NATIONAL TAXPAYERS UNION FOUNDATION

Issue Brief

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A Deeper Dive on IRS Snooping

Back in September, NTUF Vice President of Research Demian Brady published an iteration of the "What's the Deal With...?" series on tax enforcement. Included in this piece was a discussion of the IRS's proposal to snoop on all financial accounts with over $600 in gross activity.

Nevertheless, the proposal remains a serious part of reconciliation talks. As such, it's worth taking a closer look at the proposal, how exactly it would work, who it would affect, and some of the less obvious consequences.

Background

The proposal by the Treasury Department was first outlined back in May, when Treasury published this year's General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals. The proposal in question outlined the creation of a massive new financial account reporting system.

Under its provisions, financial institutions would be required to report gross inflows and outflows from any financial account — be it a checking account, savings account, loan account, or investment account — so long as it exceeded $600 in annual activity. That means that any account with a balance of $600 or higher, or any account with a cash flow of $600 or more, would be subject to the proposal.

Key Facts:

As Congress scrambles to raise revenue to fund yet more spending, one proposal would require financial institutions to report gross inflows and outflows from accounts exceeding a low threshold to the IRS in order to aid audits and enforcement.

Though the administration has framed its tax enforcement efforts as targeting the wealthiest Americans, in reality these proposals would fall upon a vast swath of Americans, including those of low and moderate income.

Should this proposal be passed into law, it would carry with it risks of data breaches, unwarranted harassment of taxpayers, and compliance burdens for financial institutions.

A similar provision applying specifically to sellers on online platforms such as eBay or Etsy was passed earlier this year as part of the American Rescue Plan Act. This dropped the thresholds requiring reporting of income from these platforms from $20,000 in total sales and at least 200 transactions to just $600 in total sales.

An even more similar idea was passed into law back in 2012 as part of the Patient Protection and Affordable Care Act. This time the onus was put on businesses to report transactions from consumers that totaled more than $600 in a year. It was eventually repealed after President Obama admitted the provision was simply too burdensome for businesses to comply with.

Nevertheless, the zombie idea to snoop on taxpayers' heretofore private financial information is once again back from the dead. As Democrats attempted to turn the proposal into legislative language, widespread backlash has led to the proposal being slightly scaled back. Rather than a $600 threshold, the new proposal would set a $10,000 threshold, while exempting payroll deposits and spending up to the level of payroll deposits.[1] Even so, this new threshold would still catch the vast majority of Americans.

Number of Taxpayers Affected

At first glance, a $10,000 threshold, especially one which exempts payroll deposits and spending up to that level, seems to be a significant improvement on the original $600 threshold. But the reality is that it may not make all that much difference.

While proponents of IRS bank reporting have argued that their goal is to catch wealthy tax cheats, just about every American's bank account would be caught up in a $600 threshold. With maybe the exception of a child's starter savings account, almost every American's main bank account runs through more than that amount in a month, let alone a year.

But while the revised threshold is far larger and aims to exempt traditional payroll income, still very few Americans would not find themselves caught up in the net at some point, if not every year. Exempting payroll deposits attempts to account for normal sources of income, but many Americans earn income outside of a traditional employer/employee relationship.

One example is small business owners. The Small Business Administration estimates that there are 31.7 million small businesses in the United States. About half of these owners pay themselves a salary, but that still leaves roughly 15.5 million small business owners who withdraw funds from the business on an as-needed basis — a compensation arrangement that would likely not be exempted as payroll under the current proposal.

Freelance workers would also likely be out of luck. With the rise of the gig economy, the amount of Americans being paid as independent contractors has risen sharply, with a study by Upwork finding that 59 million Americans received freelance income in 2020. That number is only likely to increase as the pandemic makes remote work a more popular option.

Though some of these freelancers or business owners could only be doing so as a side project, it would not take much to reach the $10,000 threshold. As both deposits and spending count towards the $10,000 threshold, taxpayers would need only earn and spend $5,000 each over the course of a year from a business or freelancing gig in order to face heightened IRS scrutiny. At the median freelancer income of $28 an hour, that would represent only about 179 hours of work — or just under 3.5 hours per week.

And even workers receiving a traditional paycheck could also receive other forms of income. Many of the 4.4 million Americans who work in the food service industry receive cash tips which would not show up as "payroll" when deposited at their bank account — and this is just one cash-based business, of which there are many.

