The Tax Information Gap at the Top

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ABSTRACT: Tax information reporting is an essential element of tax administration and compliance in the United States. When individuals earn wages, accrue interest, or receive Social Security benefits, the Internal Revenue Service almost always knows. In these situations, a third party, such as an employer or a bank, files an information return with both the individual taxpayer and the IRS. Not surprisingly, when income is subject to tax information reporting, tax compliance is extremely high. Despite the power of tax information reporting to maximize the IRS's ability to collect taxes owed, these rules also contain significant gaps where limited or no information reporting is required. Often, the beneficiaries are high-income and wealthy taxpayers (high-end taxpayers) who earn their income in situations where no third party files information reports with the IRS. Meanwhile, most wage earners are subject to tax information reporting by their employers.

This Article offers a new theory for why the U.S. tax information reporting regime treats high-end taxpayers differently from other taxpayers and offers recommendations for closing gaps in the current rules. This Article shows that the government's approach to tax information reporting applies almost exclusively to specific activities, such as certain methods of earning income or designated transactions. This approach is consistent with the government's design of other tax procedure rules that apply to specific types of activities, such as the use of tax shelters, offshore bank accounts, and noneconomic substance transactions to avoid tax liability.

This Article argues that the activity-based approach to information reporting often allows high-end taxpayers to engage in tax noncompliance while other taxpayers face significant automatic IRS scrutiny. After presenting this claim, this Article proposes that policymakers should supplement current law by introducing actor-based information reporting rules that apply once taxpayers'

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** Professor of Law, Northwestern Pritzker School of Law. We are grateful to Jordan Barry, Leslie Book, Victor Fleischer, Ariel Jurow Kleiman, Sarah Lawsky, Leigh Osofsky, Michelle Layser, Omri Marian, Katie Pratt, Joe Thorndike, Clinton Wallace, Manoj Viswanathan and participants at the 2022 Law & Society Annual Meeting and 2023 ABA Tax Section Midyear Tax Meeting. All errors are our own.

income or wealth reaches threshold amounts. Finally, this Article introduces a hybrid first- and third-party approach to information reporting, which accounts for both actor and activity-based criteria, to help close the tax information gap at the top.

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INTRODUCTION

Tax information reporting is an essential element of tax administration and compliance in the United States.[1] When individuals earn wages from their employers,[2] accrue interest in their bank accounts,[3] or receive Social Security benefits,[4] the Internal Revenue Service ("IRS") usually knows. In these types of transactions, a third-party intermediary, such as an employer or a bank, files an information return with both the individual taxpayer and the IRS, and in many cases, withholds taxes owed by the taxpayer.[5] Tax information reporting in the United States is pervasive, as over 3.9 billion information reports were filed with the IRS in 2021.[6] Not surprisingly, when income is subject to third-party information reporting, and is thus visible to the IRS, tax compliance is extremely high. The IRS estimates that where income is subject to substantial information reporting, approximately ninety-five percent of income is reported properly to the IRS and that the level of compliance is approximately ninety-nine percent when income is subject to both substantial information reporting

1. I.R.C. §§ 6041–6050Y (2018) (Information Concerning Transactions With Other Persons). *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUB. NO. 1415, FEDERAL TAX COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2011–2013 3 (2019), https://www.irs.gov/pub/irs-prior/p1415–2019.pdf [https://perma.cc/F6TW-4TQZ]; Theodore Black et al., *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation* 4 (Internal Revenue Serv. Rsch., Analysis & Stat., Working Paper, 2012), https://www.irs.gov/pub/irs-soi/06rastg12workppr.pdf [https://perma.cc/SZ2E-ZN67]; Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 697–99, 712–23 (2007) (discussing the effect of third-party reporting on tax information); Manoj Viswanathan, *Tax Compliance in a Decentralizing Economy*, 34 GA. ST. U. L. REV. 283, 296–313 (2018) (discussing tax information in centralized and decentralized economies). *See generally* Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733 (2010) [hereinafter *Reducing Information Gaps*] (discussing tax information reporting in relation to tax information gaps); Leandra Lederman & Joseph C. Dugan, *Information Matters in Tax Enforcement*, 2020 BYU L. REV. 145 (discussing tax information reporting in the context of tax enforcement); Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, J. ECON. PERSPS., Winter 2007, at 25 (2007) (discussing tax information in the context of tax evasion); Jay A. Soled, *Homage to Information Returns*, 27 VA. TAX REV. 371 (2007) (discussing the costs and benefits of tax information returns).

2. I.R.C. § 6041(a); INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0008, FORM W-2 (WAGE AND TAX STATEMENT) (2023), https://www.irs.gov/pub/irs-pdf/fw2.pdf [https://perma.cc/F9CZ-YSJR].

3. I.R.C. § 6049; INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0112, FORM 1099-INT (INTEREST INCOME) (2022), https://www.irs.gov/pub/irs-pdf/f1099int.pdf [https://perma.cc/C6XH-JJML].

4. I.R.C. § 6050F; U.S. SOC. SEC. ADMIN., FORM SSA-1099 (SOCIAL SECURITY BENEFIT STATEMENT) (2016), https://secure.ssa.gov/apps10/poms/images/SSA1/G-SSA-1099-SM-1.pdf [https://perma.cc/GVG7-UHQD].

5. *See, e.g.*, Treas. Reg. § 1.6041-1(a)(1)(i) (as amended in 2017) (payments required to be reported).

6. STAT. OF INCOME DIV., INTERNAL REVENUE SERV., PUB. NO. 6961, CALENDAR YEAR PROJECTIONS OF INFORMATION AND WITHHOLDING DOCUMENTS FOR THE UNITED STATES AND IRS CAMPUSES 4 tbl.1 (2021), https://www.irs.gov/pub/irs-pdf/p6961.pdf [https://perma.cc/H6E5-PMJU] (projecting 3,915,607,000 information returns made in 2021).

and withholding.[7] On the other hand, where income is subject to little or no information reporting, the IRS estimates that tax compliance is only about fifty-five percent.[8]

Despite the power of tax information reporting to maximize the IRS's ability to collect taxes owed, these rules also contain significant gaps. Often the beneficiaries of limited or no information reporting are high-income and wealthy taxpayers (high-end taxpayers)[9] who often earn their income in situations where no third party files tax information reports with the IRS.[10] Meanwhile, individuals who earn their income primarily through wages are subject to tax information reporting through the filing of IRS Form W-2 (Wage and Tax Statement) by their employers.[11] Consequently, the tax information reporting regime in the United States can be characterized as two-tiered, where high-end taxpayers escape scrutiny from the IRS and have the opportunity to avoid or evade taxes, while most other taxpayers have the bulk of their annual income automatically reported to the IRS by someone else.

Policymakers have attempted to address tax information reporting gaps by expanding the types of transactions that financial institutions must report to the IRS. For example, in May 2021, the Biden Administration published a proposal that would create a comprehensive financial account information reporting regime.[12] Under the proposal, banks and other financial institutions would report to the IRS the amount of gross inflows (receipts) and outflows (transfers) of more than $600 (later revised to $10,000) from any business or personal account, including bank, loan, and investment accounts.[13] The

7. INTERNAL REVENUE SERV., *supra* note 1, at 14 fig.3.

8. *Id.*

9. For purposes of this Article, the characterization of taxpayers as "high-income" or "wealthy" depends upon the relative availability of certain tax avoidance opportunities to taxpayers with greater economic resources. For example, with respect to information reporting, one study estimates that taxpayers with income in excess of $500,000 earn a disproportionate share of the business income which is not currently subject to information reporting. Natasha Sarin, *The Case for a Robust Attack on the Tax Gap*, U.S. DEP'T OF THE TREASURY (Sept. 7, 2021), https://home.treasury.gov/news/featured-stories/the-case-for-a-robust-attack-on-the-tax-gap [https://perma.cc/4H3X-CRL9].

10. *See infra* Section II.B.

11. *See* I.R.C. § 6041(a); INTERNAL REVENUE SERV., *supra* note 2.

12. *See* U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS 88–90 (2021), https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf [https://perma.cc/3QFT-VKPV] [hereinafter GENERAL EXPLANATIONS] (original proposal); *Fact Sheet: Tax Compliance Proposals Will Improve Tax Fairness While Protecting Taxpayer Privacy*, U.S. DEP'T OF THE TREASURY (Oct. 19, 2021), https://home.treasury.gov/news/press-releases/jy0415 [https://perma.cc/VW82-U4L8] [hereinafter *Fact Sheet*] (detailing the Biden Administration's revised tax compliance proposals). *See generally* U.S. DEP'T OF THE TREASURY, THE AMERICAN FAMILIES PLAN TAX COMPLIANCE AGENDA (2021), https://home.treasury.gov/system/files/136/The-American-Families-Plan-Tax-Compliance-Agenda.pdf [https://perma.cc/8UKD-AH6Y] [hereinafter TAX COMPLIANCE AGENDA] (detailing some of the proposals by the Biden Administration). For a detailed discussion of this proposal and its advantages and limitations, see also *infra* Section III.A.2.

13. GENERAL EXPLANATIONS, *supra* note 12, at 88.

rationale, according to the Treasury Department, was to provide greater "visibility of business income" and "enhance the effectiveness of IRS enforcement measures and encourage voluntary compliance."[14] Further, it noted that financial institutions already report information regarding accounts, such as interest payments, to the IRS and suspicious activity to other agencies.[15] Despite these stated goals and policy arguments, the proposal encountered significant resistance from legislators, taxpayers, and financial institutions and, ultimately, did not appear in legislation considered by Congress.[16]

This Article offers a new theory for why the U.S. tax information reporting regime treats high-end taxpayers differently from other taxpayers and offers recommendations for closing gaps in the current rules. This Article shows that the government's approach to tax information reporting applies almost exclusively to specific activities, ranging from methods of earning income to designated transactions.[17] This approach is consistent with the government's design of other tax procedure rules that apply to specific types of activities, such as the use of tax shelters, offshore bank accounts, and noneconomic substance transactions to avoid tax liability.[18] This Article argues that the activity-based approach to information reporting often allows high-end taxpayers to engage in noncompliance with the tax law while other taxpayers face significant automatic IRS scrutiny.[19] After presenting this claim, this Article proposes that policymakers should supplement current law by introducing actor-based information reporting rules that apply when taxpayers' income or wealth equals or exceeds threshold amounts.[20] Finally, this Article charts a new path forward

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14. *Id.*

15. *Id.*; *see also* Letter from Janet L. Yellen, Sec'y of the Treasury, to Richard E. Neal, Chairman of the Comm. on Ways and Means (Sept. 14, 2021) (discussing the Biden Administration's proposals and goals). For a description of the original proposal, see Charles O. Rossotti, Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: A Comprehensive Approach*, 169 TAX NOTES FED. 1467, 1473–75 (2020) (proposing new Form 1099 for financial institutions).

16. *See, e.g.*, Sarah Kolinovsky & Trish Turner, *Biden Admin Backs Down on Tracking Bank Accounts With Over $600 Annual Transactions*, ABC NEWS (Oct. 19, 2021, 4:37 PM), https://abcnews.go.com/Politics/biden-admin-backs-tracking-bank-accounts-600-annual/story?id=80665505 [https://perma.cc/486K-GSUD]; Andrew Keshner, *Biden Wants IRS to Monitor People's Bank Accounts More Closely — Will It Catch Tax Cheats, Or Invade Privacy?*, MARKETWATCH (Oct. 12, 2021, 1:43 PM), https://www.marketwatch.com/story/biden-administration-wants-irs-to-monitor-peoples-bank-accounts-more-closely-will-it-catch-tax-cheats-or-invade-privacy-11633560204 [https://perma.cc/ZN62-FSUY] (describing controversy regarding proposal).

17. *See infra* Section II.A.

18. *See generally* Joshua D. Blank & Ari Glogower, *Progressive Tax Procedure*, 96 N.Y.U. L. REV. 668 (2021) [hereinafter *Progressive Tax Procedure*] (discussing activity-based tax compliance rules); Joshua D. Blank & Ari Glogower, *The Trouble with Targeting Tax Shelters*, 74 ADMIN. L. REV. 69 (2022) [hereinafter *The Trouble with Targeting Tax Shelters*] (examining how tax shelters and other tax avoidance strategies operate).

19. *See infra* Part II.

20. *See infra* Section II.C.

by presenting a framework that policymakers can consider when introducing actor-based tax information reporting.[21]

Because current law only requires third parties to file information reports with the IRS when taxpayers engage in specific activities such as earning wages from an employer, accruing interest in a bank account, selling or exchanging stock, and receiving retirement benefits, among others,[22] many high-end taxpayers are able to avoid IRS scrutiny. In each of these situations, a sophisticated third party, such as an employer with a centralized accounting and payroll department, prepares the appropriate information return and provides it to both the taxpayer and the IRS.[23] But many high-end taxpayers earn income in ways that do not fall within the current law framework of specified activities where information reporting is required. They may earn income through self-owned or self-managed businesses, offshore bank accounts, virtual currency and digital asset transactions, and business entities, such as Subchapter S corporations, just to name a few possibilities.[24] As our examination reveals, current law exacerbates inequities in the tax system by subjecting taxpayers who cannot escape visibility before the IRS, such as middle- and low-income wage earners, to tax information reporting, while allowing those who do not participate in these types of activities to potentially evade or avoid taxes in the shadows.[25] Given the demographics of individuals who are high-end taxpayers, we also show how this two-tiered system likely provides disproportionate benefits to certain groups, especially white taxpayers.[26]

In contrast, this Article argues that policymakers should amend current law to subject certain taxpayers to additional, more general tax information reporting that would apply when taxpayers' income or wealth reaches a threshold amount.[27] This Article describes several benefits of this actor-based approach to information reporting.

First, if the IRS could observe more information regarding high-end taxpayers' personal and business finances, such as by learning more about their accounts at financial institutions, its agents may be able to identify potential discrepancies with their personal and business tax returns.[28]

Second, actor-based information reporting would be harder for high-end taxpayers to avoid than current third-party information reporting rules.[29] The IRS would use more general third-party information reports, such as data regarding inflows to and outflows from bank accounts, as an additional factor

21. *See infra* Part III.

22. *See infra* Section I.A.

23. *See infra* Section I.A.

24. *See infra* Section II.B.

25. *See infra* Section II.B.

26. *See infra* notes 218–220 and accompanying text.

27. *See infra* Section II.C.

28. *See infra* Section II.C.

29. *See infra* Section II.C.

in determining which tax returns to review further and possibly audit. Consistent with the empirical evidence regarding both third-party information returns and audits,[30] this development would likely deter high-end taxpayers from engaging in certain forms of tax avoidance and evasion that would suddenly become more detectable.

Third, an actor-based approach would reduce the inequity of current tax information reporting rules, which can impose collateral burdens on compliant or lower income taxpayers and introduce racial disparities in IRS audits and tax enforcement.[31]

After presenting the case for actor-based information reporting, this Article provides policymakers with several models and examples of how they could introduce actor-based criteria to the information reporting rules.[32] First, this Article evaluates the Biden Administration's recent bank information reporting proposal as an example of a third-party information reporting reform.[33] It uses this proposal to illustrate the critical importance of third-party information reporting to tax administration and enforcement. At the same time, it shows that the proposal encounters the same general challenges in designing effectively tailored activity-based tax compliance rules which could properly address the challenge of high-end tax avoidance.

Second, this Article provides a model for introducing first-party information reporting from high-end taxpayers regarding their finances through an annual wealth reporting form, which this Article terms the "Annual Net Asset Statement."[34] It outlines the possibilities and challenges of introducing such a form and also shows how there is precedent for this type of reporting in both tax and nontax contexts. For instance, individuals who hold non-U.S. financial assets are required to file first-party information reports with respect to these assets.[35] Similarly, approximately twenty million families calculate their net

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30. *See infra* Section I.C.

31. *See infra* Section II.C.

32. *See infra* Part III.

33. *See infra* Section III.A.

34. *See infra* Section III.B.

35. *See* FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, OMB NO. 1506-0009, FORM 114 (REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS) (2022), https://bsaefiling1.fincen.treas.gov/lc/content/xfaforms/profiles/htmldefault.html [https://perma.cc/SN8S-ZERM]; INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-2195, FORM 8938 (STATEMENT OF SPECIFIED FOREIGN FINANCIAL ASSETS) (2021), https://www.irs.gov/pub/irs-pdf/f8938.pdf [https://perma.cc/DZ77-JDYS]. *See generally Report of Foreign Bank and Financial Accounts (FBAR)*, INTERNAL REVENUE SERV. (July 12, 2022), https://www.irs.gov/businesses/small-businesses-self-employed/report-of-foreign-bank-and-financial-accounts-fbar [https://perma.cc/9PAQ-KC4H] (providing the logistical details associated with filing the Report on Foreign Bank and Financial Accounts).

wealth when applying for financial aid from colleges by completing the Free Application for Federal Student Aid ("FAFSA").[36]

This Article then introduces a hybrid system which incorporates both first- and third-party information reporting and explains how this system would have offered an alternative approach to the Biden Administration's proposal for reporting of inflows and outflows from financial accounts in 2021.[37] A hybrid system could utilize the unique types of information available to first and third parties and also address the limitations of each information reporting category. Under this Article's proposal, policymakers could require certain third parties, such as financial institutions, to file information reports with the IRS regarding financial accounts of taxpayers whose taxable income or net wealth reaches threshold amounts.[38] For example, under our proposal, individual taxpayers who have reported to the IRS taxable income equal to or exceeding a threshold amount, such as $2 million, in the previous tax year would be subject to third-party reporting regarding inflows and outflows to their personal and business accounts at financial institutions. This hybrid system could exempt lower income taxpayers from this heightened information reporting through a certification component.[39] For example, the law could exempt financial institutions from filing information reports with the IRS if account holders certify that their taxable income and net wealth (based on a first-party report) does not reach the threshold amount. As this Article describes, the tax law already incorporates this form of certification exemption in contexts such as the backup withholding rules.[40]

Finally, this Article describes how this same framework for understanding the role of both actor- and activity-based criteria in information reporting—and the roles of both first and third parties—can help improve the tailoring of penalties for noncompliance with information reporting obligations and the use of audit resources.[41]

The remainder of this Article proceeds as follows. Part I provides an overview of current tax information reporting rules, which focus almost exclusively on specific activities, and reviews the scholarly literature regarding the efficacy of tax information reporting.[42] Part II demonstrates how the current law's focus on activities creates a gap in the tax information reporting rules that especially benefits high-end taxpayers.[43] It also proposes a new

36. FED. STUDENT AID, U.S. DEP'T OF EDUC., OMB NO. 1845-0001, FAFSA (FREE APPLICATION FOR FEDERAL STUDENT AID) (2022), https://studentaid.gov/sites/default/files/2023-24-fafsa.pdf [https://perma.cc/9G3B-XQPX].

37. *See infra* Section III.C.

38. *See infra* Section III.C.

39. *See infra* Section III.C.

40. *See infra* note 296 and accompanying text.

41. *See infra* Section III.D.

42. *See infra* Part I.

43. *See infra* Part II.

approach to tax information reporting that would apply based on actors' personal financial characteristics rather than the presence of specific activities.[44] Part III presents a framework that policymakers can use when introducing actor-based information reporting and proposes a new system of first-party information reporting and a hybrid system which incorporates both first- and third-party information reporting.[45] This discussion also considers how this more comprehensive approach to information reporting can also improve the tailoring of penalties for noncompliance and the use of audit resources.[46]

I. THE ROLE OF TAX INFORMATION REPORTING

Tax information reporting plays a critical role in encouraging individuals to comply with the tax law and file their tax returns correctly.[47] This Part begins by providing an overview of the specific types of transactions and financial activities that cause taxpayers and third-party intermediaries to file information returns with the IRS. It then describes first-party information reporting by the taxpayers themselves that occurs under current law. The discussion then explains how information reporting enhances tax compliance and enforcement.

