DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

September 14, 2021

The Honorable Richard E. Neal
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Neal:

I write in enthusiastic support of the financial institution reporting provisions advanced in the President's tax compliance agenda. These information reporting provisions will make use of information financial institutions already know to help shed light on taxpayers who evade their tax obligations.

Today, compliance rates are under 50 percent for opaque sources of income—resulting in a disproportionate tax burden for complying taxpayers and a shortage of necessary funds for key national priorities. The underpayment owing to noncompliance is not evenly distributed across taxpayers. Instead, the tax gap is concentrated at the top of the income distribution, with the one percent of earners with the highest incomes responsible for nearly 30 percent of unpaid taxes: totaling over $160 billion in tax year 2019. This inequity is closely tied to gaps in information reporting, namely the disparity between when information is reported to the IRS by a third-party source to facilitate verifying the accuracy of taxpayer filings, and when it is not.

Specifically, for some categories of income, the Internal Revenue Service (IRS) can crosscheck what taxpayers report on their tax returns with information reported by third parties to ensure tax obligations are properly met. Wage and salary income is reported to the IRS on W-2 reports, and tax obligations are automatically withheld, so compliance rates stand at 99 percent. Third party information reporting already exists for the primary income that accrues to most Americans—including wage, pension, and unemployment income. It is clear that when taxpayers know that this information exchange exists, their voluntary compliance rises. But for certain income streams that accrue disproportionately to upper-income households, there is no information available to the IRS from third parties presently. As a result, underpayment is rampant.

This harmful and inequitable trend in compliance had led the IRS, the Government Accountability Office, and academic experts to conclude that improving information reporting is one of the best ways to meaningfully improve compliance. Existing empirical evidence confirms that the introduction of third-party reporting regimes is highly effective.[1]

The President's information reporting proposals were designed to ensure that there will be no increase in taxpayer burden associated with this regime. For already compliant taxpayers, the only effect is a distinct benefit—a lowered likelihood of costly and burdensome audits. It is also designed to minimize costs for financial institutions associated with providing this information to the IRS, by building off an existing reporting structure that these institutions already use to convey information about the interest income in taxpayers' bank accounts.

The objective of this reporting regime is to help the IRS pursue high-end noncompliance by providing some information about opaque income streams that disproportionately accrue to the top. In fact, audit rates are not going to rise relative to recent years for anyone with less than $400,000 in income. As you consider specific policy choices in designing an information reporting regime, it is important to ensure that the reporting regime is sufficiently comprehensive, so that tax evaders are not able to structure financial accounts to avoid it. But to be clear: a reporting regime that is broad-based will better assist the IRS in targeting enforcement priorities on the high-end who accrue income in opaque ways. Any suggestion that instead this reporting regime will be used to target enforcement efforts on ordinary Americans is wholly misguided.

The revenue potential of these approaches is substantial. As an Appendix to this letter, I include a memorandum from Mark Mazur, Acting Assistant Secretary for Tax Policy at the Treasury Department, which provides details on the magnitudes to bear in mind when you consider the proposals under consideration in this Congress. The proposals you are advancing will revitalize the agency and give it the information that it needs to identify tax evasion, thereby building a fairer tax system. That will deliver sizable revenue in a progressive way in the next ten years, and in the decades to come.

Sincerely,

Janet L. Yellen

Janet L. Yellen

Enclosure

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[1] Adhikari, B., Alm, J., Collins, B., Sebastiani, M., & Wilking, E. 2016. "Taxpayer Responses to Third-Party Income Reporting: Evidence From a Natural Experiment in the Taxicab Industry," *IRS Research Bulletin*, 6th Annual Joint Research Conference on Tax Administration, IRS and the Urban-Brookings Tax Policy Center; Johannesen, N. 2014. "Tax Evasion and Swiss Bank Deposits," *Journal of Public Economics* 111: 46-62.; Marchase, C. 2009. "Rewarding the Consumer for Curbing the Evasion of Commodity Taxes," *Public Finance Analysis* 65(4): 383-402.; Naritomi, J. 2019. "Consumers as Tax Auditors." *American Economic Review* 109(9): 3031-3072.; Phillips, M. D. 2014. "Individual Income Tax Compliance and Information Reporting: What Do the US Data Show?" *National Tax Journal* 67(3): 531-568.; Pomeranz, D. 2015. "No Taxation Without Information: Deterrence and Self-Enforcement in the Value Added Tax." *American Economic Review* 105(8): 2539-2569.

