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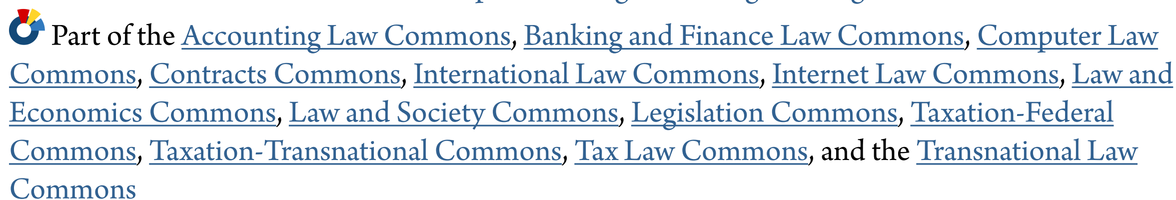
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TAX COMPLIANCE IN A DECENTRALIZING ECONOMY

Manoj Viswanathan*

ABSTRACT

Tax compliance in the United States has long relied on information from centralized intermediaries—the financial institutions, employers, and brokers that help ensure income is reported and taxes are paid. Yet while the IRS remains tied to these centralized entities, consumers and businesses are not. New technologies, such as sharing economy platforms (companies such as Airbnb, Uber, and Instacart) and the blockchain (the platform on which various cryptocurrencies are based) are providing new, decentralized options for exchanging goods and services. Without legislative and agency intervention, these technologies pose a critical threat to the reporting system underlying domestic and international tax compliance.

Until now, legal academia has paid scant attention to the extent to which U.S. tax compliance relies on centralized intermediaries as information reporters. Prior scholarship has instead focused on describing existing information reporting protocols and the characteristics of successful reporters. This Article moves further, demonstrating that both domestic and international tax compliance cannot function without these centralized intermediaries. Next, the Article argues that the potential decentralization caused by new technologies should not be neglected, and proposes a series of legislative reforms so that Congress and the IRS can act

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prospectively, rather than retrospectively, to minimize the future threat to U.S. tax compliance.

INTRODUCTION

Tax compliance depends heavily on institutions acting as intermediaries between taxpayers and the Internal Revenue Service (IRS).[1] In the domestic context, employers submit W-2s to report employee wages, banks use 1099-INTs to report interest payments, companies procuring services send 1099-MISCs, and casinos transmit W-2Gs to report substantial gambling winnings, to name a few examples.[2] Although taxpayers are obligated to pay income taxes on income from all sources, regardless of whether the income is reported to the IRS, income reported on intermediary-provided forms constitutes the overwhelming majority of both reported (and taxed) income.[3] For international tax enforcement, the IRS relies heavily on the Foreign Account Tax Compliance Act, which obligates foreign entities to submit detailed reports on assets held overseas.[4] This information reporting is a primary mechanism by which the IRS evaluates taxpayer returns for compliance.[5]

New technologies are decentralizing the economy and threatening the extent to which the IRS can rely on these intermediaries.

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1. *See, e.g.*, Omri Marian, *A Conceptual Framework for the Regulation of Cryptocurrencies*, 82 U. CHI. L. REV. DIALOGUE 53, 57 (2015) ("[O]ur financial-regulation system heavily relies on regulating intermediaries that are uniquely positioned to disrupt misconduct.").

2. IRS, U.S. DEP'T OF TREASURY, CAT. NO. 2811V, 1040 INSTRUCTIONS (2016), https://www.irs.gov/pub/irs-pdf/i1040gi.pdf. Other examples of intermediary-provided forms include various versions of Form 1098 (mortgage interest, refund of overpaid interest, mortgage interest premiums, and student loan interest, qualified tuition payments) and Form 1099 (canceled debt, dividends received, capital gains, unemployment compensation, royalties, original issue discount, health savings account distributions). *Id.* at 11.

3. *Data Book 2010*, INTERNAL REVENUE SERV. DATA BOOK, Oct. 1, 2009–Sept. 30, 2010, at 22–30 (IRS, Wash. D.C.), https://www.irs.gov/pub/irs-soi/10databk.pdf. According to IRS Statistics of Income for 2010, the aggregate amount of "other income" listed in the approximately 140 million returns submitted is $34 billion out of a total of $8.2 trillion of income reported, or 0.4%. *See id.*

4. Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §§ 501-502, 124 Stat. 97-109, 1471-74 (2010) (imposing penalties and obligations on foreign financial institutions not complying with FATCA requirements). *See also infra* notes 33–65 and accompanying text.

5. Ruth Mason, *Citizenship Taxation*, 89 S. CAL. L. REV. 169, 213–14 (2016).

Companies in the rapidly growing "sharing" (or "gig" or "on-demand platform") economy disclaim the employer/employee relationship and the reporting obligations it implies.[6] By 2020, it is estimated that approximately 40% of the workforce will earn at least some income from the sharing/on-demand economic sector.[7] Additionally, new payment methods, such as blockchain technologies, can eliminate intermediaries altogether, facilitating direct, high-value, peer-to-peer transactions.[8] In an economy in which intermediaries play a diminished role, the information provided to the IRS becomes increasingly incomplete, hindering IRS enforcement and eroding the income tax base. Current regulatory oversight is woefully incomplete at addressing these concerns.[9] How should Congress and the IRS confront these challenges?

This paper proceeds in three parts. Part I provides an overview of taxpayer noncompliance in the United States and concludes that current enforcement measures implicitly rely on centralized intermediaries to compel compliance. Part II analyzes the effects that two increasingly relevant technologies, the sharing economy and the distributed-ledger blockchain, have on reducing the need for traditional intermediaries and the resulting effect on taxpayer compliance. Part III proposes specific recommendations for how Congress and the IRS can contend with a decentralized economy.

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6. *See generally* CAROLINE BRUCKNER, KOGOD SCH. OF BUS., SHORTCHANGED: THE TAX COMPLIANCE CHALLENGES OF SMALL BUSINESS OPERATORS DRIVING THE ON-DEMAND PLATFORM ECONOMY 1 (2016), http://www.american.edu/kogod/news/Shortchanged.cfm. *See infra* note 208 and accompanying text.

7. BRUCKNER, *supra* note 6, at 8 (citing Arjan Schutte & Colleen Poynton, *1099 Problems and W2s Ain't One: The 1099 Economy's Problems, Advantages, and Outlook*, CB INSIGHTS (Sept. 15, 2015) and INTUIT, INTUIT 2020 REPORT (2010)).

8. *See infra* notes 208–222 and accompanying text.

9. *See* David Kocieniewski, *Airbnb, Others Pay Out Billions Beneath IRS's Radar: Study*, HARTFORD COURANT (May 24, 2016, 2:00 PM), http://www.courant.com/business/hc-peer-to-peet-company-taxes-20160523-story.html; I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, https://www.irs.gov/pub/irs-irbs/irb14-16.pdf; American Bar Association, Comment Letter on I.R.S. Notice 2014-21 (Mar. 24, 2015), http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/032415comments.authcheckdam.pdf (stating that Notice 2014-21 leaves many unanswered questions regarding how cryptocurrency questions should be taxed).

I. *The Current State of Taxpayer Noncompliance*

A. *The United States Tax Gap*

Nearly half a trillion dollars of tax liability owed to the U.S. government from domestic activities goes uncollected.[10] For the 2008, 2009, and 2010 tax years (the most recent period for which data is available), the IRS estimates the gross annual tax gap—the amount of true tax liability that is not paid voluntarily and timely—sits at $458 billion.[11] This amount, the total tax gap from all domestic federal tax bases, represents approximately 18% of the $2.5 trillion true annual tax liability.[12] The tax gap calculation likely does not include the entire international tax gap,[13] with a relatively recent estimate of the revenue lost due to offshore activities as high as $255 billion.[14]

The IRS calculates the tax gap by extrapolating from data obtained from audited returns over multiple years to construct a model of all U.S. taxpayers.[15] This model permits the IRS to estimate the tax gap across categories of noncompliance and further allocate the tax gap to

10. IRS, U.S. DEP'T OF TREASURY, PUB. NO. 1415(5-2016), FEDERAL TAX COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2008-2010, at 1 (2016), https://www.irs.gov/pub/irs-soi/p1415.pdf.

11. *Id*. The annual net tax gap, which takes into account taxes eventually paid, is estimated to be $406 billion, or $52 billion less than the gross tax gap. *Id.* Only $2,038 trillion (81.7% of the true tax liability) is paid voluntarily and timely. *Id.* at 7.

12. *Id.* at 7. The individual income tax, employment tax (levied on wages), corporate income tax, estate tax, and excise tax comprise $319 billion (69.6%), $91 billion (19.9%), $44 billion (9.6%), $4 billion (0.9%), and less than $1 billion (less than 0.1%) of the annual gross tax gap, respectively. *Id*.

13. *See* PHILIP SHROPSHIRE, TREASURY INSPECTOR GEN. FOR TAX ADMIN., No. 2009-IE-R001, A COMBINATION OF LEGISLATIVE ACTIONS AND INCREASED IRS CAPABILITY AND CAPACITY ARE REQUIRED TO REDUCE THE MULTI-BILLION DOLLAR U.S. INTERNATIONAL TAX GAP 3 (2009), https://www.treasury.gov/tigta/iereports/2009reports/2009IER001fr.html ("[I]dentifying hidden income within international activity is very difficult and time-consuming.").

14. Susan C. Morse, *Tax Compliance and Norm Formation Under High-Penalty Regimes*, 44 CONN. L. REV. 675, 701 (2012). The low end of the estimate is approximately $50 billion. *Id.* The tax gap estimate also excludes illegal source income. William L. Burke, *Tax Information Reporting and Compliance in the Cross-Border Context*, 27 VA. TAX REV. 399, 435 (2007) ("Taxes on illegal activities are excluded from these estimates.").

15. Nina E. Olson, *Minding the Gap: A Ten-Step Program for Better Tax Compliance*, 20 STAN. L. & POL'Y REV. 7, 8–9 (2009); IRS, *supra* note 10, at 10; IRS, TAX YEAR 2006 TAX GAP ESTIMATE–SUMMARY OF ESTIMATION METHODS 1 (2012), https://www.irs.gov/pub/irs-soi/06rastg12methods.pdf. This modeling is conducted under the auspices of the IRS's National Research Program. Olson, *supra*.

specific tax bases and types of taxpayers.[16] As discussed in the next Section, the bulk of the tax gap is from the individual income tax, with underreporting being the largest category of taxpayer noncompliance, and business income underreporting the largest subcategory.[17] The IRS divides taxpayer noncompliance into three primary categories: underreporting, underpayment, and nonfiling.[18] Taxpayer underreporting occurs when taxpayers understate the income on which they owe taxes, thereby underreporting their true tax liability.[19] Underpayment occurs when taxpayers do not pay the tax they owe, and nonfiling occurs when taxpayers simply do not file a return.[20]

Of these three categories, taxpayer underreporting (of not only income but other attributes from which tax is calculated) makes up the vast majority of the tax collection shortfall. Approximately $387 billion, or 85%, of the annual gross tax gap results from underreporting of the true tax owed on timely filed returns.[21] The tax gap associated with the two other categories of taxpayer noncompliance—underpayment and nonfiling—comprises a much smaller percentage of total noncompliance.[22] Taxpayer underpayment accounts for approximately $39 billion (8.5%) of the annual gross tax gap, whereas taxpayer nonfiling accounts for approximately $32 billion (7.0%).[23] In short, taxpayers' failure to pay taxes is due largely to their failure to report all of their income.

B. Taxpayer Underreporting of Income and Tax Compliance

The IRS frequently receives information relevant to a given taxpayer from parties other than the taxpayer herself. "Information

16. *See generally* IRS, *supra* note 10, at 10. Bases include income, employment, estate, and excise taxes. Individual and corporate taxpayers are both part of the tax gap analysis. *Id.*

17. *Id.* at 7.

18. *Id.* at 2.

19. *Id.* at 19.

20. *Id.* at 3.

21. IRS, *supra* note 10, at 2.

22. *See id.* at 8.

23. *Id.* at 2.

reporting" refers to the statutorily obligated submissions to the IRS of information (known as "information reports" or "information returns") regarding the taxpayer by some third party, typically an entity making a payment to the taxpayer.[24] In the case of reporting associated with the Foreign Account Tax Compliance Act (FATCA), however, the information reporting concerns the foreign financial institution's submission of information regarding the U.S. taxpayer's overseas assets, rather than any payment made by the reporter to the U.S. taxpayer.[25]

Information reporting requires these third-party intermediaries to submit information to the IRS on transactions involving, among other things, trade or business payments, compensation for services, interest payments, dividends, foreign investments and transactions, and sales by brokers.[26] Common information returns include Form W-2, which reports wage information; the various Forms 1099; and Forms 8966 and 8957, which relate to FATCA.[27]

Taxpayers are obligated to pay income taxes on income from all sources, regardless of whether the income is reported to the IRS via an information return.[28] But the degree to which taxpayers fail to include income on their tax returns, or underreport, is directly related to the extent these income items are subject to information reporting.[29] When substantial information reporting is combined with

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24. *See* Treas. Reg. § 1.6041-3 (2013); *infra* note 61 and accompanying text.

25. *See* Treas. Reg. § 1.6041-3 (2013); *see discussion infra* notes 48–65 and accompanying text. FATCA also requires that taxpayers self-report certain foreign assets on Form 8938. *Comparison of Form 8938 and FBAR Requirements*, IRS, https://www.irs.gov/businesses/comparison-of-form-8938-and-fbar-requirements (last updated Sept. 5, 2017).

26. *See discussion infra* notes 111–123 and accompanying text.