As this Part describes, both first and third parties can provide two general types of information to the IRS. First, reporting parties can provide the IRS with primary information used to calculate substantive tax liabilities, such as the taxpayer's income and transactions.[48] Reporting parties can also provide the IRS with additional information which can assist in tax administration and enforcement, but which do not directly factor into calculating tax liabilities, such as general indicia of activities which may indicate or enable noncompliance.[49]

A. *THIRD-PARTY INFORMATION REPORTING RULES*

The Internal Revenue Code and Treasury Regulations contain dozens of third-party information reporting rules.[50] Information returns supply the IRS with information that can be matched to an item that taxpayers self-report to the IRS, such as on the annual IRS Form 1040, which may be taxable, deducible, or excludible.[51] Below is a nonexhaustive description of some of the major information reporting requirements that apply under current law, organized into the following categories: compensation; investment and sales; noncompensation payments; and retirement and health benefits.

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44. *See infra* Part II.
45. *See infra* Part III.
46. *See infra* Part III.
47. *See supra* note 1 and accompanying text.
48. *See infra* notes 77–82 and accompanying text.
49. *See infra* notes 83–85 and accompanying text.
50. *See* I.R.C. §§ 6041–6050Y (Information Concerning Transactions With Other Persons).
51. *See Reducing Information Gaps*, *supra* note 1, at 1740 (discussing "complete reporting" as a factor in effective information reporting); *see also* I.R.S. Fact Sheet FS-2006-10 (Jan. 2006) (presenting information on how the IRS conducts audits).

Compensation for Goods or Services. Some of the most common third-party information reporting rules are those that apply to situations where an individual or entity pays compensation in exchange for goods or services. Every employer engaged in a trade or business that makes payments to an employee in exchange for services, whether in cash or in-kind compensation, must file IRS Form W-2 (Wage and Tax Statement) for the employee.[52] This requirement applies where the employer withheld any income, Social Security, or Medicare tax or where the employer paid $600 or more in wages and did not withhold any income, Social Security, or Medicare tax.[53]

Outside of the employment context, persons engaged in a trade or business who pay an independent contractor at least $600 in exchange for services must file an information return, IRS Form 1099-NEC (Nonemployee Compensation) or IRS Form 1099-MISC (Miscellaneous Information).[54] In addition, "payment settlement entities" must file IRS Form 1099-K (Payment Card and Third Party Network Transactions) for persons who earn at least a threshold dollar amount of reportable payments in exchange for goods or services.[55] Once legislation enacted in 2021 goes into effect, these entities—which include credit card companies, banks, and online sharing and auction sites—will be required to file the information return where persons receive at least $600 in gross earnings during the year (decreased from a higher threshold under prior law of $20,000 in gross earnings and more than two hundred transactions during the year).[56] This statutory change extends third-party information reporting to many individuals who earn even a small amount of income through online platforms such as Uber, eBay, Etsy, among many others.[57]

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52. Treas. Reg. § 1.6041-1(a)(1)(i) (as amended in 2017) (payments required to be reported).

53. Treas. Reg. § 1.6041-1(a)(1)(i)(A)–(B) (as amended in 2017).

54. *Instructions for Forms 1099-MISC and 1099-NEC (01/2022)*, INTERNAL REVENUE SERV. (Jan. 5, 2022), https://www.irs.gov/instructions/i1099mec [https://perma.cc/8X4E-89SX].

55. I.R.C. § 6050W(a); *Instructions for Form 1099-K (01/2022)*, INTERNAL REVENUE SERV. (Dec. 6, 2021), https://www.irs.gov/instructions/i1099k [https://perma.cc/E5QT-PCPJ]. For these purposes, the term "payment settlement entity" applies to both merchants and third parties responsible for transferring payments arising from certain specified payments to specified payees. I.R.C. § 6050W(a)–(d).

56. American Rescue Plan Act of 2021, Pub L. No. 117-2, § 9674, 135 Stat. 185 (codified at I.R.C. § 6050W(e)). In December 2022, the IRS announced that it would delay the implementation of this new reporting requirement and that the 2022 calendar year would be regarded as a "transition period for purposes of . . . [IRS] enforcement and administration" of the new rules. I.R.S., Notice 2023-10, 2023-3 IRB 403, 403. For criticism of this decision, see Daniel Hemel & Steven M. Rosenthal, *The IRS's Christmas Gift to Airbnb and PayPal Is a Loss for Law-Abiding Taxpayers*, TAX POL'Y CTR. (Jan. 11, 2023), https://www.taxpolicycenter.org/taxvox/irss-christmas-gift-airbnb-and-paypal-loss-law-abiding-taxpayers [https://perma.cc/6NLS-3JPD] (criticizing the announcement, though conceding that "Treasury [has] broad authority to issue regulations that are 'necessary or appropriate' to carry out the reporting requirement").

57. *See* American Rescue Plan Act of 2021 § 9674; *see also Additional Information Reporting Required for Third-Party Settlement Organizations and Third-Party Payment Networks*, EY (Aug. 16, 2021), https://taxnews.ey.com/news/2021-1517-additional-information-reporting-required-for-third-party-settlement-organizations-and-third-party-payment-networks [https://perma.cc/9YEF-GT3B] (discussing

Investment Income and Transactions. Parties are also subject to third-party information reporting when they engage in investment activities. Financial institutions provide IRS Form 1099-INT (Interest Income) to each person who receives at least $10 during the year of interest income.[58] Corporations file information returns, such as IRS Form 1099-DIV (Dividends and Distributions), when they pay at least $10 in gross dividends and other stock distributions during the year.[59] In addition, the IRS receives information returns when taxpayers engage in sales or dispositions of assets. When a person sells stock, securities, and other debt instruments through a broker, the broker must file IRS Form 1099-B (Proceeds From Broker and Barter Exchange Transactions) which reports information, such as the date the asset was acquired, the cost basis, the proceeds from the sale, and the date the asset was sold.[60] Further, for tax returns required to be filed after December 31, 2023, digital asset brokers are required to file IRS Form 1099-B upon a person's sale or exchange of digital assets, such as Bitcoin and other cryptocurrency.[61] The new reporting rule will require platforms, such as Coinbase, to report the gross proceeds from any sale of digital assets and the customer's name, address, and phone number to the IRS.[62] Finally, persons who purchase real estate during the year are required to report the gross proceeds from the sale on IRS Form 1099-S (Proceeds from Real Estate Transactions), subject to a number of exceptions, such as sales of personal residences, among others.[63]

Offshore Accounts. In some cases, third parties are also obligated to file information reports with respect to taxpayers' financial account balances. The Foreign Account Tax Compliance Act ("FATCA") generally requires third

the information needed by third parties when reporting); Viswanathan, *supra* note 1, at 296–306 (examining the role of centralized institutions in information reporting).

58. I.R.C. § 6049; INTERNAL REVENUE SERV., *supra* note 3.

59. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0110, FORM 1099-DIV (DIVIDENDS AND DISTRIBUTIONS) (2022), https://www.irs.gov/pub/irs-pdf/f1099div.pdf [https://perma.cc/M6B8-EM9H].

60. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0715, FORM 1099-B (PROCEEDS FROM BROKER AND BARTER EXCHANGE TRANSACTIONS) (2023), https://www.irs.gov/pub/irs-pdf/f1099b.pdf [https://perma.cc/GJY8-LGAF].

61. Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, § 80603, 135 Stat. 429, 1339–40 (2021) (to be codified as I.R.C. 6045(c)(1)(D)); *see also* Daniel Hemel, *Decrypting the Crypto Reporting Proposal in the Bipartisan Infrastructure Bill*, SUBSTANCE OVER FORM (Aug. 3, 2021), https://substanceoverform.substack.com/p/decrypting-the-crypto-reporting-proposal [https://perma.cc/XL36-TRHJ].

62. Infrastructure Investment and Jobs Act § 80603. For discussion, see Anthony J. Carbone, Rebecca M. Balinskas, Edward L. Froelich, Kevin Brown & Katherine Erbeznik, *New Cryptocurrency Reporting Requirements*, MORRISON & FOERSTER (Dec. 21, 2021), https://www.mofo.com/resources/insights/211221-new-cryptocurrency-reporting-requirements [https://perma.cc/T6U3-NKBB].

63. Infrastructure Investment and Jobs Act, § 80603; INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0997, FORM 1099-S (PROCEEDS FROM REAL ESTATE TRANSACTIONS) (2022), https://www.irs.gov/pub/irs-pdf/f1099s.pdf [https://perma.cc/UXA8-7ALK]; *Instructions for Form 1099-S (01/2022)*, INTERNAL REVENUE SERV. (Dec. 9, 2021), https://www.irs.gov/instructions/i1099s [https://perma.cc/AAW3-VFEG].

party "foreign financial institutions" ("FFIs"), such as banks, to report the account balances and other information regarding their U.S. account holders[64] on the IRS Form 8966.[65] Congress enacted FATCA in 2010 with the purpose of gathering information necessary to prevent taxpayers from avoiding tax liabilities by holding assets in offshore accounts.[66]

Miscellaneous Payments. When taxpayers make or receive a variety of miscellaneous payments other than compensation in exchange for services from employees, they are also subject to third-party information reporting. For example, when banks and other financial institutions receive mortgage interest of at least $600 during the year, they file IRS Form 1098 (Mortgage Interest Statement).[67] Similarly, when financial institutions, governmental units, and educational institutions receive student loan interest of at least $600 during the year, they file IRS Form 1098-E (Student Loan Interest Statement).[68]

Retirement and Health Benefits. Taxpayers who receive retirement and health benefits are also subject to third-party information reporting by financial institutions and their employers. When individuals receive distributions from profit-sharing or retirement plans, IRAs, annuities, and pensions, whether or not any amount of federal income tax was withheld, the financial institutions making the distributions file IRS Form 1099-R (Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.).[69] In addition, every person that provides minimum essential health insurance coverage to an individual during the calendar year must file an information return reporting the coverage on IRS Form 1095-B (Health Coverage).[70] Similarly, institutions that administer tax-favored accounts related to health

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64. I.R.C. § 1471(b) (2018). FFIs who fail to comply with these rules may be subject to additional withholding of thirty percent on U.S. source payments. *Id.* § 1471(a).

65. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-2246, FORM 8966 (FATCA REPORT) (2022), https://www.irs.gov/pub/irs-pdf/f8966.pdf [https://perma.cc/HA79-9A3P]. FFIs can also comply with both these reporting requirements and applicable laws in their home jurisdiction (such as privacy laws) by instead reporting the information to their own taxing authorities pursuant to an intergovernmental agreement. *See Foreign Account Tax Compliance Act*, U.S. DEP'T OF THE TREASURY, https://home.treasury.gov/policy-issues/tax-policy/foreign-account-tax-compliance-act [https://perma.cc/XV79-9KDM].

66. *See* Joshua D. Blank & Ruth Mason, *Exporting FATCA*, 142 TAX NOTES 1245, 1245–49 (2014).

67. I.R.C. § 6050H; INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-1380, FORM 1098 (MORTGAGE INTEREST STATEMENT) (2022), https://www.irs.gov/pub/irs-pdf/f1098.pdf [https://perma.cc/A6NN-G5SW].

68. I.R.C. § 6050S; INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-1576, FORM 1098-E (STUDENT LOAN INTEREST STATEMENT) (2023), https://www.irs.gov/pub/irs-pdf/f1098e.pdf [https://perma.cc/NZ5H-MLRD].

69. I.R.C. § 6047; INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0119, FORM 1099-R (DISTRIBUTIONS FROM PENSIONS, ANNUITIES, RETIREMENT OR PROFIT-SHARING PLANS, IRAS, INSURANCE CONTRACTS, ETC.) (2023), https://www.irs.gov/pub/irs-pdf/f1099r.pdf [https://perma.cc/4KVV-Z48G].

70. I.R.C. § 6055 (2018); INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-2252, FORM 1095-B (HEALTH COVERAGE) (2022), https://www.irs.gov/pub/irs-pdf/f1095b.pdf [https://perma.cc/99LF-WC7C].

care, such as Health Savings Accounts, must report all distributions from these accounts to individuals on specific information returns.[71]

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The third-party information reporting regime in the United States is vast. According to IRS data, in 2021, over 3.9 billion information returns were filed with the IRS.[72] Given that information reporting applies to each individual transaction, the most common type of information return was IRS Form 1099-B (Proceeds from Broker and Barter Exchange Transactions), filed over 2.6 billion times.[73] The next most common type of information return was IRS Form W-2 (Wage and Tax Statement), which was filed over 266 million times.[74] In 2021, Congress extended information reporting to a greater number of transactions by lowering the dollar threshold that triggered a reporting requirement.[75] The IRS anticipates that in 2029, the agency will receive approximately 5.2 billion information returns during that year.[76]

B. First-Party Information Reporting Rules

The tax rules also require taxpayers themselves to report information to the IRS, which may be characterized as forms of first-party information reporting. For example, the annual tax return filings themselves—such as the income tax returns for individuals (IRS Form 1040),[77] corporations (IRS Form 1120),[78] partnerships (IRS Form 1065),[79] and estates and trusts (IRS Form 1041)[80]—are first-party information reports. These forms require reporting of both primary

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71. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-1517, FORM 1099-SA (DISTRIBUTIONS FROM AN HSA, ARCHER MSA, OR MEDICARE ADVANTAGE MSA) (2019), https://www.irs.gov/pub/irs-pdf/f1099sa.pdf [https://perma.cc/45Q4-6DJE].

72. STAT. OF INCOME DIV., *supra* note 6, at 4 tbl.1 (projecting 3,915,607,000 total information returns made in 2021).

73. *Id.* (projecting 2,612,365,000 Form 1099-B information returns made in 2021).

74. *Id.* (projecting 266,213,000 Form W-2 information returns made in 2021).

75. *See supra* notes 56–57 and accompanying text.

76. STAT. OF INCOME DIV., *supra* note 6, at 5 tbl.2 (projecting 5,186,327,200 total information returns in 2029).

77. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0074, FORM 1040 (U.S. INDIVIDUAL INCOME TAX RETURN) (2022), https://www.irs.gov/pub/irs-pdf/f1040.pdf [https://perma.cc/GK28-2UZU].

78. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0123, FORM 1120 (U.S. CORPORATION INCOME TAX RETURN) (2022), https://www.irs.gov/pub/irs-pdf/f1120.pdf [https://perma.cc/S9CC-HA9J].

79. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0123, FORM 1065 (U.S. RETURN OF PARTNERSHIP INCOME) (2022), https://www.irs.gov/pub/irs-pdf/f1065.pdf [https://perma.cc/6M5T-7WWD].

80. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0092, FORM 1041 (U.S. INCOME TAX RETURN FOR ESTATES AND TRUSTS) (2022), https://www.irs.gov/pub/irs-pdf/f1041.pdf [https://perma.cc/VXL3-S88L].

information used to calculate tax liabilities as well as additional information which can assist in tax administration and enforcement. For example, the IRS Form 1040 requires reporting of information used to calculate tax liabilities (such as items of income and deductible expenses) as well as additional information which does not directly factor into this calculation.[81] Beginning in 2020, the IRS included a question on the IRS Form 1040 asking whether the taxpayer transacted in virtual currencies during the taxable year.[82]

Beyond the tax return filings, the IRS also requires additional first-party financial information reports which assist with tax administration and enforcement, even though the information reported does not directly affect the calculation of tax liabilities. For example, U.S. individuals and certain entities with significant "specified foreign financial assets" must file a Statement of Specified Foreign Financial Assets (IRS Form 8938) listing the value of these assets.[83] For these purposes, "specified foreign financial assets" include: non-U.S. financial accounts; financial contracts and securities issued by foreign counterparties; and stock or other interests in foreign entities.[84] Taxpayers subject to IRS Form 8938 reporting must identify any such assets and their maximum value during the taxable year.[85]

To minimize imposing collateral compliance burdens on taxpayers who are not the proper subjects of heightened first-party information reporting, the Code and Regulations apply wealth-based thresholds exempting less-wealthy taxpayers from IRS Form 8938 reporting obligations. In general, individuals must file the IRS Form 8938 only if they hold specified assets with an aggregate value in excess of $50,000 or an aggregate value of $75,000 at any time during the year.[86] These thresholds double to $100,000 and $150,000, respectively, for married couples filing a joint return.[87] Individuals living abroad must file the form only if their specified assets exceed $200,000 at the end of the taxable year or $300,000 at any time during the year.[88] These

81. *See* INTERNAL REVENUE SERV., *supra* note 78 (Form 1040).

82. *See id.*; *see also* William Hoffman, *Latest Form 1040 Asks for More Income Information*, TAX NOTES (Dec. 21, 2020), https://www.taxnotes.com/taxpractice/tax-system-administration/latest-form-1040-asks-more-income-information/2020/12/21/2d9mm [https://perma.cc/EAR2-9ZJT].

83. *See* INTERNAL REVENUE SERV., *supra* note 35 (Form 8938). For the statutory rules requiring the filing of this statement, see I.R.C. § 6038D (2018). Taxpayers with significant foreign holdings may also be subject to additional reporting requirements, such as an obligation to file a Report of Foreign Bank and Financial Accounts ("FBAR") on the Financial Crimes Enforcement Network Form 114. *See Report of Foreign Bank and Financial Accounts (FBAR)*, *supra* note 35. For an overview of both Form 8938 and FBAR reporting requirements, see generally Robert W. Wood & Milan N. Ball, *Reporting Cash, Gold, and Safe Deposit Boxes*, 152 TAX NOTES 593 (2016).

84. I.R.C. § 6038D(b); *see also* Treas. Reg. § 1.6038D-3 (2014) (defining financial accounts and other specified foreign financial assets).

85. I.R.C. § 6038D(c); *see also* Treas. Reg. § 1.6038D-5 (2014) (guidelines for valuing specified foreign financial assets based on their current fair market value).

86. I.R.C. § 6038D(a); Treas. Reg. § 1.6038D-2(a)(1) (as amended in 2016).

87. Treas. Reg. § 1.6038D-2(a)(2) (as amended in 2016).

88. *Id.* § 1.6038D-2(a)(3) (as amended in 2016).

thresholds similarly double to $400,000 and $600,000, respectively, for married couples filing a joint return.[89]

Outside of the tax rules, other federal agencies also require first-party reporting of financial information used to determine the reporter's qualification for other federal programs and for compliance with other legal requirements. For example, applicants for federal student aid from the U.S. Department of Education must provide detailed information on their family's income and assets through the FAFSA form.[90] Similarly, the Ethics in Government Act of 1978 requires high-level federal officials to report and publicly disclose financial information including the value of their asset holdings and sources of income.[91]

C. *How Information Reporting Enhances Tax Compliance*

When IRS officials provide policymakers and the public with information regarding the overall rate of tax compliance, they usually reference the annual "tax gap," the difference between the amount of tax owed by taxpayers and the amount that is actually paid.[92] In the most recent years in which the IRS has attempted to quantify the annual gross tax gap, the agency reports that approximately $441 billion in tax liability was not paid voluntarily and timely by U.S. taxpayers or about fourteen percent of the estimated total true tax liability.[93] According to some studies, the annual tax gap may have exceeded $600 billion in 2020 and, in the aggregate, will exceed over $7.5 trillion over the following decade.[94] A closer look at the IRS analysis of the tax gap reveals that the overwhelming majority of tax dollars that are not paid are due to underreporting of income (approximately $352 billion out of the $441 billion gross tax gap).[95] Most of this figure is attributable to underreported business income, including that earned by individuals in the cash economy.[96] Further, though the distribution of tax noncompliance among taxpayers based on income

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89. *Id.* § 1.6038D-2(a)(4) (as amended in 2016).

