DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

COMMISSIONER

August 27, 2021

The Honorable Elizabeth Warren
United States Senate
Washington, DC 20510

Dear Senator Warren:

Thank you for your letter of August 10, 2021 regarding the benefits of investing in the IRS, the consequences of inaction, and the difficulty the IRS faces without additional funding. To better understand the benefits of restoring the IRS's budget, staffing and technical abilities, and the costs of inaction, you requested we respond to several questions[1] by August 24, 2021.

Our responses to your letter are intended to explain where we have been, where we currently are, and what is possible in the future. Maintaining a flat budget will continue to deprive Americans of both the nature and quality of services they deserve, producing a continuing decline in fairness and service. Adding substantial multi-year mandatory funding, however, provides an opportunity to greatly improve federal tax administration for all Americans.

The gross revenue collected by the IRS is approximately $3.5 trillion per year, representing around 96% of the gross revenue of the United States. The success of the United States in providing meaningful services and benefits—infrastructure, education, etc.—depends, in part, upon the success of the IRS. We interact with more Americans than any other public or private organization. We must build a more modernized IRS, balancing enhanced taxpayer services with appropriate compliance initiatives. Decisions significantly and directly impacting the people of our country should not be resource driven.

Like all federal agencies, the IRS is best suited to fulfilling its responsibilities to the American people when it receives the resources it needs. At a time when the IRS has faced consequential resource challenges, it has also been called upon to take on new, significant responsibilities. Our response to the unprecedented challenges during the COVID-19 pandemic, in which we delivered more than $800 billion in historic relief to

[1] Because we have responded to the questions in a different order than they were asked, we are enclosing a separate document with the questions listed. Each section of this response indicates the questions to which it is responding.

individuals, illustrates the importance of every American to the IRS and the IRS to every American.

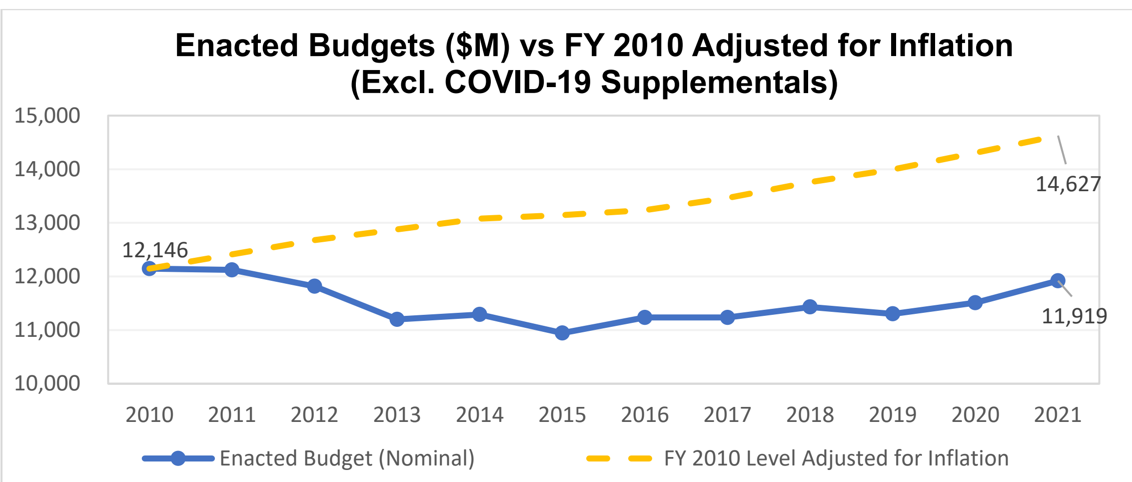
Investing in IRS technology, data analytics, and people will improve taxpayer services, restore base enforcement functions that have declined substantially over the last decade, improve the effectiveness of our existing enforcement workforce and programs, help us tackle key compliance priorities and emerging issues, and allow us to invest in programs essential to maintaining the broad compliance framework. We must earn the trust and respect of every American by providing meaningful support and assistance on behalf of compliant taxpayers while effectively pursuing non-compliant taxpayers.

We are proud to serve our country. Every employee wants to provide meaningful services supporting a fair and impartial system of tax administration every American deserves.

Background on Budget and Staffing Levels

For the better part of the last decade, the IRS has seen its budget reduced in real terms. In Fiscal Year (FY) 2010, the IRS had an enacted budget of $12.1 billion, which supported around 94,700 full-time equivalent (FTE) positions. In FY 2021, the IRS's enacted budget was $11.9 billion—$200 million less than 12 years ago.

Figure 1



This reduction does not factor in the direct effects of inflation, mandatory pay raises, increased responsibilities, and other challenges that have occurred over this same period. With inflation and anticipated mandatory pay raises considered, the IRS's FY 2021 budget is really $2.7 billion less than in FY 2010—a 22% reduction in real terms. Because of this decrease, we only expect to support around 74,200 FTEs this fiscal year—a staffing level nearly identical to the IRS's staffing level in 1973.

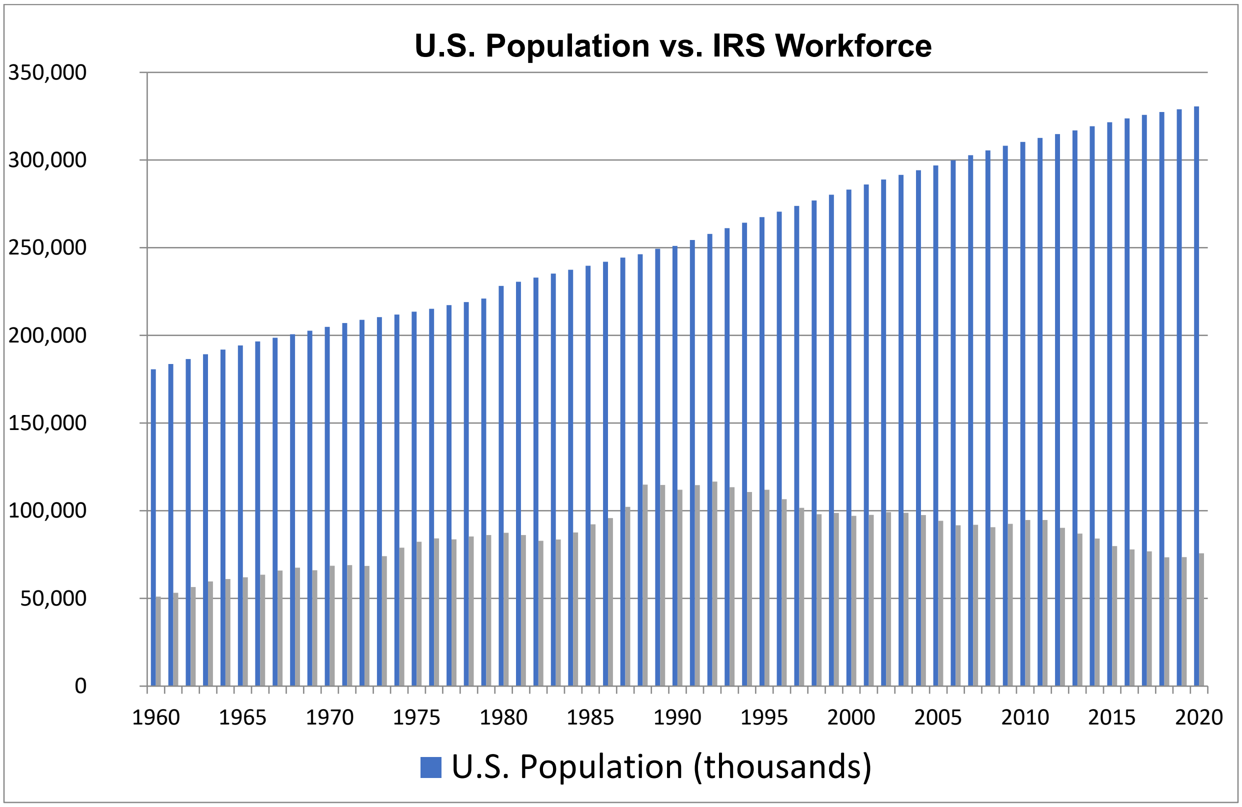
Reduced FTEs has significantly diminished our ability to:

- deliver meaningful customer service,
- maintain sufficient audit coverage of entities and individuals contributing the most to the tax gap,
- collect taxes taxpayers acknowledge they owe but have not paid,
- reduce the tax gap through a coordinated effort of both meaningful guidance and enforcement,
- fund the government, and
- modernize our Information Technology (IT) systems and facilities.

Every measure that is important to effective tax administration has suffered tremendously.

