

**WRITTEN TESTIMONY OF
DOUGLAS O'DONNELL, DEPUTY COMMISSIONER
SERVICES AND ENFORCEMENT
THE INTERNAL REVENUE SERVICE
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEES ON OVERSIGHT AND SELECT REVENUE MEASURES
ON THE TAX GAP
JUNE 10, 2021**

Chairmen Pascrell and Thompson, and Ranking Members Kelly and Smith, and members of the Subcommittees, thank you for the opportunity to discuss the tax gap.

INTRODUCTION

My name is Doug O'Donnell and I am the Deputy Commissioner for Services and Enforcement at the Internal Revenue Service. In this capacity, I provide leadership to the four taxpayer-focused IRS operating divisions: Wage & Investment, Large Business and International (LB&I), Small Business/Self Employed and Tax Exempt & Government Entities (TE/GE). My division also includes the IRS Criminal Investigation Division, Office of Professional Responsibility, Online Services, the Return Preparer Office and the IRS Whistleblower Office.

In Fiscal Year (FY) 2019, the IRS collected \$3.56 trillion in taxes and generated almost 96 percent of the funding that supports the Federal Government's operations. As such, in part, the success of our country depends upon a successful IRS. We serve and interact with more Americans than nearly any other public or private organization.

Given the events of the past year, we appreciate the \$3.1 billion in additional funding we received from Congress to respond to the COVID-19 pandemic and implement the EIPs and other tax changes. In addition, our base FY 2021 funding level (excluding these additional resources) represents a 3.6 percent increase over FY 2020. However, it will take time to overcome the challenges of the past decade, and the agency will continue to struggle to replace employees lost through attrition and expand our workforce, support implementation of our multi-year Integrated Modernization Business Plan as designed, and continue enhancing meaningful service and compliance efforts that will earn the trust and respect of every American and improve our working relationships with taxpayers and others in the tax community.

We respect and proudly serve all taxpayers. We must operate from their perspective, through their eyes, enhancing their experiences while striving to provide clear, meaningful guidance and services, in the language of their choice, wherever possible. In support of compliant taxpayers, we must aggressively pursue non-compliant taxpayers by maintaining robust, visible civil and criminal enforcement efforts.

EFFORTS TO NARROW THE TAX GAP

We are proud to serve our country and want to provide meaningful services of a nature and quality every American deserves to help them timely and accurately file their tax returns and receive any refund or pay any taxes due. In support of compliant taxpayers, we must pursue meaningful enforcement efforts, appropriately balanced with our support of taxpayer service, taxpayer rights and privacy rights. The IRS continues to develop innovative approaches to understanding, detecting, and resolving potential noncompliance to maintain taxpayer confidence in the tax system.

Section 61 of the Internal Revenue Code generally defines “gross income” as “all income from whatever source derived . . .” Taxable income is that portion of gross income that is properly subject to taxation under applicable provisions of tax law. The tax gap is defined as the difference between the amount of tax owed by taxpayers for a given year and the amount that is actually paid voluntarily and timely. The tax gap is intended to represent, in dollar terms, the annual amount of tax noncompliance with our tax laws. It does not distinguish between under-reporting, non-filing or 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.

The tax gap is determined by the IRS Research, Applied Analytics and Statistics (RAAS) organization. The most recent tax gap study released in 2019 covered Tax Years (TY) 2011-2013 (generally returns filed during calendar years 2012-2014). For that time period, the estimated gross tax gap was \$441 billion.

The net tax gap is the amount of tax that will not be paid after subtracting from the gross tax gap the portion that eventually will be collected as a result of IRS enforcement activities or paid late but voluntarily by taxpayers. RAAS estimated that \$60 billion of the gross tax gap eventually would be paid – either voluntarily or collected through IRS administrative and enforcement activities – resulting in an annual net tax gap of \$381 billion of taxes owed as compared to what is actually paid. Without action to address this gap, the potential growth in the amount of taxes left unpaid and uncollected could result in a tax gap totaling several trillion dollars over the next decade.

However, given restrictions in data availability, it is extremely difficult to empirically estimate the level of tax gap associated with all noncompliance activities in the current state of the economy. Our most recently published tax gap estimates for calendar years 2011-2013 are not intended to represent an all-inclusive, current measure of global tax non-compliance by U.S. taxpayers. They are outdated, under-inclusive, and are based on limited types of detected information. The 2021 digital world economy is significantly different from the world economy of 2011-2013. Published estimates have traditionally relied on historical audit and collection data for certain identified nonfilers, underreporters, and underpayers. For at least the past 18 months, we have been working on updating and enhancing the underlying approach and methodology, improving the currency of the estimates and considering how to better identify and incorporate additional information that may assist us in forecasting emerging compliance issues.