90. *See supra* note 36 and accompanying text; *see also* U.S. DEP'T OF EDUC., *supra* note 36 (sample FAFSA form). *See generally* Nathan Daun-Barnett & Beth Mabry, *Integrating Tax Preparation with FAFSA Completion: Three Case Models*, J. STUDENT FIN. AID, Dec. 2012, at 25 (providing a study of how the preparation of FAFSA and tax forms might be integrated).

91. Ethics in Government Act of 1978, Pub. L. No. 95-521, §§ 101–02, 92 Stat. 1824, 1824–25 (codified at 5 U.S.C. app. §§ 101–02 (2018)) (requiring reporting of general dollar value ranges for income, gifts, property interests, liabilities, transactions and certain other economic activities).

92. *See* INTERNAL REV. SERV., *supra* note 1, at 8 fig.1 (estimating the tax gap for 2011 to 2013); *see, e.g.*, David Lawder, *IRS Chief Says $1 Trillion in Taxes Goes Uncollected Every Year*, REUTERS (Apr. 13, 2021, 10:30 AM), https://www.reuters.com/article/us-usa-treasury-irs/irs-chief-says-1-trillion-in-taxes-goes-uncollected-every-year-idUSKBN2C0255 [https://perma.cc/9QVW-KLPM] (describing testimony regarding the tax gap by IRS Commissioner Charles Rettig).

93. INTERNAL REV. SERV., *supra* note 1, at 8 fig.1; Lawder, *supra* note 92.

94. *See* Rossotti et al., *supra* note 15, at 1471 tbl.2.

95. INTERNAL REV. SERV., *supra* note 1, at 8 fig.1.

96. *Id.*

is difficult to discern, one recent study estimates that tax noncompliance by the top one percent of earners alone accounts for thirty percent of the tax gap.[97]

While the IRS's estimates of the annual tax gap suggest high rates of overall tax compliance (approximately eighty-four percent),[98] the rate of compliance varies significantly, depending upon whether the income is subject to information reporting rules. According to government reports, when taxpayers are subject to information reporting and withholding at the source, the tax compliance rate is approximately ninety-nine percent.[99] When taxpayers are subject to information reporting only, the rate is approximately ninety-three percent.[100] And when taxpayers are subject to neither information reporting nor withholding, the IRS estimates that the compliance rate "is as low as [thirty-seven] percent."[101] Based on these figures, IRS officials have concluded that third-party information reporting directly impacts the level of compliance for specific types of income. As Commissioner of Internal Revenue Charles Rettig noted in 2021, the lack of third-party information reporting rules is a "significant reason" for the existing annual gross tax gap and that "[t]ax compliance is far higher" when income is subject to third-party information reporting.[102]

Why does tax compliance in the United States vary so dramatically between transactions where income is subject to information reporting and those transactions where it is not? Three major explanations are that information reporting: (1) allows the IRS to receive information from sophisticated third parties involved in arm's length transactions with the taxpayer; (2) empowers the IRS to detect noncompliance by the taxpayer; and (3) influences individual taxpayers' perceptions of the probability of IRS audit.

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97. *See* Rossotti et al., *supra* note 15, at 1468 (relying generally on data in Jason DeBacker, Bradley Heim, Anh Tran & Alexander Yuskavage, *Tax Noncompliance and Measures of Income Inequality*, 166 TAX NOTES FED. 1103 (2020)); *see also* Andrew Johns & Joel Slemrod, *The Distribution of Income Tax Noncompliance*, 63 NAT'L TAX J. 397, 401–06, 406 tbl.3 (2010) (displaying the noncompliance estimates for income groups based on 2001 data); Jesse Eisinger & Paul Kiel, *The IRS Tried to Take on the Ultrawealthy. It Didn't Go Well.*, PROPUBLICA: GUTTING THE IRS (Apr. 5, 2019, 5:00 AM), https://www.propublica.org/article/ultrawealthy-taxes-irs-internal-revenue-service-global-high-wealth-audits [https://perma.cc/2VXW-3VKF] ("The top 0.5 percent in income account for fully a fifth of all the underreported income, according to a 2010 study by the IRS' Andrew Johns and the University of Michigan's Joel Slemrod. Adjusted for inflation, that's more than $50 billion each year in unpaid taxes.").

98. INTERNAL REV. SERV., *supra* note 1, at 8 fig.1, 9 tbl.1.

99. *Id.* at 14 fig.3.

100. *IRS Oversight: Treasury Inspector General for Tax Administration: Hearing Before the Subcomm. on Fin. Servs. & Gen. Gov't of the H. Comm. on Appropriations*, 116th Cong. 8 (2019) (testimony of Hon. J. Russell George, Treasury Inspector General for Tax Administration), https://docs.house.gov/meetings/AP/AP23/20190926/110003/HHRG-116-AP23-Wstate-GeorgeJ-20190926.pdf [https://perma.cc/VV2L-843B].

101. *Id.*

102. CHUCK RETTIG, A CLOSER LOOK: IMPACTING THE TAX GAP 4 (2021), https://www.irs.gov/pub/foia/ig/cl/tax-gap-for-web.pdf [https://perma.cc/XD5Y-CGWR].

Sophisticated Third Parties. One explanation for the efficacy of information reporting is that sophisticated third parties, such as employers or financial institutions rather than individual taxpayers, are responsible for collecting and transmitting information about payments and other transactions to the IRS.[103] Third parties that are responsible for submitting information returns are often already maintaining business records in a centralized manner.[104] For example, unlike many average individual wage earners, employers maintain financial accounting reports that contain information regarding wages as part of their ordinary business operations. The tax information reporting rules essentially piggyback on these records. Where the third party complies with the information reporting requirements and has engaged in an arm's length transaction with the taxpayer, an information return provides the taxpayer and the IRS with an independent confirmation of the amount of a taxpayer's income and expenses.

IRS Detection and Enforcement. Where income is subject to third-party information reporting, the IRS can compare and analyze reported information to detect potential tax noncompliance. Before the introduction of third-party information reporting and withholding in the 1940s, IRS agents could verify a taxpayer's reported income only by auditing the individual taxpayer's return and requesting substantiating documentation.[105] When the IRS receives an information return from a third party, such as IRS Form W-2 (Wage and Tax Statement), it can quickly compare the wage information reported on this form with the wage information that the taxpayer reported on IRS Form 1040 (U.S. Individual Tax Return).[106] The IRS has confirmed that one of the methods it uses to select tax returns for further scrutiny are tax returns where "payer reports, such as Forms W-2 from employers or Form 1099 interest statements from banks, do not match the income reported on the tax return."[107]

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103. *See Reducing Information Gaps*, *supra* note 1, at 1737–43; Lederman & Dugan, *supra* note 1, at 160–82; Susan C. Morse, *Ask for Help, Uncle Sam: The Future of Global Tax Reporting*, 57 VILL. L. REV. 529, 529–44 (2012); Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Businesses and Tax Evasion*, 20 STAN. L. & POL'Y REV. 37, 38–56 (2009); Mark D. Phillips, *Individual Income Tax Compliance and Information Reporting: What Do the U.S. Data Show*, 67 NAT'L TAX J. 531, 563 (2014) ("Taxpayers are largely compliant in self-reporting matched income . . . ."); Slemrod, *supra* note 1, at 43–45.

104. *See generally* U.S. GOV'T ACCOUNTABILITY OFF., GAO-21-102, BETTER COORDINATION COULD IMPROVE IRS'S USE OF THIRD-PARTY INFORMATION REPORTING TO HELP REDUCE THE TAX GAP (2020), https://www.gao.gov/assets/gao-21-102.pdf [https://perma.cc/5AYQ-QKKZ] (discussing how third parties are required to submit information returns and recommending potential improvements); *Reducing Information Gaps*, *supra* note 1, at 1737–40.

105. *See generally* Current Tax Payment Act of 1943, Pub. L. No. 68-78, 57 Stat. 126 (providing for tax reporting procedures). For discussion, see *Getting to Know the IRS W-2 Form*, AM. BAR ASS'N (Nov. 27, 2018), https://www.americanbar.org/groups/public_education/publications/teaching-legal-docs/getting-to-know-the-irs-w-2-form [https://perma.cc/RCX3-GHPP]; Jay A. Soled, *The IRS's Voluntary Disclosure Program: Need for Codification*, 37 GA. ST. U. L. REV. 957, 967–77 (2021) (describing information reporting and withholding).

106. *See* I.R.S. Fact Sheet, *supra* note 51, at 2.

107. *Id.*

Perceived Audit Probability. Studies find that third-party information reporting also influences taxpayers' perceptions of the probability of an IRS audit. Each year when the IRS releases its overall audit figures, commentators often highlight that the formal overall audit rate is one percent or less.[108] For instance, in 2020, the IRS audit rate for individual income tax returns was approximately 0.2 percent.[109] Studies find that, despite the low overall audit rate, third-party information reporting rules cause many taxpayers to perceive that the chance of an IRS audit is significantly higher if they fail to report income correctly. For example, one study found that individual taxpayers believed that the probability that their tax returns would be audited by the IRS was forty-eight percent were they to file false returns.[110] Likewise, in the annual study of taxpayer attitudes conducted by the IRS, the IRS found that in 2021, approximately sixty percent of individual taxpayers reported that "[f]ear of an audit" either had somewhat of an influence or had a great deal of influence on their decision to pay their taxes honestly.[111]

Although tax compliance rates vary for the reasons above, third-party information reporting may not lead to increased tax compliance in every circumstance. First, even though a third party may be required to transmit information to the IRS, if that third party is related to the taxpayer or conspires with the taxpayer to misreport information, the IRS may not gain increased visibility into potential tax noncompliance.[112] For example, if a child sells property to their parent, the child may not report the amount of proceeds received from the parent correctly, if the child reports the required information to the IRS at all. Likewise, in a situation involving an independent contractor, the purchaser of services may fail to file a required information return

108. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE DATA BOOK 2021 33–44 (2021), https://www.irs.gov/pub/irs-pdf/p55b.pdf [https://perma.cc/8U25-PUVM]; Greg Iacurci, *Attention Taxpayers: Your Chances of Getting Audited have Fallen Significantly*, CNBC (Jan. 8, 2020, 1:46 PM), https://www.cnbc.com/2020/01/08/attention-taxpayers-irs-audits-have-fallen-significantly.html [https://perma.cc/A465-KC53] ("The IRS audited roughly [one] out of every 220 individual taxpayers last year. A decade ago, those odds were closer to [one] in [ninety]."); Aimee Picchi, *Your Chance of Getting Audited by the IRS is Lower Than Ever*, CBS NEWS (Jan. 7, 2020, 3:53 PM), https://www.cbsnews.com/news/irs-audit-rate-lowest-in-at-least-a-decade [https://perma.cc/C382-CQ8J] ("The audit rate for individuals declined to 0.45 [percent] for fiscal-year 2019 . . . .").

109. *See* INTERNAL REVENUE SERV., *supra* note 108, at 33–44.

110. *See* John T. Scholz & Neil Pinney, *Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior*, 39 AM. J. POL. SCI. 490, 496–98 (1995); *see also* Harold G. Grasmick & Wilbur J. Scott, *Tax Evasion and Mechanisms of Social Control: A Comparison with Grand and Petty Theft*, 2 J. Econ. Psych. 213, 222 (1982) (finding 37.9 percent of individuals believed they would be caught if they attempted to evade tax).

111. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUB. NO. 5296, COMPREHENSIVE TAXPAYER ATTITUDE SURVEY (CTAS) 2021 28–31 (2021), https://www.irs.gov/pub/irs-pdf/p5296.pdf [https://perma.cc/L59V-55PA].

112. *See Reducing Information Gaps*, *supra* note 1, at 1752–59.

properly in exchange for a lower price for the services.[113] Second, third-party information returns are unlikely to result in tax enforcement benefits where the IRS cannot compare them with information reported by the taxpayer. As Professor Leandra Lederman has argued, third-party information returns are warranted where they provide the IRS with information that it can match with corresponding amounts on the taxpayer's individual income tax return.[114] Finally, information returns generally are not likely to aid tax administration where taxpayers and third parties face little or no consequences, such as monetary penalties, for failing to file them with the IRS and the taxpayer properly.[115]

Differences Between First- and Third-Party Information Reporting. As described in greater detail in Part III, each of first- and third-party information reporting offers unique advantages and limitations as means to enhance tax compliance. Third-party information reporting leverages the specific knowledge that third parties have of the taxpayer's transactions and activities, and these parties often do not have the same economic incentives to assist taxpayers in acts of tax noncompliance.[116] First-party information, on the other hand, takes advantage of the taxpayer's more complete knowledge of their economic circumstances and activities but can also be unreliable for the same reason that the annual tax gap exists in the first instance: Taxpayers generally have a direct economic incentive to underreport their taxable activities and thereby to avoid paying their tax liabilities.[117]

II. THE TAX INFORMATION REPORTING GAP AND HIGH-END TAXPAYERS

As the discussion above illustrates, the reach of the tax information reporting rules in the United States appears to be sprawling and ever-expanding.[118] A closer look, however, shows that these rules also contain significant gaps. Each of the examples described in Part I apply to a particular type of transaction where third-party intermediaries collect information and submit it to the IRS. But in situations that do not involve these transactions, the information reporting requirements are either ineffective or do not apply at all.

This Part argues that the gaps in the tax information reporting rules are the result of the government's application of third-party information rules to

113. *See id.* (critiquing proposed gift reporting by donees); Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, 156 U. PA. L. REV. 1181, 1205–13 (2008).

114. *See Reducing Information Gaps, supra* note 1, at 1737–42.

115. *See, e.g.*, Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1662 (2009) (discussing need for tax shelter nondisclosure penalties); *see also* STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF H.R. 4520, THE "AMERICAN JOBS CREATION ACT OF 2004" 150 (Comm. Print 2004) ("Under [law then in effect], there [was] no specific penalty for failing to disclose a reportable transaction; however, such a failure [could have] jeopardize[d] a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction [was] due to reasonable cause, and that the taxpayer acted in good faith.").

116. *See infra* Section III.A.1.

117. *See infra* Section III.B.1.

118. *See supra* notes 47–117 and accompanying text.

specific activities. Further, it reveals how this approach often allows high-end taxpayers, especially, to avoid IRS audit and challenge. Finally, this Part argues that policymakers should expand the scope of the tax information reporting rules to address not just specific activities but also the personal economic characteristics of the taxpayers who pursue them, such as income and wealth.

A. The Focus on Activities

The government deploys, nearly exclusively, an activity-based approach to enable the IRS to detect and deter tax noncompliance. Under an activity-based approach, when a taxpayer participates in a particular activity, specific tax administration and compliance effects occur. Participation in a covered activity might cause a taxpayer to be required to engage in first-party reporting of certain information to the IRS.[119] It might also require one or more third parties to provide information regarding the activity to both the taxpayer and the IRS.[120] The activity may trigger not only information reporting but also tax withholding by a third party.[121] And in some cases, participation in the specific activity might subject the taxpayer or a third party, such as an advisor, to civil or criminal tax penalties.[122]

What is an "activity" for these purposes? In the information reporting context, an activity could range from a general behavior to a specific act or action.[123] For instance, the act of earning wages from an employer[124] or receiving payments in exchange for services from an individual or entity that is not an employer[125] are general behaviors that trigger third-party information reporting. An activity could also include specific actions, such as transactions, abusive tax strategies, fringe benefits, or expenses that Congress, the Treasury Department, or the IRS have targeted.[126] Other specific actions triggering reporting obligations include selling shares of corporate stock through a

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119. *See, e.g.*, Treas. Reg. § 1.6011-4(d) (as amended in 2010); INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-1800, FORM 8886 (REPORTABLE TRANSACTION DISCLOSURE STATEMENT) (2019), https://www.irs.gov/pub/irs-pdf/f8886.pdf [https://perma.cc/3MZG-READ].

120. *See, e.g.*, I.R.C. § 6041(a); INTERNAL REVENUE SERV., *supra* note 2 (Form W-2).

121. *See, e.g.*, I.R.C. § 3402(a) (2018) (requirement of withholding).

122. *See, e.g.*, I.R.C. § 6662(a)(b)(6) (2018) (non-economic substance transaction penalties).

123. *See Activity*, MERRIAM-WEBSTER'S DICTIONARY (Mar. 3, 2023), https://www.merriam-webster.com/dictionary/activity [https://perma.cc/2WZS-FYHY] ("the quality or state of being active: behavior or actions of a particular kind"). *See generally Progressive Tax Procedure*, *supra* note 18, at 691–96 (describing generally the role of activity-based tax compliance rules); *The Trouble with Targeting Tax Shelters*, *supra* note 18, at 74–76 (discussing the activity-based reportable transaction rules).

124. *See, e.g.*, I.R.C. § 6041(a); INTERNAL REVENUE SERV., *supra* note 2 (Form W-2).

125. *See, e.g.*, INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB No. 1545-0116, FORM 1099-NEC (NONEMPLOYEE COMPENSATION) (2022), https://www.irs.gov/pub/irs-pdf/f1099nec.pdf [https://perma.cc/3MTJ-MSWV]; INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0115, FORM 1099-MISC (MISCELLANEOUS INCOME) (2022), https://www.irs.gov/pub/irs-pdf/f1099msc.pdf [https://perma.cc/UAA4-J33R].

126. *See, e.g.*, Prop. Treas. Reg. § 1.6011-9, 87 Fed. Reg. 75,185, 75,185–96 (Dec. 8, 2022) (illustrating the IRS's recent efforts to combat abusive syndicated conservation easement transactions).

broker,[127] receiving pension or healthcare benefits,[128] and paying expenses that may give rise to a tax deduction, such as home mortgage interest.[129] In these examples, it is the activity, not the personal characteristics of the actor, that trigger tax compliance consequences.

While current law results in the filing of billions of information returns with the IRS each year,[130] it also features gaps where it fails to capture information regarding taxable income and events. As the next Section explains, high-end taxpayers especially benefit from tax information reporting gaps. In some cases, high-end taxpayers engage in activities that are subject to information reporting rules that they can manipulate, either by themselves or with cooperation of an accommodating party. At other times, they pursue profit-seeking activities that are not subject to any information reporting under current law. In each case, these gaps in the tax information reporting rules undermine the progressive effect of the substantive tax rules.

B. Opportunities for Avoiding Tax Information Reporting

High-end taxpayers enjoy unique opportunities to avoid and evade tax liabilities. One recent study has found that the top one percent of taxpayers fail to report twenty-one percent of their taxable income.[131] The study found that tax noncompliance is even greater for the top 0.1 percent of taxpayers.[132] One common explanation for such high rates of tax noncompliance at the top is that high-end taxpayers are not subject to third-party information reporting on significant amounts of their income.[133] Some economists have argued that increasing tax information reporting requirements that apply to high-end taxpayers could generate as much as $2 trillion over a ten-year period.[134]

To date, government officials have generally not offered specific examples of strategies that high-end taxpayer use to escape information reporting rules.[135] This Part provides several specific examples of common ways in which

127. *See* INTERNAL REVENUE SERV., *supra* note 60 (Form 1099-B).

