



TAX POLICY CENTER
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Can Closing the Information Gap Close the Tax Gap?

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Evolution of Biden Administration Proposal to Increase Information Reporting

May: Require financial institutions to report flows in and out of clients' accounts on 1099-INT

- Breakdown of physical cash, transactions with foreign account, and intra-bank transfers
- De minimis gross threshold of \$600
- Ten-year revenue = \$463 billion

June: Dropped references to breakdown by type of flow

- Ten-year revenue = ?

September: Raised de minimis to \$10,000

- Ten-year revenue = \$200 billion to \$250 billion

October: Off the table

Why would the proposal raise so much money?

Treasury's Answer

- Mostly by increasing **voluntary compliance** by sole props, partners, small corps
 - Voluntary compliance grows over time

- Enhance effectiveness of enforcement measures
 - Builds off proposal to boost IRS's 10-year budget by \$78 billion

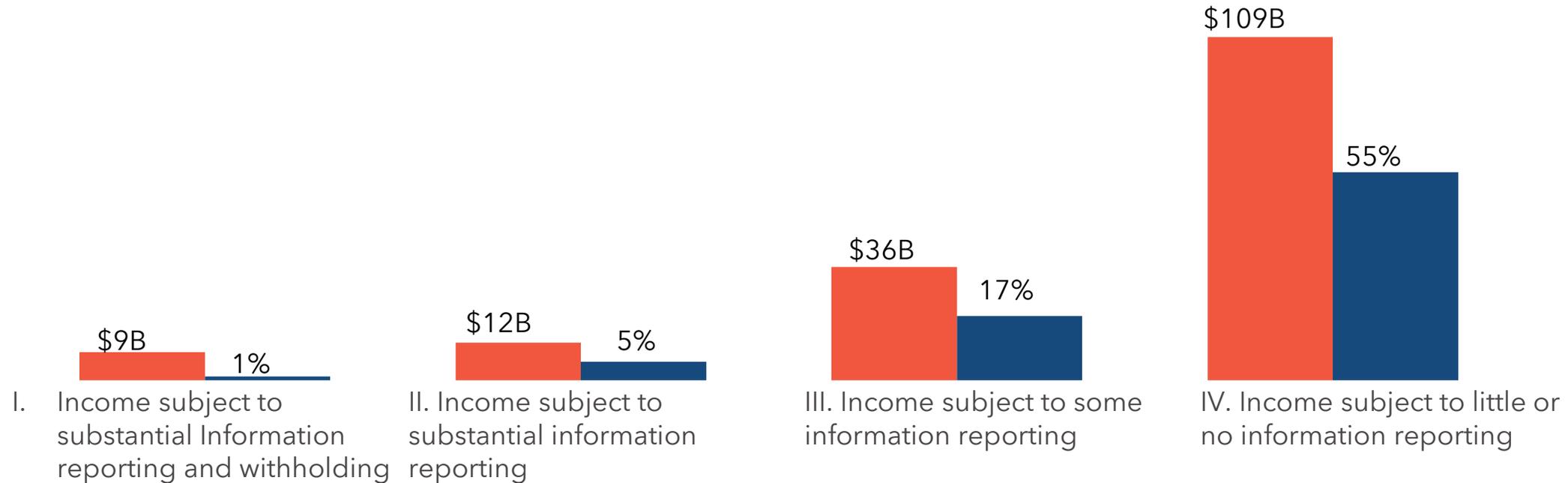
- Portion of funding for development of **machine learning** to leverage information to better identify tax returns for compliance review

Visibility Chart

By Category of Income, Tax Years 2011-2013

■ Underreporting Tax Gap (Tax)

■ Net Misreporting Percentage (Income)



Source: Internal Revenue Service, Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011-2013, Publication 1415 <https://www.irs.gov/pub/irs-pdf/p1415.pdf>

IRS has a treasure trove of Big Data

Type of Information Return	Number of forms in 2018 Millions
1099-INT	150
W-2	260
1099-B	2,300
Other	800
Total	3,500

Source: GAO, Better Coordination Could Improve IRS’s Use of Third-Party Information Reporting to Help Reduce the Tax Gap, GAO-21-102, pages 61 – 63.

Is Big Data sufficient to spur voluntary compliance?

- In simple models, voluntary compliance is a function of the **probability of detection** as well as the net rewards to cheating

- Third-party information increases probability of detection only if used effectively
 - Attitudes toward risk matter too
 - So do taxpayers' perception of the IRS's ability to use the data effectively

Specificity, Relevancy, Timing, and Current Use of Big Data

	During filing season	Post-filing season
Return-specific data	SSN: Math error	W-2: Automated underreporting program
Return-relevant data	Dependent database: Selection for pre-refund audit	Bank records: Use during post-refund audit

Budget constraints limit use of 3rd party information

Stages of AUR	Number (millions)
Information returns matched to individual income tax returns	2,754
Discrepancies identified	22
Notices issued to taxpayers	3
<i>Notes: About 20 percent of discrepancies resulted in AUR notices, on average, between 2009 and 2013. AUR staff cut by 43 percent between 2011 and 2018.</i>	

Sources: GAO, Better Coordination Could Improve IRS’s Use of Third-Party Information Reporting to Help Reduce the Tax Gap, GAO-21-102, pages 61 – 63; IRS Data Book, 2018, Table 14; TIGTA, The Use of Schedule K-1 Data to Address Taxpayer Noncompliance Can Be Improved, 2019-30-078; TIGTA, Automated Tax Assessments Have Increased Significantly; However, Accuracy-Related Penalties Were Not Always Assessed When Warranted, 2015-30-

Machine learning and the IRS

- Can machine learning make third-party information more relevant?
- Can machine learning reduce average enforcement costs?

Cautious yes?

IRS's Return Review program

- Not rules-based, hence more flexibility

- Two approaches
 - Supervised learning, such as data mining of prior-year tax returns
 - Unsupervised learning, such as clustering as current year returns are processed

- Machine learning is not Hal; it's not AI.
 - Still requires human action to review findings and adjust audit selection rules

Is the Return Review Program successful?

- Does it have a 50:1 return on investment, as some supporters claim?
 - IRS stopped \$4.4 billion in refunds in 2017 (first year)
 - IRS spent \$90 million on the program in 2017

- The 50:1 estimate does not reflect development costs before 2017
 - ROI falls to 11:1 in 2017
 - Up to 18:1 by 2020

- Limitations of ROI
 - Average, not marginal
 - Future behavioral responses uncertain

Measuring success of machine learning and tax enforcement

- **Return on investment**

Enforcement revenue

Enforcement costs

- **No-change ratio**

Number of audits settled in taxpayers' favor

Total number of audits

- **Response rate**

Number of taxpayers who respond to audit notice

Total number of audits

Considerations

- Infrastructure investments
 - Update technology
 - Solve the paper filing logjam (affects information returns as well as tax returns)
 - Bringing together coding experts with code experts
- Methodology
 - Mitigating bias
 - Validation
 - Transparency—even to the users?
- Can machines understand the gray areas of the tax code/tax gap?