27. *See, e.g.*, IRS, U.S. DEP'T OF TREASURY, CAT. NO. 59612Q, INSTRUCTIONS FOR FORM 8966 (2016), https://www.irs.gov/pub/irs-pdf/i8966.pdf; IRS, U.S. DEP'T OF TREASURY, CAT. NO. 59561K, INSTRUCTIONS FOR FORM 8957 (2016), https://www.irs.gov/pub/irs-pdf/i8957.pdf. In 2016, the IRS estimated 250,188,751 Form W-2s and 2,341,982,873 1099s (across all types) were submitted, respectively. IRS, PUBLICATION 6961, at 4 (2017). This constitutes about 83% of all information returns submitted. For purposes of this Article, the term "information reporting" also includes the reporting imposed on foreign entities by the Foreign Account Tax Compliance Act.

28. Treas. Reg. § 61(a) (2012) ("[G]ross income means all income from whatever source derived.").

29. *See* Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733, 1733, 1735 (2010) [hereinafter Lederman, *Reducing Information Gaps*]; Leandra Lederman, *Statutory Speed Bumps: The Roles Third*

withholding of tax by the reporting intermediary, as is done for wage payments reported on Form W-2, for example, the net misreporting percentage is only 1%, or $5 billion, of the approximately $500 billion of total income from these sources that should have been reported.[30]

As a smaller proportion of income is reported via mandated information returns, rates of underreporting noncompliance increase. For sources of income subject to only some information reporting, including income from partnerships, S-corporations, trust and estate allocations, alimony payments, and capital gains, the net misreporting percentage increases to 19%, or $33 billion, of the approximately $174 billion from these sources that should have been reported.[31] For sources of income subject to little or no information

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Parties Play in Tax Compliance, 60 STAN. L. REV. 695, 698 (2007) [hereinafter Lederman, *Statutory Speed Bumps*]; Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 KAN. L. REV. 971, 975–76 (2003) [hereinafter Lederman, *Tax Compliance*]; Jay A. Soled, *Call for the Gradual Phase-Out of All Paper Tax Information Statements*, 10 FLA. TAX REV. 345, 347 (2010) ("[T]he issuance of tax information statements/returns such as Form W-2s and Form 1099s, furnished annually to taxpayers, has played a vital role in the administration of our nation's income tax system and in bolstering compliance.").

30. IRS, *supra* note 10, at 18. The net misreporting percentage for a given line item is the total net misreported amount (the sum of all amounts underreported minus the sum of all amounts overreported) divided by the sum of the absolute values of the amounts that should have been reported. *Id.* at 4–5. As a result of withholding, taxpayers are incentivized to file a return in order to obtain credit for the amounts withheld. *See generally* Lily Kahng, *Investment Income Withholding in the United States and Germany*, 10 FLA. TAX REV. 315 (2010) ("Withholding has proven to be the single most effective enforcement mechanism for collecting taxes on income from labor."); Lederman, *Statutory Speed Bumps*, *supra* note 29, at 731–33. Withholding by a payor (a private party who transfers an amount to another private party) is more administratively burdensome than simply reporting amounts paid. *See* Richard L. Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595, 603 (1982) ("The mechanics of the income tax withholding requirements are simple in appearance but quite complicated in application."). The onus of withholding was a factor in Senate rejection of House bills calling for withholding expansion to include other forms of income. *Id.* at 604 n.58 ("The Senate objected that the provisions would impose heavy burdens on businesses, which would be required to perform the withholding and collection functions for the government."). But information reporting in the absence of withholding still has a significant salutary effect on rates of taxpayer income underreporting. Income items subject to substantial information reporting but not withholding still have only a 7% net misreporting percentage, or $15 billion, of the approximately $214 billion of income from these sources that should have been reported. IRS, *supra* note 10, at 18. These sources of income include interest income, dividend income, state income tax refunds, pensions and annuities, unemployment compensation, and taxable social security benefits. *Id.* These sources of income are reported on forms 1099-INT, 1099-DIV, 1099-G, 1099-R, and SSA-1099, respectively. *Id.*

31. IRS, *supra* note 10, at 18. These sources of income are reported on Schedule K-1 (partnership, S-corp, trust, and estate allocations), Form 1040 (alimony), and Schedule D (capital gains). *Id.*

reporting, such as income from sales of business property, proprietor income, farm income, rents and royalties, and other miscellaneous income, the net misreporting percentage is a staggering 63%, or $136 billion, of the approximately $216 billion of income from these sources that should have been reported.[32]

C. *International Tax Compliance*

1. *The Report of Foreign Bank and Financial Accounts*

Congress enacted the Bank Secrecy Act in 1970 to prevent the use of foreign bank accounts for illegal purposes, including tax evasion.[33] The Bank Secrecy Act required financial institutions to submit information on certain transactions, such as large cash deposits and withdrawals, to the federal government to aid regulatory and criminal investigations.[34] Part of the Bank Secrecy Act also requires certain individuals connected to the United States to report foreign financial assets and maintain records of transactions and relationships with foreign financial agencies.[35] The IRS enforces this Report of Foreign Bank and Financial Accounts (FBAR), even though the Internal Revenue Code does not obligate its submission and it is not submitted with a taxpayer's tax return.[36] U.S. persons are required to submit an FBAR if they had authority over at least one financial

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32. *Id.* Compliance rates have varied slightly over the different periods the IRS has analyzed, but the relative magnitudes of compliance for source of income grouping has remained relatively consistent. *See id.*

33. *See* Act of Oct. 26, 1970, Pub. L. No. 91-507, §§ 241, 242, 84 Stat. 1114, 1124 (1970); TAXPAYER ADVOC. SERV., 2014 ANNUAL REPORT TO CONGRESS 332 (2014) (describing how Congress was motivated to pass the Bank Secrecy Act after hearing testimony that criminals were using secret foreign bank accounts for illegal purposes).

34. Eric J. Gouvin, *Bringing Out the Big Guns: The USA Patriot Act, Money Laundering, and the War on Terrorism*, 55 BAYLOR L. REV. 955, 963 (2003); *see also* 31 U.S.C. §§ 5311–5322 (2012).

35. 31 U.S.C. § 5314 (2012); Justin Scheid, *FBAR: It's Not a Four-Letter Word When Dealing with the IRS*, 26 DCBA BRIEF 30 (2013), http://www.dcba.org/mpage/vol261213art3.

36. Hale E. Sheppard, *Evolution of the FBAR: Where We Were, Where We Are, and Why It Matters*, 7 HOUS. BUS. & TAX L. J. 1, 28 (2006) ("The FBAR is not filed as an attachment to an individual's income tax return; rather, it must be sent separately to a Michigan address for the Treasury Department."); *see also* Financial Crimes Enforcement Network, 68 Fed. Reg. 26,489, 26,489 (May 16, 2003) (codified at 31 C.F.R. § 1010.810).

account located outside of the United States, and the aggregate value of all their financial accounts exceeded $10,000 at any time during the relevant calendar year.[37] Prior to FATCA's enactment, discussed in the next Section, FBAR was the primary mechanism by which the IRS tracked offshore accounts.[38]

Compliance with FBAR reporting requirements was low, with the IRS estimating a compliance rate of less than 20% in 2002.[39] The Treasury Department, in its report to Congress, acknowledged that the FBAR rules, by obligating individual taxpayers rather than third parties, hindered efforts at compliance.[40] In an effort to spur self-reporting, Congress in 2004 increased penalties for noncompliance to include both harsher penalties for willful noncompliance and, for the first time, penalties for negligent violations.[41] In addition to increased penalties for FBAR noncompliance, the IRS also instituted various voluntary disclosure programs in which taxpayers could voluntarily report previously undisclosed assets, income, and other

37. FIN. CRIMES ENF'T NETWORK, BSA ELECTRONIC FILING REQUIREMENTS FOR REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (FINCEN FORM 114) 4 (2017). The term "United States person" includes U.S. citizens; U.S. residents; entities, including but not limited to, corporations, partnerships, or limited liability companies, created or organized in the United States or under the laws of the United States; and trusts or estates formed under the laws of the United States. *Id.* at 5.

38. Melissa A. Dizdarevic, *The FATCA Provisions of the Hire Act: Boldly Going Where No Withholding Has Gone Before*, 79 FORDHAM L. REV. 2967, 2977 (2011).

39. U.S. DEP'T OF THE TREAS., REPORT TO CONGRESS IN ACCORDANCE WITH 361(B) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001 at 6 (2005) [hereinafter TREASURY FBAR REPORT]. The IRS reported that up to one million taxpayers may have been required to file an FBAR. *Id.*; TAXPAYER ADVOC. SERV., *supra* note 33, at 332.

40. TREASURY FBAR REPORT, *supra* note 39, at 10 ("Unlike other reports filed under the BSA, such as Currency Transaction Reports or Suspicious Activity Reports, FBARs do not rely on reporting by third parties.").

41. TAXPAYER ADVOC. SERV., *supra* note 33 at 333; 31 U.S.C. § 5321(a)(5) (2012) (setting forth penalties for FBAR violations). For willful FBAR violations, the penalty is the greater of $100,000 or half of the balance of the unreported account. 31 U.S.C. § 5321(a)(5). For a one-off negligent violation, the IRS may impose a penalty of not more than $500, but a pattern of negligent violations could result in a penalty of $50,000. *Id.*; *see also* Stephan Michael Brown, *One-Size-Fits-Small: A Look at the History of the FBAR Requirement, the Offshore Voluntary Disclosure Programs, and Suggestions for Increased Participation and Future Compliance*, 18 CHAP. L. REV. 243, 243 (2014) ("In response [to FBAR noncompliance], the government has drastically increased the penalties for noncompliance.").

noncompliance in exchange for a recommendation against criminal prosecution.[42]

Prior to the IRS taking over enforcement duties from the Financial Crimes Enforcement Network, a bureau of the Treasury Department, FBAR compliance was notoriously low.[43] With the increased penalties for FBAR noncompliance, FBAR filings increased somewhat from 2003, when they numbered approximately 205,000, to 2008, when FBAR filings were approximately 350,000.[44] But even with this uptick in filings, the FBAR program was still viewed as notoriously noncompliant.[45] In 2011 and 2012, however, FBAR filings and, presumably, compliance increased significantly, with filings numbering 741,000 and 807,000, respectively.[46] A key reason for this sudden increase in FBAR filings was the 2010 passage of the FATCA, which pressures overseas centralized intermediaries into providing information to the IRS.[47]

2. *The Foreign Account Tax Compliance Act*

In the wake of a well-publicized tax evasion case involving UBS, a Swiss bank, and approximately 50,000 of their U.S. clients, Congress began drafting legislation to combat the use of foreign accounts by

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42. *See* Paul Marcotte, *IRS Winning Game of Offshore Hide and Seek Update on FBARs*, MD. BAR J. 5, 7 (2013) (describing Overseas Voluntary Disclosure Initiative programs); Leandra Lederman, *The Use of Voluntary Disclosure Initiatives in the Battle Against Offshore Tax Evasion*, 57 VILL. L. REV. 499, 514–17 (2012) [hereinafter Lederman, *Voluntary Disclosure Initiatives*] (detailing the Offshore Voluntary Disclosure Initiatives in 2009 and 2011).

43. TAXPAYER ADVOC. SERV., 2011 ANNUAL REPORT TO CONGRESS 208 (2011) ("Before [the IRS took over enforcement], the FBAR filing requirements were not well known, noncompliance was the norm, and the requirements were rarely enforced.").

44. TREASURY FBAR REPORT, *supra* note 39, at 11 (listing 204,689 FBAR filers for 2003); TAXPAYER ADVOC. SERV., 2012 ANNUAL REPORT TO CONGRESS 142 (listing 349,667 FBAR filers for 2012).

45. Ruth Mason, *Citizenship Taxation*, 89 S. CAL. L. REV. 169, 219 (2016) ("FBAR compliance is notoriously low, perhaps because the United States does little outreach to inform taxpayers of their FBAR obligations.").

46. TAXPAYER ADVOC. SERV., *supra* note 44, at 134 (listing 741,249 FBAR filers for 2011); TAXPAYER ADVOC. SERV., 2013 ANNUAL REPORT TO CONGRESS 229 (2013) (listing 807,040 FBAR filers for 2012).

47. Though FATCA was enacted in 2010, the obligations it imposed were phased in over a number of years. *See* I.R.S. Announcement 2012–42, 2012–47 I.R.B. 561 (IRS announcement setting forth FATCA timeline).

U.S. taxpayers to avoid paying U.S. income tax.[48] Although the FBAR obligations of the Bank Secrecy Act were intended to protect against this very form of tax evasion, that legislation was seen as inadequate in effectively ensuring foreign tax compliance.[49] As stated by Stephen Shay in 2009, then-Deputy Assistant Secretary for International Tax Affairs, to the House Ways and Means Committee:

> [W]hen accounts are hidden offshore, it is difficult to identify taxpayers who are supposed to file the . . . FBAR but do not. In addition, even when the IRS has evidence that a taxpayer has a foreign account, it may be difficult, time-consuming, and costly for the IRS to prove that the account has a large enough balance to require the FBAR to be filed and to assess applicable penalties.[50]

FBAR reporting did not ensure accurate reporting of accounts held overseas, thus necessitating FATCA's enactment.[51]

FATCA, enacted in 2010,[52] primarily imposes reporting obligations on foreign financial institutions.[53] Though FATCA creates some additional reporting obligations for individuals,[54] the

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48. Peter Nelson, *Conflicts of Interest: Resolving Legal Barriers to the Implementation of the Foreign Account Tax Compliance Act*, 32 VA. TAX REV. 387, 390 (2012).

49. *Foreign Bank Account Reporting and Tax Compliance: Hearing on H.R. 3933 and S. 1934 Before the H. Comm. on Ways & Means*, 111th Cong. 16 (2009).

50. *Id.* at 10–11.

51. *Id.* at 16.

52. FATCA was enacted as part of the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §§ 501–562, 124 Stat. 71, 97-118 (2010) (codified in various sections of the Internal Revenue Code); 157 CONG. REC. S4518-19 (2011) ("FATCA [is] a tough new law designed to flush out hidden offshore bank accounts.").