We will soon be implementing new tax gap approaches and methodologies, including more operational audit data and identifying additional sources contributing to more inclusive estimates that are reflective of the actual tax gap. In addition, advancements in artificial intelligence, advanced data, and analytic strategies have enhanced our capabilities to identify areas of noncompliance in ways that were not remotely possible just a few years ago. These new tax gap data and methodologies will assist us in determining and coordinating the deployment of our limited enforcement-related resources, both to minimize burden on compliant taxpayers and to concentrate on reaching noncompliant taxpayers.

While a portion of the unpaid tax obligations that make up the tax gap result from a lack of knowledge or ambiguity and complexity in tax law, willful evasion is also a significant contributing factor. The 2022 Budget includes a program integrity allocation adjustment, which includes targeted investments in enforcement activities to help IRS address this evasion.

The tax gap has many underlying causes including complexity, opaque sources of income and insufficient IRS enforcement. Budget cuts over the past decade have resulted in an agency that lacks the capacity to address sophisticated tax evasion efforts. Appropriations for the IRS have fallen by about 20 percent (adjusted for inflation) since FY 2010. The decline in the overall IRS budget has resulted in a 15 percent decline in the number of full-time employees at the agency since FY 2010.

The effect of personnel lost is most visible in enforcement activities. Among the 33,378 full-time personnel lost between FY 2010 and FY 2020, more than 13,388 were enforcement personnel. These losses included revenue agents and revenue officers who audit tax returns and perform collection activities, as well as special agents who investigate tax-related crimes and other issues.

There's no single solution to achieving a meaningful reduction in the tax gap or one type of taxpayer responsible for it. Reducing the tax gap requires a comprehensive, multi-faceted strategy and effective execution from the IRS coupled with appropriate safeguards and accountability to taxpayers. Investment in our service, enforcement and compliance efforts is extremely important. Multi-year, consistent, timely and adequate funding helps us deliver meaningful services to taxpayers, conduct critical enforcement initiatives, and support long term IT modernization efforts that help improve compliance. Greater investment in technology can help us properly assist compliant taxpayers. Modernization of our systems coupled with technological advances in artificial intelligence, availability of data in digital formats and enhanced analytical capabilities will continue to enhance services to compliant taxpayers and make tax avoidance by others more visible and more difficult.

Efforts necessary to raise compliance levels are resource intensive. We remain committed to ensuring that taxpayers receive the nature and quality of services they deserve, the tax system is enforced fairly, and that no one at any income level feels safe cheating on their taxes. In addition to the need for the IRS to run a balanced enforcement

program, the tax gap – and the underlying components – illustrate that we also need to continue focusing on solid, meaningful taxpayer service to help people understand and satisfy their filing and reporting obligations.

THE PRESIDENT’S FISCAL YEAR 2022 DISCRETIONARY BUDGET

The President’s Fiscal Year (FY) 2022 discretionary Budget proposal for the IRS provides \$13.2 billion, an increase of \$1.2 billion, or 10.4 percent, above the 2021 enacted level, to administer the nation’s tax system fairly, collect \$3.5 trillion in taxes to fund the government and strengthen tax compliance.

In addition to the base appropriations request, the Budget proposes a program integrity allocation adjustment that would provide an additional \$417 million in FY 2022, to fund investments in expanding and improving the effectiveness and efficiency of the IRS’s overall tax enforcement program, for a total of \$13.6 billion for the agency in FY 2022.

The President’s Budget proposal supports fair and equitable tax administration for all Americans, including increasing oversight of high-wealth individuals and corporations to ensure compliance and move toward closing the tax gap. It also improves the taxpayer experience by providing new and improved online tools for taxpayers to communicate with the IRS easily and quickly. The Budget also supports the IRS’s efforts to continue improving telephone and in-person taxpayer customer service, as well as expansion of the agency’s outreach and assistance to underserved communities. These increased resources represent a significant investment in tax administration, because the IRS has an overall return on investment (ROI) of about \$5 for every \$1 invested, excluding significant deterrence effects.

Specific Funding Areas

The FY 2022 Budget requests a total program increase of \$915.5 million, including the following:

- **Taxpayer First Act (TFA):** \$176.1 million for implementing major TFA initiatives, including a Taxpayer Experience Strategy to improve the American taxpayer’s experience with the IRS through expanded digital services, increased multilingual services, and an increased presence in hard-to-reach, historically underserved communities. Another major TFA initiative involves enhancing identity proofing and authentication tools, to ensure taxpayers have secure access to online services.
- **Enforcement:** \$340 million for continuing to establish enforcement strategies that will ensure a fair tax system, by allowing the IRS eventually to double its compliance efforts on partnerships and high-wealth returns and devote more resources to examining large corporations with balance sheet assets greater than \$10 million. Other initiatives supported by this investment include: The Cross Border and Treaty and Transfer Pricing Operations; expansion of oversight efforts against cybercrime; increased use of applied data analytics in enforcement activities; and enhancing taxpayer confidence in the tax-exempt sector.