128. *See generally* I.R.C. § 6047 (for "[i]nformation relating to certain trusts and annuity plans"); INTERNAL REVENUE SERV., *supra* note 69 (Form 1099-R).

129. *See* I.R.C. § 6050H(a); INTERNAL REVENUE. SERV., *supra* note 68 (Form 1098-E).

130. *See supra* notes 72–76 and accompanying text.

131. *See* John Guyton, Patrick Langetieg, Daniel Reck, Max Risch & Gabriel Zucman, *Tax Evasion at the Top of the Income Distribution: Theory and Evidence* 3–6, 41–50 (Nat'l Bureau of Econ. Rsch., Working Paper No. 28542, 2021), http://www.nber.org/papers/w28542 [https://perma.cc/3ZE8-WGBA].

132. *See id.* at 3. *See generally* Rossotti et al., *supra* note 15, (discussing ways to decrease the tax gap and combat noncompliance).

133. *See generally, e.g.*, Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26475, 2019), http://www.nber.org/papers/w26475 [https://perma.cc/AB99-7679] (analyzing the tax gap, noncompliance, and third-party reporting rules).

134. *Id.* at 16–19.

135. *See, e.g.*, GENERAL EXPLANATIONS, *supra* note 12, at 88–89; TAX COMPLIANCE AGENDA, *supra* note 12, at 18–22; *Fact Sheet*, *supra* note 12.

high-end taxpayers often earn income without being subject to third-party information reporting.

1. Business Income

The most obvious strategy for avoiding third-party information reporting is to earn income through a self-owned and self-operated business. As Part II described, when individuals earn wages from an employer, the employer files an information return and withholds tax from the payment to the employee.[136] This type of third-party information reporting does not apply, however, to individuals who are not employees, but instead, who own and operate their own businesses, either as sole proprietorships or through business entities.

For a simple example, consider a wealthy individual who owns and manages several apartment buildings and has multiple tenants in each building. The tenants of the buildings pay rent to the landlord each month, but they are not required to file information returns with the IRS or the landlord as a result of these payments.[137] There is no "IRS Form 1099-RENT" or other analogue to the types of information returns which individuals receive when they earn wages or interest.[138] Consequently, when landlords file their tax returns, they have an opportunity to underreport income received through rent payments. Several studies confirm that rental payments are subject to high rates of underreporting by taxpayers.[139] Further, there is no third-party reporting for many of the expenses that the landlord may incur, such as payments for routine repairs and maintenance of the properties.[140]

When a taxpayer, such as the owner of the apartment buildings, controls the reporting of both income and expenses to the IRS, there is high potential for tax noncompliance. This potential is magnified when taxpayers participate in cash economy businesses where there is *no* information reporting of income and expenses.[141] As Professor Natasha Sarin has commented, "[i]f you are a normal person who makes a wage, your tax compliance is [ninety-nine] percent. If you are a rich person who earns dividend income and real estate

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136. *See supra* notes 52–53 and accompanying text.

137. For discussion, see Viswanathan, *supra* note 1, at 296–300.

138. *See* I.R.C. §§ 6041–6050W (Information Concerning Transactions with Other Persons).

139. *See* INTERNAL REVENUE SERV., *supra* note 1, at 20–21 (2019) (reporting net misreporting percentage of fifty-one percent for rents and royalties); INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUBLICATION NO. 1415, FEDERAL TAX COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2008–2010 18–19 (2016), https://www.irs.gov/pub/irs-soi/p1415.pdf [https://perma.cc/8Y5V-EH4L] (reporting net misreporting percentage of sixty-two percent for rents and royalties).

140. *See generally* Morse, Karlinsky & Bankman, *supra* note 103 (discussing tax noncompliance by small businesses).

141. *Id.*

income and runs a proprietorship, your compliance rate could be as low as [forty-five] percent."[142]

For high-end taxpayers, the availability of passthrough entities—such as partnerships, Subchapter S corporations, and LLCs—only increases opportunities to avoid IRS scrutiny. When high-end taxpayers earn income through such entities, not only do they benefit from the lack of third-party information reporting, but they also benefit from the IRS's lack of auditing of these entities. One study has found that when IRS agents have conducted random audits that involve passthrough entities, they audit the entities less than five percent of the time.[143] As one of the authors of the study, Professor Gabriel Zucman, described the results, "random audits uncover very little pass-through business tax evasion, even though the character and complexity of these businesses can facilitate substantial evasion."[144] Consequently, in addition to not facing the type of third-party information reporting rules that apply to individuals as they earn wages, high-end taxpayers who use passthrough entities often escape IRS review during audits.

2. Offshore Bank Accounts

Another common strategy that high-end taxpayers have used to evade taxes—hiding assets in offshore bank accounts—hinges on the lack of information reporting to the IRS by banks and other financial institutions. For decades, high-end taxpayers have diverted earnings from U.S. sources into offshore trusts and bank accounts, whether through the deposit of cash funds or smuggling of tangible assets, such as diamonds concealed in tubes of toothpaste.[145] These schemes only worked because financial institutions outside of the United States, such as UBS, used local bank secrecy rules as a reason for not reporting information about these accounts to the IRS.[146]

In 2010, the United States triggered a sea change in offshore tax enforcement by enacting FATCA.[147] Under this legislation, financial institutions

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142. Emily Stewart, *The Trump Tax Scandal is an Indictment of the President — and the System*, VOX (Sept. 28, 2020) (quoting Natasha Sarin), https://www.vox.com/policy-and-politics/21492209/donald-trump-income-taxes-ny-times-evasion-avoidance [https://perma.cc/C5GG-L8B7].

143. *See* Guyton et al., *supra* note 131, at 26–27.

144. Daniel Reck, *Sophisticated Tax Evasion by the Super-Rich*, LONDON SCH. OF ECON. & POL. SCI. (Sept. 7, 2021), https://www.lse.ac.uk/research/research-for-the-world/economics/sophisticated-tax-evasion-by-the-super-rich [https://perma.cc/YC5S-7K55].

145. *See generally* Mark Hosenball & Evan Thomas, *Cracking the Vault: with Help from a Former UBS Banker, the Fed. Demystifying How the Swiss do Business. Inside the Tradecraft.*, NEWSWEEK, Mar. 23, 2009, at 32 (discussing offshore bank accounts).

146. For discussion, see STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SEC. AND GOVERNMENTAL AFFS, 109TH CONG., TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS AND SECRECY, at 1–11 (2006), https://www.hsgac.senate.gov/wp-content/uploads/imo/media/doc/TAXHAVENABUSESREPORT107.pdf?attempt=2 [https://perma.cc/WLW4-4WBX].

147. I.R.C. §§ 1471–1474 (2018); Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 501, 124 Stat. 71, 97–106 (2010) (codified as I.R.C. §§ 1471–1474).

must report to the IRS identifying information and account balance information regarding U.S. account holders.[148] Noncomplying financial institutions are subject to a thirty percent withholding tax on certain U.S.-source payments.[149] In addition, from 2009 through 2018, the IRS entered into settlement agreements with over fifty thousand U.S. taxpayers who participated in its Offshore Voluntary Disclosure Program.[150] Following these actions, since 2014, over one hundred countries have adopted the "common reporting standard," under which they agree to automatically share information regarding the bank and financial account holdings of other countries' residents, such as account numbers and account balances.[151]

Despite all these developments, some high-end taxpayers still evade taxes in the United States through offshore bank accounts. Academic researchers and IRS officials have estimated that the IRS fails to collect tens of billions of dollars each year due to this activity.[152] Through leaks of financial and tax information in the *Panama Papers* in 2016[153] and the *Pandora Papers* in 2021,[154] the public has learned how thousands of ultra-wealthy taxpayers and politicians

148. Payments include U.S.-source interest and dividends and gross proceeds from the sale of assets that generate U.S. dividends and interest. I.R.C. §§ 1471(a), (c), 1473(1).

149. *See id.* § 1471(a); *see, e.g.*, Blank & Mason, *supra* note 66, 1245–49; Shu-Yi Oei, *The Offshore Tax Enforcement Dragnet*, 67 EMORY L.J. 655, 682–91 (2018); J. Richard (Dick) Harvey, Jr., *Offshore Accounts: Insider's Summary of FATCA and Its Potential Future*, 57 VILL. L. REV. 471, 483–85 (2012); J. Richard Harvey Jr., *FATCA—A Report from the Front Lines*, 136 TAX NOTES 713, 713–15 (2012); Leandra Lederman, *The Use of Voluntary Disclosure Initiatives in the Battle Against Offshore Tax Evasion*, 57 VILL. L. REV. 499, 512–13 (2012); Young Ran (Christine) Kim, *Considering "Citizenship Taxation": In Defense of FATCA*, 20 FLA. TAX REV. 335, 367–70 (2017).

150. *See* Memorandum No. LB&I-09-1118-014 from Kirsten B. Wielobob, Deputy Commissioner for Servs. & Enf't, on Updated Voluntary Disclosure Practice to Division Commissioners Chief, Criminal Investigation (Nov. 20, 2018), https://citizenshiptaxation.files.wordpress.com/2015/06/voluntary-disclosure-lbi-09-1118-014.pdf [https://perma.cc/QR7B-5L4A]; *IRS: Offshore Voluntary Compliance Program to End Sept. 28*, INTERNAL REVENUE SERV. (Sept. 4, 2018), https://www.irs.gov/newsroom/irs-offshore-voluntary-compliance-program-to-end-sept-28 [https://perma.cc/QB6M-QV25].

151. *See* OECD, AUTOMATIC EXCHANGE OF INFORMATION (AEOI): STATUS OF COMMITMENTS 1–2 (2023), https://www.oecd.org/tax/transparency/AEOI-commitments.pdf [https://perma.cc/C9EJ-URSM]. *See generally* OECD, STANDARD FOR AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION IN TAX MATTERS (2014) (providing background information on the information exchange standards).

152. *See* Guyton et al., *supra* note 131; *Closing the Tax Gap: Lost Revenue from Noncompliance and the Role of Offshore Tax Evasion: Hearing Before the Subcomm. On Tax'n and IRS Oversight, S. Comm. on Fin.*, 117th Cong. 48 (2021) (statement of Hon. J. Russell George, Treasury Inspector General for Tax Admin., Dep't of the Treasury, estimating $46 billion in revenue loss due to offshore bank accounts in 2019).

153. *See Pandora Papers: Offshore Havens and Hidden Riches of World Leaders and Billionaires Exposed in Unprecedented Leak*, INT'L CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Oct. 3, 2021), https://www.icij.org/investigations/pandora-papers/global-investigation-tax-havens-offshore [https://perma.cc/J9AA-BY8V].

154. *See The Panama Papers: Exposing the Rogue Offshore Finance Industry*, INT'L CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Apr. 3, 2016), https://www.icij.org/investigations/panama-papers [https://perma.cc/F6VK-QH8Q].

continued to maintain offshore bank accounts even after the enactment of FATCA and the introduction of the common reporting standard. For example, in October 2021, journalists reported on offshore accounts of U.S. billionaires, such as Robert Brockman, who had been charged in a $2 billion federal tax evasion case.[155] The U.S. Department of Justice has continued to announce indictments of high-end taxpayers who have hidden assets in offshore accounts.[156] And in 2021, a whistleblower accused Credit Suisse of continuing to assist U.S. taxpayers to avoid tax through such strategies, even though it had entered into a settlement with the United States in 2014 in which it pleaded guilty, paid fines of $2.6 billion, and committed to "close any . . . accounts of recalcitrant account holders."[157]

There are several reasons that explain why the use of offshore bank accounts still remains a potential option for evading tax obligations and information reporting for high-end taxpayers. First, while many jurisdictions have adopted the common reporting standard, some countries (including the United States) have opted not to participate in this program and, thus, continue to offer bank secrecy opportunities.[158] Second, while FATCA provided the IRS with a powerful deterrent, the IRS has conceded that its agents have been overwhelmed by the volume of information reporting from FFIs.[159] According to a review by the Government Accountability Office, the "IRS has had difficulties matching the information reported by foreign financial institutions ("FFI") with U.S. taxpayers' tax filings due to missing or inaccurate Taxpayer

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155. *See, e.g.*, *"Pandora Papers" Reveal Billions Hidden by the Rich and Powerful*, CBS NEWS (Oct. 4, 2021, 7:30 AM), https://www.cbsnews.com/news/pandora-papers-billions-hidden-tax-rich [https://perma.cc/6KSJ-EU48] (discussing Robert T. Brockman); Chas Danner, *Leak Exposes Massive Trove of Documents Detailing Offshore Wealth*, N.Y. MAG. (Oct. 3, 2021), https://nymag.com/intelligencer/2021/10/pandora-papers-massive-trove-of-offshore-data-exposed.html [https://perma.cc/37JQ-WH8T].

156. *See., e.g.*, *Offshore Compliance Initiative*, U.S. DEP'T OF JUST. https://www.justice.gov/tax/offshore-compliance-initiative [https://perma.cc/Y2RA-JJPF]; Press Release, U.S. Dep't of Just., Private Equity CEO Enters into Non-Prosecution Agreement on International Tax Fraud Scheme and Agrees to Pay $139 Million, to Abandon $182 Million in Charitable Contribution Deductions, and to Cooperate with Government Investigations (Oct. 15, 2020), https://www.justice.gov/opa/pr/private-equity-ceo-enters-non-prosecution-agreement-international-tax-fraud-scheme-and-agrees [https://perma.cc/CD22-TPPD]; Press Release, U.S. Dep't of Just., Indictment Unsealed Against Six Individuals and Foreign Financial Service Firm for Tax Evasion Conspiracy (Sept. 28, 2021), https://www.justice.gov/opa/pr/indictment-unsealed-against-six-individuals-and-foreign-financial-service-firm-tax-evasion [https://perma.cc/BJK6-EGW9].

157. *See* Katie Benner & Michael Forsythe, *Whistle-Blower Says Credit Suisse Helped Clients Skip Taxes After Promising to Stop*, N.Y. TIMES (July 29, 2021), https://www.nytimes.com/2021/03/13/business/whistle-blower-credit-suisse-taxes.html [https://perma.cc/56PN-RPXT].

158. *See* OECD, AUTOMATIC EXCHANGE OF INFORMATION (AEOI): STATUS OF COMMITMENTS, *supra* note 152, at 1–2.

159. *See generally* U.S. GOV'T ACCOUNTABILITY OFF., GAO-19-180, FOREIGN ASSET REPORTING: ACTIONS NEEDED TO ENHANCE COMPLIANCE EFFORTS, ELIMINATE OVERLAPPING REQUIREMENTS, AND MITIGATE BURDENS ON U.S. PERSONS ABROAD (2019) (discussing the problems the IRS has encountered regarding foreign asset reporting).

Identification Numbers provided by FFIs."[160] Third, some high-end taxpayers have pursued opportunities to circumvent FATCA, especially where they hold dual citizenship and are able to obfuscate their U.S. citizenship from financial institutions.[161] Finally, consistent with the literature on collusion between interested parties,[162] some foreign banks appear to be unwilling to investigate their clients' citizenship as a result of the high value of their accounts and business with these financial institutions.[163]

3. Virtual Currency and Digital Assets Transactions

Like offshore bank accounts, virtual currency and digital assets offer high-end taxpayers another opportunity to evade taxation without being subject to effective third-party information reporting.

Under current law, the IRS treats virtual currency, such as Bitcoin and Ethereum, as property, resulting in ordinary income treatment when taxpayers receive it in exchange for services and capital gain or loss treatment when they sell or exchange it.[164] As discussed earlier, starting for tax returns filed after December 31, 2023, digital asset brokers, such as Coinbase, will be required to file IRS Form 1099-B when their customers sell or exchange Bitcoin and other cryptocurrency.[165] Further, under legislation enacted in 2021, individuals engaged in a trade or business and businesses that receive digital assets worth more than $10,000 will be required to file currency transaction reports, IRS Form 8300, just as they do when then receive such amounts in cash.[166]

While Congress has attempted to increase visibility of this activity to the IRS,[167] significant opportunities remain for avoiding information reporting through the virtual currency and digital asset transactions, especially by high-end taxpayers. Some high-end taxpayers engage in transactions worth millions of dollars or more through wallet-to-wallet transfers rather than through services

160. *Id.* at i.

161. *See* Alexis Leondis, *Yes, You Can Still Hide Bank Accounts Offshore*, BLOOMBERG TAX (Dec. 3, 2021, 7:30 AM), https://news.bloombergtax.com/tax-insights-and-commentary/yes-you-can-still-hide-bank-accounts-offshore-alexis-leondis [https://perma.cc/B5QZ-3CJR] ("People who have dual citizenship, minimal connections to the U.S. and a willing accomplice at a bank have the easiest time.").

162. *See supra* notes 112–113 and accompanying text.

163. *See* Leondis, *supra* note 161.

164. I.R.S. Notice 2014-21, I.R.B 2014-16; Rev. Rul. 2019-24, 2019-44 I.R.B. 1004; *Frequently Asked Questions on Virtual Currency Transactions*, INTERNAL REVENUE SERV. (Jan. 13, 2021), https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions [https://perma.cc/M5HT-HDJR].

165. *See supra* note 61 and accompanying text.

166. I.R.C. § 6050I(d); Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, § 80603(b)(1)(8), 135 Stat. 429, 1340 (2021).

167. *See* I.R.C. § 6050I(d); Infrastructure Investment and Jobs Act, § 80603(b)(1)(B).

such as Coinbase.[168] The absence of an intermediary, including a digital platform, reduces the likelihood that all significant virtual currency transactions will yield information returns to the IRS. Another potential loophole is that the legislation does not appear to directly address situations where individuals exchange one virtual currency, such as Bitcoin, for another virtual currency.[169] Further, in exchanges involving virtual currency, the filing of the currency transaction report may depend in some cases upon the cooperation of the other party. For example, if the transaction involves an exchange of virtual currency for virtual currency, both parties may have an incentive not to file an information report and may be able to share the benefits from any tax avoidance. In this case, the buyer may not comply with the tax information reporting rules in exchange for a reduced price from the seller.[170] And in some cases, such as wallet-to-wallet transfers, a party may not be able to obtain the information necessary to file the required information return.[171] As one practitioner has commented: "If Treasury and the IRS say that we're going to do that verification exactly like for cash, it's going to be really hard to comply."[172] Especially in light of these difficulties, in 2021, the Commissioner of Internal Revenue speculated that, as a result of virtual currency transactions and other strategies, the annual tax gap may be as high as $1 trillion.[173]

4. Use of Business Entities

High-end taxpayers can also escape information reporting by earning income indirectly through certain business entities.

Under current law, when a person engaged in a trade or business pays another party (who is not an employee) $600 or more in exchange for services, that person must file an information return, such as IRS Form 1099-MISC or IRS Form 1099-NEC.[174] However, under the applicable regulations, if the service provider is a corporation, this reporting requirement does not apply.[175] As a

168. *See, e.g.*, Greg Iacurci, *Cryptocurrency Poses a Significant Risk of Tax Evasion*, CNBC (May 31, 2021, 8:30 AM), https://www.cnbc.com/2021/05/31/cryptocurrency-poses-a-significant-risk-of-tax-evasion.html [https://perma.cc/LG5Q-XUMB].