DEPARTMENT OF THE TREASURY
OFFICE OF TAX POLICY
WASHINGTON, D.C. 20220

September 14, 2021

MEMORANDUM

FROM: Mark J. Mazur, Assistant Secretary for Tax Policy (Acting)

SUBJECT: The Revenue Impacts of Compliance Proposals

This memo summarizes the Treasury analyses estimating the effects of tax compliance proposals, incorporating the Office of Tax Analysis (OTA) estimates as well as other considerations that would have predictable effects on the revenue potential of possible Congressional compliance proposals. Together, these factors imply that tax compliance proposals along the lines of those being contemplated by Congress have the potential to raise around $700 billion over the ten-year budget window and much larger amounts in subsequent years.

In developing the FY 2022 Budget proposals, OTA (working with Internal Revenue Service staff) analyzed the administration's tax compliance proposals using methods similar to those used previously by OTA and IRS (and, as you know, these methodologies are similar to those used by the Congressional Joint Committee on Taxation (JCT) and the Congressional Budget Office (CBO)). However, the Administration proposals were larger in scale than recent proposals and historical experience and therefore the estimating approaches required some adaptation.

Our current understanding is that Congress is considering the adoption of financial reporting proposals that are likely to be narrower in scale and scope than those proposed by the Administration. Clearly, this will lower the estimated revenue raised from the proposed reporting regime relative to earlier Administration estimates.

Conventional revenue estimating approaches incorporate the behavioral responses to legislative changes. For instance, if tax rates change on some economic activities, taxpayers respond by reducing those activities. We see similar results in the information reporting area, where income sources with detailed third-party reporting result in taxpayers reporting 90 percent or more of this income, while income sources without robust third-party reporting generate reporting rates of 50 percent or even lower. In this case, improved information reporting leads taxpayers to increase their voluntary reporting of previously under-reported income sources.

However, when analyzing proposals that provide increased enforcement resources to the IRS, the conventional approach is to merely estimate the increased revenue collected by the IRS through additional audits and additional collection activities, but not to ascribe any changed behavior on the part of taxpayers who potentially would be subject to added enforcement scrutiny. This convention leads to an underestimate of future revenues generated by the proposal.

The revenue potential for the two aspects of the compliance agenda can be analyzed as follows:

<u>IRS Funding Proposals</u>

- Estimates for the effect of IRS resource changes on increased enforcement revenue (revenues associated directly with increased audit or collection activity) come directly from the IRS. IRS estimates the return on investment (ROI) for most of its enforcement activity based on historical enforcement data. The IRS collects this information on an ongoing basis.
  - The expected return is estimated as the increase in the direct enforcement tax revenue, or revenue generated by an examination or a collection activity (or both). Importantly, these estimates do not incorporate a potential deterrence effect from having more IRS personnel undertaking enforcement action in future years.
  - IRS does not provide any ROI estimate associated with non-enforcement functions, such as IT improvements or enhanced taxpayer services, because these activities do not by themselves generate enforcement revenue. However, these investments in services and IT will positively impact tax administration.
- The estimated revenue effects for proposals to increase IRS funding proposals are based on the IRS ROI estimates. In general, new hires are expected to take several years to reach the full ROI potential due to the time needed for hiring and training. IRS also assumes a declining marginal return for its enforcement activity as the level of enforcement function increases.
- The estimated revenues are clearly backloaded. Under the current funding proposal, investments in IRS personnel and fixed assets would be phased-in over a 9-year period, and then remain at that level (in real terms) for the rest of the budget window (and on into the future).
- The estimates for the direct effect of $80 billion in additional resources derived from the IRS's revenue estimation model for budget initiatives is that it raises about $320 billion in additional tax collection over the ten-year budget window. This estimation reflects the additional revenue from enforcement activities; but not the increase in compliance that will result from investment in taxpayer services and IT modernization.
  - This is because the IRS does not calculate a ROI in terms of enforcement revenue for these investments, and as a consequence, neither Treasury nor CBO account for the effects of such spending on revenues. However, there is a large scholarly literature that supports beneficial effects on compliance from investments in service and technology.[1]
- The conventional revenue estimate described above does not include any deterrent effect of the increased IRS resources. Just like have a police officer on the median of an interstate will result in fewer cars excessively speeding, having more IRS agents able to