The decline in FTEs over time is even more glaring when compared with other variables that would ideally stay in line with the IRS's overall size. Figure 2 shows annual IRS FTEs compared to the overall U.S. population. Between 1960 and the early 1990s, IRS staffing grew at approximately the same rate as the growth in U.S. population. That trend started to change once electronic filing became the standard for individual returns.

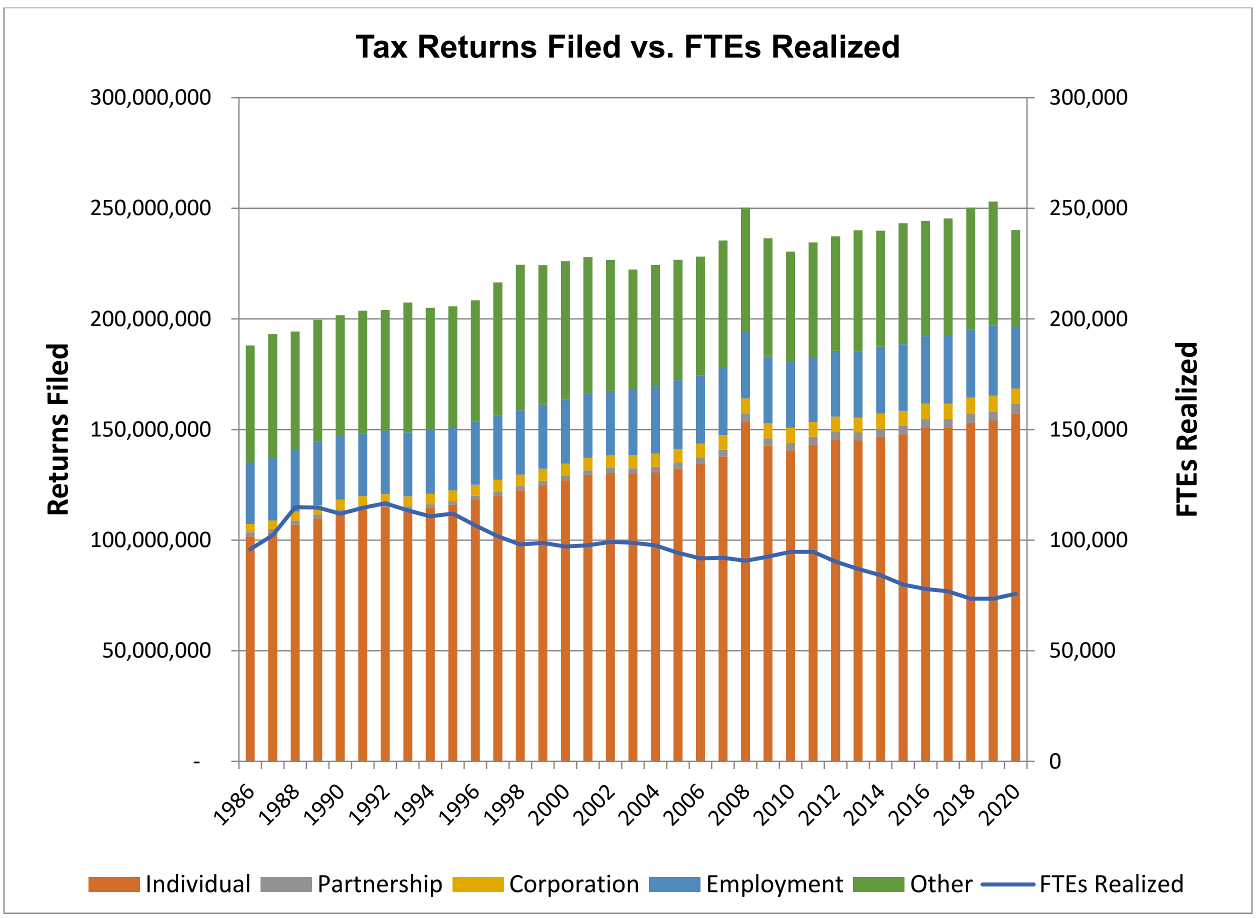
Figure 2



Since 2012, over 80 percent of individual returns have been filed electronically and the IRS no longer has to hire thousands of employees each filing season to process paper returns. However, this means that workforce losses over the course of the last decade are not about efficiency gains from e-filing. Instead, the IRS has had to reduce front-line compliance and service programs, which limits help to those most in need and most vulnerable, further reducing the overall fairness of the tax system.

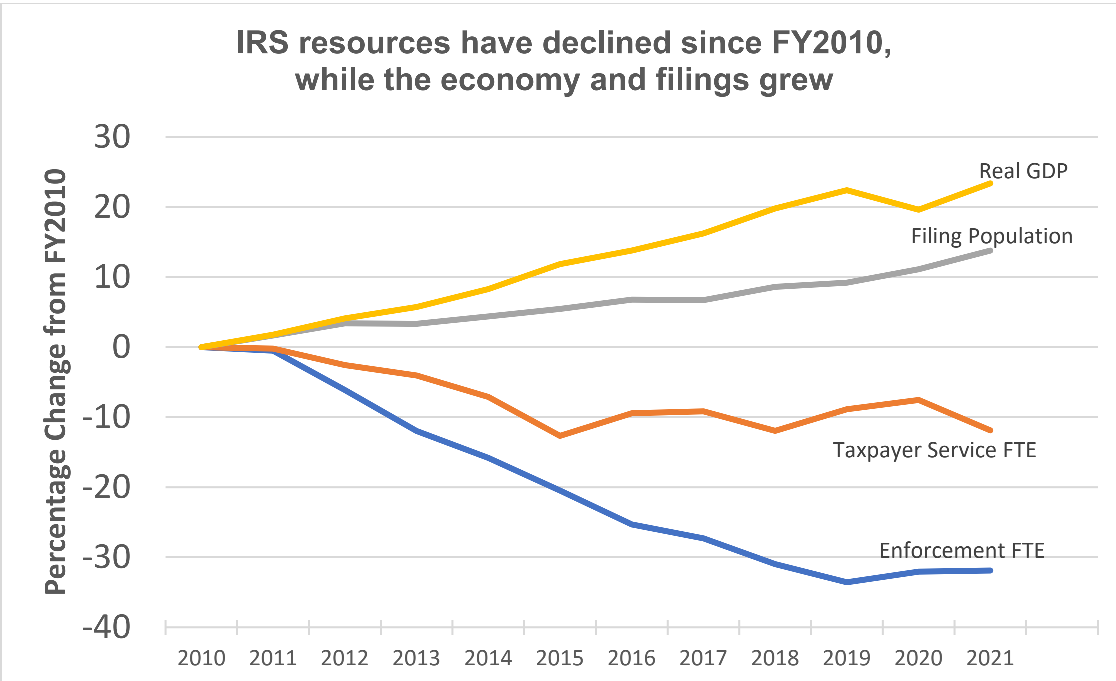
Figure 3 shows how IRS staffing has also not kept pace with total tax returns filed. Reduced IRS staffing affects enforcement through declining rates of audit coverage, collection, and customer service. Technology has helped increase IRS productivity; however, we are now at the point where inadequate investments in systems, facilities, and people outstrip those productivity gains. The IRS is in desperate need of funding across all appropriations—Taxpayer Services, Enforcement, Operations Support, and Business Systems Modernization.

Figure 3



Much has been written about the dramatic decline in our enforcement staffing since FY 2010. As can be seen in Figure 4, taxpayer services staffing has also declined, although not as dramatically. Comparing the decline in staffing levels to changes in the U.S. filing population and GDP demonstrates the significance of this decline in staffing.