Ironically, while any cash deposits and spending would count towards the $10,000 transaction threshold, someone intentionally looking to dodge their tax obligations could far more easily avoid IRS scrutiny by simply keeping their cash outside a bank. IRS bank reporting requirements would be far more likely to hassle people with no nefarious intentions.

[1] In other words, a taxpayer receiving $20,000 in payroll deposits would only have their bank information reported to the IRS should their spending, plus any other inflows into their accounts, exceed $30,000.

All told, based on these numbers it's likely that somewhere in the realm of 60-70 million Americans would be affected by the IRS's reporting requirements. Though the Biden Administration has pitched their proposals as targeting the wealthiest Americans, those making over $400,000 per year, only about 2.8 million taxpayers fall under that category. By any measure, IRS reporting requirements would rope in far more than that.

And those are just the numbers that are somewhat quantifiable. Financial gifts received up to $15,000 are not taxable, but they alone would put a taxpayer over the $10,000 threshold. Qualifying for IRS scrutiny of your bank account on the basis of non-taxable income is fairly illogical.

Americans also routinely earn "income" from other sources. Payments between friends or housemates through electronic transfer services such as Zelle or Venmo would be flagged as "unexplained income." Sales of items on private marketplaces, particularly high-value items such as cars, could also trigger the threshold.

Neither is the method of exempting payroll income and spending up to that level perfect even for a taxpayer with *solely* payroll income. Consider a taxpayer who earns $40,000 from their job per year but only spends $35,000 as they save up for a car. The third year, even if they continue their habit of spending $35,000 on everything else, the $15,000 car purchase will push them up to the threshold.

After all, while $10,000 sounds like a lot of money, even the poorest Americans routinely spend far more than that on an annual basis. The bottom ten percent of income earners in the country spend over $28,000 a year on average. Between the myriad non-exempt sources of income and spending, it's not a stretch to imagine that the majority of Americans will exceed even the broader $10,000 threshold.

Impact on the Banking Industry

Banks have raised concerns that complying with the reporting regime will impose significant burdens. If this becomes law, banks and financial institutions will see a one-time cost to revise user account agreements and an ongoing yearly cost for compiling and reporting the data to the IRS. This would require the institutions to create a process for determining which accounts have inflows and outflows above the reporting threshold while taking into account the types of transactions that might be excluded, and then making this available to the IRS.

Banking associations have gathered information on these compliance burdens from their member institutions and shared the feedback with lawmakers. These groups have consistently emphasized the fact that a $10,000 threshold is no less burdensome than a $600 one, insisting it remains costly and difficult for their member organizations, particularly smaller community banks, to implement.

Nevertheless, Democrat lawmakers, such as Senators Wyden and Elizabeth Warren (D-MA), appear determined to ignore these concerns, even going so far as to say that the banks are "lying" about the compliance costs. It's hard for these legislators to claim that they are aware of the potential impact of their proposals when they dismiss legitimate criticism from affected industries as "lies."

Consequences of Violations of Taxpayer Privacy

For all the rhetoric suggesting that citizens who pay their taxes have nothing to fear from expanded IRS data collection, that's unfortunately not the case. Even taxpayers who make every effort to pay their taxes promptly and correctly could find themselves harassed by the IRS were it to succeed in gaining access to additional taxpayer financial data.
While the proposal as written would only give the IRS access to a given account's annual inflows and outflows, in practice they would have access to so much more. Any discrepancy between reported income on tax filing and bank account inflows, for example, could trigger an IRS demand to provide details on individual transactions or else face an audit.

There are many innocuous reasons why a taxpayer's reported income may not match their bank inflows — such as receiving a gift under the gift exclusion or depositing money held previously in cash or another account. Nevertheless, taxpayers could find themselves challenged by the IRS to explain the discrepancy, creating a "guilty until proven innocent" standard for taxpayers.

There can also be worse consequences than harassment and audits. Government bodies have a poor history of handling what it considers to be "suspicious" use of Americans' own money. Take the fact that the Department of Homeland Security (DHS)has seized over $2 billion in cash from air travelers between 2000 and 2016 — over two-thirds of whom were never convicted of a crime.

Many of these air travelers were doing nothing worse than traveling with a "suspiciously" large amount of cash. Suspecting it was being used for nefarious purposes, the DHS chose to seize it, forcing the victims to spend years in administrative and legal battles attempting to get their money back.

And that's just people traveling through airports. The Institute for Justice estimates that government agencies have seized $68.6 billion through civil asset forfeiture over the past 20 years.