[1] See, for example, Alm, J., Cherry, T., Jones, M., & McKee, M. 2010. "Taxpayer information assistance services and tax compliance behavior." *Journal of Economic Psychology* 31(4): 577-586.; Feld, L.P., and Frey, B.S. 2002. "Trust Breeds Trust: How Taxpayers are Treated." *Economics of Governance* 3: 87-99.; Torgler, B., Schaffner, M., & Macintyre, A. 2007. "Tax Compliance, Tax Morale, and Governance Quality." Consider also the success of the IRS's Return Review Program, which detects and prevents the disbursement of invalid refunds, using automated, anomaly-detecting analytic techniques. In 2017, this program saved the IRS $4.4 billion, at a cost of $90 million. See "Tax Fraud and Noncompliance: IRS Could Further Leverage the Return Review Program to Strengthen Tax Enforcement." 2018. GAO-18-544.; "Internal Revenue Service: FY 2019 Capital Investment Plan." 2019.

audit potential tax evaders should increase voluntary compliance with the tax system, or deter tax evasion. Recent academic work speaks to the importance of deterrent effects. DeBacker et al (2018) find that increased income reported in the 5-8 years following a random individual audit is about 1.5 times the revenue generated by the audit itself.[2] Studies in the U.K. and Denmark find similar effects.[3] Boning et al. (2020) find that in-person collection visits raise as much revenue from firms sharing a tax preparer with the visited firm as from the visited firm itself.[4]

- Using the results from the more conservative of these estimates suggests that the deterrent effect from additional IRS resources is about as large as the direct effect of additional revenue collected from enforcement activity. That means that the $320 billion of enforcement revenue generated over a decade from the additional investment in IRS resources would lead to about $640 billion in additional revenue over the budget window if the deterrent effect is incorporated into the revenue estimate (leading to $560 billion over 10 years net of the $80 billion investment).
- The deterrent effect associated with different types of enforcement activities varies, and these effects can be challenging to identify. For example, evidence for the follow-on effects of corporate audits is mixed; as a result, we suggest only including a 50 percent boost for deterrent effects. Conservatively, about $400 billion of additional revenue can be collected (incorporating both the direct and indirect effects of enforcement investment) from the President's proposals, net of the $80 billion investment.

<u>Information Reporting and Interaction Effects of the Proposals</u>

- The Treasury's revenue estimation for a financial information reporting regime begins with an estimate of the tax gap for business income and employment taxes. This includes Schedule C, E, and F income for individual income tax, corporate income tax, and employment taxes (SECA, NIIT, etc.).
- The amounts of business income reporting are estimated using random audit data from the IRS' National Research Program (NRP) for the individual income tax. The additional pass-through entity gap relies on the preliminary results of the NRP S-corporation study. For small corporations, the tax gap comes from IRS tax gap estimates.
- OTA converts the estimated tax gap for business income and employment taxes into a revenue estimate by assuming increased voluntary compliance as taxpayers react to the increased information reporting. This is assumed to be a gradual increase in voluntary compliance that phases in over time.
- OTA estimated the revenue effects of the Administration's financial reporting proposal using these basic steps. That proposal included information on inflows and outflows for a wide range of financial accounts, additional account information including additional information on business accounts, and an annual account threshold of $600.