Figure 4

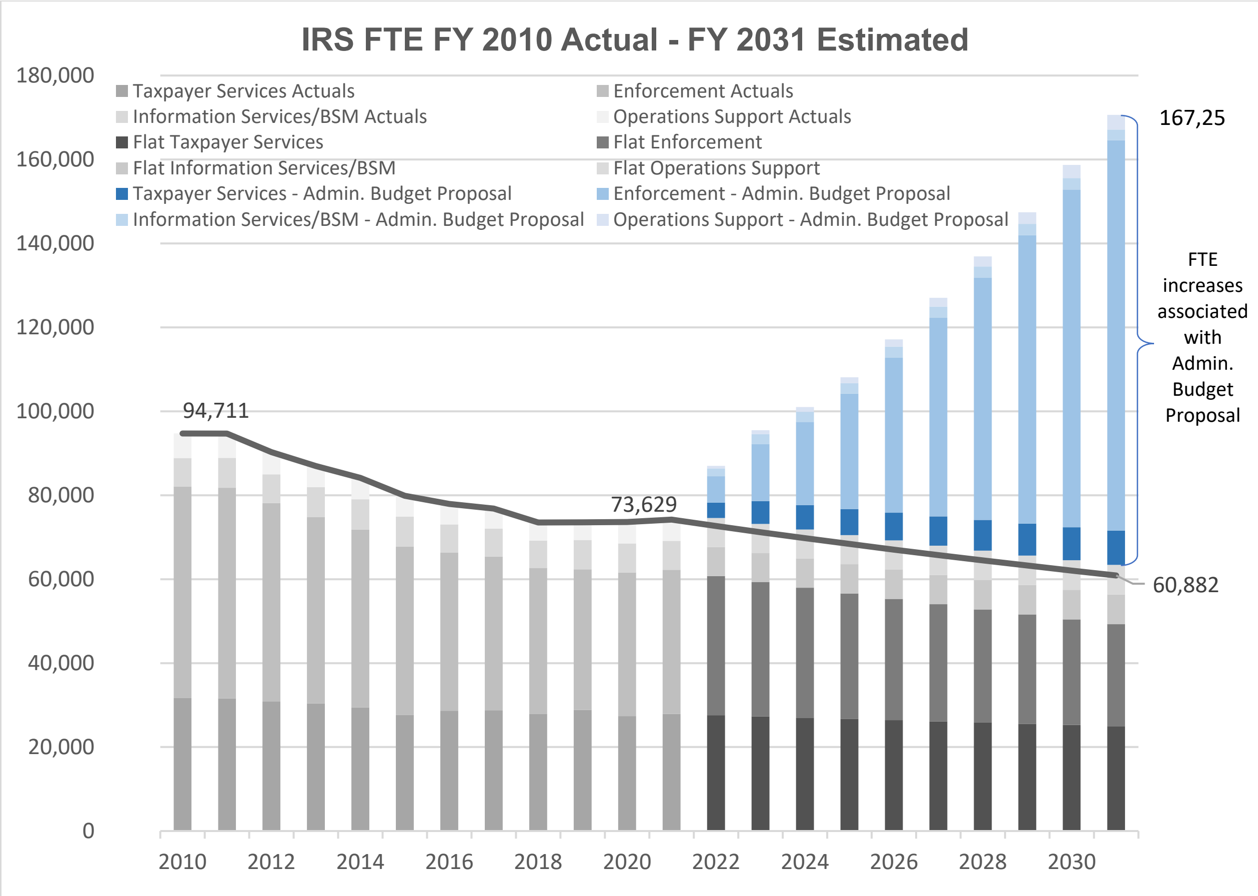


Enforcement and taxpayer services FTEs have declined by 32 percent and 12 percent, respectively, while the filing population has increased by 14 percent and Real GDP has increased 23 percent.

Tax Compliance, Taxpayer Services, IT and Other Critical Staff
Response to Questions 1.a. and 2.a.

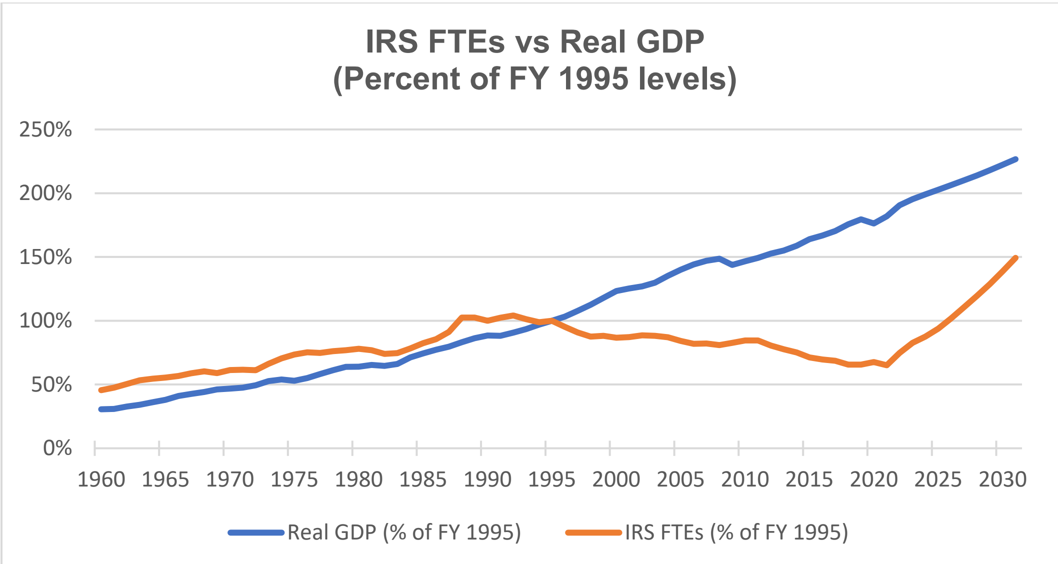
Tax compliance, taxpayer services, IT, and other critical staff roughly correspond to our main funding accounts—Taxpayer Services, Enforcement, Operations Support (OS), and Business Systems Modernization (BSM). IT is funded through both OS and BSM, but to be responsive to your questions, we accounted for it separately. As shown in Figure 5, IRS staffing is down 22 percent since FY 2010. If funding were to remain flat at current levels, given projected inflation and pay raises, IRS staffing would fall to just over 60,000 FTEs by FY 2031. This staffing level would diminish critical services taxpayers deserve and halt modernization efforts entirely. It would also further degrade our audit, collection, and criminal investigation coverage levels, threatening the foundation of voluntary compliance on which our tax administration system is built.

Figure 5



For 35 years, IRS staffing increases remained relatively consistent with GDP growth. However, since 1995, real GDP has increased by 76%, whereas IRS staffing decreased by 32% (See Figure 6). If the IRS received the full appropriations requested in the FY 2022 President's Budget along with the proposed additional program integrity allocation adjustment and mandatory funding described in the American Families Plan, we anticipate the IRS would end FY 2031 with 167,000 FTE. In addition, it would allow us to invest in critical technology to improve the taxpayer experience and use additional information reporting to increase compliance in areas where we currently lack information.

Figure 6



Customer Service

Response to Questions 1.e. and 2.f.

Since the pandemic began more than a year ago, the IRS has worked hard to maintain quality taxpayer service. The IRS currently provides service on phones, in-person, online or through correspondence mailed to the IRS. The IRS maintains, analyzes, and regularly reports on a suite of budget level, performance, quality, and customer feedback measures and indicators, most of which have performance goals and targets based on funding received.

IRS customer service measurements are mostly tied to the annual appropriated Taxpayer Services budget. One such budget-level measure is the IRS Level of Service (LOS) for telephone support. LOS generally refers to how many callers actually reach a Customer Service Representative (CSR). Another budget-level measure is our annual goal for toll-free accuracy. Other examples of budget-level measures relate to the timeliness with which we deliver critical filing season tax products and the number of taxpayer contacts that are resolved through self-assistance.

In addition to budget-level measures, we maintain an extensive set of performance, quality, and operational measures across all major service channels. These channels include return processing, in-person service, and online services, all of which are either directly or indirectly affected by the IRS appropriated budget.

IRS employees have performed well under exceptionally difficult circumstances and extreme resource challenges. Resource issues impairing tax administration are not new and have been highlighted by almost every Commissioner over the past few decades. We have been forced to continually modify processes and redeploy our limited resources wherever possible in an effort to accommodate immediate demands and the highest current priorities. Every employee wants to be effective. However, we simply have not had the resources to be as effective as we could be. Therefore, I am extremely supportive of the Administration's funding proposals.

Online Services

We encourage taxpayers to use existing electronic tools available on IRS.gov where possible. Since Congress authorized the first Economic Impact Payments (EIPs) in the CARES Act in March 2020, people have visited IRS.gov in record numbers to perform a variety of tasks. In addition to the services and information previously requested, visitors to the site are gathering information and taking actions regarding their EIPs, delayed tax refunds, and Advance Child Tax Credit (CTC) payments.

Table 1 illustrates the IRS online services with significant growth since the start of the pandemic.

Table 1

Service or Application	FY 2021 through July 31	FY 2019
IRS.gov visits	2 billion	650 million
Attempts to check EIP status through Get My Payment	680 million	N/A
Refund queries in Where's My Refund	600 million	370 million
Transcript downloads through Get Transcript	67 million	21 million
Online Account visits	43 million	12 million
Status queries in Where's My Amended Return	10 million	5 million
Visits to CTC Update Portal	11 million	N/A

As the pandemic affected the ability to provide certain traditional services, the IRS has been increasing the scope of our Taxpayer Digital Communications (TDC) program. TDC provides secure messaging and chat capabilities for certain issues. This program requires an investment in both technology and staff to handle chat sessions and respond to digital correspondence. Table 2 compares these services now and before the pandemic.

