

# Information Reporting and Tax Compliance<sup>†</sup>

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There is much evidence that compliance rates vary significantly by income type, and there is emerging evidence that this variation is due largely to the presence—or the absence—of third-party information reporting. In this paper, we examine the impact of information reporting on tax compliance. We first discuss the practice of information reporting in the United States, including a recent Internal Revenue Service (IRS) initiative that implemented information reporting for certain forms of income in the United States via a new Form 1099-K, which required payment settlement entities such as American Express, third-party settlement entities such as PayPal, and online platforms such as Uber to send information reports on gross receipts received by businesses using their services to the IRS. We then describe recent research on the impact of information reporting. Finally, we report some new evidence that indicates that Form 1099-K information reporting had significant—but quite variable—

impacts on compliance rates of different types of business reporting.

## I. The Role of Information Reporting in Tax Compliance Decisions

Ensuring tax compliance is an enduring problem for governments in all countries. For example, the IRS has recently estimated the tax gap (or the difference between what taxpayers pay in taxes in a timely manner and what they would pay if they fully complied with the tax law) to be \$441 billion annually (for tax years 2011–2013), with an associated voluntary compliance rate (defined as taxes paid relative to taxes legally due) of 83.6 percent (IRS 2019). There is widespread, if somewhat anecdotal, evidence that compliance with taxes is an even larger problem in most other countries around the world.

However, tax compliance with the individual income tax varies significantly by type of income, due largely to differences in information reporting by income type. A standard feature of most individual income tax systems is that a third party (e.g., the individual's employer) reports an individual's taxable income to the tax authority via third-party information reporting (and the third party often also withholds income taxes on this income). Information reporting is the legal requirement by third parties such as employers, banks, and credit card companies to report information such as income, receipts, or expenses incurred by the individuals directly to the government, thereby allowing the government to verify tax returns filed by individuals against such reports. Well-designed and well-implemented information reporting can, in principle, significantly increase the likelihood of uncovering tax evasion during the audit process, because the tax authorities will likely detect an individual who underreports income on a tax return. Indeed, the most recent IRS estimates indicate that the voluntary compliance rate for income subject to substantial information reporting (and withholding) is virtually 100

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percent, while the voluntary compliance rate on income subject to little or no information reporting is significantly lower at only 55 percent (IRS 2019).

In large part because of this type of evidence, a standard policy proposal to improve tax compliance is to expand information reporting (e.g., World Bank 2012, OECD 2019, National Taxpayer Advocate 2019).

However, the actual evidence to support this recommendation is not entirely clear-cut, as we discuss later.

## II. The US Practice of Information Reporting

The history of information reporting is as old as that of income taxes. For instance, the IRS received almost ten million information reports of salaries, interest, and dividends as early as 1925, and it used about half of those information reports to compare the amount declared by taxpayers to the information reports (IRS 1925). This practice has expanded considerably over time. Currently, incomes from wage and salary (via W-2), interest income (1099-INT), investment income (1099-DIV), and various nonemployee income (1099-MISC) are all third-party reported.

However, until recently, subjecting business income to information reporting was challenging, because businesses earn income by providing services to millions of final consumers, and there is no easy way to use consumers as third-party reporters. Many studies find this lack of information reporting of self-employed income to be one of the major reasons for the low tax compliance rate among self-employed businesses. It is here where a recent IRS initiative enters. In an attempt to make business income visible to the IRS, US Congress enacted Internal Revenue Code section 6050W in 2008 (with its implementation starting in 2011). Section 6050W introduced a new information report called Form 1099-K, which required payment settlement entities to send information reports on gross receipts to the taxpayer, the IRS, and some state tax agencies.

Form 1099-K makes business receipts through payment cards visible to the IRS. Importantly, however, cash income and many business expenses are still invisible to the IRS since cash income and business expenses are not reported by third parties. Thus, the effective coverage of

Form 1099-K depends on the intensity of the use of payment cards, which gives rise to significant variation in its coverage across many dimensions such as industry, business type, and geography.

Indeed, this basic limitation of information reporting—it does not cover all forms of income, receipts, and expenses—suggests that the effects of information reporting on tax compliance may not always be positive. Recent research is largely consistent with this suggestion, as discussed next.

## III. The Lessons of Recent Research on Information Reporting

Recent research has increasingly examined the impacts of information reporting on tax compliance, assisted by the growing access to administrative data. This research generally finds that tax compliance is far greater on income subject to third-party information reporting (and also to employer source withholding) than on income not subject to these features. In particular, providing third-party information to the tax authorities significantly improves tax compliance (Marchese 2009, Johannesen 2014, Phillips 2014, Adhikari et al. 2016, Slemrod et al. 2017, Naritomi 2019).

However, the effects of information reporting can still be mixed. Information reporting that applies to only some sources of income has been found to improve compliance of these sources (Agostini and Martínez A. 2014, Pomeranz 2015, Fack and Landais 2016). However, if there are other margins of behavior that are not subject to withholding, individuals have been found to reduce compliance along these other margins (Carrillo, Pomeranz, and Singhal 2017). Also, Gillitzer and Skov (2018) finds that the introduction of information reporting for charitable deductions in Denmark actually led to an increase in the number of claimed deductions because the information reporting increased taxpayer knowledge about previously unclaimed deductions.

In sum, information reporting does not always lead to improved tax compliance, or at least to increased tax collections.

## IV. New Evidence on Information Reporting from Form 1099-K

In this section, we describe the heterogeneous impact of Form 1099-K across business types and industries. We then summarize some of our

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recent research on the impact of Form 1099-K on tax compliance. See Adhikari, Alm, and Harris (forthcoming) for a complete discussion.