169. *See Senate-Passed Infrastructure Bill Would Impose Information-Reporting Requirements on Sales of Cryptocurrency and Other Digital Assets*, EY (Aug. 19, 2021), https://taxnews.ey.com/news/2021-1538-senate-passed-infrastructure-bill-would-impose-information-reporting-requirements-on-sales-of-cryptocurrency-and-other-digital-assets [https://perma.cc/4MM6-Y47C] (noting that bill does not address trades of "bitcoin for litecoin" and other similar swaps).

170. *See supra* note 113 and accompanying text.

171. *See* Marie Sapirie, *Implementing the New Crypto Reporting Guidance*, 173 TAX NOTES FED. 1058, 1058–59 (2021).

172. *Id.* at 1060 (quoting Megan L. Brackney).

173. *See* Alan Rappeport, *Tax Cheats Cost the U.S. $1 Trillion per Year, I.R.S. Chief Says*, N.Y. TIMES (Oct. 13, 2021), https://www.nytimes.com/2021/04/13/business/irs-tax-gap.html [https://perma.cc/H7V3-7AEG].

174. *Instructions for Forms 1099-MISC and 1099-NEC (01/2022)*, *supra* note 55.

175. Treas. Reg. § 1.6041-3(p)(1) (1960).

result, with few exceptions, when a Subchapter S corporation receives payments and other compensation in exchange for services, the payor does not file an information return with the IRS.[176]

This exception to the information reporting rule offers an opportunity for individuals to engage in tax avoidance and evasion without raising the possibility of IRS detection. Scholars, including Professors Joseph Bankman[177] and Leandra Lederman,[178] have proposed that the government should close this loophole rather than allowing "individuals inclined to evade taxes [to]. . . form a wholly owned corporation simply to avoid receiving information reports."[179] An additional consideration, not emphasized in the literature, is that this exception likely benefits high-end taxpayers disproportionately. In order to take advantage of the corporate exception to information reporting, individuals must have the knowledge to pursue the strategy, the resources to hire advisors in order to incorporate, and the ability to manage ongoing compliance costs of operating in corporate form.[180]

5. Disguised Dividends

A related possibility for evading tax and avoiding information reporting occurs when high-end taxpayers extract disguised dividends from corporations they control.

Under U.S. tax law, when a Subchapter C corporation makes a distribution of cash or other property to its shareholders, the distribution may be taxable to the shareholders as a dividend.[181] When this occurs, the corporation is required to file an information return, IRS Form 1099-DIV, with the shareholders and the IRS.[182] As students of corporate tax learn in the introductory course, however, sometimes the form of a transaction may be inconsistent with its substance, especially in tax avoidance and evasion contexts.[183] For example, one abusive transaction that many high-end taxpayers have attempted is to direct a wholly-owned Subchapter C corporation to make a "loan" of cash to the

176. *Id.*

177. Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506, 506–15 (2007).

178. *See Reducing Information Gaps*, *supra* note 1, at 1744–48.

179. *Id.* at 1745.

180. *See, e.g.*, *How Much Does a Tax Attorney Cost*, CROSS L. GRP. (Jan. 16, 2017), https://www.crosslawgroup.com/blog/hiring-tax-attorney-worth-cost [https://perma.cc/4JXC-PHVM]; *What is the Average Cost of Hiring a Tax Attorney*, SUPERMONEY (Oct. 31, 2022), https://www.supermoney.com/what-average-cost-hiring-tax-attorney [https://perma.cc/P9UY-ZK6D]. *See generally* Heather M. Field, *Tax Lawyers As Tax Insurance*, 60 WM. & MARY L. REV. 2111 (2019) (discussing the role of tax lawyers in transactions).

181. *See* I.R.C § 301 (2018).

182. INTERNAL REVENUE SERV., *supra* note 59 (Form 1099-DIV).

183. *See generally, e.g.*, Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 TAX LAW. 457 (1999) (discussing the relationship between form and substance in tax law).

shareholder rather than distribution of a dividend.[184] This technique enables the shareholder to claim that the distribution is not taxable as borrowing, even though the IRS or a court may later recharacterize it as a taxable "disguised dividend."[185]

In addition to the general tax avoidance motivation, this strategy enables the shareholder to avoid information reporting by the corporation. Since the corporation treats the distribution as a loan, it does not issue the shareholder an IRS Form 1099-DIV, which only occurs when the corporation pays a dividend.[186] Further, even if the shareholder pays interest to the corporation, whether at market rates or not, the shareholder is also not required to file an information report, IRS Form 1099-INT, because this requirement does not apply when the interest payee is a corporation.[187] High-end taxpayers may pursue other similar strategies that would also avoid information reporting requirements, such as by claiming that transfers from their wholly-owned corporations are reimbursements for expenses incurred by the shareholders on behalf of the corporation.[188]

Although the IRS should challenge transactions that taxpayers do not characterize properly as dividends, the lack of information reporting by either the corporations or the shareholders may prevent the IRS from discovering that the transactions have occurred.

6. Payroll Taxes

In addition to using business entities to obscure information reporting, high-end taxpayers also use them to manipulate the character of their income that is reported to the IRS.

By forming a Subchapter S corporation, high-end taxpayers can control the extent to which they report their earnings as compensation income. For a simple example, an individual who receives compensation as an investment fund manager might earn $10 million each year. If the individual's wholly

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184. *See generally, e.g.*, Weigel v. Commissioner, 72 T.C.M. (CHH) 1119 (1996) (providing an example).

185. *See, e.g.*, *id.*; Alterman Foods, Inc. v. United States, 611 F.2d 866, 871–73 (Ct. Cl. 1979); Levy v. Comm'r, 30 T.C. 1315, 1323–30 (1958); *see also* Albert B. Ellentuck, *Using Loans to Extract Cash From a Closely Held Corporation*, TAX ADVISOR (Dec. 31, 2014), https://www.thetaxadviser.com/issues/2015/jan/case-study-jan2015.html [https://perma.cc/C4M4-VJ8P]; John W. Lee, *Shareholder Withdrawal—Loan or Dividend: Repayments, Estoppel, and Other Anomolies*, 12 WM. & MARY L. REV. 512, 515–17 (1971).

186. *See Instructions for Form 1099-DIV (Dividends and Distributions) (01/2022)*, INTERNAL REVENUE SERV. (Dec. 15, 2021), https://www.irs.gov/instructions/i1099div [https://perma.cc/BZ3B-XE37].

187. Treas. Reg. § 1.6049-4(c)(1)(ii)(A) (as amended in 2017); *Instructions for Forms 1099-INT and 1099-OID (01/2022)*, INTERNAL REVENUE SERV. (Dec. 6, 2021), https://www.irs.gov/instructions/i1099int [https://perma.cc/4PGR-U4YY].

188. *See generally, e.g.*, Santos v. Comm'r, 118 T.C.M. (CCH) 392 (2019) (finding disguised dividend through cash reimbursements of shareholder personal expenses).

owned Subchapter S corporation, rather than the individual, receives the payments, the Subchapter S corporation could then designate $200,000 of this amount as the individual's salary. In this case, only the $200,000, not the entire $10 million, would be designated as compensation income and would be subject to payroll (Social Security and Medicare) taxes. The IRS has challenged taxpayers who have engaged in such S corporation strategies as failing to satisfy the "reasonable compensation" requirement,[189] but in many cases, the IRS has not audited high-end taxpayers who have used this tax avoidance technique or asserted challenges.[190] Numerous high-end taxpayers have used this strategy, including several well-known public figures, such as former Speaker of the House Newt Gingrich,[191] former U.S. Senator John Edwards,[192] and, prior to winning the 2020 election, former Vice President Joe Biden.[193] Congress has considered legislative proposals, including the Build Back Better Act, which would have prevented taxpayers from using this strategy and potentially raised $250 billion in revenue over a ten-year period, but as of 2022, Congress has not enacted them.[194]

Yet ability to control the extent to which the taxpayer's earnings are reported as compensation to the IRS is not available to all taxpayers. When wage earners receive their paychecks, for instance, their employers automatically characterize the payments as compensation for services, which causes them to

189. *See* I.R.S. Fact Sheet FS-2008-25 (Aug. 2008). *See generally* Robert W. Wood, *Payroll Taxes and S Corporations (Again)*, M&A TAX REP., Mar. 2012, at 5 (discussing compensation deductions for S corporations).

190. *See* Robert Faturechi & Justin Elliott, *How the Trump Tax Law Created a Loophole That Lets Top Executives Net Millions by Slashing Their Own Salaries*, PROPUBLICA (Aug. 19, 2021, 5:00 AM), https://www.propublica.org/article/how-the-trump-tax-law-created-a-loophole-that-lets-top-executives-net-millions-by-slashing-their-own-salaries [https://perma.cc/3ABP-TMRR]; Joe Hughes, *Key Reform in Build Back Better Act Would Close Loophole Used by the Rich to Avoid Funding Healthcare*, INST. ON TAX'N & ECON. POL'Y: JUST TAXES BLOG (Nov. 18, 2021), https://itep.org/key-reform-in-build-back-better-act-would-close-loophole-used-by-the-rich-to-avoid-funding-healthcare [https://perma.cc/HU8V-6FW9].

191. *See Newt Gingrich's Tax Payments Questioned*, ACCT. TODAY (Jan 23, 2012, 4:46 PM), https://www.accountingtoday.com/news/newt-gingrichs-tax-payments-questioned [https://perma.cc/JL93-CGRF].

192. *See* Mark Koba, *How the Gingrich-Edwards Tax Loophole Works*, CNBC (Mar. 5, 2014, 11:35 AM), https://www.cnbc.com/2014/03/05/cnbc-explains-the-gingrich-edwards-tax-loophole.html [https://perma.cc/MUS2-ZQ7J]; Walter D. Schwidetzky, *The John Edwards Technique: Is the IRS Winning the Battles And Losing the War?*, TAXPROF (Sept. 6, 2013), https://taxprof.typepad.com/files/taxprof-blog-op-ed-schwidetzky-090613.pdf [https://perma.cc/U8HJ-PNS5].

193. Richard Rubin, *Joe Biden Used Tax-Code Loophole Obama Tried to Plug*, WALL ST. J. (Jul. 10, 2019, 1:21 PM), https://www.wsj.com/articles/joe-biden-used-tax-code-loophole-obama-tried-to-plug-11562779300 [https://perma.cc/PN5S-9DSH] (discussing Subchapter S corporations used by President Biden and First Lady Jill Biden for speaking fees).

194. *See* Chuck Marr & Samantha Jacoby, *Build Back Better Requires Highest-Income People and Corporations to Pay Fairer Amount of Tax, Reduces Tax Gap*, CTR. ON BUDGET & POL'Y PRIORITIES (Nov. 2, 2021), https://www.cbpp.org/research/federal-tax/build-back-better-requires-highest-income-people-and-corporations-to-pay [https://perma.cc/9G9N-5PXH].

file information returns and withhold federal income taxes and, up to the statutory caps, payroll taxes.[195]

7. Sales, Exchanges, and Dispositions

A final illustration of tax avoidance advantages that high-end taxpayers enjoy can be observed in their ability to avoid effective third-party information reporting regarding sales, exchanges, and dispositions of property.

When average investors purchase and subsequently sell shares of stock through a broker, such as through their Vanguard brokerage accounts, they receive an information return, IRS Form 1099-B (Proceeds from Broker and Barter Exchange Transactions), that reports their cost basis and the proceeds from sale.[196] Some high-end taxpayers, on the other hand, often participate in transactions that are not subject to comparable third-party information reporting and, in some cases, may exploit this feature to underreport taxable gains and overreport taxable losses. For example, when high-end taxpayers sell certain assets, such as shares of a Subchapter S corporation, they do not receive an information return that states their cost basis in their shares.[197] As a result of the complexity of the applicable law, the IRS does not require the Subchapter S corporation to provide the shareholder with an overall basis figure on the annual IRS Schedule K-1 (Form 1120-S).[198] Similar issues occur in the partnership context, where the IRS Schedule K-1 (Form 1065) does not contain an overall outside basis figure.[199] As another example, when high-end taxpayers purchase stock or assets in situations not involving a broker,

195. *See supra* notes 52–53 and accompanying text.

196. INTERNAL REVENUE SERV., *supra* note 60 (Form 1099-B).

197. *See* 1 TAXPAYER ADVOC. SERV. ANN. REP. TO CONG. 394–400 (2015); *see also* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0123, FORM 1120-S (SCHEDULE K-1: SHAREHOLDER'S SHARE OF INCOME, DEDUCTIONS, CREDITS, ETC.) (2022), https://www.irs.gov/pub/irs-pdf/f1120ssk.pdf [https://perma.cc/9S8J-EZGK] (displaying a sample form).

198. *See* 1 TAXPAYER ADVOC. SERV. ANN. REP. TO CONG., *supra* note 197, at 394–400.

199. *See* INTERNAL REVENUE SERV., *supra* note 79 (Form 1065). *See generally* James Alm & Jay A. Soled, *Tax Basis Determinations, Pass-Through Entities, and Taxpayer Noncompliance*, 40 OHIO N.U. L. REV. 693 (2014) (discussing the relationship between taxes and pass-through entities); James Alm & Jay A. Soled, *Tax Basis Reporting Should Be Required for Passthrough Entities*, 150 TAXNOTES 1358 (2016). In 2020, the IRS issued guidance that would require partnerships to use one of two alternative methods to report capital accounts on Schedule K-1 for years ending on or after December 31, 2020. I.R.S. Notice 2020-43, 2020-27 I.R.B. 1; I.R.S. Notice 2021-13, 2021-6 I.R.B. 832. Before these notices, partnerships were permitted to use any reasonable method, including GAAP, to report capital accounts. Despite these changes, commentators have noted that a partner's outside basis may differ from the figure that could be calculated using the information reported on Schedule K-1, even with these changes. *See, e.g.*, Grant W. McMichael, *CPA Skeptical of Scrapping Method for Tax Capital Reporting*, TAXNOTES (Sept. 1, 2020), https://www.taxnotes.com/tax-notes-today-federal/basis/cpa-skeptical-scrapping-method-tax-capital-reporting/2020/09/04/2cxnm? [https://perma.cc/4DXB-YKHM]; Eric Yauch, *Tax Capital Reporting Continues to Vex Partnership Community*, TAXNOTES (Mar. 1, 2021), https://www.taxnotes.com/taxpractice/information-reporting/tax-capital-reporting-continues-vex-partnership-community/2021/03/01/2zdz7? [https://perma.cc/5R3M-3J9B].

such as a direct purchase from another shareholder of a closely held corporation, they may not receive an information return at all, allowing them to later claim an inflated cost basis in a subsequent sale.[200] And where a buyer and seller collude, such as by not filing an information return, such as IRS Form 1099-S or IRS Form 8300, in exchange for a lower purchase price, the IRS will not receive any third-party information return that a sale has even occurred.[201] Consequently, unlike average taxpayers' sales of stock purchased through brokerage accounts, in such situations involving high-end taxpayers, the IRS does not receive information returns that computers can quickly compare to taxpayers' self-reported gains or losses on their individual tax returns.

C. *THE CASE FOR AN ACTOR-BASED APPROACH*

The multitude of opportunities that high-end taxpayers may exploit to avoid tax information reporting should motivate scholars and policymakers to consider alternatives to the law's current approach. Instead of targeting information reporting to specific activities exclusively, policymakers could apply more general tax information reporting when taxpayers' income or wealth reaches a threshold amount. Under this model, certain tax information reporting rules would apply as a result of the presence of a particular actor rather than an activity.

One example of an actor-based approach to information reporting is a requirement that certain third parties, such as financial institutions, file information reports with the IRS regarding financial accounts of taxpayers whose taxable income or net wealth equals or exceeds threshold amounts. This measure would supplement, not replace, the existing activity-based tax information reporting rules under current law. The actor-based approach builds upon our prior work on "progressive tax procedure," which proposes that high-income or wealthy taxpayers could be subject to increased tax penalty rates, longer periods of assessment, and narrower tax penalty defense, among other means-adjusted tax procedure and compliance rules.[202]

Current tax compliance and procedure rules—including those that apply to tax information reporting—generally apply to all taxpayers in the same way. The law does not vary the information that a third party must provide to the IRS even though a high-end taxpayer may earn income in different ways from other taxpayers.[203] As we have noted in prior work, the tax compliance and procedure rules, such as civil tax penalties on underreporting and underpayments, apply equally to all taxpayers, even though high-end taxpayers enjoy

200. *See Instructions for Form 1099-B (2023)*, INTERNAL REVENUE SERV. (Dec. 1, 2022), https://www.irs.gov/instructions/i1099b [https://perma.cc/KQH4-87PC] (requiring participation of broker).

201. *See supra* text accompanying notes 112–13.

202. *See Progressive Tax Procedure*, *supra* note 18, at 715–18; *The Trouble with Targeting Tax Shelters*, *supra* note 18, at 82–86.

203. *See Progressive Tax Procedure*, *supra* note 18, at 674–78 (discussing tax noncompliance among high-end earners).

advantages in their dealings with the IRS that are not available to other taxpayers.[204] Some tax compliance and procedure rules under current law contain limited actor-based adjustments.[205] For instance, low-income taxpayers who claim the Earned Income Tax Credit ("EITC") fraudulently lose the ability to claim the credit again for ten years and face higher effective penalty rates than other taxpayers.[206] But these means-based adjustments often occur in a haphazard manner rather than as part of a greater coordinated legislative strategy.[207]

The introduction of actor-based information reporting rules would provide several tax administration and enforcement benefits.

First, by supplementing the tax information reporting rules under current law with actor-based adjustments tied to income or wealth, the IRS would cast a wider net to capture the tax avoidance and evasion strategies that high-end taxpayers pursue. When high-end taxpayers manipulate the content of information returns, such as by underreporting business income, they often do so because there is no arm's length third-party intermediary that has an information reporting obligation to the IRS.[208] However, if the IRS could access more general information about high-end taxpayers' financial affairs, such as by reviewing inflows and outflows of capital, it could identify situations where there are discrepancies between information reported by the third-party intermediary and the taxpayer. Just as the IRS uses differences between taxpayers' reported wages and those reported by their employers as a justification for an audit,[209] IRS computers could flag differences between high-end taxpayers' regarding reported taxable income and cash receipts in bank accounts as signals of potential tax noncompliance.

Second, more general information reporting that applies to actors rather than specific activities would be harder for high-end taxpayers to avoid. Under current law, high-end taxpayers can simply avoid meaningful third-party information reporting by failing to engage in covered activities, such as earning wages.[210] Instead, high-end taxpayers use vehicles that are not subject to third-party information reporting requirements, such as wholly-owned Subchapter S corporations and partnerships.[211]

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204. *See id.*

205. *See id.*

206. *See* I.R.C. § 32(k)(1)(B)(i) (2018). In this case, the taxpayer can bear an effective penalty equal to many multiples of the underlying underpayment. A taxpayer who makes an EITC claim recklessly or in disregard of rules or regulations can lose the credit for the next two years, which can result in an effective penalty rate of 200 percent of the underlying underpayment. *See id.*

207. For further discussion, see *Progressive Tax Procedure*, *supra* note 18, at 712–15 (describing means-based adjustments in the current tax compliance rules and their inconsistent application).

208. *See supra* notes 136–44 and accompanying text.

209. *See* I.R.S. Fact Sheet, *supra* note 51, at 1–3.

210. *See supra* note 2 and accompanying text.

211. *See supra* notes 136–44 and accompanying text.