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[2] DeBacker, J., Heim, B.T., Tran, A., & Yuskavage, A. 2018. "The Effects of IRS Audits on EITC Claimants." *National Tax Journal* 71(3): 451-484.
[3] See Besley, T., Jensen, A., & Persson, T. 2019. "Norms, Enforcement, and Tax Evasion." NBER Working Paper 25575.; Kleven, H.J., Knudsen, M.B., Kreiner, C.T., Pedersen, S., & Saez, E. 2011. "Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark." *Econometrica* 79(3): 651-692.
[4] Boning, W.C., Guyton, J., Hodge, R., & Slemrod, J. 2020. "Heard it through the grapevine: The direct and network effects of a tax enforcement field experiment on firms." *Journal of Public Economics* 190(3-4): 104261.

- We do not know the exact parameters of Congressional proposals, but we expect that they are likely to incorporate a narrower reporting regime than was the basis of the Administration's information reporting proposal scored by Treasury. Although we have not scored any particular proposal, we suspect the revenue potential of a narrower reporting regime would be lower, perhaps in the range of $200-250 billion over the ten-year budget window. The estimated path of revenues for this proposal is backloaded, and expected revenue generated in the decade after the budget window would be larger than the revenue estimate for the initial ten-year period. This is because information reporting proposals take some time to implement and for the IRS to determine how best to deploy this new information. Moreover, the reactions of taxpayers to this increased visibility into business income also will lead to gradually increase voluntary reporting over time.
- Neither of the estimates of the revenue generation potential for the compliance proposals (increased resources and increased information reporting) reflects the interaction effects of these two major changes to the tax compliance environment. Additional information reporting is valuable to address the tax gap not just because of an increase in voluntary compliance (which is reflected in the OTA scoring approach described above), but also because additional information can help the IRS better target enforcement activities. With the resources to meaningfully pursue tax evasion that is identified through improved information reporting, there will be a meaningful direct effect on additional tax collections. In addition, the IRS investments in IT and enhanced taxpayer services will also increase the efficacy of IRS enforcement resources. While there is not an official estimate of the size of these interaction effects, due to the size of the compliance initiatives outlined here, it is reasonable to expect that the interaction effects would serve to increase revenues by at least $50 billion over the 10-year budget window, with an increase of at least that size in the subsequent decade.

<u>Overhauling the IRS by giving it the information and resources that it needs to pursue tax evasion will create a more equitable tax system. The pieces of this proposal work well together: additional information for the IRS is crucial to its ability to efficiently and effectively select enforcement actions; and additional resources are essential to help the IRS use the information at its disposal. To truly overhaul tax administration, both components of the plan are essential.</u>

The factors detailed above imply that tax compliance proposals along the lines of those being contemplated by Congress have the potential to raise around $700 billion over the ten-year budget window. Much more will be raised in the second decade, and in the decades that follow, because revenue raised from these reforms is backloaded, in part because investments in the IRS often take several years to reach their full potential. Outside estimates are more optimistic.[5] But it is also important to appreciate that this is an area with substantial uncertainty. Therefore, I have been cautious in evaluating the revenue that is likely to accrue from Congressional compliance proposals.

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[5] As one example, work by former IRS Commissioner Charles Rossotti suggests that the appropriate estimate for similar proposals to those being advanced is closer to $1.6 trillion. Rossotti, Charles. "Recover $1.6 Trillion, Modernize Tax Compliance and Assistance." Tax Notes Federal, March 2020. Other work also suggests a revenue potential from these proposals in excess of $1 trillion. See also Sarin, Natasha and Lawrence H. Summers. "Shrinking the Tax Gap: Approaches and Revenue Potential." Tax Notes Federal, November 2019.