53. *Hearing on H.R. 3933 and S. 1934*, *supra* note 49 ("This bill creates a new reporting regime for foreign financial institutions . . . who will bear the brunt of this new disclosure.").

54. *Id.* at 16 ("[FATCA] is tailored for both individual and corporate taxpayers."). Individual taxpayers are required to report, directly to the IRS, an information statement concerning assets they hold overseas. *Id.* at 3. FATCA requires taxpayers having any interest in a specified foreign financial asset with an aggregate value greater than $50,000 to submit Form 8938 to the IRS as part of the taxpayer's return. Treas. Reg. § 1.6038D-2 (2015). Forms 114 and 8938 differ in who must file; inclusion of U.S. territories in the definition of "United States"; threshold value reported; when a taxpayer has an interest in the relevant interest; what is reported; asset valuation; filing date deadline; where to file; penalties; and which foreign assets are reportable. *Comparison of Form 8938 and FBAR*

bulk of its requirements burden overseas institutions holding accounts of U.S. persons.[55] FATCA requires foreign financial institutions to enter into agreements with the IRS to provide information on the accounts of the foreign financial institutions' U.S. account holders.[56] Any foreign financial institution[57] that does not meet FATCA's reporting requirements is subjected to a 30% withholding tax on payments from U.S. sources paid to non-U.S. persons.[58] Prior to FATCA, these U.S. source payments to non-U.S. persons were generally exempt from withholding tax.[59] This additional withholding tax creates a strong incentive for foreign

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Requirements, IRS, https://www.irs.gov/businesses/comparison-of-form-8938-and-fbar-requirements (last updated Sept. 5, 2017). This obligation, Form 8938, is distinct from and in addition to the FBAR's Form 114, which must be filed with the Financial Crimes Enforcement Network. Lederman, *Voluntary Disclosure Initiatives*, *supra* note 42, at 512 ("This requirement may overlap with the FBAR, but it has a higher reporting threshold and includes non-cash assets."); *see generally* I.R.S. News Release IR-2016-42 (Mar. 15, 2016), https://www.irs.gov/uac/newsroom/foreign-account-filings-top-1-million-taxpayers-need-to-know-their-filing-requirements (describing some of the intricacies of Form 114 and Form 8938).

55. *Hearing on H.R. 3933 and S. 1934*, *supra* note 49.

56. Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 1471(b), 124 Stat. 71, 97 (2010). Nonfinancial foreign entities are also required to submit information proving they do not have any substantial U.S. owners. *Id.* § 1472(b).

57. A financial institution is defined as any entity that:

> (i) Accepts deposits in the ordinary course of a banking or similar business . . . (ii) Holds, as a substantial portion of its business . . . financial assets for the benefit of one or more other persons . . . (iii) Is an investment entity . . . (iv) Is an insurance company or a holding company . . . that is a member of an expanded affiliated group that includes an insurance company, and the insurance company or holding company issues, or is obligated to make payments with respect to, a cash value insurance or annuity contract . . . (v) Is an entity that is a holding company or treasury center . . . that— (A) Is part of an expanded affiliated group that includes a depository institution, custodial institution, specified insurance company, or investment entity . . . or (B) Is formed in connection with or availed of by a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.

Treas. Reg. § 1.1471-5(e)(1) (2013).

58. Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 1471(b), 124 Stat. 71, 97 (2010). These U.S. source payments include payments of interest, dividends, royalties, and the proceeds of sales of items producing interest or dividends from U.S. sources. Treas. Reg. § 1.1471-1(b)(113)-3406(b)(3) (2013).

59. *See generally* I.R.C. § 871 (2010) (tax on nonresident alien individuals) and I.R.C. § 881 (1993) (tax on income of foreign corporations not connected with United States business).

financial institutions to supply the information the IRS requests or rid themselves of U.S. account holders.[60] The desired result of FATCA is for the IRS to learn about foreign assets held overseas in order to ensure compliance with all taxes that might be owed from owning these foreign assets.[61]

In order to standardize FATCA reporting between the IRS and the relevant foreign entities, the Department of the Treasury has negotiated intergovernmental agreements with several foreign countries.[62] An intergovernmental agreement provides for the reporting of relevant financial account information (that of U.S. account holders) to the tax authorities in that country.[63] This permits foreign financial institutions to tell their own governments about U.S.-owned accounts, and the foreign governments then give the information to the IRS.[64] The U.S. has been extremely successful in reaching international cooperation with regard to FATCA; as of this writing, there are 113 countries that have intergovernmental agreements with the U.S.[65]

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60. Hiring Incentives to Restore Employment Act, Pub. L. 111-147, § 1471(b)(1)(F)(ii), 124 Stat. 97 (2010). Corporate affiliation rules prevent simply cabining all U.S. account holders into a related corporate entity. *Id.* § 1471(e).

61. *See Hearing on H.R. 3933 and S. 1934*, *supra* note 49 ("[The FATCA] gives the Treasury Department the necessary tools it needs to get tough with those Americans hiding their assets overseas.").

62. Press Release, U.S. Dep't of the Treasury, U.S. Engaging with More than 50 Jurisdictions to Curtail Offshore Tax Evasion (Nov. 8, 2012), https://www.treasury.gov/press-center/press-releases/Pages/tg1759.aspx.

63. Press Release, U.S. Dep't of the Treasury, Treasury Releases Model Intergovernmental Agreement for Implementing the Foreign Account Tax Compliance Act to Improve Offshore Tax Compliance and Reduce Burden (July 26, 2012), https://www.treasury.gov/press-center/press-releases/Pages/tg1653.aspx. Under the reciprocal form of the model intergovernmental agreement the U.S. agrees to "exchange information currently collected on accounts held in U.S. financial institutions by residents of partner countries," with the goal of achieving comparable levels of information exchange between the U.S. and the partner country. *Id.*

64. Allison Bennett, *IRS to Countries: Hurry up with FATCA Reporting Enforcement*, TAX MGMT. WKLY. REP. (Aug 8, 2016).

65. *Foreign Accountant Tax Compliance Act (FATCA)*, U.S. DEP'T OF TREASURY, https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx (last updated Sept. 15, 2017); *see also* N.Y. STATE BAR ASS'N, RESERVED PORTIONS OF THE FATCA FINAL REGULATIONS: FOREIGN PASSTHRU PAYMENTS WITHHOLDING, REP. NO. 1362 (Jan. 19, 2017) (questioning the need for FATCA withholding given IRS success in signing intergovernmental agreements).

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In transitioning from using FBAR to using FATCA to deter international tax evasion by U.S. persons, Congress and the IRS tacitly acknowledged that obligating centralized intermediaries was necessary to catalyze tax compliance.[66] Even after harsh penalties for FBAR violations were imposed in 2004, noncompliance remained rampant because obligating individuals—as opposed to large, centralized intermediaries—was simply not as effective.[67] Only after taxpayers were made aware that information on their foreign accounts would soon be reported did voluntary self-disclosures on these taxpayers' foreign assets begin to increase.[68] Without centralized intermediaries to obligate, information reporting and FATCA/FBAR reporting would not be effective, and tax compliance would suffer.

D. The Reliance on Centralized Institutions for Successful Information Reporting

To the extent that information reporting increases tax compliance, it does so by relying primarily on documentation submitted to the IRS by third-party intermediaries, rather than relying on documentation submitted by individuals. The statutory and regulatory framework for imposing information reporting obligations implicitly acknowledges that centralized institutions are easier to regulate than individuals.[69] In this context, the term "centralized" is used to refer to intermediaries that transact with large numbers of counterparties relative to the number of intermediaries with which these

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66. Letter from Stephen B. Land, Chair N.Y. State Bar Ass'n, to Mark Mazur, Assistant Secretary (Tax Policy), Dep't of the Treasury (Jan. 19, 2017), https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2017/Tax_Section_Letter_1362.html.

67. *See* Edward K. Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U. L. REV. 655, 666 (2006).

68. *See* I.R.S. News Release IR-2016-137 (Oct. 21, 2016).

69. TAXPAYER ADVOC. SERV., *supra* note 33, at 334 ("Civil penalties for failure to report foreign accounts on an FBAR can be disproportionate in comparison to the value of the unreported account and the amount of associated unreported income."); Cheng, *supra* note 67, at 666 ("Institutions, usually in the form of corporations, are easier to regulate because they are smaller in number, have known locations, and have significant economic incentives to comply with government mandates.").

counterparties are doing business.[70] A bank paying interest to its account holders is one such example. Even though the account holder might have accounts at multiple banks, the average number of account holders at a given bank is much larger than the average number of banks holding accounts for a given taxpayer.[71] The IRS can rely upon these centralized information reporters to actually give the information they are asked to provide. Penalties for failing to file information reports are easier to impose when there are fewer entities to regulate.[72] Additionally, these centralized information reporters are generally engaging in arms-length transactions with the taxpayers about whom they are submitting information reports.[73]

Current law imposes obligations on payors making payments in the course of their trade or business, and not on all payments generally.[74] This excludes payments made by consumers, even though these payments are often income to the payee and comprise a large part of total underreporting noncompliance.[75] Income from small businesses (nonfarm proprietor income), which is largely generated through consumer transactions, comprises 29% of the entire individual income tax underreporting gap.[76] This represents the largest share of all the line items the IRS assesses.[77] This is a consequence of larger, centralized payors being subject to the information reporting requirements with greater frequency than smaller, decentralized payors, such as individuals.[78] Small, cash-based businesses are difficult to tax.

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70. *See* Lederman, *Reducing Information Gaps*, *supra* note 29, at 1170.

71. *See generally id.*

72. The penalties for failing to correctly file an information return are determined on a per-return basis, subject to a penalty cap ranging from $500,000 to $3 million depending on the severity of the errors. *See generally* I.R.C. § 6721 (2012).

73. *See infra* notes 84–87 and accompanying text.

74. Treas. Reg. § 1.6041-3(a) (2013).

75. Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, TAX NOTES, *8 (2007) ("[C]onsumers are exempt from filing information returns.").

76. IRS, *supra* note 10, at 18.

77. *Id.* This income is misreported at a rate of 64%. *Id.*

78. *Id.* at 19.

The lack of information reporting associated with these underreported sources of income is not typically due to inadequate legislative and regulatory oversight.[79] In other words, the issue is that these underreporting taxpayers are obtaining their income from sources that are difficult to regulate, not that Congress does not want these payments reported.[80] Imposing an information reporting obligation on parties with no incentive to report would not only likely be ineffective, but would also highlight to the public the extent to which tax laws go unenforced. As such, the sources of income with little or no information reporting are generally also the sources of income for which information reporting is the most challenging to enforce.[81] By virtue of the information reporting obligations Congress and the IRS have set forth, they have implicitly acknowledged the difficulty of regulating entities other than large, centralized intermediaries, even though the bulk of underreporting noncompliance is attributable to these smaller payors.

Rental payments to property owners, for example, are underreported at a rate of 62%.[82] Although these rental payments are not covered by any existing information reporting requirement,[83] simply enacting a statute requiring renters to report amounts paid to their landlords would likely be ineffective. Without an additional incentive (either by carrot or by stick), any reporting requirement covering rental payments would be hard to enforce. Any such attempt at incentivizing could result in collusion between renter and landlord.[84] Contrast this to the relationship between a bank and a

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79. That being said, there are some areas where heightened reporting requirements could reduce the underreporting gap without a significant increase in administrative burdens. *See infra* note 196; *see generally* Jay A. Soled, *Homage to Information Returns*, 27 VA. TAX REV. 371 (2007).

80. Information reporting standards are often modified to capture income reporting where compliance is likely. For example, starting in 2011, brokers have been required to state a customer's adjusted basis for securities sold by the broker on the customer's behalf during the year. Treas. Reg. § 1.6045-1(v)(B)(d)(ii) (2013).

81. IRS, *supra* note 10, at 18.

82. *Id.* Underreporting for rents and royalties comprises about $20 billion, or 8%, of the total gross tax gap. *Id.*

83. Consumptive payments are not typically subjected to information reporting rules. *See infra* section II.D.

84. *See* Lederman, *Statutory Speed Bumps*, *supra* note 29 at 731–33.

typical interest-earning client, for example. Given the size of the bank relative to the client, there is little opportunity for negotiation to occur between bank and customer to avoid information reporting, even if such collusion would result in a mutually beneficial, tax-efficient outcome. This is true even in the absence of penalties which, for centralized intermediaries with many customers, could be harsh.[85]

Consider an effort to incentivize renters to report payments to landlords via a renter's credit.[86] The hypothetical legislation would give tenants a 1% credit for rent paid to a landlord and reported on an information return. Although such a measure would motivate renters to submit the required paperwork, a savvy landlord would simply reduce her tenant's rent by greater than one percent in exchange for the renter's nonfiling of the information return.[87] Given that the enforcement of information reporting is not an IRS priority,[88] such collusion could be rampant. As a result, obtaining proper reporting for rental income remains challenging. Any effective information reporting protocol depends, in large part, on centralized intermediaries providing the information returns to the IRS.

The heart of the statutory scheme governing information reporting on payments is § 6041, which requires:

> All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income . . . of $600 or more in any taxable year . . . shall render a true and accurate return . . . setting forth the amount of such gains,

85. *See supra* notes 71–73 and accompanying text.

86. *See* Kenya Covington & Rodney Harrell, *From Renting to Homeownership: Using Tax Incentives to Encourage Homeownership Among Renters*, 44 HARV. J. ON LEGIS. 97, 111 (2007); Anthony C. Infanti, *Tax Reform Discourse*, 32 VA. TAX REV. 205, 264 (2012).

87. This assumes the reported rent paid by the tenant would be taxable to the landlord at a rate greater than 1%.

88. Bankman, *supra* note 75, at *12–*13 ("Looking to see whether a taxpayer has met its reporting obligations is not an audit priority.").