Policymakers could close such gaps by empowering the IRS to observe and analyze more general categories of financial information for high-end taxpayers. The types of tax noncompliance that IRS agents may discover as a result of such red flags could include information regarding tax strategies that the IRS has *not* specifically designated as abusive, such as "listed transactions" or "transactions of interest."[212] This broader actor-based approach to information reporting would thus assume a more proactive, rather than reactive, approach to tax avoidance and evasion strategies than current law.[213] And consistent with the empirical literature, the introduction of more general, actor-based information reporting rules could deter high-end taxpayers from pursuing the most blatant forms of tax evasion, such as underreporting income from wholly-owned businesses.[214]

Third, an actor-based approach would reduce the inequity of current tax information reporting rules. Today, hundreds of millions of individual taxpayers who earn income where a third-party intermediary is involved, whether employers or financial institutions, are subject to omnipresent, automated information reporting.[215] As some scholars have characterized these taxpayers, their tax compliance is so high because they have no opportunity to fail to avoid or evade taxation on much of their income.[216] These taxpayers, which include the vast majority of low- and middle-income individuals, face heightened probability of IRS audit if they fail to report information to the IRS in manner consistent with that of these intermediaries.[217]

Further, an investigation by ProPublica in 2021 documented especially high IRS audit rates in predominantly Black, low-income counties in the South.[218] Professor Dorothy Brown has argued that, even though about half of EITC recipients nationally are white, the ProPublica reports show that "[p]redominantly Black counties have higher audit rates than predominantly

212. Treas. Reg. § 1.6011-4(b)(2), (6) (as amended in 2010); *The Trouble with Targeting Tax Shelters*, *supra* note 18, at 684–96.

213. In many of its listed transaction notices, the IRS states it has "become aware of certain types of transactions . . . that are being marketed to taxpayers for the avoidance of federal income taxes[,]" emphasizing that it is issuing the notice in response to growing use of a tax avoidance strategy. *See, e.g.*, I.R.S. Notice 2001-16, 2001-1 C.B. 730 (discussing intermediary corporation tax shelters as a tax avoidance strategy).

214. *See supra* notes 112–115 and accompanying text (discussing third-party reporting as a tool to minimize federal tax evasion).

215. *See* STAT. OF INCOME DIV., *supra* note 6, at 4 tbl.1.

216. *See, e.g.*, *Reducing Information Gaps*, *supra* note 1, at 1752–57.

217. *See supra* notes 105–07 and accompanying text (describing how information reporting can enable IRS audits).

218. *See* Paul Kiel & Hannah Fresques, *Where in The U.S. Are You Most Likely to Be Audited by the IRS?*, PROPUBLICA (Apr. 1, 2019), https://projects.propublica.org/graphics/eitc-audit [https://perma.cc/EL7S-2KHL]; *see also* Kim M. Bloomquist, *Regional Bias in IRS Audit Selection*, 162 TAX NOTES 987, 989–91 (2019) (reporting research on IRS audit intensity).

white ones because of the large number of EITC claimants living there."[219] In response, scholars and policymakers have called for investigation by Congress and the IRS into the racial distribution of IRS audits.[220] By contrast, high-end taxpayers, who are predominantly white,[221] tend to control their own sources of income and methods of earning income. They operate in a different system, where they may choose to underreport income undetected. More general actor-based information reporting rules would subject high-end taxpayers to a similar risk of audits as most other taxpayers.

The challenge for policymakers is to determine how to execute actor-based adjustments to information reporting rules. What type of information would aid the IRS's ability to enforce the tax law and detect noncompliance? How should policymakers design income and wealth thresholds that would trigger such requirements? Who should provide the information to the IRS, individual high-end taxpayers, third-party intermediaries, or both? Part III addresses these and other design and implementation questions.

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219. Dorothy A. Brown, *The IRS is Targeting the Poorest Americans*, ATLANTIC (July 27, 2021), https://www.theatlantic.com/ideas/archive/2021/07/how-race-plays-tax-policing/619570 [https://perma.cc/K4SJ-GRN6].

220. *See, e.g.*, Jeremy Bearer-Friend, *Colorblind Tax Enforcement*, 97 N.Y.U. L. REV. 1, 44–47 (2022) (arguing that general institutional vulnerability to racial bias necessitates the need for data regarding tax enforcement and race); Brian Faler, *Taxes May Not Be Colorblind, and Critics Say More Data Could Prove It*, POLITICO (Mar. 16, 2021, 4:22 PM), https://www.politico.com/news/2021/03/16/race-taxes-irs-476371 [https://perma.cc/5ZHH-P48H]; *see also* Dorothy A. Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790, 831 (2007) (arguing for greater "empirical data concerning the racial demographics of who benefits from the EITC"); Steven Dean, *Beware the Unintended Consequences of Biden's New IRS Spending*, N.Y. DAILY NEWS (May 5, 2021, 5:00 AM), https://www.nydailynews.com/opinion/ny-oped-beware-the-unintended-consequences-of-bidens-irs-spending-20210505-ty6iwne2eneupocy26mnkcd2au-story.html [https://perma.cc/8E5C-BZXD] (addressing increased IRS funding and racially disparate tax enforcement); Jeremy Bearer-Friend, *Should the IRS Know Your Race? The Challenge of Colorblind Tax Data*, 73 TAX L. REV. 1, 1–6 (2019) (addressing the lack of questions regarding race on tax forms). In 2021, President Biden issued an executive order that established an "Interagency Working Group on Equitable Data," including the Assistant Secretary of the Treasury for Tax Policy, which must offer recommendations on best practices for studying effects of legal rules and policies on different individuals based on race, ethnicity, gender, disability, and other characteristics. *See* Exec. Order No. 13,985, 86 Fed. Reg. 7009 (2021).

221. *See* Chye-Ching Huang & Roderick Taylor, *How the Federal Tax Code Can Better Advance Racial Equity*, CTR. ON BUDGET & POL'Y PRIORITIES (July 25, 2019), https://www.cbpp.org/research/federal-tax/how-the-federal-tax-code-can-better-advance-racial-equity [https://perma.cc/XJP6-QBZH] ("Black and Latino households are one-and-one-third times likelier than white households to be in the bottom [sixty] percent of the income scale, while white households are three times likelier than Black and Latino households to be in the top 1 percent. As for wealth, [nine] in [ten] of the wealthiest [one] percent of households are white."); Dorothy A. Brown, *What Pro Publica Missed about Taxing Rich White Men*, MEDIUM (June 13, 2021), https://profdabrown.medium.com/what-pro-publica-missed-about-taxing-rich-white-men-992cad0d19aa [https://perma.cc/S4JC-5JWD]. *See generally* DOROTHY A. BROWN, THE WHITENESS OF WEALTH (2021) (discussing the tax system's impact on Black taxpayers).

III. CAN THE TAX INFORMATION REPORTING GAP BE CLOSED? REFORM POSSIBILITIES

This Part introduces a framework that policymakers can use to begin to close the tax information reporting gap through both first- and third-party information reporting reforms. The discussion assesses the advantages and limitations of both third-party and first-party reporting requirements in light of the preceding discussion and evaluates reform possibilities for each. In general, third-party information reporting can utilize the knowledge these parties have of the taxpayer's specific activities when transacting with the third parties, whereas the taxpayer's themselves, as first parties, have the most complete knowledge of their general economic circumstances and any actor-based criteria which are necessary when implementing an actor-based approach to tax compliance.[222]

As an example of a third-party information reform, this discussion evaluates the Biden Administration's recent bank information reporting proposal.[223] As an example of a first-party information reform, this Article proposes and evaluates a first-party "Annual Net Asset Statement" for taxpayers with wealth or income equal to or exceeding specified thresholds.[224]

This discussion then argues that a hybrid first- and third-party information reporting system can utilize the unique advantages from both first- and third-party information reporting, while also addressing the limitations of each approach. As an example of a hybrid approach, this Article proposes and evaluates a modified version of the Biden Administration's bank information reporting proposal which would only apply to taxpayers with income or wealth equal to or exceeding specified thresholds. Under this hybrid system, the first-party taxpayers would directly inform the third-party banks whether the taxpayer is subject to these heightened information reporting rules.[225]

Finally, this Part argues that this first- and third-party information reporting model, which would account for information on both actors and their activities, can also allow for more effective tailoring of penalties for noncompliance with information reporting rules and targeting of IRS audit resources.[226]

A. *THIRD-PARTY INFORMATION REPORTING*

1. Advantages and Limitations

For the reasons described in Part I, third-party information reporting plays an essential role in tax administration and compliance. Sophisticated third parties

222. *See infra* Section III.C.

223. *See infra* Section III.B.1. For a general description of the Biden Administration's proposal, see also *supra* notes 12–16 and accompanying text.

224. *See infra* Section III.B.2.

225. *See infra* Section III.C.

226. *See infra* Section III.D.

such as brokers and financial institutions have valuable first-hand knowledge of the taxpayer's transactions and activities and often have the administrative capacity to report this information efficiently.[227] Furthermore, these third parties do not have the same economic "stake" in tax noncompliance by their clients and, therefore, often have less incentive to misreport or hide the taxpayer's taxable activities from the IRS.

Notwithstanding these advantages, the IRS also cannot depend on third-party information reporting alone to close the tax information gap. Third parties have different substantive compliance obligations than taxpayers and lesser culpability in the noncompliance of the taxpayers with whom they transact.[228] As a result, the tax system cannot impose the same types of penalties and sanctions on third parties that it can impose on the taxpayers themselves.

The types of information which are available to third parties also necessarily determines—and limits—the role of third-party information reporting as a means to increase tax compliance. Most critically, third-party information reporting alone cannot close the tax information reporting gap, because these third parties can only provide information as to a taxpayer's specific activities and account holdings.

Because third parties can only observe specific activities of the actor, these rules also encounter the same limitations of other activity-based rules, including the risk of imposing collateral burdens on the wrong actors while enabling sophisticated actors to avoid these rules.[229]

Third-party information reporting of specific activities—regardless of the characteristics of the actor—nonetheless serves a critical role in tax administration and enforcement. Third-party reporting of specific activities can notify the IRS of transactions which it would not otherwise detect and allows the IRS to identify discrepancies between these third-party information reports and the taxpayer's own tax reporting.[230] Furthermore, in many respects tax enforcement priorities do not directly depend on the identity or characteristics of an actor. For example, any underreporting of a tax liability by any taxpayer can result in equivalent amounts of revenue loss, as measured in dollars of uncollected tax liabilities.[231]

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227. *See supra* notes 103–04 and accompanying text.

228. The potential penalties for third parties who fail to comply with information reporting requirements are typically limited, as compared to the potential penalties for failing to report and remit primary tax obligations. For example, the general penalty for failure to file an information return is $310 (adjusted for inflation), even if that information corresponds to a significantly higher potential tax liability. I.R.C. § 6721(a) (2018) (setting the statutory penalty); Rev. Proc. 2022-38, 2022-45 I.R.B. 445, 455 (adjusting the statutory penalty for inflation). The Code does provide for higher third-party penalties for nonreporting of certain significant items in cases of "intentional disregard of the filing requirement." I.R.C. § 6721(e).

229. *See supra* Section II.B.3.

230. *See supra* notes 106–09 and accompanying text.

231. In a progressive tax system premised on a principle of declining marginal utility of income, however, a dollar of revenue lost from noncompliance by a high-income taxpayer would represent

Third-party information reporting of specific activities, however, also encounters the same general limitations of other activity-based tax compliance rules. In many cases, sophisticated taxpayers can avoid the application of these rules by simply changing the form of their tax avoidance activities.[232]

On the other hand, if policymakers limit opportunities to avoid these activity-based rules by defining them too broadly, this measure can have the adverse effects of unduly burdening taxpayers who are compliant or who are otherwise not the proper priorities for tax enforcement.[233]

Actor-based adjustments to these rules could resolve this challenge by accounting for characteristics of the actors and not just their activities.[234] These third parties, however, are less likely to have complete knowledge of the taxpayer's complete economic circumstances which would be necessary for these actor-based adjustments.[235] Of course, third parties may have knowledge of certain activities which partially signal the taxpayer's complete economic circumstances and which may serve as proxies for a taxpayers income or wealth.[236] For example, some of the specific activities subject to third-party information reporting under current law are disproportionately—and in some cases exclusively—engaged in by higher income taxpayers with access to

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a greater social cost than an equivalent dollar of revenue lost from noncompliance by a lower income taxpayer. *See Progressive Tax Procedure*, *supra* note 18, at 677–78.

232. *See supra* notes 210–14 and accompanying text.

233. *See supra* notes 200–08 and accompanying text.

234. *See supra* Section II.C.

235. A limited subset of third parties may have complete knowledge of the taxpayer's economic circumstances, such as an attorney or a tax advisor in a position of legal privilege with respect to a taxpayer or a financial advisor who manages all of the taxpayer's assets and income.

236. For example, wealthier taxpayers as a group generally tend to engage more frequently in certain activities currently subject to some forms of third-party information reporting, such as the investment activities described *supra* notes 58–63 and accompanying text and the reportable transaction reporting by material advisors described *infra* note 237. The possibility that certain activities can indicate characteristics of the actor illustrates the limits of a clear distinction between actor and activity-based criteria. In the context of optimal taxation, the literature on "tagging" considers how observable taxpayer characteristics—such as their height or level of education—can correlate with (and therefore indicate) their income earning potential and which therefore may be more efficient bases for taxation. *See* Matthew C. Weinzierl, *Why Do We Redistribute So Much but Tag So Little? The Principle of Equal Sacrifice and Optimal Taxation* 8–9 (Nat'l Bureau Econ. Rsch., Working Paper No. 18045, 2012) ("Tags carry information about ability but are hard to modify, so taxing them allows for redistributive gains without efficiency losses."). In a similar manner, certain observable activities of a taxpayer can correlate with or indicate their economic circumstances, such as their income or wealth, and therefore may be appropriate bases for heightened tax compliance rules. *Id.* To the extent that taxpayer can easily modify their activities, these activities would not serve as an effective "tag." *Id.* Furthermore, the optimal tax literature also observes that certain tags may correlate with income-earning potential "across the population in aggregate" but not always with respect to any specific individual. *See id.* at 6. For the same reason, certain taxpayer activities may in the aggregate tend to correlate with taxpayers income and wealth, but these activities would not always necessarily indicate that any specific taxpayer has a certain level of income or wealth. *See id.* at 5.

sophisticated financial and legal advice.[237] Beyond these specific activities, financial intermediaries such as brokers, investment managers, and banks also have additional sources of knowledge as to a client's economic circumstances, such as their account balances or assets held with the intermediary. In all these cases, however, the third party's knowledge of the taxpayer's economic circumstances will be defined and limited by the scope of the taxpayer's transactions with that third party.

The difficulties in defining the information reporting thresholds under FATCA[238] illustrate this inherent tension in third-party information reporting design, which results from the limited knowledge third parties have of a taxpayer's complete economic circumstances. As discussed earlier, FATCA generally requires third-party FFIs, such as banks, to report information regarding their U.S. account holders to the U.S. Treasury.[239]

In designing the thresholds for information reporting required under FATCA, however, policymakers faced this same tension in defining rules which were both broad enough to minimize avoidance opportunities but also narrow enough to avoid unduly burdening the wrong set of taxpayers. For example, the FATCA rules currently exempt FFIs from reporting depository accounts with an aggregate value of $50,000 or less.[240] Policymakers had to define a threshold which was broad enough to prevent easy avoidance, since taxpayers could easily avoid a high threshold which only narrowly targeted the highest accounts by splitting their offshore holdings among multiple accounts.[241] This splitting strategy would have allowed taxpayers to undermine the objectives of FATCA by exploiting the fact that any third-party FFI can only be expected to have knowledge of accounts held by the taxpayer with their firm but cannot be expected to have knowledge of the taxpayer's other assets or activities.

Setting a relatively low threshold of $50,000 subjected a broader range of accounts to this third-party information reporting system and thereby limited the availability of splitting strategies but encountered the alternative challenge. In many cases, this lower threshold covering a broader range of accounts imposed disproportionate burdens on fully compliant and lower income taxpayers who had legitimate reasons to hold assets in offshore accounts. For example, Professor

237. For example, third-party "material advisors" may be required to report information with respect to their client's participation in "reportable transactions" on the Form 8918. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0865, FORM 8918 (MATERIAL ADVISOR DISCLOSURE STATEMENT) (2021), https://www.irs.gov/pub/irs-pdf/f8918.pdf [https://perma.cc/YCN8-WPCA]. For the rules governing reportable transactions and material advisor reporting obligations, see I.R.C. § 6111 (2018) (disclosure obligations for material advisors of reportable transactions); *id.* § 6707A(c)(1) (definition of reportable transactions).

238. I.R.C. §§ 1471–1474 (2018).

239. *See supra* notes 64–66 and accompanying text.

240. I.R.C. § 1471(d)(1).

241. For example, a taxpayer with $1 million of offshore assets could avoid a higher exemption level of $200,000 by splitting their assets among only five offshore accounts but would have to split their assets among twenty offshore accounts to avoid the imposition of the lower $50,000 threshold.

Shu-Yi Oei has documented how FATCA casts "a wide reporting net" that "applies to a broad swath of taxpayers, not just deliberate offshore tax cheats," including inbound immigrants and U.S. taxpayers living abroad.[242] She argues further that FATCA and related offshore asset disclosure programs impose "[u]niformly [h]arsh [p]enalties on [h]eterogeneous [t]axpayers" while often providing "[i]nsufficient [p]unishment for [m]ajor [o]ffenders."[243]

2. Reform Proposal: Financial Account Reporting

The Biden Administration's bank tax reporting proposal reflects the same general limitations of activity-based third-party information reporting. In 2021, the Biden Administration sought to expand the scope of information reporting to include more general information regarding inflows to and outflows from taxpayers' bank accounts and other financial accounts.[244] The Department of Treasury's Fiscal Year 2022 revenue proposals included a legislative proposal similar to a prior set of recommendations for shrinking the federal tax gap offered by Charles O. Rossotti, Natasha Sarin, and Lawrence Summers.[245] Under the Treasury Department proposal, banks and other financial institutions would be required to report on a new IRS Form 1099-K (Payment Card and Third Party Network Transactions) the gross amount of any inflows (receipts) and outflows (transfers) of more than $600 in any business or personal account, including bank, loan, and investment accounts that occurred during the year.[246] The new rules would apply to all taxpayers, irrespective of wealth or income, but would exclude accounts with a gross cash flow of less than $600 or a fair market value of less than $600.[247] The proposal would also apply to payment settlement entities, not just bank accounts, and would include reporting on "gross purchases, physical cash, as well as payments to and from foreign accounts, and transfer inflows and outflows."[248] This low threshold would have applied to a broad scope of accounts and would have thereby prevented taxpayers from avoiding the application of these rules by splitting up their financial activities among multiple smaller transactions and accounts.

While the proposal as originally structured would apply to "all business and personal accounts" above the de minimis threshold, the Treasury Department stated that its proposed financial account reporting regime was

242. Oei, *supra* note 149, at 706–08.

243. *Id.* at 707–09. Professor Oei reports, for example, that in the IRS's 2009 Offshore Voluntary Disclosure Program "the median offshore penalty paid by those with the smallest accounts . . . was almost *six times* the median unreported tax liability, while for those with the largest accounts, it was only about three times the unreported tax." *Id.* at 703 (italics in original).

244. *See* GENERAL EXPLANATIONS, *supra* note 12, at 88–93; TAX COMPLIANCE AGENDA, *supra* note 12, at 1–4.