### A. Data

We use confidential administrative data from individual and businesses' tax returns and information reports for tax year 2011 provided by the IRS. We restrict our analysis to businesses by using two tests described in Prisinzano et al. (2016). The first test is the "de minimis test," which requires that businesses have either total income or total deductions greater than \$10,000 or that their sum exceeds \$15,000. The second test is the "business activity test," which requires businesses to have total deductions greater than \$5,000. If a tax filer meets both requirements, then it is classified as a business and included in our sample. We also remove some outlier values (e.g., firms that did not have positive receipts and firms that reported receiving 130 percent or more of their gross receipts via Form 1099-K). Our final sample consists of 14.5 million businesses (S corporations, C corporations, partnerships, and Schedule C filers).

### B. Descriptive Statistics

In 2011, firms in our sample received a combined \$56.57 trillion in receipts, of which \$1.73 trillion (3.1 percent) was reported via Form 1099-K. This share can be interpreted as the effective coverage of Form 1099-K. About 21 percent of the sample of firms received at least one Form 1099-K, suggesting that around 21 percent of the firms accept payment cards. For firms that received at least one Form 1099-K, the share of receipts reported via Form 1099-K is 11.5 percent, with the median firm having 29.6 percent of total receipts reported on Form 1099-K.

This average share of receipts from Form 1099-K masks substantial heterogeneity in the coverage of Form 1099-K across industries and business types. For example, the share of businesses that received at least one Form 1099-K ranges from 12.6 percent for Schedule C to 37.1 percent for C corporations. Similarly, 66.3 percent of firms in the accommodation and food services sector received at least one Form 1099-K, while only 2.5 percent of firms in the mining, quarrying, and oil and gas extraction sector received at least one Form 1099-K.

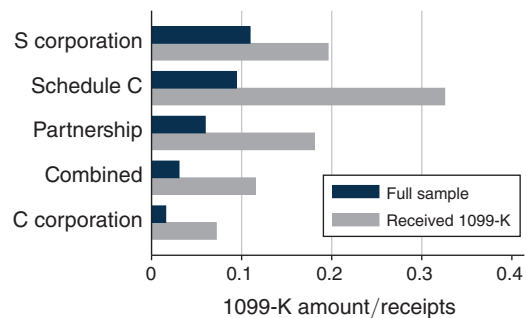


FIGURE 1. THE SHARE OF REPORTED REVENUE RECEIVED VIA FORM 1099-K ACROSS BUSINESS TYPES IN 2011

Figure 1 depicts the share of receipts reported via Form 1099-K across business types, which ranges from 1.6 percent of C corporations' receipts to 10.9 percent of S corporations' receipts. Similarly, Figure 2 depicts the share of receipts reported via Form 1099-K across industries, which ranges from 0.03 percent in the finance and insurance sector to 39.8 percent in the accommodation and food services sector.

The heterogeneity in the effective coverage of Form 1099-K cannot be fully explained by the differential adoption of payment card readers across industries or business types since there is substantial heterogeneity in the coverage even when we restrict the sample of firms to only those that accept payment cards. For instance, the share of receipts via Form 1099-K conditional on receiving at least one 1099-K ranges from 7.2 percent for C corporations to 32.6 percent for Schedule C (see Figure 1). The heterogeneity, conditional on receiving Form 1099-K, is even more pronounced across industries, ranging from 1.7 percent for the management of companies and enterprises sector to 50.0 percent for the accommodation and food services sector (see Figure 2).

### C. New Evidence on Tax Compliance

In addition to the heterogeneous impacts of Form 1099-K across industries and business types, there is also significant geographic variation. In Adhikari, Alm, and Harris (forthcoming), we use this variation to construct an index of payment card use at the commuting-zone level by dividing the total amount of revenue reported in Form 1099-K for small businesses

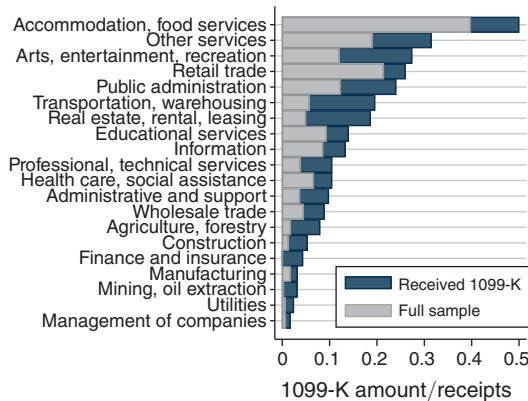


FIGURE 2. THE SHARE OF REPORTED REVENUE RECEIVED VIA FORM 1099-K ACROSS INDUSTRIES IN 2011

located in a commuting zone by the total amount of revenue reported from all sources by these businesses. We argue that if a business operates in a locality where the use of payment cards is high, then a greater share of the firm's revenue will be reported to the IRS using Form 1099-K. We then employ a difference-in-difference research design in which we compare the trends in receipts, deductions, and net incomes between small businesses located in high payment card use areas and those located in low payment card use areas for several years before and after the introduction of Form 1099-K.

We find that the implementation of information reporting via Form 1099-K led in most cases to a modest but economically meaningful and statistically significant increase in reported receipts by small businesses. In our preferred specification, we estimate that doubling the index of payment card use in a geographic area results in an increase of 2.9 percent in reported receipts. However, we also find substantial heterogeneity in this response across industry, business type, and firm size. Finally, we find little impact of Form 1099-K on business deductions. Indeed, net income generally increased with greater payment card use. These results are robust to a variety of alternative specifications and placebo tests. See Adhikari, Alm, and Harris (forthcoming) for a complete discussion.

## V. Conclusions

Information reporting clearly has the potential to improve tax compliance. However, its results

often vary depending on the effective coverage of the information reporting. More research is needed to document its many possible effects.

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