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> profits, and income, and the name and address of the recipient of such payment.[89]

Section 6041 is a general provision; if a payment otherwise qualifies under § 6041 but is covered by another statute, the reporting requirements of the other statute take precedence.[90] For example, payments related to dividends and corporate earnings and profits, patronage dividends, trusts and annuity plans, payments of interest, and payments of royalties have different reporting requirements.[91] Various exceptions to this rule also apply, most notably for payments to corporations.[92]

1. *Payments of Compensation*

The lion's share of reported income, approximately 68%, is reported on Form W-2,[93] which lists wages paid and requires the withholding of taxes.[94] Large food and beverage establishments with employees receiving compensation primarily through tips must allocate to these employees 8% of the establishment's gross receipts, minus whatever the employee reports.[95] Other compensation not

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89. I.R.C. § 6041(a) (2012). If a payment qualifies under sections 6042 (dividends and corporate earnings and profits), 6044 (patronage dividends), 6047(e) (trusts and annuity plans), 6049(a) (payments of interest), or 6050N(a) (payments of royalties) the reporting rules of those sections apply. *See generally* IRS, U.S. DEP'T OF TREASURY, CAT. NO. 27976F, GENERAL INSTRUCTIONS FOR CERTAIN INFORMATIONAL RETURNS (2017), https://www.irs.gov/pub/irs-pdf/i1099gi.pdf [hereinafter GENERAL INSTRUCTIONS].

90. Treas. Reg. § 1.6041-3(a) (2013).

91. *See* I.R.C. § 6042 (2012) (dividends and corporate earnings and profits); I.R.C. § 6044 (2012) (patronage dividends); I.R.C. § 6047(e) (2012) (trusts and annuity plans); I.R.C. § 6049(a) (2012) (payments of interest); I.R.C. § 6050N(a) (2012) (payments of royalties); s*ee generally* GENERAL INSTRUCTIONS, *supra* note 89.

92. Treas. Reg. § 1.6041-3 (2013). Other exceptions to section 6041 include payments to (1) tax-exempt organizations; (2) governments; (3) real estate agents of rent; and (4) scholarship recipients of scholarships properly excluded under section 117. *Id.* This exception was eliminated in 2010 by section 6041(i), but section 6041(i) was subsequently repealed, leaving the exception in place. *Id.*

93. In 2010 the total amount of reported income was $8.208 trillion, of which $5.594 trillion was reported on Form W-2s. *See 2010 Estimated Data Line Counts Individual Income Tax Returns*, DEP'T OF THE TREASURY, IRS, at 14 (2010); INTERNAL REVENUE SERV., 2010 STATS. OF INCOME, *Table 5.A.3. Summary of Items for Taxpayers with Form W-2, by Return and Earner Type, Tax Year 2010*.

94. Treas. Reg. § 1.6041-2(a) (2017).

95. 23 U.S.C. § 6053(c)(3) (2014). Large food and beverage establishments are defined as a business

otherwise qualifying for Form W-2 reporting generally will qualify for Form 1099-MISC reporting, provided the amount is greater than $600.[96]

The average number of W-2 forms per individual is approximately 1.2,[97] but the average number of employees per employer is far higher.[98] A majority of Americans, approximately 51.6% in 2012, work for companies with over 500 employees, with only 17.6% of the American workforce working at companies with fewer than twenty employees.[99] The information reporting associated with compensation thus regulates primarily larger, more centralized institutions.

2. *Payments of Interest and Dividends*

Both interest and dividend payments greater than $10 are reported on Forms 1099-INT and 1099-DIV, respectively. Only "qualifying" interest is required to be reported.[100] Interest arising from obligations in registered form, the most common qualifying type, encompasses a broad range of debt instruments since registration is a prerequisite for the deduction of the interest paid.[101] Interest on the debt of individuals, among other types of interest, is exempt from this reporting requirement.[102] Interest payments constitute approximately

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that typically employs more than ten employees daily where tipping is customary. *Id.* at § 6053(c)(4).

96. I.R.C. § 6041(a) (2017).

97. The total number of W-2 forms distributed in 2015 was approximately 255 million. IRS, PUBLICATION 6961 (2016). These W-2s were received by individuals filing approximately 150 million returns. IRS, SOI TAX STATS tbl. 1.2, https://www.irs.gov/pub/irs-soi/15in12ms.xls. Of these 150 million returns, approximately 55 million were of couples filing jointly, so approximately 205 million individuals are represented by these 150 million returns. *Id.* This results in approximately 1.2 W-2 forms per individual (255,000,000 W-2 forms ÷ 205,000,000 individuals).

98. ANTHONY CARUSO, U.S. CENSUS BUREAU, G12-SUSB, STATISTICS OF U.S. BUSINESSES EMPLOYMENT AND PAYROLL SUMMARY: 2012 at 1 (2015), https://www.census.gov/content/dam/Census/library/publications/2015/econ/g12-susb.pdf.

99. *Id.* at 2.

100. I.R.C. § 6049(b) (2012). Qualifying categories include (1) obligations in registered form; (2) obligations of a type issued to the public; (3) bank deposits; and (4) deposits with brokers. *Id.*

101. I.R.C. § 163(f) (2012).

102. I.R.C. § 6049(b)(2)(A) (2012). Individuals are not, therefore, obligated to send information reports to banks to which they pay interest. *See id.*

1% of all reported income.[103] Dividend payments are also subject to the $10 threshold, with recipients receiving a Form 1099-DIV.[104] Information reporting on dividends is not required for certain recipients, including corporations, tax-exempt entities, and governments.[105] Although payments of interest and dividends made by foreign payors are includible in a U.S. taxpayer's income, foreign payors are not subject to the reporting obligations that obligate U.S. payors.[106] Under FATCA, however, the *assets* generating these interest and dividend payments are reportable.[107]

Interest and dividend payments are typically made by large entities, usually either financial institutions or publicly traded companies.[108] As is the case with payments of compensation, payors of interest and dividends are typically outnumbered by the customers they are serving.[109] The information reporting requirements applicable to these payments almost exclusively obligate large, centralized entities rather than small businesses or individuals.[110]

3. *Transactions Involving Brokers*

The Treasury has broad authority to regulate the information returns that brokers must submit. For this purpose, a "broker" is defined as any "person who (for consideration) regularly acts as a middleman with respect to property or services."[111] Brokers in securities, commodities, and certain financial instruments are the brokers for whom the treasury regulations specify the greatest detail

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103. In 2015, the estimated total amount of taxable interest reported was approximately $96 billion out of total income reported of $10.36 trillion. IRS, INDIVIDUAL INCOME TAX RETURNS LINE ITEM ESTIMATES, 2015, at 15 (2016) (line 8a).

104. I.R.C. § 6042(a)(1) (2012).

105. *Id.* § 6042(b)(2)(B).

106. *Id.*

107. *See infra* notes 128–133 and accompanying text. There is also an individual reporting obligation. *See supra* notes 46–59.

108. *See* IRS, U.S. DEP'T OF TREASURY, CAT. NO. 27978B, INSTRUCTIONS FOR FORM 1099-DIV (2016), www.irs.gov/ form1099div.

109. *Id.*

110. *Id.*

111. I.R.C. § 6045(a), (c) (2012).

of reporting obligations.[112] Brokers are required to report the gross proceeds from sales and the adjusted basis of securities sold by the broker on their customer's behalf during the year.[113]

Brokers are typically institutional third parties who have experience dealing with financial instruments.[114] Brokers typically serve many customers and therefore are centralized relative to their clients.[115] It is relatively straightforward to impose regulatory burdens on most brokers because they are often certified by another regulatory body, such as the Securities Exchange Commission (SEC).[116] Therefore, payors submitting 1099-Bs are almost always larger, centralized institutions and entities.

4. *Other Transactions Requiring Information Reporting*

The IRS requires information returns for many other situations in which a payor remits payment to a taxpayer.[117] Similar to the transactions described above, these payors are typically centralized entities where the number of payees is large relative to the number of payors.[118] In addition, these payee entities are, due to their size and

112. *See generally* Treas. Reg. § 1.6045-1 (2010).

113. I.R.C. § 6045(g). Only sales of a "covered security" are required to be reported. *Id.* Covered securities encompass a wide range of products, including corporate stock, commodity and derivatives contracts, and certain debt instruments. *See* I.R.C. § 6045.

114. I.R.C. § 6045(c)(1).

115. Over 1.8 billion 1099-Bs were submitted to the IRS in 2016. IRS, REV. 7-2016, PUBLICATION 6961 2017 UPDATE: CALENDAR YEAR PROJECTIONS OF INFORMATION AND WITHHOLDING DOCUMENTS FOR THE UNITED STATES AND IRS CAMPUSES 4 (2017).

116. *See generally* Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963, 964 (2012). Individuals trading in securities often obtain Series 7 certification, for example. The Series 7 exam is administered by the Financial Industry Regulatory Authority (FINRA). *Id.* FINRA is, in turn, regulated by the SEC. *Id.*

117. *See* I.R.C. §§ 6039, 6039D–F, 6039I, 6043, 6043A, 6044, 6047, 6050E–F, 6050H–Q, 6050S–T, 6050W (2012). These include but are not limited to certain options transactions; certain fringe benefits plans; large gifts from foreign persons; employer-owned life insurance contracts; liquidating transactions of corporations; taxable mergers and acquisitions; payments of patronage dividends; certain trusts and annuity plans; state and local income tax refunds; social security benefits; mortgage interest received; cash received in a trade or business; foreclosures and abandonments of security; exchanges of certain partnership interests; certain donated property; contracts from Federal executive agencies; payments of royalties; cancellation of indebtedness; long-term care benefits; higher education costs; health insurance costs; payments made in settlement of payment card and third party network transactions. *See id.*

118. *See* Lederman, *Reducing Information Gaps*, *supra* note 29, at 1170.

financial significance, easier to regulate.[119] It is difficult, for example, for a state government issuing tax refunds (which are included in recipients' federal gross income) to escape the regulatory reach of the IRS.[120] The vast majority of the miscellaneous reporting rules apply to financial institutions, corporations engaging in reorganization, and governmental branches—all entities with relatively high levels of sophistication and regulatory oversight.[121]

Section 6050W of the Internal Revenue Code obligates certain intermediaries making payments on behalf of other parties to submit information reports on Form 1099-K to the payees only if the total number of transactions to a given payee is greater than 200 *and* the total dollar amount of all transactions exceeds $20,000.[122] Many companies involved in the sharing economy characterize their relationship to payees as one falling under this more relaxed reporting requirement.[123] Since the payors often do not reach these threshold requirements, the corresponding payees often receive no information report from the payor.

5. *FATCA Reporting of Foreign Assets*

FATCA-mandated reporting concerns assets held overseas rather than payments made between parties.[124] In order to avoid the 30% withholding tax, a foreign financial institution must provide the following information for each U.S. account it maintains: (1) the identifying information on the account, including the taxpayer

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119. Cheng, *supra* note 67, at 666 ("Institutions, usually in the form of corporations, are easier to regulate because they are smaller in number, have known locations, and have significant economic incentives to comply with government mandates.").

120. A state government whose income tax refund was not included in the taxpayer's federal gross income would be incentivized to over-withhold due to the time value of money. Taxpayers deducting the overpayment of state income taxes in the previous year would also prefer this result, assuming that the value of the deduction is worth more than the loss in time value of money from the over-withholding.

121. *See supra* note 117 and accompanying text.

122. I.R.C. § 6050W. The intermediaries required to submit these Form 1099-Ks are known as "third party settlement organizations." *Id.* These organizations are a subset of the category of intermediaries known as "payment settlement entities." *Id.*

123. Shu-Yi Oei & Diane M. Ring, *Can Sharing Be Taxed?*, 93 WASH. U. L. REV. 989, 1034 (2016).

124. I.R.C. § 1471(c)(1) (2012).

identification number(s);[125] (2) the account number and the account's balance or value;[126] and (3) a transaction history of the account.[127] The foreign financial institutions submitting this information will almost always be larger depository institutions that hold accounts not just for U.S. persons but also likely for local clients.[128] The institutions submitting FATCA information will thus almost always be centralized intermediaries.

This is especially true for countries with which the Treasury has signed an intergovernmental agreement. For these jurisdictions, the foreign financial institutions will first report the relevant FATCA information to their local tax authorities.[129] Then, pursuant to an existing tax treaty or agreement, tax authorities in the foreign country will automatically exchange the information with the IRS.[130] The intergovernmental agreement effectively makes the tax authority of the foreign country itself the reporting entity.[131] Such an obligation unequivocally puts the burden of compliance on a centralized intermediary, namely, the government of a foreign country.

6. *Consumer Transactions*

Notably absent from information reporting requirements are consumer transactions, which involve amounts paid in furtherance of personal consumption, rather than a trade or business.[132] Even though these transactions represent a large percentage of the total amount of the underreporting tax gap, any statutory scheme for reporting these payments would generally obligate individuals rather than

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125. I.R.C. § 1471(c)(1)(A).
126. I.R.C. § 1471(c)(1)(B)-(C).
127. I.R.C. § 1471(c)(1)(D).
128. Treas. Reg. § 1.1471-5(e)(2) (2013). The definition of a foreign financial institution is extremely broad and includes any institution that accepts deposits in the ordinary course of a banking or similar business or holds, as a substantial portion of its business, financial assets for the benefit of one or more other persons. *Id.*
129. Press Release, U.S. Dep't of the Treasury, *supra* note 63.
130. *Id.*
131. *Id.*
132. IRS, *supra* note 10, at 10.