- **Taxpayer Service:** \$318 million to increase taxpayer assistance via the various communication channels taxpayers use to reach us, including phone calls, correspondence and in-person visits. This investment provides a projected phone level of service (LOS) of 75 percent in FY 2022, assuming phone demand returns to pre-pandemic levels and the IRS is able to provide in-person services at pre-pandemic levels. These funds will also be used to reduce the current projected FY 2022 ending correspondence inventory by about 400,000 pieces.
- **Modernization:** \$78.1 million for IT modernization activities. This investment will support IRS efforts to continue implementing its Integrated Modernization Business plan for upgrading IT systems and retiring legacy applications. With this funding, the IRS will be able to take the next steps on such significant modernization initiatives as Enterprise Case Management, Taxpayer Digital Communications and customer callback on its taxpayer phone lines.

The IRS dedicates itself to improving the taxpayer experience so that taxpayers and their representatives can understand and meet their tax obligations with minimal burden. The IRS's aim is to increase voluntary compliance through simplifying the tax filing, correction, and payment processes. To help achieve this, the IRS will focus on improving education and outreach on taxpayer rights and obligations and enhancing service channels to meet taxpayer needs.

THE PRESIDENT'S LONG-TERM PLAN TO IMPROVE TAX ADMINISTRATION

As a part of the American Families Plan, the President recently made a series of proposals that would overhaul tax administration and provide the IRS with the resources and information it needs to address tax evasion over the long term. A key component of this initiative is the provision of a sustained, multi-year stream of funding for tax administration. Receipt of consistent, timely, multi-year funding is critical to the future success of tax administration. All told, these reforms will generate an additional \$700 billion in tax revenue over the course of a decade, net of the investments made.

The proposal directs nearly \$80 billion to the IRS over a decade to hire new specialized enforcement staff, modernize antiquated information technology, and invest in meaningful taxpayer service—including the implementation of the newly expanded Child Tax Credit and Child and Dependent Care Tax Credit aimed at providing support to American families.

Components of the Plan

The proposal to provide the IRS with \$80 billion over 10 years has two primary components:

- A multi-year program integrity allocation adjustment of \$6.7 billion over a decade. It is estimated to generate \$38.6 billion in new direct revenue and protect \$11.6 billion over 10 years. This ROI is likely understated because it does not reflect the effect that enhanced enforcement has on deterring non-compliance.

- Approximately \$72.5 billion in mandatory funding over the budget window. A portion of these proposed IRS resources would fund improvements and expansions in enforcement and compliance activities. The proposed mandatory funding would also provide the IRS with resources to enhance its information technology capability – including implementation of the proposed financial information reporting regime described later in this testimony – and to strengthen taxpayer service. The proposal would direct that additional resources go toward enforcement against those with the highest incomes, rather than Americans with actual income of less than \$400,000.

Absorbing Additional Resources over the Next Decade

The 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 plan allocates the mandatory funds over a 10-year period, and the plan design ensures that the IRS is able to absorb and usefully deploy additional resources over the entire 10-year horizon.

The plan provides enforcement resources, including a significant investment in revitalizing the IRS's examination of large corporations, partnerships, and global high-wealth individuals. It also includes funding for other important IRS priorities that support tax administration. It includes nearly \$6 billion for 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. It also includes \$4.5 billion to implement a new information reporting regime as well as additional resources to protect against imminent threats to the security of the tax system, like cyberattacks.

Additional IT tools will help support a staff capable of deploying new analytical techniques and ensure that enforcement personnel have the most up-to-date tools to support their work to enhance compliance. Investing in developing machine learning capabilities will enable the IRS to leverage the information it collects to better identify tax returns for compliance review.

Initial Hiring Plans and Estimates for Return on Investment

The IRS is committed to appropriately, efficiently and wisely using the resources we receive from Congress. The IRS is developing a hiring plan that will allow us to hire the necessary people with the right skills. We will hire people with a mix of experience; that is, along with people just or recently out of college or graduate school, we will also hire people at the mid-point and beyond in their careers who would have greater levels of experience and expertise, so that we could greatly accelerate the impact their hiring would have in the enforcement and service areas for which they are selected.

We will hire enforcement staffing to support our base enforcement functions but also hire a balanced mix of staffing, including employees in our research division, our Criminal Investigation division, Chief Counsel, Appeals and the Taxpayer Advocate Service.