Table 2

TDC Capability	FY 2021 through July 31	FY 2019
Chats Serviced	620,000	100,000
Chat Average Handle Time	6 min	7 min
Forms 2848 or 8821 Submitted	230,000	0
Secure Messaging Messages from Taxpayers	80,000	30,000
Secure Messaging Messages to Taxpayers	90,000	45,000
Secure Messaging Taxpayer Accounts Created	40,000	8,000

Additional funding is needed both to sustain these programs and to deliver taxpayers additional digital self-assistance services they have come to expect. We are developing improved authentication methods and a range of new services, such as:

- electronically viewing and receiving IRS notices,
- updating taxpayer addresses online,
- expanding online account access to business taxpayers,
- expanding online chat and secure messaging options, and
- providing new online tools for tax professionals.

All these new services require additional funding to build the technical solutions and re-engineer services. Our goal is to provide an integrated online taxpayer experience.

Toll-Free Telephone Services

We currently have about 14,800 CSRs, which makes the IRS customer service telephone operation one of the largest in the world. We provide phone service to individuals, businesses, tax professionals, and tax-exempt entities. We have specialty lines for the hearing impaired, identity theft victims, the taxpayer protection program, and appointment services for our Taxpayer Assistance Centers (TACs). We also offer over-the-phone translation services in 350 languages. During disasters, such as February’s extreme weather in Texas, our CSRs assist the Federal Emergency Management Agency in answering urgent intake calls from disaster victims.

When we closed most of our facilities in March 2020 to protect employees and others from COVID-19, we quickly provided our CSRs laptops, related equipment, and training to become telework eligible. In March 2020, only 3% of our CSRs were telework eligible. Within weeks, they were all telework eligible and able to work remotely in a virtual environment. Even with all our CSRs working, though, we cannot keep up with the volume of phone calls that has skyrocketed beyond anything we’ve ever experienced.

At the same time, the average duration of each call has also increased due to the complexity of COVID-related tax law changes and because taxpayers have personally endured a lot throughout the pandemic. Some taxpayers have experienced isolation without anyone else to talk to for a long time. Our average time per call has increased from 13 minutes in calendar year 2019 to more than 19 minutes so far in calendar year 2021. Spending more time on each call to provide the customer service taxpayers deserve reduces the operator's ability to handle more calls during a shift. We have encouraged our CSRs to take that time since we are many taxpayers' sole contact with the government.

To provide insight into the scope of our phone operations, we have already received over 199 million calls since January 1 of this year. That volume is about 400% more calls than we get in an average year. Between live assistors and automated services, we have answered more than 49.2 million calls. For comparison, we received a total of 42 million calls in 2018, 40 million calls in 2019, and 55 million calls in 2020.

During a typical filing season, we average two to three million calls each day. On March 15, 2021, we received 8.6 million calls on just that one day, *an average of about 1,500 calls per second*. The high call volume has significantly hampered our ability to manage telephone demand based on the capacity limitations of our telephone routing equipment used to place callers in line for service.

Customer Service Hiring Efforts

As a result of the increasingly high call volumes, our LOS is significantly lower than in previous years. This LOS decrease is exacerbated by our inability to employ enough CSRs to meet the demand. It's hard to turn this situation around quickly as even under typical pre-pandemic levels of demand, each 10% increase in LOS requires an appropriation of approximately $100 million to achieve. As discussed above, current demand greatly exceeds typical levels. The resources currently required are at least four times as high and are far beyond what is available in our appropriated budget. For these reasons, it is extremely difficult to increase LOS in response to a significant, unexpected rise in taxpayer contacts.

When we submitted our FY 2021 funding request to Congress in early 2020, there was no way to predict the severity of the pandemic and the effect it would have on call demand, filing season and hiring. The FY 2021 funding we received from Congress allowed us to employ about 14,800 CSRs for the 2021 filing season for an expected LOS of approximately 50%. That estimate, however, was before approval of three rounds of EIPs, the Advance CTC, and other important tax law changes that taxpayers needed help navigating.

We attempted to ease these challenges by starting the CSR hiring process for the 2021 filing season months earlier than normal. However, the pandemic caused significant hiring challenges, including low applicant pools in some locations, delays in fingerprinting due to closed facilities, and delays in processing applicants virtually. While we were able to hire an additional 3,800 CSRs for the 2021 filing season, it was short of our goal of 5,000.

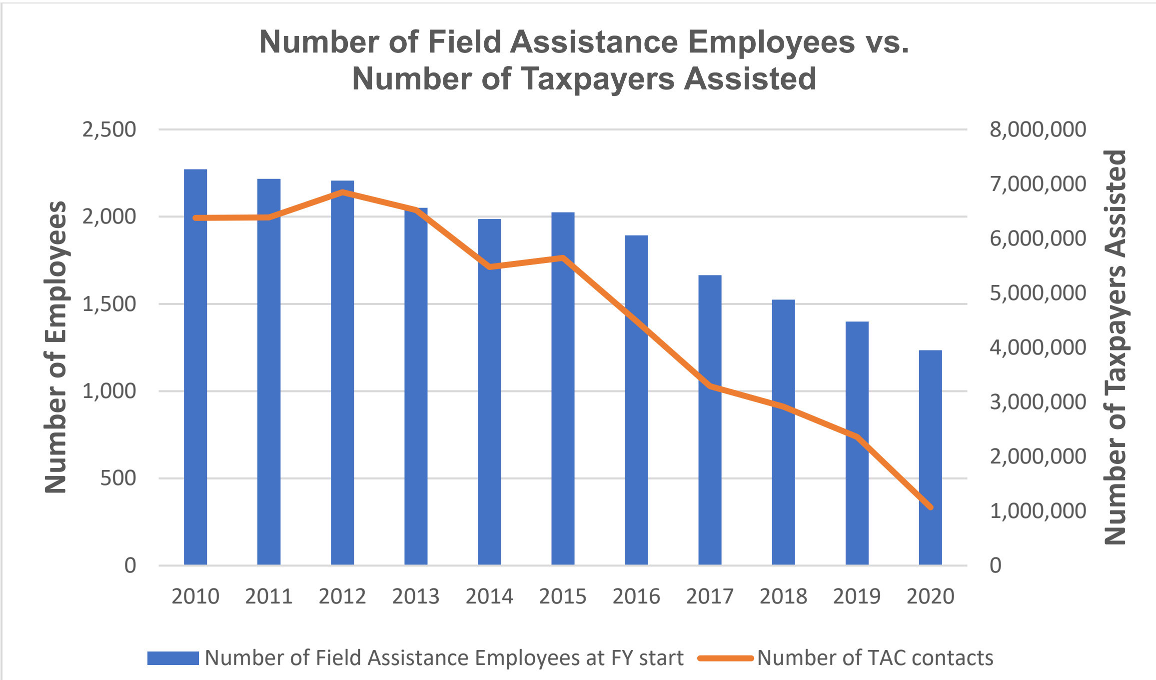
We want to do better in assisting taxpayers. We are working to improve the situation to the extent our resources allow. For example, we are testing new training approaches to get new CSRs ready to work the phones in less than the usual 14-week timeframe. We also are using artificial intelligence (AI) and automated call systems to answer simple questions and free CSRs to handle more complex calls. We are working to reduce hold times by expanding our customer callback feature, which gives callers the option to receive a return call from us rather than stay on hold. This feature has saved people hundreds of thousands of hours waiting for assistance, and we plan to continue expanding this capability in the future.

Customer Service Improvements

We cannot overemphasize the importance of multi-year consistent funding. The timing of funding is critical to service delivery. Without a sufficient and steady stream of funding for taxpayer service, our LOS will remain at an unacceptable level. Too many taxpayers will be unable to reach live assistance when needed, and those who do get through will face longer wait times for service. Further, having consistent funding in place for taxpayer service will enable the IRS to respond to customer demand in real-time, which is important given that demand can at times be difficult to predict, as the last year has highlighted.

Providing quality taxpayer service is crucial to ensuring voluntary compliance, but improving service requires investments in both additional staffing and technology modernization. The FY 2022 Congressional Budget Justification includes a $318 million program increase for annual discretionary funding to increase our ability to answer more telephone inquiries, reduce correspondence inventory by 400,000, and increase TAC staffing levels to re-open TACs and restore office hours. Additional resources through the mandatory funding proposal would add an additional 1,000 employees to our toll-free lines and over 400 employees to the TACs, which would allow for roughly 1,880,000 *additional* taxpayer contacts and help reverse the decline in face-to-face services due to insufficient budget appropriations (see Figure 7).

Figure 7



Modernization is another critical element in expanding the IRS's ability to meet taxpayers' service needs. We are making meaningful progress with modernization efforts and promptly delivered recently enacted financial assistance and administrative relief to hundreds of millions of deserving and needy Americans. However, the speed at which we can deliver services to taxpayers and increase our efficiency through technology is slowed by insufficient funding.