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institutions.[133] Although such a reporting scheme would, if adhered to, greatly improve tax compliance, imposing reporting obligations on individual consumers has not been seriously contemplated.[134] Even if some financial incentive existed for the payor in a consumer transaction to report the payment, the potential relationship between the parties could still easily result in a lack of reporting. Even between parties with no previous relationship, a negotiated, mutually tax-beneficial payment structure is not uncommon.[135] Given that enforcement of information reporting for consumer transactions is administratively problematic and not a priority for the IRS,[136] Congress has implicitly conceded that the most effective information reporting regimes are those that obligate large, centralized payors.[137] These reporters are both easily scrutinized and have a business infrastructure that facilitates the reporting.[138]

In short, the bulk of the U.S. federal tax gap (both domestically and internationally) is due to underreporting. Information reports submitted on a given source of income or for other items (such as overseas assets) that permit the IRS to determine which taxpayers are evading taxes significantly reduce the likelihood of income underreporting. However, current law governing the submission of information reports implicitly acknowledges that centralized intermediaries can most easily file the required information, despite the fact that smaller, less centralized payors are the largest contributors to the tax gap.

133. Another approach to incentivizing the reporting of these payments is to provide something of value to the consumer in exchange for reporting the transactions. *See* Lederman, *Reducing the Tax Gap*, *supra* note 29, at 1753 ("A creative alternative used in some countries is to have consumers' receipts double as lottery tickets.").

134. *See* H.R. REP. NO. 112-15, at 4 (2011) ("[T]he Committee is concerned that the expansion of the information reporting requirements imposes a substantial tax compliance burden on small businesses.").

135. *See, e.g.*, Ron Lieber, *Doing the Right Thing by Paying the Nanny Tax*, N.Y. TIMES, (Jan. 23, 2009), http://www.nytimes.com/2009/01/24/your-money/taxes/24money.html?mcubz=3.

136. Bankman, *supra* note 88 and accompanying text.

137. *See* Lederman, *Reducing Information Gaps*, *supra* note 29, at 1737–42.

138. *Id.* at 1740.

E. The Role of Centralized Intermediaries in Effective Information Reporting

The preceding Section showed that the statutory and regulatory framework of information reporting, both domestically and internationally, relies heavily on centralized, third-party intermediaries to provide information reports to the IRS. Once the IRS has the information contained within the information reports, it has a straightforward mechanism to quickly determine noncompliance and assess deficiencies.[139] For income items subject to substantial reporting requirements, not only does the IRS have the information previously known only to the reporting intermediary and the taxpayer, but the taxpayer also knows that the IRS now has this information, thus increasing the likelihood of taxpayer compliance from the outset.[140]

But simply enacting statutes to address the payments that currently go unreported will not solve the issue of underreporting. Congress could enact statutes and the IRS could promulgate regulations requiring the payors contributing the most to the tax gap to report their payments, but such statutes and regulations would largely be toothless.[141] In general, these intermediaries report their payments of income because the benefit to them—either in the form of minimizing risk from penalties or obtaining a tax benefit from their

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139. *Data Book 2015*, INTERNAL REVENUE SERV. DATA BOOK, Oct. 1, 2014–Sept. 30, 2015, at 38 (IRS, Wash. D.C.), https://www.irs.gov/pub/irs-soi/15databk.pdf. The IRS' first pass at enforcement is of minimal cost and done via its Automated Underreporter and Automated Substitute for Returns programs, systems through which third-party information returns are used to automatically identify unreported income and calculate tax return delinquencies. *See also* IRS, INTERNAL REVENUE MANUALS, § 4.19.2.1 (2016) (describing procedure by which Automated Underreporter cases are processed); I.R.S. Gen. Couns. Mem. 200211040 (Jan. 30, 2002).

140. *See* Lederman, *Reducing Information Gaps*, *supra* note 29, at 1738–39 ("What likely makes information reporting so successful in spurring compliance in the first instance is that, like 'red light cameras' that snap pictures of vehicles failing to stop for a red light, the taxpayer is aware that the government is watching.")

141. Even extremely punitive penalties might not be sufficient to compel compliance if the perceived risk is low. The penalties associated with FBAR noncompliance were severe, but did not alter the perception that FBAR did little, even with the additional penalties, to promote tax compliance. *See supra* notes 41–42 and accompanying text. In addition, extremely punitive penalties in the tax content can be politically challenging to enact.

own recordkeeping—outweighs the costs of submitting returns.[142] As described below, there are criteria by which to evaluate the success of proposed information reporting schemes. These criteria all favor, either implicitly or explicitly, information reporting protocols that obligate large, centralized third-party intermediaries over payors that are more diffuse and distributed.

Not all information reporters are created equal. Leandra Lederman has identified six factors to assess the success of information reporting protocols.[143] Though not exhaustive, these criteria provide a framework to evaluate any information reporting scheme.[144] The factors include the extent to which (1) the reporting intermediary and the taxpayer are engaging in arm's length transactions; (2) a reporting intermediary has a bookkeeping infrastructure in place; (3) information reporting is concentrated; (4) the information reports filed by the intermediary constitute complete reporting; (5) the taxpayer has few alternatives other than to use the reporting intermediary; and (6) the stakes of noncompliance are significant.[145] Assuming the stakes of noncompliance are significant, all other factors, either directly or implicitly, favor using large (relative to the taxpayer), centralized third-party intermediaries as information reporters.[146]

1. Arms-Length Transactions

An arm's-length transaction is one where each of the parties acts independently to further its own economic interests.[147] A party to a transaction not acting at arm's length will potentially take into account the counterparty's economic interests, even if such action

142. Lederman, *Reducing Information Gaps*, *supra* note 29, at 1737.
143. *Id.* at 1739–40.
144. *Id.* at 1739.
145. *Id.* at 1739–41.
146. *See id.* at 1753–54.
147. *See* Treas. Reg. § 1.482-1(b)(1) (2009); Kevin K. Leung, *Taxing Global Trading: An Appropriate Testing Ground for Formula Apportionment?*, 1 MINN. J. GLOBAL TRADE 201, 203–04 (1992).

does not result in its own economic gain.[148] An uncle might not, for example, submit a required Form 1099 for his payee niece. If her tax savings have some value to him, his risk of audit may be worth her tax savings. In contrast, large, centralized intermediaries are less likely to accept risk and share in the tax savings of their payees.[149] This is especially true for publicly traded companies whose corporate actions are subject to disclosure rules and heightened public scrutiny.[150] The consequences of engaging in transactions that are not arms-length are higher for larger institutions; as a result, large third-party intermediaries are less likely to engage in transactions that are not arm's-length.[151]

2. *Bookkeeping Infrastructure*

A reporting intermediary with a bookkeeping infrastructure in place can more easily track accounts payable, and can therefore more easily track payments with reporting obligations.[152] With an extant bookkeeping infrastructure, the costs of reporting compliance necessarily decrease, making reporting less burdensome.[153] The larger the reporting intermediary, the more likely the intermediary has such a cost-saving bookkeeping infrastructure in place.[154] As the size of an intermediary increases, the costs associated with bookkeeping generally represent a decreasing proportion of an entity's overall expenses.[155] The marginal cost for a large intermediary to produce each additional information return is likely negligible.[156]

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148. Lederman, *Reducing Information Gaps*, *supra* note 29, at 1739.
149. *Id.* at n.25.
150. Lederman, *Statutory Speed Bumps*, *supra* note 29, at 730–31.
151. *See* Lederman, *Reducing Information Gaps*, *supra* note 29, at 1743.
152. *Id.* at 1740.
153. *See id.* at 1739 n.26.
154. *See id.* at 1740.
155. Soled, *supra* note 79, at 376 ("[T]he information return issuer so regularly and frequently encounters a particular situation that, unlike the individual taxpayer, it develops a unique expertise to distill and disseminate this information.").
156. *Id.* at 393.

3. *Concentration of Information Reporting*[157]

When reporting obligations are concentrated amongst fewer payors (relative to the payees), information reporting is more effective. Large, centralized intermediaries typically outnumber the taxpayers about whom information returns are filed.[158] These third parties are repeat players in the areas in which they do business, either as employers (with respect to wage reporting) or as payors for goods and or services.[159] Although it is mathematically possible for the number of income payors to exceed the number of payees within a given industry, such a result is highly unlikely.[160] Any large intermediary responsible for filing information returns will likely submit returns for a significant number of taxpayers.

4. *Complete Reporting*

Information reporting is most effective when the amounts submitted by the reporter permit the IRS to determine what amount should be included in the taxpayer's gross income.[161] For example, information reporting on interest paid is more complete than reporting only the gross proceeds (and not also the basis) from the sale of an asset.[162] The larger the reporting intermediary, the more likely the intermediary has access to the information needed to submit a complete information report.[163] For example, a large, established securities broker will likely be involved in both the purchase and sale of the transacted security, permitting the broker to completely report on the transaction.

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157. Professor Lederman describes this factor as "centralization"; however, to avoid conflating her definition with how the term "centralized" is used elsewhere in this Article, I have described this factor as "concentration of information reporting." Lederman, *Reducing Information Gaps*, *supra* note 29, at 1740 ("Information reporting is more efficient when required of parties who are fewer in number than the recipients of the reports.").

158. *Id.* at 1740 n.27.

159. *See id.* at 1737–38.

160. *Id.* at 1740 ("[B]usinesses tend to be fewer in number than their customers or employees.").

161. *See id.*

162. *See id.* at 1738.

163. Lederman, *Reducing Information Gaps*, *supra* note 29, at 1740.

Another element of complete reporting relates to the degree to which the reporter-submitted information corresponds to a line item that can be easily checked against the payee's return. As an intermediary who is required to submit information returns grows in size, it will submit an increasing number of information returns and an increasing amount of income in total. If some triggering criterion—be it an actual bright-line trigger or simply a punitive enforcement trigger (like an audit)—exists to obligate the intermediary to report, this triggering criterion is more frequently implicated if the intermediary is a larger institution.[164] As such, the larger the intermediaries doing the reporting, the greater the likelihood that the amounts being reported represent a complete account of the amounts to be reported by the taxpayers.[165] For example, an employer with a single employee might pay this single employee off the books. But as the employer grows in size, the risk associated with noncompliance increases, and the employer is incentivized to properly report its employee's wages.

5. *Few Alternative Arrangements*

Information reporting will be less effective if the taxpayer can easily avoid it by engaging in an alternative, equivalent transaction not subject to information reporting.[166] Taxpayers would enjoy having the option, rather than the obligation, to report income. That is, all things being equal, taxpayers would prefer an identical relationship without the intermediary filing the required information returns.[167] But due to barriers to market entry, taxpayers receiving payments from large, centralized intermediaries often have few alternative options that are not also large and centralized.[168] Financial institutions, for example, are regulated in areas such as capital and

164. *Id.* at 1738 n.18.
165. *Id.* at 1740.
166. *See id.*
167. James Alm, *A Perspective on the Experimental Analysis of Taxpayer Reporting*, 66 ACCT. REV. 577, 577–78 (1991).
168. Lederman, *Reducing Information Gaps*, *supra* note 29, at 1756.

reserve requirements, corporate governance, and licensing standards to reduce systemic risk.[169] With regard to gambling, a "mom and pop" betting parlor might offer a more favorable point spread than a casino, but the required licensing restricts their ability to find customers.[170]

Additionally, taxpayers choose to use centralized intermediaries because the transaction costs with the centralized intermediary can be lower than those with a decentralized intermediary.[171] Large, centralized intermediaries are providing a value to the taxpayers to whom they make payments and on whom they are reporting.[172] Again, without this value, all things being equal, taxpayers would generally prefer an identical relationship without the intermediary filing the required information returns. But any large, centralized intermediary, by virtue of the stakes at risk for failure to comply with the law, will be motivated to file information returns appropriately.[173] For example, the market for paying workers off-the-books is not strong enough to incentivize most W-2 recipients to seek under-the-table employment from their large employers who employ dozens of others.[174] Even outside the wage context, the advantages of transacting with large, centralized intermediaries often outweigh the costs associated with receiving an information return and paying taxes on the reported income.[175] For example, although an unregulated individual or entity might pay a taxpayer at higher interest rates, the decreased risk associated with using a large bank does not preclude depositing money with a large depositary financial

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169. Kristin Johnson, Steven Ramirez & Cary Martin Shelby, *Diversifying to Mitigate Risk: Can Dodd-Frank Section 342 Help Stabilize the Financial Sector?*, 73 WASH. & LEE L. REV. 1795, 1798 (2016).

170. *See generally* NEV. REV. STAT. ANN. § 463.160 (West 2013) (discussing licenses required for Nevada sports books).

171. Lederman, *Reducing Information Gaps*, *supra* note 29, at 1753–54.

172. *Id.*

173. Alm, *supra* note 167, at 577.

174. *See* Bankman, *supra* note 75, at 13.

175. *See, e.g.*, S. POVERTY LAW CTR., UNDER SIEGE: LIFE FOR LOW-INCOME LATINOS IN THE SOUTH 25 (2009) (undocumented immigrants getting paid in cash are vulnerable to robbery); Liz Robbins, *New Weapon in Day Laborer's Fight Against Wage Theft: A Smartphone App*, N.Y. TIMES (Mar. 2, 2006) (describing wage theft for day laborers).

institution. Large, centralized intermediaries can provide value in the form of risk mitigation, services, rates of return, et cetera, that smaller intermediaries lack the economy of scale to deliver.[176] The value provided to payees doing business with large, centralized intermediaries compensates for any tax savings a payee might obtain by transacting with a smaller, non-reporting intermediary.

Current law implicitly acknowledges that the only practical information reporting protocols are those that obligate centralized intermediaries.[177] Scholarship on the factors by which information reporting protocols should be assessed confirms that a successful information reporting scheme is one in which centralized intermediaries are responsible for submitting information reports.[178] Our current law relies on centralized intermediaries, and the factors described above show that this reliance is well-placed. But how should an information reporting scheme operate when there is a paucity of centralized intermediaries to obligate?

II. Ensuring Tax Compliance in a Decentralizing Economy

In a decentralizing economy, transactions occur without the need for the centralized intermediaries that currently provide the information reporting integral to enforcing tax compliance.[179] What approaches can Congress and the IRS take to ensure this income is appropriately taxed?