It's not a stretch to imagine that Americans who deposit significantly larger sums of money in their accounts one year than another — for any number of legitimate reasons — could face demands by the IRS to explain their transactions, audits, or even the involvement of law enforcement. Taxpayers should rightly expect a far greater degree of financial privacy than that.

For taxpayers caught up in the IRS's dragnet, another major concern should be the agency's ability to secure the data it is collecting. Even setting aside the potential impact of proposals to rapidly and drastically expand the size of the IRS, its ability to guarantee the security of taxpayer data has some major question marks.

Infamously, earlier this decade the IRS targeted groups for heightened scrutiny based on political affiliation on applications for tax-exempt status for years before eventually entering into a financial settlement. Organizations seeking tax-exempt status were left in bureaucratic limbo for far longer than usual based on their use of words like "Tea Party" or "Patriots." In a reminder that political targeting can go both ways, progressive organizations were targeted as well, though on a smaller scale.

Leaks also continue to be an issue. A report earlier this year from investigative outlet ProPublica used the tax filings of hundreds of the wealthiest taxpayers in the country. Yet ProPublica should never have been able to access this supposedly confidential information, and the IRS has yet to explain how a nongovernmental organization managed to come across this data.

Questions have been raised in the past about IRS protocols monitoring unauthorized access to taxpayer data. A report last year by the Treasury Inspector General for Tax Administration found that 67 requests for taxpayer information should have been monitored for unauthorized access, but less than ten percent of these received complete and accurate audit trails. About half received no audit trails at all.

The most recent GAO report about data security failures of IRS IT systems is heavily redacted. Each blacked out section of the report underscores the seriousness of the risk to data security.

After all, leaks of taxpayer information can have consequences beyond just having your tax records turned into political footballs. Over the past five years, at least two incidents have seen taxpayer data used in identity fraud schemes — once due to a data breach, and once due to a rogue IRS employee.

Should the IRS succeed in seeing its budget doubled, adding 87,000 new enforcement officials to its ranks, and receiving a vast new trove of taxpayer information, it's hardly a stretch to imagine already shoddy data security standards being weakened even further. Someone impersonating a bank agent or IRS official would be greatly aided by the ability to accurately identify a taxpayer's gross spending or deposits.

Impact on Revenue Collections

A question that has often gone unasked is whether the IRS is even capable of handling this torrent of data. There are already long-standing concerns about the IRS information technology systems and capabilities. Senators who are upset with private sector institutions concerned about the costs of the new reporting regime should take a look at the technological problems encountered by federal agencies, especially the IRS, which maintains the oldest database across the federal government. Its core tax information system dates back to the early 1960s. Plans have been in process for years and years to modernize this legacy system, but a recent report from the Government Accountability Office (GAO) warns that effort is being scaled back and, worse, "it may not be completed until 2030."

Advocates of this proposal are also whistling past the graveyard of IRS' mistreatment of taxpayers through heavy-handed enforcement efforts. The long history of these problems, as well as recent cases and reports should give pause to lawmakers considering vast amounts of new IRS funding and enforcement authority without structural reforms to fix flaws in the agency.

Treasury estimates it can raise revenues by $700 billion over the decade through its tax enforcement plan. The first part of the plan includes improving IRS information technology and hiring 87,000 new IRS agents (more than doubling the size of the agency). Treasury estimates that this would increase tax revenues by $316 billion over the decade. This is likely an optimistic figure — CBO's analysis estimated that the changes would boost revenues by $200 billion.

The second part of the plan is the financial data reporting. The Treasury had estimated that its original threshold for any account with inflows and outflows totaling at least $600 a year would yield $463 billion in new revenues. CBO and JCT have not yet produced their independent analysis, and with the lack of details on the proposal, a new estimate from the Treasury has not yet been reported. However, the Congressional Research Service has expressed that "it is not clear how knowing one's financial flows throughout the year would help in determining taxable income."

If the end result does significantly reduce the number of accounts reported to the IRS, this may reduce the revenue estimate, forcing lawmakers to find another way to finance trillions of new spending in the reconciliation package.

Conclusion

Clearly, what has been billed as a narrow proposal to target wealthy tax cheats is anything but. Not only would taxpayers of every income level be caught up in the IRS's dragnet, but they would also likely be subjected to harassment and scrutiny on the basis of perfectly legal bank account activity.

Americans who pay their taxes every year deserve better than to be subjected to a financial surveillance regime. No matter how the Treasury attempts to spin it, this proposal would represent an unprecedented intrusion into taxpayers' financial affairs.

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