245. Rossotti et al., *supra* note 15, at 1471–75.

246. GENERAL EXPLANATIONS, *supra* note 12, at 88–89.

247. *Id.*

248. *Id.*

designed to enhance the IRS's ability to enforce the tax law against wealthy and high-income taxpayers specifically.[249] By providing the IRS with information about inflows to and outflows from a taxpayer's bank account, Treasury Department officials argued that the proposal would allow the IRS to identify potential tax noncompliance.[250] Treasury officials reinforced this argument with the illustration of a taxpayer with $10,000 of reported annual income but $10 million of inflows to and outflows from their bank account.[251] They argued that by mandating that banks to share this information with the IRS, Congress could allow the IRS to "target its enforcement activities on those who are actually evading their tax obligations."[252] Under the Treasury Department proposal, individual taxpayers would also be required to report corresponding information regarding their bank accounts and other financial accounts on a new line on the annual personal income tax return, IRS Form 1040 (U.S. Individual Income Tax Return).[253] Treasury Department officials estimated that the new third-party information reporting regime would generate approximately $460 billion in revenue over a ten-year period.[254]

In response to the Treasury Department's proposed financial account reporting rules, opponents offered several common criticisms of the measure. First, opponents argued that the financial account reporting measure was overbroad as it would affect millions average taxpayers, not just millionaires and billionaires, and would thereby impose collateral burdens on taxpayers who are compliant or otherwise not the proper priorities for the heightened tax enforcement measures.[255] For instance, Representative Jason Smith, House Budget Committee Republican Leader, commented that the financial accounting reporting measure "would set up millions of middle class families, farmers, small businesses, and gig economy workers for potential audits and legal battles against a powerful federal agency with a troubling history of abusing that power."[256] In December 2021, the Joint Committee on Taxation

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249. *Id.*

250. *Id.*

251. *Fact Sheet*, *supra* note 12.

252. *Id.*

253. GENERAL EXPLANATIONS, *supra* note 12, at 88–89.

254. TAX COMPLIANCE AGENDA, *supra* note 12, at 20; Sarin, *supra* note 9.

255. *See* Letter from 21 Democratic Members of Congress, to Nancy Pelosi, Speaker of the House, U.S. House of Representatives, and Richard Neal, Chairman of the Ways & Means Comm., U.S. House of Representatives 1 (Oct. 27, 2021), https://www.nafcu.org/system/files/files/House%20Dem%20IRS%20Letter%20FINAL.pdf [https://perma.cc/K7V5-8GUU]. The letter authors expressed concern with "the significant burden and potential unintended consequences" from the reform and argued that even a higher $10,000 threshold would still affect many other taxpayers who "are not the wealthy tax evaders who are the stated targets of this proposal." *Id.*

256. Press Release, House Budget Comm. Republicans, Tax Scorekeeper Confirms Millions of Americans Making less than $400,000 Would Have Accounts Targeted Under Biden IRS Spying Scheme (Dec. 7, 2021), https://budget.house.gov/press-release/tax-scorekeeper-confirms-millions-of-americans-making-less-than-400000-would-have-accounts-targeted-under-bidenirs-spying-scheme [https://perma.cc/RF6R-J7CS] (quoting Jason Smith, H. Budget Comm. Republican Leader).

estimated that the proposed measure would apply to at least forty million (twenty-seven percent) and less than 134 million (ninety percent) of taxpayers reporting less than $400,000 of taxable income each year, stating further that the average of this range was eighty-seven million (sixty percent) of such taxpayers.[257]

Second, representatives of financial institutions argued that the measure would create logistical difficulties. The Credit Union National Association ("CUNA"), the largest national trade organization representing credit unions, stated that proposal would cause "smaller credit unions [to] be especially burdened."[258]

Third, opponents argued that increased financial account reporting would violate the privacy of taxpayers. As the House Majority Leader, Representative Kevin McCarthy, argued, the proposal would empower "87,000 new IRS agents to spy on your bank account. It's invasive, unconscionable, and will impact nearly every American."[259]

Following weeks of criticism from opponents throughout the summer of 2021,[260] the Treasury Department attempted to narrow its proposal. In October 2021, the Treasury Department attempted to respond to concerns regarding overbreadth by modifying the proposed threshold for reporting account information from $600 to $10,000 in annual outflows and inflows and by including an exemption for outflows and inflows for wages and federal program benefits.[261]

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257. Letter from Thomas A. Barthold, Chief of Staff, The Joint Comm. on Tax'n, Congress of U.S., to Hon. Jason Smith, Rep., U.S. House of Representatives (Dec. 3, 2021), https://budget.house.gov/wp-content/uploads/2021/12/117-0809-fjs.pdf [https://perma.cc/ND6X-WZZD].

258. *Increased IRS Reporting 'Risky and Unnecessary' for Consumers*, CUNA (Oct. 6, 2021), https://news.cuna.org/articles/119980-increased-irs-reporting-risky-and-unnecessary-for-consumers [https://perma.cc/X5L9-URYX].

259. Kevin McCarthy (@SpeakerMcCarthy), TWITTER (Nov. 9, 2021, 7:46 PM), https://twitter.com/gopleader/status/1458234464862101508?lang=en [https://perma.cc/3V3H-JZ47].

260. *See, e.g.*, Scott Horsley, *Biden's Proposal to Give IRS More Info On Bank Accounts Faces Criticism*, NPR: IOWA PUB. RADIO (Oct. 2, 2021, 8:02 AM), https://www.npr.org/2021/10/02/1042667366/bidens-proposal-to-give-irs-more-info-on-bank-accounts-faces-criticism [https://perma.cc/JFT6-953U]; Naomi Jagoda, *Democrats Face Growing Storm Over IRS Reporting Provision*, HILL (Oct. 16, 2021, 12:00 PM), https://thehill.com/policy/finance/577017-democrats-face-growing-storm-over-irs-reporting-provision [https://perma.cc/9F7J-CJGW]; Callie Patteson, *'This is Screwed Up': Manchin Says IRS 'Snooping' Won't be in Final Biden Bill*, N.Y. POST (Oct. 26, 2021, 3:57 PM), https://nypost.com/2021/10/26/sen-manchin-says-irs-snooping-wont-be-in-final-biden-bill [https://perma.cc/WWQ2-NEKM].

261. *Fact Sheet*, *supra* note 12; *see also* Kolinovsky & Turner, *supra* note 16 ("The changes would exempt millions of Americans from the reporting requirement, and help the IRS target wealthier Americans, especially those who earn money from investments, real estate, and other transactions that are more difficult for the IRS to track."); Alan Rappeport & Jonathan Weisman, *Democrats, facing a Republican barrage, scale back plans for a crackdown on tax cheating*, N.Y. TIMES (Oct. 19, 2021), https://www.nytimes.com/2021/10/19/us/politics/irs-bank-account-reporting-requirement.html [https://perma.cc/CSR2-4YR7] ("The plan was narrowed after a steady lobbying campaign by banks and a barrage of criticism from Republicans . . . .").

This higher threshold significantly narrowed the taxpayers and accounts subject to this rule, but thereby encountered the alternative challenge in defining the scope of activity-based information reporting rules. With a higher threshold, and a narrower scope of activities subject to the rule, taxpayers could more easily avoid the application of the rule by splitting up their transactions among a greater number of accounts.[262]

In connection with this change, the Treasury also offered a detailed "fact sheet" that directly addressed the most common critiques of the proposed financial account reporting rules.[263] In response to criticism that the measure would create logistical challenges for financial institutions, the Treasury Department stated that these institutions would only be required to add two figures to the information that they already provide to the IRS under current law, such as the amount of interest paid to account holders.[264] It addressed industry concerns by stating that "[i]t is implausible that a requirement to add two pieces of information on a report that is already sent by financial institutions to the IRS could be onerous."[265] Further, the Treasury Department attempted to rebut privacy concerns by arguing that the scope of information financial institutions would share with the IRS would be "extremely limited" and would not include information about individual transactions.[266]

Despite the Treasury Department's sustained efforts to convince policymakers and the public, Congress did not adopt, or formally consider, the financial account reporting measure in tax legislation. Those objecting to the reform argued that even this higher $10,000 threshold would still impose collateral burdens on "taxpayers [who] are not the wealthy tax evaders who are the stated targets of this proposal."[267] By the time the House passed tax legislation in November 2021, the measure had been excised from the legislation.[268] It was also absent from the revised tax provisions in the Senate version of the legislation.[269] As of February 2022, the Biden Administration and Democratic members of Congress appear to have abandoned the proposed

262. For example, a taxpayer seeking to hide $100,000 of income from IRS scrutiny would have had to hold a minimum of 167 separate accounts to avoid application of the bank reporting rules under the initial $600 threshold, but only eleven separate accounts to avoid application of these rules under the $10,000 threshold.

263. *Fact Sheet*, *supra* note 12.

264. *Id.*

265. *Id.*

266. *Id.*

267. *See* Letter from 21 Democratic Members of Congress, *supra* note 255.

268. *See* Build Back Better Act, H.R. 5376, 117th Cong. (2021) (as passed by House, Nov. 19, 2021).

269. *See* Inflation Reduction Act, H.R. 5376, 117th Cong. (2022) (as passed by Senate, Aug. 7, 2022).

financial account reporting proposal in favor of narrower third-party information reporting and withholding proposals.[270]

The experience with the Biden Administration's bank information reporting proposal illustrates both the critical importance of third-party information reporting, as well as the challenges in designing these systems. These reforms could provide crucial information to aid in tax enforcement, prevent erosion of the income tax base from noncompliance, encourage voluntary compliance, and raise substantial revenue.[271] At the same time, because this third-party information reporting reform relies upon the third party's limited knowledge of the taxpayer's specific transactions and activities, the reform also encounters the same general challenges in designing effectively tailored activity-based tax compliance rules which could properly address the challenge of high-end tax avoidance, while avoiding collateral burdens to compliant or lower income taxpayers.

B. *First-Party Information Reporting*

1. Advantages and Limitations

The Biden Administration's bank reporting reform illustrates both the advantages and limitations of third-party information reporting. First-party information reporting by the taxpayers themselves presents an alternative set of challenges and opportunities. Unlike third parties, taxpayers generally have the most complete knowledge of their own transactions and economic circumstances. First-party information reporting by taxpayers, however, faces the same limitations which give rise to the challenge of tax noncompliance in the first instance: As the primary obligor of their own tax liabilities, taxpayers have a direct economic incentive to both underreport their tax liability and also to underreport any corresponding information the IRS may need to determine their true tax liability.[272] As a result, first-party information reporting by the taxpayers themselves can only play a limited role in a system which is intended to improve taxpayer compliance.

This Section argues that, notwithstanding this basic limitation, first-party information reporting still plays a valuable role in tax administration. Furthermore, reforms to expand first-party information reporting can leverage these advantages to help close the tax information gap. First-party information

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270. *See, e.g.*, Inflation Reduction Act, Pub. L. No. 117-169, 136 Stat. 1818 (2022) (enacted law without § 138402 (Application of Backup Withholding With Respect to Third Party Network Transactions)).

271. *See* GENERAL EXPLANATIONS, *supra* note 12, at 88–89; TAX COMPLIANCE AGENDA, *supra* note 12, at 1–2.

272. Noneconomic factors may also affect a taxpayer's decision whether to accurately report and pay taxes or to misreport and face potential penalties or other sanctions. *See, e.g.*, Marjorie E. Kornhauser, *A Tax Morale Approach To Compliance: Recommendations for the IRS*, 8 FLA. TAX REV. 599, 606–26 (2007) (evaluating the literature on taxpayers intrinsic motivation to pay taxes, or "tax morale," and its implications for tax enforcement).

reporting can allow the IRS to utilize the taxpayer's first-hand knowledge of their transactions and economic circumstances, in order to improve tax enforcement and detection of noncompliance. When designed properly, first-party information reporting can also avoid the noncompliance incentives that taxpayers encounter when reporting their substantive tax liabilities.

As described above, the tax rules require individual taxpayers to report both primary information which is used to calculate substantive tax liabilities as well as additional information which can assist with tax administration and enforcement.[273] Individuals subject to these different first-party information reporting rules face different incentives to underreport or misreport financial information, depending on both their consequences and their design. In the case of information which factors into determining substantive tax liabilities—such as reporting items of taxable income or deductions on the IRS Form 1040—every additional dollar of income a taxpayer underreports will generally translate into additional marginal dollars of tax savings. In this case, a taxpayer will generally experience an economic advantage from underreporting as much as possible, and their decision regarding how much to underreport will depend upon such factors as their intrinsic motivation to pay taxes,[274] the direct costs they would incur from underreporting, and both the likelihood of detection and the potential costs from tax penalties and other sanctions.[275] A progressive tax system—where taxpayers with greater income pay tax at proportionally higher rates—can compound these economic incentives for higher earners to underreport, to the extent additional dollars of income which *are* reported would result in proportionally larger tax liabilities.[276]

In the cases of other first-party information reporting requirements, however, underreporting marginal dollars of income or wealth can have lesser consequences or no consequences at all. For example, to determine whether to file IRS Form 8938, taxpayers must first determine whether they meet the asset thresholds in the statute and regulations.[277] Assume a single taxpayer living in the United States has $51,000 in actual specified foreign financial assets. If the taxpayer underreports their assets' value by $1000, this underreporting would not directly affect the taxpayer's substantive tax liabilities for the year (as would underreporting $1000 of income on IRS Form 1040). Rather,

273. For a description of first-party information reporting requirements under current law, see *supra* Section I.B.

274. *See* Kornhauser, *supra* note 271, at 601–26; *Progressive Tax Procedure*, *supra* note 18, at 707–09.

275. *See Progressive Tax Procedure*, *supra* note 18, at 684–88 (describing basic models of taxpayer compliance and the effects of the costs of tax avoidance, penalties, and the chance of detection).

276. That is, to the extent taxpayers with higher incomes will be taxed at higher rates on this income if it is reported, they would face a greater financial advantage from underreporting this income. Lower income taxpayers may also be subject to localized high effective marginal rates resulting from the phase-out of income-based benefits. *See* Manoj Viswanathan, *The Hidden Costs of Cliff Effects in the Internal Revenue Code*, 164 U. PA. L. REV. 931, 947–59 (2016) (describing the relationship between income-based phaseouts or "cliff effects" and effective marginal rates).

277. *See supra* notes 86–89 and accompanying text.

underreporting their assets by $1000 could only enable the taxpayer to avoid indicating their obligation to file the IRS Form 8938. This underreporting could in turn indirectly affect the taxpayers ultimate tax liabilities, however, since avoiding the IRS Form 8938 reporting could enable the taxpayer to hide underreporting of substantive tax liabilities from IRS detection more effectively.

In other cases, nonreporting of a certain amount of assets or economic activity could have no effect at all on the taxpayer's compliance obligations. For example, assume in the alternative that the same taxpayer has $60,000 in specified foreign financial assets, and fails to disclose and report $1000 in assets, and instead reports only the first $59,000 in assets. In this case the underreporting of the marginal $1000 will have no effect at all on the taxpayer's obligation to file the IRS Form 8938, since they will still report applicable assets in excess of the compliance threshold. Unlike in the case of underreporting of substantive tax liabilities—where every marginal dollar of nonreported income results in additional tax avoided—the taxpayer can only avoid the application of the IRS Form 8938 compliance by failing to disclose enough asset value, or $10,000, to fall below the threshold.[278] As a result, underreporting up to $10,000 of the taxpayer's assets will have no direct effect to the taxpayer in changing their compliance obligations.

More generally, this example illustrates how measuring income or wealth for use as a threshold in determining the application of certain compliance rules—such as the obligation to file IRS Form 8938—creates different and often lower incentives for taxpayers to underreport these items. A taxpayer with total income far above the threshold may have no incentive or ability at all to hide enough income to claim that they are below the threshold for application of the IRS Form 8938 reporting requirements.

As described above, information from first-party reporting can be used in different ways, such as for calculating substantive tax liabilities, for determining the application of certain compliance rules, or for other uses in tax compliance and enforcement. These different uses will also affect the taxpayer's incentive to underreport items used for these different purposes.

This distinction among the uses of information from first-party reporting—and consequent differences in the taxpayer's underreporting incentives—also has implications for the feasibility of a reform requiring first-party wealth reporting. In recent years policymakers have proposed new wealth tax reforms,

278. In general, the taxpayer will incur greater costs to underreport additional marginal dollars of income on the assumption that a taxpayer will first underreport or hide amounts of income which are the easiest to hide, and therefore which the taxpayer can underreport at the lowest cost. In general, at the margin, the taxpayer would only be expected to expend up to one dollar (or an amount slightly less than one dollar) to evade one dollar of tax labilities. *See* Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1423, 1459–65 (Alan J. Auerbach & Martin Feldstein eds., 2002).

which would require taxpayer to both report their net wealth holdings and to pay substantive taxes based on these amounts.[279]

The debate over these wealth tax reforms has primarily focused on the challenges in accurately valuing assets and taxpayer opportunities to avoid the taxes by undervaluing or underreporting their asset holdings.[280] Scholars have argued that a wealth tax could use simplified valuation methodologies which could reduce—but not eliminate—the opportunities for tax avoidance and the administrative burdens required to value a broad scope of assets on an annual basis.[281] For example, a wealth tax reform could use a combination of data from asset dispositions and market valuations, imputed returns to cost basis, third-party information reports, such as from financial institutions and asset managers, and asset appraisals to approximate the value of assets in different classes.[282] A tax reform which relies upon imperfect asset valuations can still effectively raise substantial revenue, and the goal of any valuation approach should be to define a tax base which fairly allocates tax burdens, accounts for administrative burdens, and minimizes avoidance opportunities.[283]

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279. For recent proposals, see Elizabeth Warren, *Ultra-Millionaire Tax*, WARREN DEMOCRATS, https://elizabethwarren.com/plans/ultra-millionaire-tax [https://perma.cc/P45V-98QB] (proposing a wealth tax with rates reaching six percent on net wealth above $1 billion); Bernie Sanders, *Tax on Extreme Wealth*, FRIENDS OF BERNIE SANDERS, https://berniesanders.com/issues/tax-extreme-wealth [https://perma.cc/S6JL-HG6T] (proposing a wealth tax with rates reaching eight percent on net wealth above $10 billion). For wealth tax reforms proposed by scholars, see BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY 94–112 (1999); THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY 515–18, 524–30 (Arthur Goldhammer trans., 2013). *See generally* Emmanuel Saez & Gabriel Zucman, *Progressive Wealth Taxation*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2019, at 437 (analyzing feasibility of progressive wealth taxation in the United States); David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 TAX L. REV. 499 (2000) (discussing wealth tax design).

280. *See, e.g.*, Ari Glogower, *Comparing Capital Income and Wealth Taxes*, 48 PEPP. L. REV. 875, 887–905 (2021) (comparing the valuation, administration, and avoidance challenges in either a capital income tax or a wealth tax). *See generally, e.g.*, James R. Repetti, *It's All About Valuation*, 53 TAX L. REV. 607 (2000) (evaluating the asset valuation challenges in a wealth tax); Leandra Lederman, *Valuation as a Challenge for Tax Administration*, 96 NOTRE DAME L. REV. 1495 (2021) (describing the role of valuation as a challenge for the federal tax system).

281. *See generally* DAVID GAMAGE, ARI GLOGOWER & KITTY RICHARDS, ROOSEVELT INST., HOW TO MEASURE AND VALUE WEALTH FOR A FEDERAL WEALTH REFORM (2021), https://rooseveltinstitute.org/wp-content/uploads/2021/03/RI_WealthTax_Report_202104.pdf [https://perma.cc/LV7L-EZXL] (discussing valuation and measurement methods for the design and implementation of a successful progressive wealth tax regime).