To the extent that information reporting protocols do not accurately capture income, these standards should be modified.[180] Changes to these standards have the potential to change compliance costs, but the prevalence of electronic accounting would likely make these increased compliance costs relatively minor.[181]

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176. *See* THE CLEARING HOUSE, UNDERSTANDING THE ECONOMICS OF LARGE BANKS 13–16 (2011).

177. *See* Cheng, *supra* note 67, at 666.

178. Lederman*, Reducing Information Gaps*, *supra* note 29, at 1739–41.

179. *See* Oei & Ring, *supra* note 123, at 990–92 (discussing the regulatory challenges emerging as a result of "peer-to-peer consumption").

180. *See infra* notes 198–209 and accompanying text.

181. Oei & Ring, *supra* note 123, at 1012–13.

The IRS could also work in conjunction with state and local governments to share information that has direct relevance to federal tax enforcement efforts. For example, San Francisco law requires Airbnb hosts to report reservation information to city authorities.[182] Knowing the IRS has this information could motivate these taxpayers to report this income.

The following Section describes two technological shifts that have the potential to decentralize the economy, and the responses Congress and the IRS could take to ensure that income from these transactions is appropriately taxed.

A. Technological Shifts Toward Economic Decentralization

New technologies have altered the paradigm by which suppliers of labor and owners of capital bring their services and goods to the marketplace. This Section focuses on two increasingly relevant technological developments that shift payments from traditional, centralized intermediaries to alternative payors outside the current regulatory ambit of the IRS: (1) the sharing economy and (2) the blockchain—a secure, distributed method of recordkeeping.

1. The Sharing Economy and Tax Compliance

The sharing economy, also known as the "on-demand platform" or "gig" economy, is a broad term used to describe a system in which underutilized assets or labor supplies are matched with a consumer.[183] The provider-consumer matching is done via a third party that typically takes a small percentage of the sale price as a fee

182. *See* S.F. OFF. OF SHORT-TERM RENTALS, https://shorttermrentals.sfgov.org/ (last visited Aug. 31, 2017) (describing reporting obligations of Airbnb hosts).

183. Oei & Ring, *supra* note 123, at 990–91; Rashmi Dyal-Chand, *Regulating Sharing: The Sharing Economy As an Alternative Capitalist System*, 90 TUL. L. REV. 241, 253–54 (2015); *The Rise of the Sharing Economy,* ECONOMIST (Mar. 9, 2013), https://www.economist.com/news/leaders/21573104-internet-everything-hire-rise-sharing-economy; Sarah Jaffe, *Silicon Valley's Gig Economy Is Not the Future of Work—It's Driving Down Wages*, GUARDIAN (July 23, 2013, 6:45 AM), https://www.theguardian.com/commentisfree/2014/jul/23/gig-economy-silicon-valley-taskrabbit-workers.

for coordinating the transaction.[184] The provider of the assets or labor is typically (though not always) a limited participant in the market, with the third-party company seldom using its own employees to engage directly with customers.[185] Commonly available goods and services of the sharing economy include ride-sharing (Uber and Lyft), accommodations (Airbnb), delivery services (Instacart, Postmates, and Seamless), and the provision of miscellaneous services (TaskRabbit).[186]

There is evidence that workers are increasingly using the on-demand economy to supplement traditional methods of earning wages[187] while also shifting transactions away from more traditional businesses.[188] It is estimated that the number of Americans working in the sharing economy will double to more than 6.4 million by 2020.[189] Individuals working on the labor side of the on-demand economy do not typically use these earnings as their primary source of income, but rather as a supplement to other sources of pay.[190] A typical monthly income in the on-demand economy represents approximately 20% to 30% of total income, or about $300 to $500 in absolute terms.[191]

184. Oei & Ring, *supra* note 123, at 997–98. Airbnb, a company connecting hosts with available housing with guests in search of housing, charges hosts 3% of the reservation fee and charges guests between 6% to 12%. *What Are Airbnb Service Fees?*, AIRBNB, https://www.airbnb.com/help/article/104/what-are-guest-service-fees (last visited Aug. 31, 2017).

185. *See* BRUCKNER, *supra* note 6, at 8. Many sharing companies classify their workers as independent contractors. *See id.* at 9.

186. *Id.* at 1. This list is by no means exhaustive. There are dozens of other companies that could conceivably be categorized as participating in the sharing economy. *Id.*

187. *Id.* at 2.

188. Georgios Zervas, Davide Proserpio, & John W. Byers., *The Rise of the Sharing Economy: Estimating the Impact of Airbnb on the Hotel Industry*, J. MARKETING RES. (Oct. 2017) (finding hotel revenues decreased by up to 10% in certain markets due to Airbnb); Thor Berger, Chinchih Chen, & Carl Benedikt Frey, *Drivers of Disruption? Estimating the Uber Effect*, OXFORD MARTIN SCH. 1 (2017) (finding decline in wages earned by taxi drivers due to Uber).

189. BRUCKNER, *supra* note 6, at 4.

190. *Id.* at 5. Providers of labor include Uber drivers and TaskRabbit workers. *Id.* Airbnb is an example of capital platform; i.e., the monetization of an asset held by the payee of the on-demand economy. DIANA FARRELL & FIONA GREIG, JP MORGAN CHASE & CO. INST, PAYCHECKS, PAYDAYS, AND THE ONLINE PLATFORM ECONOMY 5 (2016).

191. BRUCKNER, *supra* note 6, at 5; FARRELL & GREIG, *supra* note 190, at 5.

Most earnings from the on-demand economy are characterized as something other than Form W-2 wages.[192] In part, this is because payors have an incentive to classify workers as independent contractors rather than employees: classification as an employee triggers increased employment tax obligations to employers.[193] Many companies working in the labor sector of the sharing economy, however, disclaim both employee and independent contractor relationships with the payees to whom an information reporting obligation would typically exist.[194] For these payees, many sharing companies have claimed status as a third-party settlement organization obligated to report payments only when the total number of transactions to a given payee is greater than 200 and the total dollar amount exceeds $20,000.[195]

a. Underreporting Issues of the Sharing Economy

The acceptance of the sharing economy has resulted in taxpayers earning income in ways outside of the traditional employer-employee context. By renting out rooms in their homes on a short-term basis or using their personal car to transport paying passengers, these taxpayers can earn income that is generally not treated as wages by the companies from whom they are receiving payments. Instead of having income reported on Form W-2 or a Form 1099-MISC, payors characterize many of these payments as payments from "third party settlement organizations," which are only reported on a Form 1099-K if certain, fairly lax threshold requirements are satisfied.[196]

192. BRUCKNER, *supra* note 6, at 9.

193. *See generally* IRS, U.S. DEP'T OF THE TREASURY, PUB. NO. 3908, GAMING TAX LAW AND BANK SECRECY ACT ISSUES 14 (2013) (discussing payroll tax obligations).

194. *See, e.g.*, Mike Isaac, *Judge Overturns Uber's Settlement with Its Drivers*, N.Y. TIMES (Aug. 19, 2016), https://www.nytimes.com/2016/08/19/technology/uber-settlement-california-drivers.html?mcubz=3&_r=0 (discussing California lawsuit litigating classification of Uber workers as independent contractors).

195. *See* Treas. Reg. § 1.6041-3 (2013); *see also* Oei & Ring, *supra* note 123, at 1032–33; Erik J. Christenson & Amanda T. Kottke, *Guidance Needed to Clarify Reporting Obligations for Online Marketplaces and Peer-to-Peer Platforms*, TAX MGMT. MEMORANDUM, at *6 (2014); *supra* note 63 and accompanying text.

196. *See* Christenson & Kottke, *supra* note 195, at *5.

Companies sending workers Form 1099-K (rather than a W-2 or Form 1099-MISC) include Airbnb, Etsy, Lyft, and TaskRabbit.[197]

Most payments made to sharing economy participants are not reported because of the higher thresholds associated with Form 1099-K.[198] Workers benefit to the extent this income goes untaxed and undetected by the IRS, and sharing economy companies also have an incentive to not submit information returns on this income. By paying these workers an untaxed income, the amount that sharing economy companies must pay workers to properly incentivize their participation is lower than what they would otherwise need to pay if workers included these payments in their gross income. As a result, this somewhat lax reporting threshold benefits not only the worker, but sharing economy companies as well.

Given that many companies in the on-demand sector are privately held,[199] it is difficult to precisely determine amounts paid to their workers and the amount of income these companies are not reporting to the IRS. One estimate of Airbnb's revenue from 2015 was approximately $1 billion.[200] Given that Airbnb has seen annual revenue increases of greater than 80%,[201] a conservative estimate for their current annual revenue is $2 billion. This revenue represents 6% to 12% of the total amount collected from guests and, consequently, paid to hosts.[202] As such, there is approximately $20 billion of revenue paid to hosts, the bulk of whom likely do not receive a Form 1099-K.[203] Even if hosts might otherwise reach the threshold limits of $20,000 *and* 200 reservations, it is simple to use multiple accounts

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197. BRUCKNER, *supra* note 6, at 2, 3, 9.

198. *Id.* at 15–16. 61% of those surveyed receiving income from a sharing economy company did not receive a Form 1099. *Id.* at 15.

199. Riley McDermid, *Airbnb Rakes in $850 Million in Funding, Raises Value to $30 Billion*, S.F. BUS. TIMES (Aug. 8, 2016, 10:12 AM), https://www.bizjournals.com/sanfrancisco/blog/real-estate/2016/08/airbnb-valued-at-30-billion-hospitality-tourism.html.

200. Rolfe Winkler & Douglas Macmillan, *The Secret Math of Airbnb's $24 Billion Valuation*, WALL STREET J. (June 17, 2015, 3:15 PM), https://www.wsj.com/articles/the-secret-math-of-airbnbs-24-billion-valuation-1434568517.

201. *Id.*

202. *Id.* Airbnb charges guests 6% to 12% of the cost of booking. *Id.*

203. Using an average service fee rate of 9%, the total amount paid to hosts equals $2 billion. When divided by 0.09 times 0.91, this equals $20.2 billion.

to ensure a Form 1099-K is not received. As a result, payors do not report several billion dollars to the IRS, and most of that is likely unreported by taxpayers.[204]

But the compliance issues associated with this underreported income are well within the power of Congress to correct. Although a shift from traditional employer to alternative income sources has occurred, there still exist centralized intermediaries on which information reporting obligations can be imposed. There are simple solutions to more adequately regulate the companies responsible for developing the infrastructure allowing payors to obtain this alternative revenue stream. Airbnb, Lyft, TaskRabbit, and Etsy (among others) do not currently issue any information reports to payors unless an individual payor receives $20,000 and more than 200 transactions, a threshold not reached by many income earners.[205] But these companies are large, established companies (i.e., centralized intermediaries) on which reporting obligations can easily be imposed. Although specific questions remain regarding the characterization of some of these payments from company to worker,[206] Congress can and should lower the information reporting thresholds to easily capture income that is currently going unreported.

2. *The Decentralizing Potential of Blockchain Technology*

In contrast to the current state of the on-demand sharing economy, blockchain technology permits true decentralization, wherein taxpayers receive value transfers not from a centralized intermediary

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204. *See* David Kocieniewski, *Airbnb, Others Pay Out Billions Beneath IRS's Radar*, BLOOMBERG TECH. (May 24, 2016, 10:00 AM), https://www.bloomberg.com/news/articles/2016-05-23/airbnb-others-pay-out-billions-beneath-irs-s-radar-study-finds (citing study finding "that billions of dollars in taxable income a year are probably going unreported every year").

205. Oei & Ring, *supra* note 123, at 1035, 1037. Uber, on the other hand, issues 1099-Ks to all drivers earning more than $600. *See generally* Kathleen DeLaney Thomas, *Taxing the Gig Economy*, U. PA. L. REV. (forthcoming).

206. Isaac, *supra* note 194. The distinction between wage income and independent contract payments remains an issue for drivers working for Uber, for example. *See id.* ("The drivers first sued Uber in 2013, claiming that they should have been classified as employees rather than independent contractors of the company.").

but from peers within a secure, distributed network operating independently of any governing authority.[207]

a. *Overview of Blockchain Technology*

Blockchain technology came to public attention in a paper published by Satoshi Nakamoto outlining a purely electronic payment system known as Bitcoin.[208] Whereas traditional electronic transactions require clearance by some trusted third-party financial institution, the payment infrastructure imagined by Nakamoto distributes the burdens of verification to the network at large, relying on all participants to maintain the integrity of the network's whole.[209] All participants of the network maintain a copy of the entire transactional ledger, with additions to the ledger made only after a critical mass of participants verify the legitimacy of the transaction.[210] Any attempt to corrupt the publicly maintained ledger would require a near simultaneous corruption of a majority of the systems running the blockchain application, a feat whose difficulty safeguards the security of the network.[211] The security of the network is maintained not by trusting the other network participants but by each network participant acting in its own self-interest.

Despite the fact that all network participants maintain a complete record of the transactional ledger, transactions between network

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207. ACCENTURE, BLOCKCHAIN TECHNOLOGY: PREPARING FOR CHANGE *2 (2015), https://www.accenture.com/us-en/~/media/Accenture/next-gen/top-ten-challenges/challenge4/pdfs/Accenture-2016-Top-10-Challenges-04-Blockchain-Technology.pdf.

208. Satoshi Nakamoto, A Peer-to-Peer Electronic Cash System 1 (Oct. 31, 2008) (unpublished white paper) (available at https://bitcoin.org/bitcoin.pdf).

209. *See id.* at 1, 5.

210. Lance Koonce, *The Wild, Distributed World: Get Ready for Radical Infrastructure Changes, from Blockchains to the Interplanetary File System to the Internet of Things*, 28 INTELL. PROP. & TECH. L.J. 3, at *2 (2016) ("Transactions facilitated by blockchain technology are verified automatically by a multitude of computers, and the transactions are recorded in a digital ledger that exists on all of those computers simultaneously."). Verification of a transaction's legitimacy is done by solving a computationally intensive math problem, with the solution broadcast to the network and confirmed by other network participants. *Id.*

211. The mathematics undergirding the cryptographic security of the blockchain system is beyond the scope of this article. *See* Michael Crosby, et al., *Blockchain Technology: Beyond Bitcoin*, APPLIED INNOVATION REV. 6, 11–13 (2016) (providing overview of blockchain technology and mathematics).