Providing us with multi-year, consistent, and adequate funding for modernization will help us improve the taxpayer experience and meet taxpayer and stakeholder needs. Some examples of the improvements include:

- More meaningful taxpayer experiences and improved interactions with the IRS;
- Expanded digital services, including secure document exchange, expanded payment options for taxpayers, and digital authorization with eSignature;
- Improved taxpayer experience through expanded automated callback, increased use of the appointment process tool, and expanded AI-powered interactions such as chat-bot appointments;
- Strengthened community presence by hiring and training new professionals in hard-to-reach communities;
- Increased access to digital services, including for taxpayers living abroad, through new authentication protocols;
- Expanded multi-lingual services, including increased translation of forms, publications, and notices, as well as multi-lingual assistance;

- Increased access to and use of data, improving program and AI service delivery and creating a continuous feedback loop; and
- Reduced dependency on legacy systems.

As noted earlier, an investment in modernization will support the IRS's efforts to continue implementing its Integrated Modernization Business Plan for upgrading IT systems and retiring legacy applications. This funding will enable the IRS to advance significant modernization initiatives that directly benefit taxpayers. These initiatives include digital communications, customer callback, and Enterprise Case Management, all of which will allow our customer service staff to provide more comprehensive service to taxpayers.

The unprecedented COVID-19 pandemic illustrates the significant role that the IRS plays in the overall health of our country. We have been called upon to provide economic relief during this national crisis while also fulfilling our routine responsibilities of tax administration. Like all federal agencies, the IRS is best suited to fulfilling its responsibilities when it receives the resources it needs. Yet even as the IRS has been asked to take on new responsibilities affecting almost every American, we continue to face significant resource challenges. Our response to the unprecedented COVID-19 challenges illustrates the importance of every American to the IRS and the importance of the IRS to every American.

IT System Needs
Response to Questions 1.b.and 2.b.

IRS's technology needs are severely underfunded, a problem that has worsened over time as the demand for IT services grew and funding did not keep pace. There are several main reasons IT demand is growing:

- Taxpayers expect more electronic interactions, and the IRS strives to provide them;
- Digital services increase speed, reduce errors, and allow operations to continue 24/7 regardless of staff presence;
- As increasingly sophisticated cybersecurity attacks threaten IRS systems, the IRS must increase IT security efforts;
- New statutory requirements require additional IT investment; and,
- Implementation of past information reporting regimes, such as the Foreign Account Tax Compliance Act (FATCA) and merchant card reporting, require IT overhaul.

Because of this growth in demand, current funding levels do not satisfy the IRS's IT needs. Each year, the IRS must take extraordinary measures to fund IT. For FY 2021, we were able to fund about $2.0 billion of the necessary $2.6 billion in OS IT needs from appropriated resources. To fund the remaining $600 million, we had to request an inter-appropriation transfer of approximately $200 million from Enforcement and apportion approximately $400 million of user fees to IT.

In this digital age, so much of what the IRS and taxpayers do each day depends on technology. From electronic filing to web-based online services, technology is at the core of tax administration. To improve compliance and taxpayer service activities, we must not only hire additional employees, but also invest in technology to modernize existing systems and develop new capabilities to further reduce taxpayer burden and ensure compliance with our tax laws.

IT investments drive improved compliance and provide taxpayers with the information and services they need to understand and comply with tax laws. The benefits of increased funding for IRS IT include:

- Expanding online capability to complement existing channels—not replace—to give taxpayers and their representatives more choices in how to engage with the IRS to view, correct, and update account information securely, and to receive and submit documents electronically and securely with the IRS;
- Expanding taxpayer service channels to include text chat, virtual assistant and video chat assistance technologies;
- Improving the selection of returns for audit and enabling identification of the "next best case" across compliance workstreams;
- Identifying specific mismatches between Forms K-1, Forms 1099-K, and FATCA reports;
- Increasing the usability of FATCA report information;
- Using new information reports to identify noncompliant partnerships and other sources of noncompliance;
- Increasing compliance with enhanced online tools and systems to engage and exchange data with taxpayers;
- Moving toward real-time tax processing to identify suspect taxpayers;
- Enabling taxpayer self-service tools to improve voluntary compliance; and
- Enabling proactive taxpayer self-correction by reducing the time between filing and compliance activities—for example, by blending compliance with outreach.

Increased funding for IRS technology will improve our efficiency and overall effectiveness while reducing future operating costs.

In FY 2019, the IRS developed a detailed six-year Integrated Modernization Business Plan (Modernization Plan)[2] that would cost $2.3 - $2.7 billion to fully implement. In the first two years of the Modernization Plan (FY 2019 and FY 2020), the IRS completed 60 deliverables. However, from FY 2019 through FY 2021, the IRS only received around 55% of the planned BSM funding. Even with our use of supplementary funding sources,

[2] https://irssource.web.irs.gov/Linked%20Documents%20Library/IRS-Integrated-Modernization-Business-Plan.pdf

such as inter-appropriation transfers, this funding shortfall required us to significantly rescope and reschedule the Modernization Plan, which proceeded at a slower pace than initially planned. The mandatory funding proposal would provide funding to deliver many of the capabilities described in the Modernization Plan along with on-going Operations & Management costs once the modernized systems are operational and can no longer be funded from the BSM account, which solely funds development.

With increased funding, the IRS will also be also better positioned to implement the proposed Financial Account Information Reporting regime as outlined in the American Families Plan.[3] In addition, the Bipartisan Infrastructure Deal[4] contained a provision for additional information reporting related to cryptocurrency transactions. These two new sources of information would result in significant volumes of new data regarding financial transactions. The new data will provide the IRS with a lens into otherwise opaque sources of income with historically lower levels of reporting accuracy, such as partnership and sole-proprietorship income. Because these transactions do not precisely correspond to line items on tax returns, however, maximizing the effectiveness of this new reporting (as well as existing reporting on foreign accounts and merchant card transactions) requires adequate funding to implement comprehensive systems. These comprehensive systems will not only ingest and store the new data, but will also identify entity relationships and help IRS researchers develop and apply analytics to select the most productive audit work.

In addition to an end-to-end solution to intake and analyze all Form 1099 information returns, additional funding would be used to transition from legacy case management systems. Eliminating legacy systems will allow for quicker issue resolution and increased audit efficiency and productivity. It will also allow the IRS to implement broader, more proactive digital communication systems to support taxpayers earlier in the filing process.

Overall, modernization funding will allow the IRS to address core technology challenges and transform taxpayer services and tax enforcement efforts. It will make data more easily accessible, allow the IRS to integrate case management systems, and move the IRS toward near real-time tax processing. Machine learning capabilities will enable the IRS to leverage the information it collects to better identify tax returns for compliance review. Additional investments in the IT workforce will ensure staff can deploy new analytical techniques and meet imminent threats to the security of the tax system, like cyberattacks.

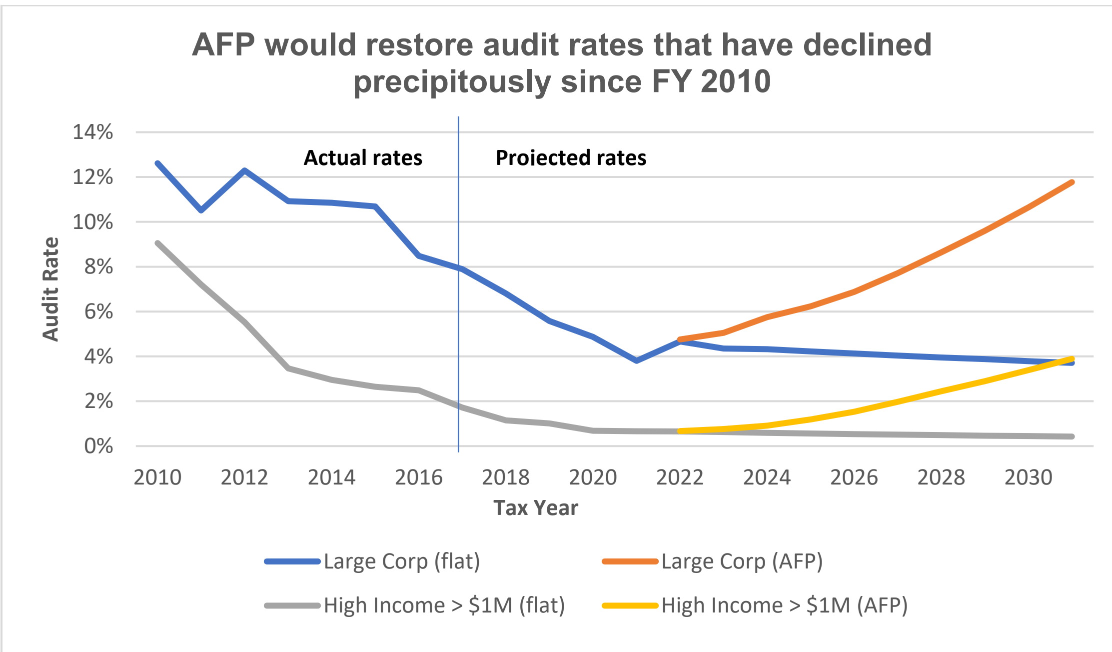
[3] See https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/.