282. *See id.* at 7–19 (proposing a range of valuation methodologies for different asset classes).

283. *See* Glogower, *supra* note 280, at 894 ("[P]ossible imperfections in the implementation of either a wealth tax or an improved capital income tax should be evaluated in the context of the much more serious failings of the current income tax to accurately measure and tax income.").

2. Reform Proposal: An Annual Net Asset Statement

As an alternative to implementing a substantive federal wealth tax,[284] policymakers could instead implement a narrower first-party wealth information reporting requirement. This Article's proposed "Annual Net Asset Statement" would require taxpayers with net assets equal to or exceeding certain thresholds to report these assets and their approximate value but not to pay substantive tax liabilities based on these asset valuations as under a substantive wealth tax.

In effect, this proposal would resemble an expanded version of the current IRS Form 8938 (Statement of Specified Foreign Financial Assets).[285] Like that form, the Annual Net Asset Statement could minimize the compliance burden on lower-wealth taxpayers by similarly only requiring taxpayers with assets equal to or exceeding a certain value threshold to file the report. For example, the Annual Net Asset Statement could only be required for taxpayers who hold assets with an aggregate value of $10 million or more or who have taxable income of $2 million or more in the prior year. Unlike the Form 8938, however, a broader wealth information return could also require reporting assets regardless of whether they are held in the United States or abroad.[286]

The Annual Net Asset Statement would not face the same avoidance challenges as would a substantive wealth tax reform, since taxpayers would not have the same immediate economic incentive to underreport every marginal dollar of wealth in the same manner as would a substantive wealth tax reform.[287] As a result, this reform would encounter less pressure to require precise valuations and to prevent avoidance than would a substantive wealth tax.[288]

The Annual Net Asset Statement could consequently take greater advantage of simplified valuation methods for hard to value asset classes, or in some cases, taxpayers could be wholly exempted from reporting these valuations. For example, taxpayers could be required to only report their cost basis for

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284. This Article does not address the possible independent advantages of a substantive wealth tax reform. For discussion of these advantages, see Saez & Zucman, *supra* note 279, at 463–68 (evaluating the effect of a wealth tax on tax progressivity); Ari Glogower, *A Constitutional Wealth Tax*, 118 MICH. L. REV. 717, (2020) (arguing that a wealth tax could raise revenue while addressing the harmful effects from concentrated wealth). In contrast, this Article considers the independent advantages of a first-party wealth information reporting reform.

285. *See* INTERNAL REVENUE SERV., *supra* note 35 (Form 8938).

286. In this manner, the Annual Net Asset Statement could be also be simpler than the Form 8938 reporting requirements, because it would not need to distinguish between taxpayers living in the United States and abroad and between domestic and foreign assets. *See* Treas. Reg. § 1.6038D-2 (2014) (rules distinguishing between taxpayers and entities located in the United States and abroad); Treas. Reg. § 1.6038D-3 (2014) (rules defining foreign assets).

287. That is, like in the case of IRS Form 8938, the reporting of assets on the Annual Net Asset Statement would not directly affect a taxpayer's substantive tax liabilities but would only provide information which could assist the IRS with tax administration and enforcement. Similarly, taxpayers could only avoid application of the Annual Net Asset Statement if they underreport enough wealth to fall below the threshold. For discussion of these same considerations in the context of the Form 8938 rules, see *supra* notes 277–78 and accompanying text.

288. *Supra* notes 280–83 and accompanying text.

hard-to-value assets or to only provide descriptive accounts of these assets without attributing any value to them. A first-party wealth information return could also take advantage of the valuations that taxpayers have received from third parties. For example, the wealth information return could require taxpayers to report valuations of nontraded or irregularly traded financial interests, such as in private equity and in hedge funds, or in digital assets, which are already provided by third party investment managers.[289]

The Annual Net Asset Statement rules could also adopt a more flexible approach in defining the thresholds used to determine when a taxpayer is subject to these rules. For example, like in the case of the Form 8938, the threshold can be defined by reference to either an aggregate value at the end of the year or a highest asset value at any time during the year.[290] A substantive wealth tax reform could not adopt a similarly flexible approach to asset valuation if it is considered improper to impose a substantive tax liability on the basis of an assets highest value at any time during the year.

The Annual Net Asset Statement could improve tax administration and enforcement by allowing the IRS to more accurately detect patterns indicating noncompliance and to focus audit resources.[291] Scholars have also argued that wealth reporting could allow for more accurate analysis of both trends in tax noncompliance and in economic inequality, thereby improving fiscal policy.[292] As described in the following Section, first-party information through the Annual Net Asset Statement could also be used to improve the design of third-party information reporting rules.

C. A HYBRID APPROACH

As argued in the preceding two Sections, policymakers can implement reforms to both third-party and first-party information reporting rules in order to improve tax enforcement and administration. Third-party information reporting reforms can take advantage of the fact that these third parties have specific knowledge of the taxpayer's transactions and activities. First-party

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289. *See generally, e.g.*, INST. LTD. PARTNERS ASS'N, QUARTERLY REPORTING STANDARDS (2016), https://go.ilpa.org/QRBPP [https://perma.cc/6RWU-YGG7] (providing sample reports representing "best practices" for private equity and investment fund managers in keeping investors informed of an investment fund's activities and economic performance).

290. *See supra* notes 86–89 and accompanying text (describing the similar design in the Form 8938 thresholds).

291. For example, annual wealth reporting through the Annual Net Asset Statement could facilitate the work of a restored IRS "wealth squad" focused on high end tax evaders who hide assets from the IRS. *See* Paul Sullivan, *Plan to Revive I.R.S. 'Wealth Squad' Puts the Richest on Notice*, N.Y. TIMES (June 11, 2021), https://www.nytimes.com/2021/06/11/business/tax-audits-irs.html [https://perma.cc/Q4Q5-XS5E].

292. *See, e.g.*, PIKETTY, *supra* note 279, at 518–19 (describing how more accurate information on the distribution of wealth could improve democratic and financial transparency and inform financial regulation policy); Emmanuel Saez & Gabriel Zucman, *The Rise of Income and Wealth Inequality in America: Evidence from Distributional Macroeconomic Accounts*, J. ECON. PERSPS., Fall 2020, at 3, 9–12 (describing how information on high-end wealth could improve fiscal analysis and policy).

information reporting reforms, in contrast, can take advantage of taxpayers' more complete first-hand knowledge of their own economic circumstances.

As the preceding discussion also argues, however, each of third-party and first-party information reporting encounters different limitations. Third parties do not always have complete knowledge of the taxpayer's complete economic circumstances but only of their specific activities. As a result, third-party information reporting faces the same challenge of other activity-based compliance rules when seeking to define the scope of the activities subject to these rules broadly enough to prevent easy avoidance but narrowly enough to prevent improperly burdening the wrong taxpayers. First-party information reporting, in contrast, faces the different limitation that taxpayers may be unreliable sources on their own taxable activities, which is the problem giving rise to the need for tax enforcement and detection of noncompliance in the first instance.

This Section introduces a hybrid first- and third-party approach to information reporting, which can utilize the advantages of each approach while also accounting for their limitations. The discussion then illustrates how these hybrid principles could be applied by proposing an alternative structure for the Biden Administration's bank information reporting reform.

A hybrid first- and third-party information reporting system could be implemented by first introducing heightened third-party information reporting requirements which only apply if the taxpayer's income or assets reaches certain thresholds. Taxpayers would then be required to report, or certify to third parties if they have income or assets equal to or exceeding the threshold amounts, and are therefore subject to the third-party information rules. In effect, this hybrid system would use actor-based criteria reported by a first-party (the taxpayer themself) to determine the applicability of additional activity-based reporting by third parties such as financial institutions.

For an illustration, this model for a hybrid first- and third-party information reporting system could have offered an alternative design for the Biden Administration's bank reporting reform.[293] As described above, this reform would have required banks to report gross inflows to and outflows from accounts at a threshold amount which was initially $600 and subsequently increased to $10,000.[294] An alternative system could have only required this third-party bank flow reporting for taxpayers with income or assets equal to or exceeding specified thresholds. Financial institutions could collect this information directly from the account holders, who would in effect be required to certify whether they are subject to these heightened information reporting rules or not.

For example, these account holders could be required to certify that their reported taxable income for the prior year or in recent years did not equal or exceed a specified threshold, such as $2 million, or that the total net value of

293. For descriptions of this reform and its advantages and limitations, see *supra* Section III.A.2.

294. *See supra* notes 244–62 and accompanying text.

their financial assets does not equal or exceed a specified threshold, which could be set, for instance, at $10 million. This hybrid system could be implemented in conjunction with the Annual Net Asset Statement requiring high-end taxpayers to report an estimated value of their assets to the IRS.

The current tax compliance rules already use first-party certifications to notify third parties of the application of heightened third-party tax compliance rules. For one example, taxpayers provide information to employers on IRS Form W-4 to notify their employers of their economic circumstances, thereby defining the third-party employers' withholding obligations.[295] Similarly, taxpayers must report information regarding their economic circumstances to third-party payors on IRS Form W-9, including a certification regarding whether they are subject to FATCA reporting or backup withholding.[296]

In effect, this hybrid system would draw from the advantages of both first- and third-party information reporting, while also accounting for the limitations of each. As described above, banks do not have complete knowledge of their account holders' economic circumstances and can only observe their specific transactions or account balances. A hybrid first- and third-party system, in contrast, utilizes taxpayer's first-person knowledge of their economic circumstances to only impose the heightened third-party information reporting rules when they are warranted. Consequently, this approach could utilize a lower transaction threshold—to prevent avoidance through transaction splitting—without encountering the same concern of unduly burdening lower-income taxpayers subject to rules with lower transaction thresholds.

At the same time, the income or asset thresholds for determining the application of these rules could be set at a level that is high enough to exclude lower- or middle-income taxpayers but also low enough that the wealthiest taxpayers could only avoid these rules by failing to report a substantial portion of their income or wealth. That is, under this proposal, taxpayers with income or wealth far above the threshold amounts would not experience any marginal effect from underreporting their last dollars of income or wealth, as they would under a substantive income tax or a wealth tax.[297] In effect, this hybrid system would utilize the advantages of third-party information reporting systems, while also providing these third parties with the information they do not have and which is necessary to design more effectively targeted third-party information reporting requirements.

Because the income and wealth calculations used for purposes of the thresholds would not affect substantive tax liabilities, this hybrid system could

295. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, OMB NO. 1545-0074, FORM W-4 (EMPLOYEE'S WITHHOLDING CERTIFICATE) (2023), https://www.irs.gov/pub/irs-pdf/fw4.pdf [https://perma.cc/97Q2-SEQ3].

296. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, REV. 10-2018, FORM W-9 (REQUEST FOR TAXPAYER IDENTIFICATION NUMBER AND CERTIFICATION) (2018), https://www.irs.gov/pub/irs-pdf/fw9.pdf [https://perma.cc/C8HY-XD8F].

297. *See supra* note 276 and accompanying text.

minimize the compliance burdens on first parties as well as their avoidance opportunities. Taxpayers could certify to third parties whether an income-based threshold applies based on the taxpayer's own income tax filings from prior years, which would not require any additional calculations of their income for purposes of the certification.[298] Similarly, taxpayers with wealth far above a wealth-based threshold would not have to undertake the exercise of actually valuing their wealth assets, if they are certain that the threshold exemption for taxpayers with low asset holdings would not apply.

For the same reasons, this approach would allow policymakers even greater flexibility in determining the calculation of income and wealth used for purposes of these thresholds. For example, the income-based threshold could be based on a taxpayer's gross income[299] or adjusted taxable income,[300] which would further limit taxpayers' opportunities to avoid the application of these rules by claiming improper deductions or expenses. As in the case of IRS Form 8938 and the Annual Net Asset Statement, the wealth-threshold used in this approach could also account for a taxpayer's maximum asset value at any point during the taxable year without encountering the concern that a maximum value would be an improper basis for determining substantive liabilities.[301]

D. Penalty and Audit Enforcement

Any first-party or third-party information reporting system also needs enforcement measures—including penalties and audits—to deter and detect noncompliance by any parties subject to the applicable reporting requirements. For example, the Biden Administration's third-party bank information reporting proposal would necessarily also include penalties or other consequences for financial institutions that did not comply with the new reporting requirements.[302] Similarly, taxpayers who fail to disclose information required to be reported on the first-party IRS Form 8938 can be subject to a $10,000 penalty, which can increase to $50,000 for continuing nondisclosure following an IRS notification.[303]

A hybrid first- and third-party information reporting system could also afford policymakers greater flexibility in setting penalty amounts at levels which can improve their deterrent effect. Policymakers face distinct challenges in

298. Even if a high-income taxpayer underreported a portion of their income in prior years, they would have to incur even greater costs to underreport enough income to fall below the income threshold in a hybrid information reporting system. For explanation of this same advantage in the current Form 8938 reporting rules, see *supra* note 276–78 and accompanying text.

299. I.R.C. § 61 (2018).

300. I.R.C. § 62 (2018).

301. *See supra* notes 86–89, 278 and accompanying text.

302. The Biden Administration proposal did not specify the nature or amount of any such penalties. The proposal would have granted the IRS, however, "broad authority to issue regulations necessary to implement this proposal." GENERAL EXPLANATIONS, *supra* note 12, at 88–89.

303. I.R.C. § 6038D(d); *see* INTERNAL REVENUE SERV., *supra* note 35 (Form 8938).

setting penalties for nondisclosure of information which does not directly affect substantive tax liabilities. The amount of percentage-based penalties—such as the accuracy-related penalties on income-tax underpayments[304]—vary with the amount of underreported income or other factor used as the base for determining the penalty. As a result, higher income taxpayers will typically face a higher penalty amount, to the extent they tend to have more underreported income at stake and to the extent that the income would generally be taxed at higher progressive rates.[305] Penalties with fixed dollar amounts, in contrast, impose the same absolute penalty burden on all taxpayers. As a result, these penalties will almost always have a lower deterrent effect for wealthier taxpayers.[306]

Policymakers cannot impose percentage-based penalties in all cases, and in many cases, fixed-amount penalties are more appropriate for nondisclosure of information which does not directly affect tax liabilities or for other acts of noncompliance.[307] Fixed amount penalties for activities, however, encounter a basic tension since they must be set high enough to effectively deter high-income taxpayers but low enough to avoid disproportionately high burdens on low-income taxpayers. In this case as well, actor-based criteria can allow policymakers more flexibility in setting penalty levels and in reconciling this tension. For example, Section 6038D can provide substantial penalties for noncompliance with IRS Form 8938 reporting requirements[308] while still minimizing the risk of overburdening lower income taxpayers, because these requirements only apply to wealthier taxpayers with substantial foreign assets reaching the threshold levels.[309]

A hybrid first- and third-party information reporting system can similarly afford policymakers greater flexibility in setting fixed-amount penalties and to set penalties which are high enough to have a significant deterrent effect while also avoiding the risk of collateral burdens on lower income taxpayers. For example, a hybrid first- and third-party variation of the Biden Administration's bank reporting proposal incorporating income- and asset-based thresholds certified by the account holders could allow for more accurately tailored penalties on both the first parties (the account holders) and the third party (the bank). Because these additional information reporting requirements would only apply to wealthy taxpayers, the system could allow for higher fixed-amount penalties

304. I.R.C. § 6662.

305. *See Progressive Tax Procedure*, *supra* note 18, at 700–01.

306. *Id.* at 702–03. Percentage-based penalties can also have a reduced deterrent effect for higher income taxpayers in many circumstances, including when these taxpayers face a lower chance of detection. *Id.* at 703–04.

307. That is, a percentage-based penalty would be most appropriate where an amount that is not disclosed corresponds directly with the magnitude of the cost to the fisc, such as the amount of an income tax underpayment under I.R.C. § 6662.

308. *See supra* note 303 and accompanying text.

309. *See supra* notes 86–89 and accompanying text.

for noncompliance which are necessary to effectively deter these taxpayers, while avoiding the risk of imposing collateral consequences or burdens for less wealthy account holders who would not be subject to these rules.

Audits also play a critical and necessary role in ensuring compliance with both tax compliance rules and the proper reporting and payment of substantive tax liabilities.[310] In this case as well, accounting for both actor and activity-based criteria can allow for more accurate tailoring of audit priorities. A hybrid system which accounts for both the actor and their activities can allow the IRS to focus a greater proportion of audit resources on substantial acts of noncompliance by wealthy taxpayers, as indicated by characteristics of both the actor and their activities. Conversely, accounting for a broader scope of data on both actors and activities can allow the IRS to avoid unnecessary intrusions and audits when they would not be warranted.

CONCLUSION

Tax information reporting plays a vital role in tax administration and enforcement and affects hundreds of millions of individual taxpayers and billions of transactions each year. While tax information reporting is the primary explanation for high rates of voluntary compliance among certain taxpayers, these rules also contain significant gaps. As this Article has demonstrated, high-income and wealthy taxpayers often engage in transactions which are not subject to effective tax information reporting rules or, in many cases, any tax information reporting rules at all, enabling them to pursue tax avoidance and evasion strategies. This Article makes several contributions to the tax compliance literature.

First, this Article shows *how* high-end taxpayers avoid tax information reporting using methods that are not available to most taxpayers. High-end taxpayers may avoid tax information reporting—and ultimately, taxation—by earning income through self-owned or self-managed businesses, offshore bank accounts, virtual currency and digital asset transactions, and Subchapter S corporations, among other techniques. Our analysis reveals the inequity of current law, as high-end taxpayers enjoy myriad opportunities to avoid tax information reporting while other taxpayers, such as middle- and low-income wage earners, are subject to extensive third-party information reporting and withholding and, in the event of reporting inconsistences, IRS audits.

Second, this Article offers a theory for *why* the U.S. tax information reporting regime treats high-end taxpayers differently from other taxpayers. This Article argues that the government's approach to tax information reporting applies almost exclusively to specific activities, ranging from methods of earning income to designated transactions, such as listed transactions and other abusive tax strategies. This activity-based approach often enables high-end taxpayers to avoid these rules and can impose collateral burdens on lower-income

310. *See supra* notes 105–07 and accompanying text.

or fully compliant taxpayers. The activity-based approach to information reporting is the primary reason why high-end taxpayers are able to engage in tax noncompliance while other taxpayers face extensive automatic IRS scrutiny.

Third, this Article proposes that policymakers should supplement current law by introducing actor-based information reporting rules that apply when taxpayers' income or wealth reaches threshold amounts. As this Article explains, an actor-based approach which also accounts for economic characteristics of the taxpayers, and not just their activities, can allow for more effective targeting of tax information reporting rules. This Article describes several benefits of this actor-based approach to information reporting, including that it would enhance the ability of the IRS to identify potential discrepancies in high-end taxpayers' personal and business tax returns, would be harder for high-end taxpayers to avoid than current third-party information reporting rules, and would reduce the inequity of current tax information reporting rules.

Finally, this Article introduces a new framework that policymakers can use to introduce actor-based information reporting rules. Applying this framework, this Article explains both the opportunities and the challenges in the Biden Administration's recent proposal for third-party bank information reporting of gross account flows. This Article applies the framework to propose a new first-party information reporting requirement for high-end taxpayers, an Annual Net Asset Statement. It then demonstrates how this information can be incorporated into a hybrid first- and third-party information reporting system, which can utilize the advantages of both types of information reporting in order to close the tax information gap at the top. The analysis of tax information reporting and the application presented in this Article are relevant to tax scholars, legislators and other policymakers, and federal and state tax officials.