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participants can have a high level of anonymity. Transactions occur between addresses, and each network participant is entitled to an unlimited number of addresses.[212] The public can see that two addresses are transacting but will not know the identities of the addresses' owners.[213] Who controls individual addresses is unknown to the public, but the content that passes between addresses is known to all.[214]

Although Bitcoin is the most well-known application of the blockchain, it is but one specific use of the general blockchain technology. Other applications using blockchain technologies include Ethereum, Ripple, and Litecoin, to name just a few.[215] The aggregate value of cryptocurrencies is significant; one current estimate places the market capitalization of all cryptocurrencies at greater than $100 billion.[216]

For any network in which participants currently rely on a trusted third party (such as a bank) to confirm the legitimacy of transactions, blockchain technology has the potential to eliminate the need for the centralized intermediary providing the verification.[217] Cryptocurrency payments represent a simple instantiation of blockchain technology: person A wishes to transfer X Bitcoins to person B, and person B wants to receive X Bitcoins from person A. The criteria for which value transfers occur, however, need not be so simple.

For value transfers where the criteria for the transfer are objective, blockchain applications can add increasing levels of complexity beyond transfers of cryptocurrency. These so-called "smart contracts" replicate commercial contracts and validate the parties'

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212. *See* Nakamoto, *supra* note 208, at 8.
213. *Id.* at 6.
214. *Id.*
215. Tara Mandjee, *Bitcoin, Its Legal Classification and Its Regulatory Framework*, 15 J. BUS. & SEC. L. 157, 160 (2015).
216. Denise Lugo, *Auditing in Blockchain Waters Bring Uncharted Challenges*, Daily Tax Rep. (BNA), at 1 (June 26, 2017).
217. *See* Mandjee, *supra* note 215, at 170.

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performances through the decentralized blockchain.[218] Consider two persons wishing to bet against one another on the outcome of a sporting event. Traditionally, these parties must either place their wager with a reliable counterparty (say, a casino) or trust that the losing party will pay.[219] Collecting on the winning bet would require physically cashing in a winning ticket at the casino or finding the counterparty and collecting the funds.[220] This transaction can easily be regulated since casinos are large, centralized intermediaries.

In contrast, by using blockchain technology, the entire wagering transaction can be automated without relying on either a third-party intermediary or the integrity of the counterparty. Each party would simply move their wager to an address that functions as an escrow account. The escrow address can be programmed to release its contents to the winning party once the sporting event concludes and the results are known. This relies on the smart contract having a verifiable data stream from which to draw the results.[221] Attempting to defraud the escrow account would require a majority of the users of the entire blockchain to confirm that the outcome of the sporting event is contrary to reality, a scale of fraud unlikely to be successful.

b. The Effect of Blockchain Technology on Tax Enforcement

As discussed earlier, centralized intermediaries add value by providing their customers with risk mitigation and economies of

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218. ACCENTURE, *supra* note 207 (describing applications of the blockchain technology); *see also* TIM SWANSON, GREAT CHAIN OF NUMBERS: A GUIDE TO SMART CONTRACTS, SMART PROPERTY, AND TRUSTLESS ASSET MANAGEMENT 16 (2014). Use of "smart contracts" is not limited to transactions involving just two parties. Any combination of conditional events can be programmed amongst several parties, provided the contingencies are clearly defined as amenable to objective validation. *Id.*

219. Although casinos often are exposed to some risk when accepting wagers, they typically mitigate this by accepting equal (or as close as possible to equal) amounts of wagers on either side. *See* Christine Hurt, *Regulating Public Morals and Private Markets: Online Securities Trading, Internet Gambling, and the Speculation Paradox*, 86 B.U. L. REV. 371, 419 (2006) ("If the bookie is setting the line at equilibrium, then the bookie makes money whether bettors win or lose.").

220. *See id.* at 416. If gambling winnings exceed certain thresholds, winners receive Form W-2G. *About Form W-2G, Certain Gambling Winnings*, IRS, https://www.irs.gov/forms-pubs/about-form-w2g (last updated Aug. 27, 2017).

221. A reliable data stream is any trusted source for data such as stock prices, sports scores, the weather, et cetera.

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scale.[222] As a consequence of their centrality as payors of income, Congress and the IRS have placed the bulk of reporting obligations on these entities, recognizing that to impose these obligations on other parties would be far less successful.[223] But applications of blockchain technology have the potential to offer the value provided by these centralized intermediaries without being subject to any information reporting requirements. In other words, savvy taxpayers could use blockchain applications to effectuate the previously discussed "alternative arrangements" that undermine the effectiveness of information reporting.[224]

Some income sources are not likely to shift from their existing centralized payors to the blockchain. For instance, the relationship between wage earner and employer is one that cannot be effectively duplicated via a decentralized technology.[225] Anonymity is not possible with most effective employer-employee relationships. Blockchain applications are most helpful for parties acting at a distance when effectuating transfers that are contingent upon verifiable, objective criteria. Employees and employers have an ongoing affiliation that requires frequent interaction. As a result, blockchain technology will not likely increase the low rates of noncompliance for the reporting of wage income.[226]

Though wage income is not likely to move to a blockchain application, other sizable income sources are contenders for this shift. Any income derived from investments where the value of the investments is ascertainable from an easily verifiable data source has the potential to move away from regulated exchanges and onto the blockchain.[227] A blockchain trader would theoretically be able to purchase a synthetic share of stock (assuming a willing, selling counterparty) and mimic the economic return on an identical equity

222. *See* Lederman, *Reducing Information Gaps*, *supra* note 29, at 1740 n.27.
223. *Id.* at 1756 n.122.
224. *See supra* notes166–175 and accompanying text.
225. *See* Lederman, *Reducing Information Gaps*, *supra* note 29, at 1740 n.31.
226. *Id.*
227. *See* Mandjee, *supra* note 215, at 185.

investment.[228] According to IRS data, several of the largest income sources in the United States (outside of wages) are from the return on investments, including the sale of capital assets ($716 billion) and income from pensions and annuities ($663 billion).[229] Although more specifics on the assets comprising this income are not available, to the extent these sales consist of sales of financial products that can be emulated using blockchain technology, they risk going unreported.

Moving transactions away from the centralized intermediaries of regulated exchanges and brokerage houses and onto decentralized platforms would result in dramatically reduced information reporting oversight.[230] For example, Form 1099-B, as discussed earlier, is required to be submitted by brokers acting as middlemen (for consideration) with respect to property or services.[231] Of the 2.3 billion information returns submitted in 2014, approximately 1.1 billion, or 49%, were 1099-Bs.[232] Brokers buying and selling products on these exchanges on behalf of customers typically require licensure and must pass various certification tests.[233] Customers using brokers to obtain products on these exchanges benefit from standardization with regard to products purchased and other regulatory safeguards.[234] To the extent a smart contract could be drafted to provide the standardization and regulatory oversight that currently exist on exchanges, transactions in derivatives (and the

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228. This assumes the selling counterparty is obligated, via the smart contract, to make the appropriate margin calls. Additionally, the owner of such a synthetic equity would not have voting rights.

229. In 2014, wage income comprised $6.8 trillion (69%) of the $9.9 trillion of income reported by all taxpayers. IRS, U.S. DEP'T OF THE TREASURY, PUB. NO. 1304, SOI TAX STATS–INDIVIDUAL INCOME TAX RETURNS at tbl.1.3 (2014).

230. Regulated futures contracts, for example, are traded on exchanges such as the Chicago Mercantile Exchange & Chicago Board of Trade. *See also* I.R.C. § 1256 (2012).

231. I.R.C. § 6045(a), (c) (2012). *See supra* notes 111–116 and accompanying text.

232. I.R.C. § 6045(c)(1).

233. *See, e.g.*, MELINDA H. SCHRAMM, CME GROUP, THE COMPLETE IB HANDBOOK 41 (2016). To trade on the Chicago Mercantile Exchange a commodity broker "must pass a Series 3 examination, be licensed by the Commodity Futures Trading Commission and be a member of the National Futures Association." *Id.*

234. *Id.* at 41.

attendant information reporting) could easily evade regulatory oversight.[235]

Consider a regulated futures contract, which by definition is traded on an exchange registered with either the SEC or the Commodity Futures Trading Commission.[236] Gains and losses associated with a regulated futures contract would be reported on Form 1099-B, as discussed previously.[237] Although a taxpayer might not have reported the associated gain otherwise, trading on a registered exchange gives the trader assurance that certain safeguards are met.[238] Such safeguards include requiring market participants to maintain margin requirements, suspending trading in an emergency, and preventing market manipulation.[239] A smart contract on a platform using blockchain technology might be able to provide these same safeguards, but without the centralized intermediary of the registered exchange.[240] As a result, the proceeds of the transaction would go unreported and the gain potentially untaxed.[241]

Another potential source of future noncompliance is income earned from pass-through entities. Even though this income source includes income from sole proprietorships, an income source that is already dramatically underreported,[242] the potential of the blockchain to function as a depositary institution opens the door to even more

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235. *Id.* at 41–42. Trading in equities, in contrast, would likely still involve regulated exchanges, given that rights of equity ownership (such as voting) would be lost if transferred via an anonymous blockchain system. SWANSON, *supra* note 218, at 54.

236. I.R.C. §§ 1256(g)(1), 1256(g)(7).

237. *See supra* notes 27–28, 111–123 and accompanying text.

238. *See* 7 U.S.C. § 7(c)–(d)(1)(A), (d)(20) (2012) (setting forth requirements for a contract market to be a "designated contract market" as defined by Commodity Futures Trading Commission).

239. 7 U.S.C. § 7(d)(20).

240. Theodore W. Reuter, *Bitcoin's Digital Enterprise Creates Alternative Business Transactions*, 57 ADVOCATE 33, 34 (2014). The blockchain application combined with a smart contract could establish an escrow function for margin calls and trigger automatic sale (or prohibition of sale) if the volatility of the asset in question exceeds certain threshold values. *Id.* ("Because Bitcoin is a ledger rather than an exchange of digital objects, the possibility exists for writing additional information into that ledger to expand its application to different types of transactions.").

241. *See* Lawrence J. Trautman, *Is Disruptive Blockchain Technology the Future of Financial Services?*, 69 CONSUMER FIN. L.Q. REP. 232, 239 (2015) (describing potential disruptions to the financial sector that blockchain technology could create).

242. *See supra* note 32 and accompanying text.

noncompliance. Small business owners might currently report some income in order to use local banking services or make investments. The blockchain technology could provide this same value to small business owners without the attendant pressure to report the income. The risks of noncompliance due to blockchain technology are similar to those associated with cash transactions, but with the ability to transact with counterparties at a distance and without the risk of storing and transporting large amounts of currency.

c. Sharing Economy Transactions Without a Corporate Payor

Blockchain technology has the potential to replicate many transactions currently occurring via sharing economy platforms.[243] Currently, blockchain technology is primarily used to keep track of financial payments between users, but a similar system could be used to track and confirm many other forms of data, such as location.[244] In theory, blockchain technology could serve as a substitute for other sharing economy companies, such as Uber.[245] If these transactions are facilitated without the existence of a corporate entity, the IRS has no entity on which to impose reporting obligations. As such, the IRS would need some other means of ensuring that payments of income are being reported.

d. Blockchain Technology and International Tax Evasion

The potential of blockchain technology to evade international taxes is especially troubling.[246] A U.S. taxpayer living abroad could easily use blockchain technology in a manner very similar to how taxpayers

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243. *See* Nathaniel Popper & Steve Lohr, *Blockchain: A Better Way to Track Pork Chops, Bonds, Bad Peanut Butter?*, N.Y. TIMES (Mar. 4, 2017), https://www.nytimes.com/2017/03/04/business/dealbook/blockchain-ibm-bitcoin.html?mcubz=3.

244. *Id.*

245. *See* Swanson, *supra* note 218, at 69. Any decentralized version of Uber would necessarily lack customer support but would provide the core services of rider transport and payment.

246. *See generally* Omri Marian, *Are Cryptocurrencies Super Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38, 42 (2013).

used foreign accounts to evade taxes prior to FATCA.[247] By depositing funds in a cryptocurrency account, taxpayers could engage in an endless number of transactions, with any gains going unreported (and virtually undetectable) until those cryptocurrency balances are converted into U.S. dollars, an event that may never occur. Taxpayers based in the U.S. could use a similar approach to evade taxes (removing the international component), but this would require, at the very least, transmitting U.S. dollars to the blockchain technology, which could receive some regulatory scrutiny.[248]

FATCA's solution to the problem of international tax avoidance is to impose reporting obligations on the foreign financial entities holding the U.S. accounts in question.[249] This approach is untenable when attempting to prevent a tax avoidance scheme based on blockchain technology because the operation of these applications does not rely upon the existence of financial intermediaries and is out of the regulatory reach of foreign governments.[250] FATCA incentivizes foreign financial institutions to disclose information on U.S. taxpayers because adverse consequences are associated with failure to comply.[251] It is much more difficult to create adverse financial consequences for any of the participants in a cryptocurrency network.

e. Addressing the Information Reporting Gap Caused by the Blockchain

Blockchain technologies have the potential to shift transactions away from centralized, established third-party reporters to distributed networks of payors, thereby undermining existing information protocols.[252] Rather than waiting until blockchain transactions become a significant proportion of payments to taxpayers, Congress

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247. *See supra* notes 52–68 and accompanying text.
248. *See infra* notes 286–297 and accompanying text.
249. Marian, *supra* note 246, at 41.
250. *See id.* at 42.
251. *Id.* at 41.
252. *See id.* at 44.

and the IRS should take proactive steps to prevent the erosion of the reported income base. Two potential approaches include scrutinizing the entry and exit points of blockchain systems, and incentivizing participants to shed the anonymity provided by the technology.

i. Entry to and Exit from the Blockchain Technology

Participants in a cryptocurrency network can obtain cryptocurrency by actively participating in the computationally cumbersome calculations that confirm the legitimacy of transactions between network participants.[253] This process, known as mining,[254] is essential to ensuring network integrity. Identifying who is earning cryptocurrency from mining is difficult, since these network participants are earning cryptocurrency without providing a good or service to any identifiable person.[255]

But even though the blockchain infrastructure is a distributed platform allowing for endogenous anonymity, the entry and exit points from the system have the potential to be regulated. The flow of value within the system cannot be definitively allocated to known network participants, but the deposit of funds into or extraction of funds out of a blockchain network *can* potentially be monitored.[256] Entry into the blockchain system by converting existing funds into cryptocurrency is common.[257] If funds are transmitted from a traditional financial intermediary (say, a bank) for use in a blockchain network, this centralized financial intermediary could be

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253. Brad Jacobsen & Fred Peña, *What Every Lawyer Should Know About Bitcoins*, 27 UTAH B.J. 40, 40–41 (2014).