[4] See https://www.whitehouse.gov/briefing-room/statements-releases/2021/07/28/fact-sheet-historic-bipartisan-infrastructure-deal/.

Audit Rates for Wealthiest Taxpayers and Large Corporations
Response to Questions 1.c., 1.d., 2.c., and 2.d.

Figure 8 displays the anticipated audit rate scenarios for high income individuals (more than $1 million in income) and large corporations (assets greater than $10 million) if the IRS funding levels were to remain the same compared to if we were to receive the full funding requested in the FY 2022 President's Budget and the American Families Plan (AFP).[5] The inherent risk of the current reduced IRS audit coverage levels is that taxpayers may become emboldened to take riskier tax positions, such as overclaiming deductions, underreporting income, and not paying what they owe.

Figure 8



We have already begun to shift examination resources to increase our focus on tax returns with complex issues, such as:

- high-income taxpayers,
- pass-through entities,
- multi-national taxpayers with international tax issues,
- large pension plans, and
- private foundations.

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[5] The estimated figures in this graph for FY 2017 and beyond are based on the average number of closed and in process audits each year multiplied by the number of anticipated FTEs under current funding levels and under the funding levels requested in the AFP.

Increased funding will allow the IRS to hire additional specialized examination personnel to raise audit coverage in these areas. We currently have about 6,500 front line examiners. For perspective, we received approximately 4.2 million pass-through returns last year, including returns for complex, tiered entities otherwise subject to little third-party reporting.

Enhancements in IRS technology are clearly helpful in offsetting some portion of the declining enforcement workforce. However, it would be difficult for such enhancements on their own to significantly offset the increased sophistication of taxpayers, who operate in a digital world economy with an increasingly complex set of tax laws. With technological advances, we will be able to identify more instances of noncompliance that would not have been possible just a few years ago.

Auditing Wealthy Individuals with Offshore Accounts
Response to Question 2.e.

Analyzing FATCA reports shows that partnerships hold the plurality of offshore assets and income, and the wealthiest taxpayers are the most likely to hold assets in a foreign account. Increased technology funding is essential to link foreign-held assets back to their beneficial owners and to detect potential non-compliance. New technology resources will accelerate our ability to link data from multiple reporting systems. They will also enable us to develop analytical systems that use information reporting to detect unreported income and identify when account holders or foreign financial institutions may be engaging in non-compliant or fraudulent behavior.

Once we detect potential non-compliance or fraudulent behavior, we need sufficient funding to pursue the information and ensure proper compliance. We particularly need additional personnel with specialized training to follow cross-border money flows. They will help ensure tax compliance by improving the IRS's capacity to detect unreported accounts and income generated by those accounts, as well as the sources of assets in offshore accounts.

Tax Gap Estimate
Response to Question 1.f.

Reducing the tax gap and improving compliance is a central part of the IRS mission. The tax gap represents, in dollar terms, an estimate of the annual amount of noncompliance with our tax laws. It does not distinguish between under-reporting, non-filing, or the underpayment of tax based on a good faith misunderstanding of the tax law; intentional evasion of filing or reporting obligations; domestic or foreign source income; legal or illegal source income; etc. However, we base our published estimates on *observed* noncompliant behavior for certain identified non-filers, under-reporters, and underpayers. To the extent we do not have reliable data, our historical estimates do not represent an all-inclusive measure of global tax non-compliance by U.S. taxpayers.

The most recent official tax gap estimates (reflecting a $441 billion annual gap) relate to tax years 2011-2013. We released those estimates in 2019. We are in the process of preparing a new study on the tax gap covering tax years 2014-2016, which we expect to release early in 2022.

Over the years, our studies have consistently suggested that overall tax compliance is holding steady in the 82 percent to 84 percent range.[6] For tax years 2011-2013, the estimated tax gap translated to about 83.6% of taxes paid voluntarily and on time, which is in line with recent levels. This estimate is essentially unchanged from a revised tax year 2008-2010 estimate of 83.8%. After enforcement efforts are considered, the estimated share of taxes eventually paid is 85.8% for both periods, which is in line with the estimates for tax years 2001 and 2006 of 86.3% and 85.5%, respectively. Based on what we know about the deterrent or indirect effects of tax enforcement activities, the overall decrease in IRS audits over the last decade is likely eroding the historically stable voluntary compliance rate.

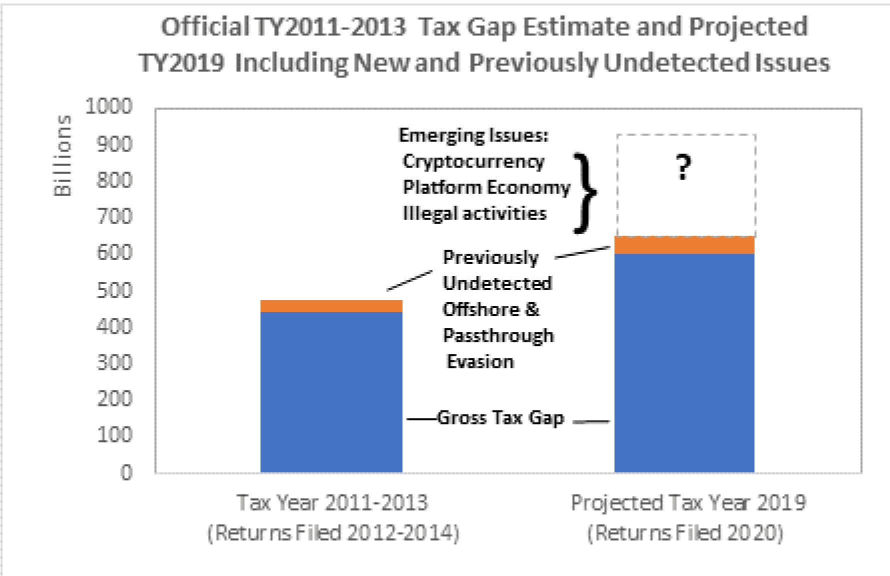
The data needed to produce tax gap estimates using our traditional methodology takes a few years to collect, due to several factors, including the statutory protections and processes granted to taxpayers to file, dispute and appeal tax findings. Taxpayers have until late each year to file a previous year's tax returns and it takes a few years after filing to measure compliance. The IRS uses examination data to estimate some components of the tax gap, and that takes the longest amount of time to collect. Also, reliable estimates require resource-intensive, time-consuming research gathered from a wide range of sources, including statistically selected in-person taxpayer audits conducted under the National Research Program (NRP). The audit findings are then supplemented by other information sources, such as third-party income and expense reporting, late-filed returns, and tabulations from IRS master files of enforced and other collections. These steps mean that tax gap estimates traditionally trail the tax year as we gather data about compliance upon which to base the estimates. Current efforts to produce more timely estimates are detailed below.

For much of the past few years, we have been pursuing new approaches and methodologies to estimate the tax gap in an effort to enhance the currency of future tax gap estimates as well as identify and measure emerging sources contributing to the tax gap. New methodologies will make greater use of information collected during operational audits to augment a smaller, focused random statistical sample of NRP audits. By applying modern machine learning techniques to our data in close to real time, we hope to produce more timely estimates and projections of the tax gap that will better support current strategic planning. These analyses will be grounded in data reported on tax returns along with contemporaneous audit results. In our preliminary research, applying this methodology to the 2011-2013 official tax gap estimate of $441

[6] The actual dollars represented by the tax gap can be affected by whether the country is experiencing a recessionary economy, but the percentage has remained mostly steady since about 2001.

billion suggests the gross tax gap for 2019 would be approximately $600 billion (see Figure 9).

Figure 9



It is important to note that simply projecting data from 2011-2013 forward in time omits important structural changes in the economy since that period. For example, the data underlying the 2011-2013 tax gap estimate did not include the modern platform economy, cryptocurrency, micro-captive insurance schemes and syndicated conservation easements, which were just beginning to gain popularity in that period. Today, they are significant U.S. economic activities. Noncompliance associated with taxpayers conducting transactions in virtual currencies is a particular area of concern today. As of August 20, 2021, there are approximately 11,000 virtual currencies with a current global market cap of more than $2 trillion.[7] Recognizing compliance challenges associated with virtual currencies, the IRS has focused significant enforcement resources over the past two years in the virtual currency environment.

