DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

June 7, 2021

The Honorable Mike Crapo
Ranking Member
Committee on Finance
United States Senate
Washington, DC 20510

Dear Ranking Member Crapo:

Thank you for your letter dated May 10, 2021. Let me begin by expressing our appreciation to you and other Members of the Senate Finance Committee for your patience, understanding and support of our employees during the pandemic, as well as your general support for an increase in IRS resources to reduce the annual Tax Gap.

We are proud to serve our country and want to provide meaningful services of a nature and quality every American deserves. IRS receipt of consistent, timely, multi-year funding is critical to the future success of tax administration. In support of compliant taxpayers, we must pursue meaningful enforcement efforts, appropriately balanced with our support of taxpayer service, taxpayer rights and privacy rights.

Your recent letter asks for a more current estimate of the Tax Gap following the April 13, 2021 hearing before the Senate Finance Committee and our recent article, "A Closer Look – Impacting the Tax Gap," published on April 23, 2021. For convenience, we incorporate the information discussed at the hearing and set forth in the foregoing article, as well as the written and oral testimony of Douglas O'Donnell, IRS Deputy Commissioner, Services and Enforcement, and Barry Johnson, Acting Chief, IRS Office of Research, Applied Analytics and Statistics (RAAS), at the May 11, 2021 hearing on the Tax Gap before the Senate Finance Committee, Subcommittee on Taxation and IRS Oversight.

In addition to asking for a more current estimate of the Tax Gap, you ask about the portion of the Tax Gap that may be attributable to (1) the growth in the dollar-value, (2) cryptocurrency holdings, and (3) unreported or concealed income held offshore or in pass-through entities. You also request that we update the official IRS assessment of the income taxes that taxpayers in the top one percent owe but have not paid and what potential revenue would be generated for the federal government if the IRS collected those taxes. Please note we are diligently working to also respond to your Questions for the Record, from the April 13 hearing, which include additional questions related to the Tax Gap. We will provide responses to your questions as quickly as possible.

Section 61 of the Internal Revenue Code generally defines gross income as “all income from whatever source derived.” Taxable income is the portion of gross income that is properly subject to taxation under applicable provisions of tax law. The Tax Gap is 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 represents, in dollar terms, the annual amount of tax law noncompliance. It does not distinguish between underreporting, nonfiling 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. However, we base our estimates on observed noncompliant behavior and to the extent we do not have reliable data the estimates do not represent an all-inclusive measure of global tax non-compliance by U.S. taxpayers.

The most recent official Tax Gap estimates relate to tax years 2011-2013 and were released in 2019. Tax Gap data assists 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. Advancements in artificial intelligence, advanced data, and analytic strategies are enhancing our capabilities to identify areas of noncompliance in ways that were not remotely possible just a few years ago.

Official Tax Gap estimates have traditionally relied on historical audit and collection data for certain identified nonfilers, underreporters, and underpayers. The 2011-2013 estimates apply to returns filed for tax years 2011-2013 and subsequently audited. They therefore cannot fully represent the compliance landscape in 2021.

We have been working on updating and enhancing the underlying methodology, improving the currency of the estimates, and considering how to identify and incorporate additional information and emerging compliance issues. By including more operational audit data, RAAS anticipates we'll be able to produce estimates that are more timely and inclusive and include forecasts of emerging issues. Although we anticipate releasing Tax Gap estimates for 2014-2016 (the last tax year for which nearly all returns have been filed), and projections for Tax Year 2019 early in 2022, estimates fully based on the new methodology won’t be available until after we complete field testing, which we hope will begin in FY22, resources permitting. Therefore, we cannot presently provide you the specific updated details. However, we can provide an overview of the primary factors that RAAS believes are contributing to the current-year Tax Gap estimates.