254. *Id.*

255. *See id.*

256. *See* Sarah Jane Hughes & Stephen T. Middlebrook, *Advancing A Framework for Regulating Cryptocurrency Payments Intermediaries*, 32 YALE J. ON REG. 495, 533–34 (2015) (describing methods by which a Bitcoin transaction executor can be regulated).

257. *See* Nathaniel Popper, *Bitcoin Price Soars, Fueled by Speculation and Global Currency Turmoil*, N.Y. TIMES (Jan. 3, 2017), https://www.nytimes.com/2017/01/03/business/dealbook/bitcoin-price-soars-fueled-by-speculation-and-global-currency-turmoil.html?mcubz=3 ("[P]reviously released Bitcoins can be bought and sold on exchanges around the world."). A network participant is permitted to set up addresses without any seed funding and could be sent funds in exchange for providing goods or services.

required to collect identifying information that would incentivize the network participant to report on any transactions resulting in taxable gain.

This is most relevant for users wanting to convert traditional currency into a cryptocurrency for use on a blockchain platform. Some exchange between the seller and buyer of the cryptocurrency must occur. If this exchange is facilitated by some third party, as opposed to an all-cash, in-person transaction, this third party can be the entity on which Congress and the IRS can turn their regulatory focus. The same is true if the third party is a seller of goods and services wishing to accept cryptocurrency as payment. If these sellers are established entities, reporting rules could require them to collect and submit information on the electronic "addresses" with which they regularly transact.[258]

New York State adopted this approach when enacting its framework for regulating Bitcoin and other cryptocurrencies.[259] This statute, known as the BitLicense, requires anyone who engages in "Virtual Currency Business Activity" to obtain a license, meet certain capital requirements, maintain books and records, file financial reports, and subject themselves to examination.[260] Although the New York regulation was enacted as a consumer protection statute analogous to those governing money transmitters,[261] similar legislation enacted at the federal level could provide some minimum oversight of network participants entering into or exiting the blockchain.

This legislation could mimic the approach taken by the federal government in regulating internet gambling in 2006. The Unlawful

258. *See* Hughes & Middlebrook, *supra* note 256, at 522–23.

259. N.Y. COMP. CODES R. & REGS. tit. 23, § 200.1 to -.22 (2015).

260. Hughes & Middlebrook, *supra* note 256, at 537; *see also* N.Y. COMP. CODES R. & REGS. tit. 23, § 200.1 to -.22 (2015).

261. John L. Douglas, *New Wine into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INST. 17, 47 (2016) ("The BitLicense regime can be described as 'money transmitter plus' because, in addition to imposing requirements similar to those imposed by money transmitter regulation, the BitLicense regime also imposes requirements tailored to the unique nature of the virtual currency business.").

Internet Gambling Enforcement Act of 2006 (UIGEA)[262] required financial transaction providers to identify payments made to entities involved with internet gambling.[263] Notably, the legislation did *not* explicitly ban the gambling itself. But by regulating financial transaction providers (the centralized intermediaries), U.S.-based gamblers were prevented from funding their offshore gambling accounts.[264] The same approach could be used when federally regulating blockchain technologies. Transactions to entities categorized as impermissibly anonymous blockchain platforms could either be restricted or simply monitored by the institution effectuating the transfer. As a result, the IRS would be on notice (and the taxpayer would know that the IRS was on notice) about the taxpayer's involvement with the blockchain platform.

One limitation to this approach is that the reported amount may not correspond to the amount the taxpayer is actually required to include in her gross income.[265] Given that a taxpayer could enter and exit the blockchain platform using two different entities, obtaining complete information on the taxpayer's actual gain could be challenging. Another concern is that monitoring the entry and exit points would not provide any direct oversight of transactions occurring internally to the blockchain system. Gain or loss from transactions with other network participants would only be reported if the regulatory oversight provided at the blockchain's entry point reduced anonymity to the extent that the public ledger's secrecy was somewhat compromised. Decreasing the incentive to remain anonymous, discussed in the next Section, is another possible method by which network participants could be motivated to accurately report relevant gains and losses.

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262. Unlawful Internet Gambling Enforcement Act of 2006, Pub. L. No. 109-347, 120 Stat. 1886 (2006) (codified at 31 U.S.C. §§ 5361-5367 (2006)).

263. Charles P. Ciaccio, Jr., *Internet Gambling: Recent Developments and State of the Law*, 25 BERKELEY TECH. L.J. 529, 542 (2010).

264. *Id.* at 543 ("The UIGEA does not target Joe the Gambler; instead, it targets the flow of funds to internet gambling operators.").

265. *See supra* note 161 and accompanying text, discussing helpfulness of complete reporting on information returns.

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The IRS has taken this approach in attempting to gain information on the tax compliance of cryptocurrency users.[266] Coinbase, the largest United States cryptocurrency exchange, was issued a summons by the IRS that would require Coinbase to produce records for any users who conducted transactions in a cryptocurrency.[267] Although the summons issued in this case is a John Doe summons, wherein specific users need not be identified by the responding party,[268] the IRS could potentially use the information obtained from the summons to determine which of the anonymous users are potentially evading their income tax obligations. This could be done simply by observing when cryptocurrency sales likely generated a profit that was converted to dollars.[269]

ii. Incentivizing Transparency

Blockchain technology has a variety of uses beyond its ability to facilitate high-value transactions anonymously.[270] Existing financial institutions have invested resources into proprietary blockchain concepts intended to reduce clearing times and reduce recordkeeping requirements.[271] In the absence of anonymity, and in contrast to current cash-settled transactions, the blockchain provides an exact ledger of who has received what payments and when.[272] Because all

266. *See* United States v. Coinbase, Inc., Case No. 17-cv-01431-JSC, 2017 U.S. Dist. LEXIS 111756, at *3 (N.D. Cal. July 28, 2017).

267. Allyson Versprille, *Virtual Tax Reality: Four Issues Facing the Bitcoin World*, Daily Tax Rep. (BNA), at *2–*3 (July 11, 2017).

268. Cecelia Kehoe Dempsey, *The Application of the John Doe Summons Procedure to the Dual-Purpose Investigatory Summons*, 52 FORDHAM L. REV. 574, 578 (1984).

269. The IRS currently treats cryptocurrencies as property, and not currency. *See supra* note 9 and accompanying text.

270. *See* Nathaniel Popper, *Central Banks Consider Bitcoin's Technology, if Not Bitcoin*, N.Y. TIMES (Oct. 11, 2016), https://www.nytimes.com/2016/10/12/business/dealbook/central-banks-consider-bitcoins-technology-if-not-bitcoin.html?mcubz=3.

271. ACCENTURE, *supra* note 207, at 4 (identifying blockchains as useful to investment banks in reducing total cost of ownership, managing system-of-record sharing, clearing and settling transactions faster, and creating self-describing electronic transactions). These blockchain technologies would not pose significant hurdles to tax enforcement since the institutions behind their promulgation are large, centralized intermediaries. Cheng, *supra* note 67, at 666.

272. ACCENTURE, *supra* note 207, at 4.

network participants confirm the legitimacy of each transaction, the ledger of all transactions is publicly available.[273]

For some network participants, anonymity is a secondary concern relative to these other benefits.[274] If these parties can be encouraged to shed the anonymity provided by the blockchain, the anonymity of the other parties is weakened.[275] If a series of payments originate from different addresses that are linked to a network user who has voluntarily surrendered her anonymity, the destination of these payments can be tracked more easily. Even if the payee has spread the payment across several network addresses, the payor knows the rationale for the series of payments. When even some users surrender anonymity, regulatory bodies can more easily investigate the flow of value transfer.

Surrendering anonymity can be incentivized by regulating network participants whose business activities are too significant to intentionally evade the reporting requirements that are already in place. By requiring, say, the blockchain equivalent of Amazon to levy an additional tax on all anonymous network participants with whom they do business, parties for whom anonymity gives no value will be motivated to surrender their anonymity.[276] With some number of network participants choosing transparency over anonymity, the anonymity of the remaining participants becomes compromised, potentially leaving solely the bad actors choosing anonymity. Knowing some of the identities on the public ledger makes it easier to determine to whom the unknown addresses on the public ledger might belong. If, for example, a pool of one hundred users has one bad actor, one good actor surrendering anonymity will not significantly increase the bad actor's risk of capture.[277] But if all ninety-nine good actors surrender anonymity, the bad actor will be outed.

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273. *Id.* at 3.
274. *See* SWANSON, *supra* note 218, at 84.
275. *See* Marian, *supra* note 1, at 64–65.
276. *See generally id.*
277. This assumes the bad actor is identifiable from her transaction history. *See id.* at 66.

Incentivizing transparency has the added benefit of potentially improving certain aspects of tax collection. Many of the world's largest banks are working together and investing in developing blockchain technology for use in banking transactions.[278] If these centralized intermediaries incorporate blockchain technologies into their already-existing businesses, it could make tax enforcement much simpler.[279] Consider a distributed ledger on which all financial firms record and settle transactions. The IRS would need only to determine which "addresses" were owned by a certain taxpayer in order to fully construct a transaction history for that taxpayer.[280]

There are some blockchain applications for which anonymity is a fundamental value. Zcash, a nascent virtual currency, uses advanced cryptography to confirm the legitimacy of its transactions, but without revealing, as Bitcoin does, the transaction history of its users.[281] Although users can voluntarily surrender anonymity if they choose, this does not (in theory) increase the risk that the Zcash participants choosing to retain anonymity will be outed.[282]

B. *The Shift Away from Cash Transactions*

Not all technological shifts will reduce the IRS's capacity for tax enforcement. Businesses are increasingly moving away from cash transactions and toward all-electronic payments.[283] For the compliant

278. Trautman, *supra* note 241, at 239.
279. *Id.* at 232.
280. Outside of the income tax context, tax compliance benefits also exist for the collection of certain consumption taxes. *See* Richard T. Ainsworth & Andrew B. Shact, *Blockchain Technology Might Solve VAT Fraud*, 83 TAX NOTES INT'L 1165, 1167 (2016).
281. Nathaniel Popper, *Zcash, a Harder-to-Trace Virtual Currency, Generates Price Frenzy*, N.Y. TIMES (Oct. 31, 2016), https://www.nytimes.com/2016/11/01/business/dealbook/zcash-a-harder-to-trace-virtual-currency-generates-price-frenzy.html?mcubz=3.
282. *Id.*
283. Megan Woolhouse, *No Cash Allowed: Stores Refusing to Accept Money*, BOS. GLOBE (Aug. 4, 2016), https://www.bostonglobe.com/business/2016/08/03/paying-cash-some-stores-say-thanks-greenbacks-credit-only/a4EvjwgTpI7r4lD3xVOENO/story.html. Prior to banning cash in 2016, Sweetgreen's cash transactions declined to less than 10% of all transactions from 40% in 2007. Gloria Dawson, *At Sweetgreen, a Suitcase Full of Cash Won't Buy You Lunch*, N.Y. TIMES (July 30, 2016), https://www.nytimes.com/2016/07/31/business/where-a-suitcase-full-of-cash-wont-buy-you-lunch.html?mcubz=3.

taxpayer, the benefits of prohibiting cash transactions include increased transaction speed, ease of accounting, and a decreased security need.[284] These benefits are increasingly worth the service charges levied by credit card companies and other facilitators of electronic transactions, so that in certain locations spending cash can be challenging.[285] The electronic record of transactions is itself not a report of the taxpayer's income, of course. But the IRS's ability to construct a complete transaction history of a taxpayer under audit would likely be sufficient to incentivize the taxpayer to avoid willful evasion. To the intentionally noncompliant taxpayer, however, the move away from cash does not necessarily mandate full compliance. Transacting in cryptocurrencies, such as Bitcoin, would potentially give intentionally noncompliant taxpayers the benefits of going cashless and provide a method by which to avoid reporting income.

CONCLUSION

Tax compliance in the United States relies in large part on successful information reporting by both payors and other third parties. Information reporting protocols are most successful when the obligating statutes impose the burden of filing returns on centralized intermediaries. These intermediaries exist because they provide value to the customer/payee in the form of reduced risk or transactional simplicity.

Emerging technology has the potential to render these centralized intermediaries far less important. Congress and the IRS should prepare for this eventuality and take steps to ensure that American income remains correctly reported and appropriately taxed.

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284. James Alm and Jay Soled, *W(h)ither the Tax Gap?* 3 (May 31, 2017) (unpublished paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2978215 (claiming that the tax gap will diminish due to the rise of electronic transactions).

285. Nathan Heller, *Imagining a Cashless World*, NEW YORKER (Oct. 10, 2016), https://www.newyorker.com/magazine/2016/10/10/imagining-a-cashless-world (describing Sweden's nearly complete shift away from cash transactions).