THE PRESIDENT'S LEGISLATIVE PROPOSALS

In addition to the multi-year IRS funding plan in the American Families Plan, the Budget includes several important proposals to improve tax administration and provide the IRS with a blueprint to address various facets of the tax gap. These proposals align with the President's plan for sustained, multiyear funding of the IRS. The major tax compliance and administration proposals include the following:

- ***Increase oversight of paid tax return preparers.*** Paid tax return preparers have an important role in tax administration because they assist taxpayers in complying with their obligations under the tax laws. The proposal would amend Title 31, U.S. Code (Money and Finance) to provide the Secretary with explicit authority to regulate all paid preparers of Federal tax returns, including by establishing mandatory minimum competency standards. The proposal would be effective on the date of enactment.
- ***Increase penalties on ghost preparers.*** So-called ghost preparers are compensated for preparing returns but refuse to identify themselves on the returns purposely to avoid detection. The proposal would increase the penalty amount to the greater of \$500 per return or 100 percent of the income derived per return by a ghost preparer. The proposal would also increase the limitations period during which the penalty may be assessed from three years to six years. The proposal would be effective for returns required to be filed after December 31, 2021.
- ***Introduce comprehensive financial account information reporting.*** This proposal would create a comprehensive financial account information reporting regime. Financial institutions would report data on financial accounts in an information return. The annual return will report gross inflows and outflows with a breakdown for physical cash, transactions with a foreign account, and transfers to and from another account with the same owner. This requirement would apply to all business and personal accounts from financial institutions, including bank, loan, and investment accounts, with the exception of accounts below a low de minimis gross flow threshold of \$600 or fair market value of \$600. Other accounts with characteristics similar to financial institution accounts will be covered under this information reporting regime. In particular, payment settlement entities would collect Taxpayer Identification Numbers (TINs) and file a revised Form 1099-K expanded to all payee accounts (subject to the same de minimis threshold), reporting not only gross receipts but also gross purchases, physical cash, as well as payments to and from foreign accounts, and transfer inflows and outflows. Similar reporting requirements would apply to crypto asset exchanges and custodians. Separately, reporting requirements would apply in cases in which taxpayers buy crypto assets from one broker and then transfer them to another broker, and businesses that receive crypto assets in transactions with a fair market value of more than \$10,000 would have to report such transactions. The Secretary would be given broad authority to issue regulations necessary to implement this proposal. The proposal would be effective for tax years beginning after December 31, 2022.

- **Expand authority to require electronic filing for forms and returns.** Under this proposal, electronic filing would be required for returns filed by taxpayers reporting larger amounts or that are complex business entities, including: (1) income tax returns of individuals with gross income of \$400,000 or more; (2) income, estate, or gift tax returns of all related individuals, estates, and trusts with assets or gross income of \$400,000 or more in any of the three preceding years; (3) partnership returns for partnerships with assets or any item of income of more than \$10 million in any of the three preceding years; (4) partnership returns for partnerships with more than 10 partners; (5) returns of real estate investment trusts, real estate mortgage investment conduits, regulated investment companies and all insurance companies; and (6) corporate returns for corporations with \$10 million or more in assets or more than 10 shareholders. Further, electronic filing would be required for the following forms: (1) Forms 8918, “Material Advisor Disclosure Statement”; (2) Forms 8886, “Reportable Transaction Disclosure Statement”; (3) Forms 1042, “Annual Withholding Tax Return for U.S. Source Income of Foreign Persons”; (4) Forms 8038-CP, “Return for Credit Payments to Issuers of Qualified Bonds”; and (5) Forms 8300, “Report of Cash Payments Over \$10,000 Received in a Trade or Business.” Return preparers that expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file such returns electronically. The Secretary would also be authorized to determine which additional returns, statements, and other documents must be filed in electronic form in order to ensure the efficient administration of the internal revenue laws without regard to the number of returns that a person files during a year.
- **Improve reporting for payments subject to backup withholding.** The proposal would treat all information returns subject to backup withholding similarly. Specifically, the IRS would be permitted to require payees of any reportable payments to furnish their TINs to payors under penalty of perjury. The proposal would be effective for payments made after December 31, 2021.
- **IRS Centralized Services Fund / Working Capital Fund.** The Budget includes appropriations language to establish a working capital fund for IRS centralized services. The fund will allow the IRS to achieve cost savings, promote economies of scale, establish more consistent processes and policies, and improve how it delivers facility services, technology, and other centralized services for its business units. For FY 2022, the fund proposes to start with several pilot projects that would test use of the fund, including, potentially, IT development and operations projects, facilities projects, and/or postage funding.

CONCLUSION

Chairmen Pascrell and Thompson, Ranking Members Kelly and Smith, and members of the Subcommittees, thank you again for the opportunity to discuss the tax gap and IRS efforts to address it. The agency remains dedicated to improving service to taxpayers, modernizing its systems and maintaining the integrity of the tax system.

We believe we have made great strides over the past year and will continue this progress with the help of Congress as we move the agency into the future. This concludes my statement, and I would be happy to take your questions.