor of cryptocurrencies.” See, e.g. Marian, Omri, 2013. “Are Cryptocurrencies Super Tax Havens,” Michigan
This is why the President’s proposal includes additional resources for the IRS to address the growth of cryptoassets. Despite constituting a relatively small portion of business income today, cryptocurrency transactions are likely to rise in importance in the next decade, especially in the presence of a broad-based financial account reporting regime. Within the context of the new financial account reporting regime, cryptocurrencies and cryptoasset exchange accounts and payment service accounts that accept cryptocurrencies would be covered. Further, as with cash transactions, businesses that receive cryptoassets with a fair market value of more than $10,000 would also be reported on. Although cryptocurrency is a small share of current business transactions, such comprehensive reporting is necessary to minimize the incentives and opportunity to shift income out of the new information reporting regime.  

C. Other Compliance Proposals

The Administration’s compliance proposals include a number of other additional tools for the IRS that complement the transformational nature of the investments and information reporting regime discussed above.

For example, the proposal provides the IRS with the authority to regulate and establish minimum competency standards for all paid tax preparers. Unregulated preparers submit more tax returns than all other preparers combined, and they often make costly mistakes that subject their customers to audits. A recent GAO study shed light on the scope of this problem. During undercover visits to 19 randomly selected unregulated preparers, only two calculated taxpayers’ refunds accurately. The issues of unregulated tax preparers go beyond the quality of services provided. Some unregulated preparers enrich themselves by ascribing to themselves a portion of taxpayers’ refunds; or they commit fraud while failing to sign returns (so called, “ghost preparers”), leaving the taxpayers who are audited without the ability to prove that fraudulent returns are the fault of unscrupulous preparers. In addition to establishing standards for unregulated tax preparers, the President’s proposal would include additional penalties for ghost preparers.

Other proposals identify opportunities in several areas to strengthen tax collection. An additional change would improve taxpayer information accuracy by permitting the IRS to require payment recipients to certify their taxpayer identification numbers (TINs) to payers who issue third-party information reports; another proposal imposes unpaid corporate tax liability on shareholders in specified tax shelter cases.

Law Review First Impressions, 112(38).

60 It is worth noting that the IRS has identified cryptocurrency transactions as an enforcement priority and recently included cryptocurrency reporting on the individual tax return, Form 1040.

61 A previous initiative in 2010 launched by the IRS proposed requiring a basic competency exam and taking annual classes to stay abreast of tax changes; however, courts ruled that the IRS required statutory authority to regulate in this space. The IRS’s experience administering the test before this ruling indicates its importance: roughly 25% of unenrolled preparers who took it did not pass the exam. See, e.g. GAO, 2014. “Protecting Taxpayers from Incompetent and Unethical Return Preparers: Hearing Before the Committee on Finance.”


D. Interaction Between Compliance Initiatives

The increase in information reporting and the IRS’s resources and enforcement tools are complementary, and both are essential ingredients to effective and equitable tax administration. For reporting to be most useful, the IRS needs the funding to understand and process the information it receives. For the IRS’s funding to be best spent, the IRS needs more lenses into opaque sources of income.

To be effective in promoting accurate reporting of business income, the new financial account reporting regime would require a substantial expansion of the IRS’s information technology and data analytic capacity. This funding is provided for with mandatory funds that are predesignated for implementing the new reporting regime.

Financial account reporting will also make underreported business income that has historically only been revealed at audit visible in some form to the IRS. Information on inflows and outflows can help the IRS select cases for enforcement activity and may make the audit process more efficient. Finally, the proposed enforcement funding, coupled with the improved visibility of business income, could increase the IRS’s efficiency, facilitating the pursuit of a greater share of suspected evaders.

V. Conclusion

Over the last decade, and even prior, the IRS has lacked the resources it needs to enforce the tax laws and best serve taxpayers. This costs the government around 3% of GDP each year in owed but uncollected taxes. But it also decreases the progressivity of the tax code since the benefits of noncompliance accrue disproportionately to top earners. Further, tax noncompliance creates inefficiencies and distortions by pushing economic activity toward those areas where there are the most opportunities for evasion.

The President’s proposals would address these deficiencies, benefitting those who fulfill their tax obligations, and raising revenue to fund urgent fiscal priorities. At the crux of these proposals is a commitment to revitalizing tax enforcement, decreasing noncompliance by about 10% over the course of a decade.

Achieving this goal will require providing the IRS the resources it needs for hiring specialized auditors, training them to detect noncompliance by sophisticated taxpayers, and investing in a 21st century technology infrastructure. Equally important, these investments are coupled with new third-party information reports that the IRS can use to help detect evasion. More effective enforcement will improve the experience of most taxpayers by reducing the number of audits imposed on compliant taxpayers. A robust investment in the IRS will rebuild taxpayer service to help ensure that the agency is capable of responding to taxpayer needs in a timely manner and efficiently delivering tax credits, refunds, and other benefits to families and workers.

Overhauling tax administration in this manner will require a sustained, multi-year commitment to foundational change. Effective management of a well-resourced IRS will be essential to the agency’s long-term success and will strengthen voluntary compliance in the United States. Frequent reporting on milestones and performance metrics—including a more current tax gap report—will be essential, providing insight into the efficacy of new programs.

Working to close the tax gap reflects a commitment to ending our two-tiered tax system, one where most American workers pay their full obligations, but high earners who accrue income from opaque sources often do not. The President's proposals address this inequity in a way that will pay large dividends in this decade—and in the decades to come.