A greater use of operational audit data along with advanced analytics will also provide insights into issues that are not well measured through statistical samples. These issues include noncompliance related to certain foreign transactions and activities, illegal source income (which is taxable and is pursued by the IRS, often in coordination with other federal and state agencies), and other types of concealed taxable income. Such issues are often highly concentrated in relatively small segments of the tax filing population.

[7] https://coinmarketcap.com/

A recently released National Bureau for Economic Research working paper titled Tax Evasion at the Top of the Income Distribution: Theory and Evidence,[8] demonstrates the utility of operational audit data for this purpose. By combining data from randomly selected audit cases and operational audits, the research team was able to measure sophisticated tax evasion by taxpayers at the very top of the income distribution that is not fully captured by our legacy tax gap methodology. The research team indicated they used conservative methods and estimated that evasion through offshore bank accounts and/or complex pass-through business structures contributed an additional $33 billion to the 2011-2013 tax gap. That amount would equal about $46 billion for tax year 2019 in addition to the previous estimate of $600 billion for tax year 2019.

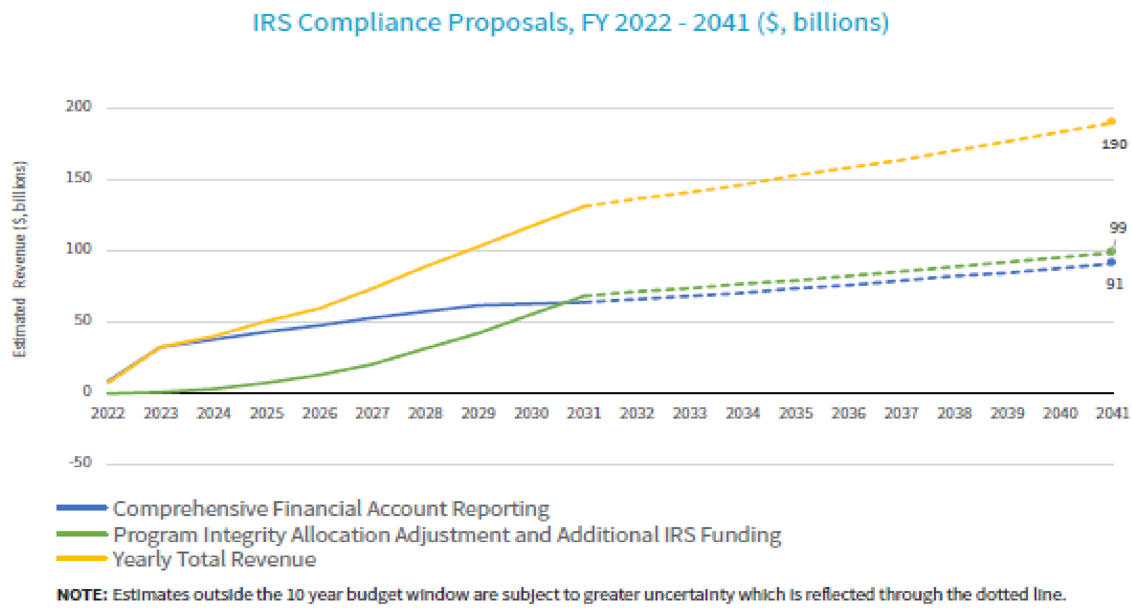
If IRS resources continue to decline, the number of examination and collection activities will decline, and we will collect less direct enforcement revenue in both absolute terms and relative to a growing population. While the U.S. has generally enjoyed high rates of voluntary compliance, declining enforcement activity will result in a smaller deterrent effect and potentially embolden some formerly compliant taxpayers to adopt more aggressive positions or attempt to evade some of their tax responsibilities. Even a 1% decline in the voluntary compliance rate can result in the loss of over $30 billion in annual revenue, exceeding the more immediate effect of declining resources on direct enforcement revenues.

Closing the Tax Gap
Response to Question 2.g.

Figure 10 displays the projected additional revenue over the next 20 years from the cumulative efforts of increasing enforcement funding and financial account information reporting as proposed in the American Families Plan, assuming the increased funding will remain after FY 2031. The Administration estimates that enhanced tax gap efforts will generate $700 billion in additional tax collections over the first ten years, and around $1.6 trillion over the course of the second decade. The rest of this section discusses how these gains will be realized.

[8] Available at https://www.nber.org/papers/w28542.

Figure 10



As discussed above, the gross tax gap is the difference between true tax liability for a given tax year and the amount that is paid on time. It is composed of the nonfiling gap, the underreporting gap, and the underpayment (or remittance) gap. With additional mandatory funding, we will better address the tax gap on all fronts—nonfiling, underreporting, and underpayment.

First, to address the underreporting gap, the IRS will hire specialized examiners, significantly increasing audit activity on high income individual taxpayers, partnerships, and large corporations. As explained in the American Families Plan, the Administration projects that over 10 years, we will collect an additional $269 billion in direct enforcement revenue and will protect an additional $46 billion by preventing fraudulent refunds.

Second, assuming we receive additional information reporting for cryptocurrency transactions plus account inflows and outflows from financial institutions, we will have significant, meaningful insight on areas where we currently have limited or no information. Enhanced information reporting is one of the few means of sizably increasing the compliance rate, largely due to the increased visibility of income sources and financial transactions. When the IRS has information returns to cross-reference with tax returns, we see voluntary compliance of around 95 percent. In short, the more transparent a taxable payment is to the IRS, the more likely it is to be reported. Although this new reporting will not be a direct match to line items on the tax return like wage or interest income reporting, we will be able to apply sophisticated data analysis to better identify underreporting of income.

The Department of the Treasury's Office of Tax Analysis estimated that the additional information reporting for financial inflows and outflows could bring in an additional $460 billion over 10 years. The Joint Committee on Taxation (JCT) estimated the cryptocurrency reporting provision could bring in an additional $28 billion over 10 years.

Moreover, whenever we implement new information reporting requirements, we see behavioral changes among taxpayers that result in higher voluntary compliance. In 1991, the New York Times published an article[9] that reported the following two examples of these behavioral changes:

- The IRS required Social Security numbers for all dependents over the age of 5 starting in 1987. The number of claimed dependents that year dropped by 9 percent (or 7 million children). The reduction in dependents increased revenue by $2.9 billion. Although about 20 percent of those dependents were children who had been claimed by both parents after a divorce, most of the vanished dependents likely never existed.
- In 1989, taxpayers claiming the dependent-care credit had to start reporting the name, address, and Social Security number of the care provider. That year, thousands of day-care providers began reporting income. The number of taxpayers claiming the credit also dropped by 30 percent—from 8.7 million in 1988 to 6.1 million in 1989—effectively eliminating 2.6 million alleged baby-sitters.

When the IRS introduces new technologies, we also see tangible and measurable improvement to tax compliance. For example, the IRS began developing the Return Review Program in 2010. The program's purpose is to detect and stop identity theft and other fraudulent activity in individual return filings. Between 2015 and 2019, the number of taxpayers reporting that they were identity theft victims fell 79% from 677,000 in 2015 to 137,000 in 2019. Between 2015 and 2019, the IRS protected a combined $26 billion in fraudulent refunds by stopping confirmed identity theft returns.[10]

We also plan to increase our collection staff with increased funding. While we send an initial notice and demand letter to every taxpayer with a balance due, we were able to dispose of only 41 percent of the available collection inventory in FY 2019, leaving 59 percent unresolved. At the end of FY 2019, there were over 30 million cases left in our collection inventory that had either a delinquent return or outstanding balance due. Additional trained collection employees will improve taxpayer compliance by getting taxpayers to fully pay the taxes they owe, addressing the underpayment gap. They will also be able to better interact with taxpayers who simply don't file a return at all, addressing the nonfiling gap.

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[9] *See* Tamar Lewin, *I.R.S. Sees Evidence of Wide Tax Cheating on Child Care* (Jan. 6, 1991), available at https://www.nytimes.com/1991/01/06/us/irs-sees-evidence-of-wide-tax-cheating-on-child-care.html.
[10] *See* Internal Revenue Service Progress Update, Fiscal Year 2020, Publication 5382 (Rev. 12-2020), available at https://www.irs.gov/pub/irs-pdf/p5382.pdf.

Where the IRS can make the greatest progress on closing the tax gap is by improving voluntary compliance. It is important to point out that failures to comply with the tax law are often due to unintentional mistakes from not fully understanding what has come to be an extremely complex tax code. For that reason, efforts to reduce the tax gap and increase overall tax compliance absolutely must include efforts to assist taxpayers in meeting their filing, reporting and payment obligations. These efforts include the issuance of timely and clear guidance and programs to educate taxpayers in their tax obligations.