As you state, my written and oral testimony at the April 13, 2021 hearing provided an unofficial estimate of the current (~2021) annual Tax Gap, but it is generally supported by RAAS and is based on a specific awareness of much of what is, and is not, included in our most recent official Tax Gap estimate for tax years 2011-2013. Specifically:

> WYDEN:
> And I went through the estimates which seem like they're from the Dark Ages, you know, a decade ago, and I've been digging into this. And I've come to the conclusion that the tax gap is, in fact, far greater than has been officially reported. So what I would like to start with, Commissioner--is--what is your personal opinion about how big the annual tax gap actually is?"
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> RETTIG:
> The published Tax Gap estimate of the Internal Revenue Service--the current one that's out, and we'll be issuing one next year. But the published Tax Gap estimate is for tax years 2011 to 2013, has a gross tax gap of $441 billion. As you indicated, Mr. Chair, in 2011, folks were unaware--generally unaware of the term crypto currency, Bitcoin, and all. There's more than 8600 crypto currencies, virtual currencies in the marketplace, and the market worldwide for crypto currencies is almost $2 trillion.
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> Our Tax Gap map for 2011 to 2013 is based on information that is from 2011 to 2013. It does not include any focus with respect to virtual currencies, which I indicated now is about a $2 trillion market. It does not include much information with respect to foreign source income. It does not include information with respect to illegal source income, which is still taxable, and we do chase.
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> And it also--more recently within the last two weeks, there was a report published that included two IRS researchers from our RAAS organization, that indicated that the top 1 percent of all taxpayers by high income account for as much as an additional $175 billion in the--in the tax gap computations.[1] That's associated with their look at only two issues, which were pass-through entities and offshore income associated with the top 1 percent.
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> If you aggregate the points that I'm talking about and you look at the fact that there is a current estimate by folks on the outside that the Tax Gap is $7.5 trillion over the next 10 years, and you add in the component pieces that I referenced--there are more - I just referenced the ones that are most highly visible at this point.

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[1] This statement should have said that the top 1 percent of all taxpayers by high income account for as much as $175 billion of the tax gap.

> If you add those in, I think it would not be outlandish to believe that the actual tax gap could approach and possibly exceed $1 trillion per year.

At the May 11, 2021 hearing on the Tax Gap before the Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, Barry Johnson, Acting Chief of RAAS, testified it has been well publicized that audits have significantly declined, adversely affecting the potential deterrent effect of a visible, robust enforcement effort. After describing relevant issues, including changes in the economy that have occurred since 2013, Mr. Johnson stated, “So I think that if we add all of these things together and think about what the Tax Gap might be today, I don't think it's unreasonable to speculate [it] to be as high as the Commissioner's testimony. I mean, that's even before we think about the illegal sourcing income.”

Mr. Johnson also confirmed we are developing an improved Tax Gap methodology we expect to produce more accurate, inclusive and timely estimates. According to Mr. Johnson, limited research using some of this methodology to gross up the 2011-2013 estimates provides an initial estimated adjusted gross Tax Gap for tax year 2019 of approximately $600 billion.

Further, an IRS research team working with others used randomly selected audit data to review sophisticated tax evasion by certain taxpayers though the use of offshore bank accounts and/or complex pass-through business structures. This information is not fully captured by our legacy Tax Gap estimation methodology. IRS researchers estimated evasion limited to the use of offshore bank accounts and/or complex pass-through business structures contributed an additional $33 billion to the 2011-2013 Tax Gap. While this work is still undergoing peer review, Mr. Johnson states that “the results seem very plausible.” Using asset and price growth information, Mr. Johnson estimates the adjustment would increase the tax year 2019 Tax Gap by an additional $46 billion. With this increase, the overall estimated gross Tax Gap for tax year 2019 is approximately $646 billion.

RAAS’s new approaches and methodologies will enhance the currency of future Tax Gap estimates. They will also help to identify additional emerging sources of noncompliance contributing to the Tax Gap. For example, while there were very few virtual currency transactions in 2011-2013, there are now approximately 8,600 virtual currencies with a current global market cap of almost $2 trillion. Reporting compliance falls far short of what would be expected given the number of users, transactions, and value that virtual currency exchanges publicize on an annual basis. Recognizing this compliance challenge, the IRS has focused significant enforcement resources over the past two years in the virtual currency environment.