For every 1 percent improvement in voluntary compliance, annual revenue should increase by about $30 billion per year. An example is the additional enforcement efforts we undertook surrounding Reports of Foreign Bank and Financial Accounts (FBARs). The Bank Secrecy Act requires taxpayers to file FBARs annually when the total value of their foreign accounts exceeds $10,000. The IRS saw a large increase in the number of self-reported foreign accounts after we implemented enhanced and well-publicized enforcement efforts in 2008. In 2009, the number of first-time FBAR filers more than doubled compared to the prior years to about 90,000 individuals. According to an article in the American Economic Journal published last year:[11]

> The steep increase [in filed FBARs] is suggestive that a large number of taxpayers—a simple difference estimate would be around 50,000 individuals—disclosed previously unreported foreign accounts in response to the new enforcement policies. Only about 15,000 of the first-time FBAR filers in 2009 participated in the voluntary disclosure program, suggesting that much of the compliance response—a simple difference estimate would imply around 35,000 individuals—occurred in the form of "quiet disclosures" outside of the voluntary disclosure program. We estimate that the combined value of the accounts disclosed because of the enforcement efforts was just over $100 billion.

Enhanced Enforcement through Additional Information Reporting
Response to Questions 3.a. and 3.b.

Tax compliance is far higher when reported income is subject to verification against information reporting. Our research shows that compliance is as low as 45 percent when income is subject to little or no information reporting or tax withholding. When there is substantial information reporting, compliance rises above 95 percent.

There are behavioral reasons for this: Taxpayers are more likely to be compliant when they know the IRS has the information necessary to pursue them should they not meet their tax obligations. Furthermore, additional information reporting will improve IRS

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[11] *See* Niels Johannesen, et al., *Taxing Hidden Wealth: The Consequences of US Enforcement Initiatives on Evasive Foreign Accounts*, American Economic Journal: Economic Policy, Vol. 12, No. 3 (August 2020), available at https://www.aeaweb.org/articles?id=10.1257/pol.20180410.

enforcement actions by providing the IRS with data we do not currently have on wealthy taxpayers, and could provide insight to their potential tax liability without requiring an examination.

While tax enforcement is necessary and financially worthwhile, significant mitigation of the tax gap will also require policy and other changes, such as:

- legislative expansions of IRS authority,
- reduced complexity of the tax code,
- increased information reporting, and
- policy changes that improve IRS access to relevant data.

The IRS can also apply data analytics to newly collected data and detect emerging areas of compliance risk, as well as improve case selection so we are focusing on the most egregious instances of noncompliance. By focusing our compliance efforts on noncompliant taxpayers, we will simultaneously reduce the burden on compliant taxpayers.
Increased information reporting targets underreported income, which is the largest category of the tax gap. It does this task by making it more difficult to hide and underreport income. The President's plan includes three elements that are complementary to increased information reporting—improved technology, expanded analysis, and increased staffing for compliance. The proposal allocates $4.5 billion over ten years for IT to administer the new program by ingesting, storing, and analyzing large financial transaction data to identify cases and improve examination outcomes. It also funds additional research staff to identify the best methods to use the new information. Finally, the proposal funds large increases in enforcement staff. This last element is important, because once the IRS identifies a case of likely tax evasion, we must have examination staff to prove impropriety and assess additional taxes owed.

This combination is expected to provide revenue to the government through direct enforcement collections. Even more importantly, the analysis from the Department of the Treasury's Office of Tax Analysis (OTA) discussed earlier shows its greatest effect would be improving voluntary compliance among taxpayers who otherwise might have chosen to underreport their income. As previously stated, OTA estimated the generation of $460 billion in additional tax revenues over the course of the next decade, and the JCT estimated that information reporting associated with cryptocurrency assets will generate an additional $28 billion.

Impact of Additional Information Reporting on Compliant Taxpayers
Response to Question 3.c.

Additional information reporting serves compliant taxpayers in multiple ways. First, it provides them information relevant to completing their return, which reduces their filing and compliance costs. Second, it reduces the burden of unnecessary compliance contacts with IRS. With more effective data matching and near real-time processing of the additional information from the Financial Account Information Reporting (FAIR) regime, the IRS is less likely to engage in unnecessary or erroneous interactions with compliant taxpayers. Third, technological investments that enable timely access to third-party information and increased data usage will allow prompt communication with taxpayers and help them correct inadvertent errors before penalties and interest accrue. Finally, by improving the IRS's ability to detect and rectify willful noncompliance, additional information reporting will ensure the tax ecosystem remains fair for the majority of taxpayers who are striving to meet their tax obligations.

Impact of Additional Information on Financial Institutions
Response to Question 3.d.

We have worked with our colleagues at the Department of the Treasury (Treasury) to think about the implementation of a new FAIR regime, including the information that will be reported to the IRS and how this new information will be stored and deployed in enforcement activities. As explained above, increased information reporting is one of the best ways to improve tax compliance. Our history with information reporting reveals its immense value. It is important, however, that any new reporting requirements be designed to mitigate any costs to individual taxpayers and businesses.

Treasury has been careful to mitigate such costs in the context of the FAIR regime. Specifically, individual taxpayers do not have any new requirements. From a compliant taxpayer's perspective, there is a potential benefit—due to better enforcement targeting from new information reports, there is a lower likelihood they will need to undergo a costly and burdensome audit.

The FAIR regime has also been designed to minimize any costs for financial institutions associated with providing additional information to the IRS about account inflows and outflows. Specifically, FAIR builds off the existing Form 1099-INT. Financial institutions already send this report to the IRS when a taxpayer earns more than $10 in interest income during the year. Further, Treasury has made clear they are actively working with members of Congress to reduce any new burden associated with this new reporting requirement, particularly on small financial institutions.

It is worth noting that Treasury also worked to ensure that banks are not at a competitive disadvantage with non-bank competitors. For that reason, and to ensure the reporting regime is comprehensive, the new reporting regime also includes non-bank financial institutions. The objective is to provide information that can help the IRS identify high-end tax evaders and make meaningful progress in addressing their noncompliance.

Mandatory multi-year, consistent funding will help us deliver meaningful services to taxpayers, conduct critical enforcement initiatives, and support long-term modernization efforts improving both service and compliance. We remain committed to ensuring the tax system is administered fairly and impartially and that every American receives the nature and quality of services they deserve.

I hope this information is helpful. I am sending a similar response to Senators Whitehouse and Sanders. If you have questions, please contact me, or a member of your staff may contact Amy Klonsky, Chief, National Congressional Affairs Branch, at 202-317-6985.

Sincerely,

Charles P. Rettig

Digitally signed by Charles P. Rettig
Date: 2021.08.27 17:49:38 -04'00'

Charles P. Rettig

Enclosure

Enclosure

Questions from Senators Warren, Whitehouse, and Sanders

1. What are the IRS' current needs and capacity at the funding levels that are now in place for the agency? Specifically,
    a. What are current staffing levels for tax compliance, taxpayer services, IT, and other critical staff, and how will these evolve if we continue at current funding levels?
    b. What are current IT system needs, and will these needs be met at current funding levels?
    c. What are current audit rates for the wealthiest taxpayers? What will happen to these audit rates in future years if there are no changes in IRS funding?
    d. What are current audit rates for large corporations? What will happen to these audit rates in future years if there are no changes in IRS funding?
    e. How does the IRS measure customer service needs and the agency's ability to meet these needs? What will happen to these measures in future years if there are no changes in IRS funding?
    f. What is your best estimate of the tax gap? If there are no funding changes in future years, what will happen to the size of the tax gap?

2. How will proposed increases in funding help close the tax gap and improve IRS customer service? Specifically,
    a. How will increased funding help the IRS hire more tax compliance, taxpayer services, IT, and other critical staff?
    b. How will increased funding help the IRS meet IT system needs, and how will this benefit taxpayers?
    c. How will increased funding affect audit rates for the wealthiest taxpayers?
    d. How will increased funding affect audit rates for large corporations?
    e. How will increased funding help the IRS more effectively audit wealthy taxpayers with income hidden in offshore accounts?
    f. How will increased funding help the IRS improve customer service? In what ways will taxpayers benefit from these improvements?
    g. How will increased funding help IRS close the tax gap and ensure that the wealthy pay their fair share? How much could the tax gap be closed with the proposed increase in funding?

3. How will proposed information reporting requirements for financial institutions help close the tax gap and target audits towards noncompliant taxpayers and away from compliant taxpayers? Specifically,
    a. How will the additional information help the IRS enhance its enforcement activities with respect to tax evasion by the wealthy and large corporations?
    b. How will the information reporting requirements interact with increased IRS funding, including for staffing and IT systems, to build more capable and targeted enforcement efforts with respect to tax evasion by the wealthy and large corporations?
    c. How will the additional information impact compliant taxpayers, including individuals and small businesses?
    d. How has the reporting proposal been planned and developed in order to make sure that it is fair and reasonable in how it impacts financial institutions?