In addition, the 2011-2013 Tax Gap estimate does not fully reflect noncompliance related to various undetected taxable international or foreign-based taxable transactions and activities; and other types of undetected, concealed taxable income. Previous Tax

Gap estimates only measured international activities by domestic tax return filers; they did not include individuals with foreign addresses, foreign businesses, or other similarly situated taxpayers. Illegal source income, which is taxable and is pursued by the IRS, often in coordination with other federal and state agencies, remains a significant concern, but is not generally considered in the official tax gap estimates

At the May 11, 2021 hearing, Mr. Johnson stated,

> We do hope that with the methodology that I mentioned, that we would be able to address that in the future. . . . We've done some preliminary analysis of the reporting for 2017, and we find that there are $3.7 trillion in assets that are abroad. And 56 percent of those or $2 trillion of that is located in what the OECD would consider to be tax evading countries. So we think that the Tax Gap attributable to international activities, particularly overseas accounts, as typically being quite large.

At the same May 11, 2021 hearing, J. Russell George, the Treasury Inspector General for Tax Administration (TIGTA), testified,

> Improving international tax compliance remains a challenge for the IRS. [The] IRS has not developed a reliable estimate of the international Tax Gap. Non-IRS estimates of the international tax gaps vary widely. Previous estimates range from $40 billion to $123 billion annually.

The estimated 2011-2013 Tax Gap translated into about 83.6% of taxes paid voluntarily and on time, which is in line with recent levels. Over the years, our studies have consistently suggested overall tax compliance is holding steady in the 82 percent to 84 percent range based on detected noncompliance.[2] However, while actually-detected noncompliance levels have been somewhat steady, we do not yet have sufficient data to make a similar determination as to levels of additional noncompliance from sources that are not otherwise included in the Tax Gap data.

Your letter references the potential effect volatility in the virtual currency marketplace may have on future Tax Gap estimates. A volatile market often creates an increased amount of taxable transactions. Taxpayers could transfer their interests in virtual currencies to limit potential losses or capture gains. There may be an increased volume of taxable transactions to the extent virtual currencies continue to expand into our mainstream economy. The resulting tax effect of these transactions depends upon many factors such as the underlying cost basis, holding period, appetite to hold an interest in virtual currencies, etc.

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[2] The actual dollars represented by the Tax Gap can be impacted by whether the country is experiencing a recessionary economy, but the percentage has remained mostly steady since about 2001.

Increasing compliance levels is resource intensive. Additional withholding and third-party information reporting are impactful, which is why we need legislation. However, we recognize enhanced record keeping and reporting, although necessary, may be perceived as a somewhat burdensome approach to the Tax Gap. We are committed to working with Congress and others to carefully balance the need for additional information with the burden of providing that information.

We remain committed to ensuring the tax system is enforced fairly, taxpayers receive the nature and quality of services they deserve, and no one at any income level feels safe cheating on their taxes. In addition to a balanced enforcement program, the IRS also needs to continue focusing on solid, meaningful taxpayer service to help people understand and meet their filing and reporting obligations. The Tax Gap and its underlying components illustrate this need for taxpayer service.

Greater investments in technology can also help us properly assist compliant taxpayers. Modernization of our systems coupled with technological advances in artificial intelligence, data, and analytics will continue to enhance services to compliant taxpayers and make tax avoidance by others more visible and more difficult.

There is no single solution to achieving a meaningful reduction in the Tax Gap. No one type of taxpayer is responsible for it. Reducing the Tax Gap will require a comprehensive, multi-faceted strategy, effectively executed by the IRS and balanced with appropriate safeguards and accountability to taxpayers. Investment in IRS 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. These things help improve taxpayer compliance, which in turn will reduce the Tax Gap.

I hope this information is helpful. If you have questions or would like to arrange a meeting for further discussions regarding the Tax Gap, 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

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Charles P. Rettig