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Rebuilding IRS Would Reduce Tax Gap, Help Replenish Depleted Revenue Base

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Several factors have coalesced to create an urgent need to launch a multi-year rebuild of the IRS. Overall IRS funding is down one-fifth since 2010, and a decade of budget cuts has severely undermined the agency’s ability to perform its fundamental jobs of enforcing the nation’s tax laws and helping taxpayers navigate a tax system that relies on voluntary compliance. New research underscores the extent to which some wealthy filers evade paying their fair share of tax and the IRS’s failure to detect it, which is unfair to honest taxpayers and risks undermining the integrity of the tax code. Former IRS Commissioner Charles Rossotti estimates that $574 billion in legally owed taxes went uncollected in 2019; new research indicates this may be an understatement. In fact, IRS Commissioner Charles Rettig said today that figure could exceed $1 trillion. The IRS’s audit staff is severely depleted and its computer systems are antiquated. Budget cuts have even made it hard for the IRS to answer most taxpayers’ phone calls.

The IRS performs a basic function of government. As a central piece of the federal government’s infrastructure, it needs to be rebuilt. The IRS rebuild needs to be multi-year, sufficiently robust, and certain, to allow the IRS to hire and train enough sophisticated audit staff to meet the 21st century tax evasion challenges it faces and to make and implement technology commitments to upgrade its computer systems.

In its request for fiscal year 2022 appropriations, the Biden Administration proposed increasing IRS funding by 10 percent over the 2021 level and recommended additional funding for

3 Guyton et al., op. cit.
enforcement. The Administration’s request for the IRS is an important step forward, but it is only a first step.

Regular annual appropriations are the foundation for IRS funding and should remain so, but they can’t realistically provide the IRS with the amount or certainty of resources it needs to rebuild. Policymakers should therefore employ two additional mechanisms — preferably concurrently — to provide robust, multi-year funding for IRS enforcement and technology upgrades:

- **Multi-year “allocation adjustment” to appropriations.** The congressional budget resolution would allow for additional appropriations for the IRS that wouldn’t count toward its overall allocation to the House and Senate Appropriations committees and thus wouldn’t compete with other discretionary spending priorities. Congress has adopted similar adjustments in the past to help fund IRS tax enforcement as well as for various “program integrity” activities estimated to save considerably more than they cost, as IRS enforcement does. The Administration’s new budget proposal includes a modest one-year $417 million adjustment for IRS enforcement and encouragingly hints that a proposed multi-year effort is forthcoming.

- **Mandatory multi-year funding.** The House Ways and Means and Senate Finance committees would craft legislation establishing a multi-year, mandatory funding stream (that is, funding provided directly in authorizing law) to help rebuild the IRS enforcement division and upgrade its outdated computer systems. Such mandatory funding would be analogous to the temporary IRS funding in the recently enacted American Rescue Plan.

These proposals require collaboration among the appropriations and tax-writing committees: House and Senate Appropriations, House Ways and Means, and Senate Finance. These committees have shared responsibility in the past, including for the Health Care Fraud and Abuse Control (HCFAC) program to address Medicare and Medicaid fraud. Funding HCFAC involves three parts: a base of regular annual appropriations for the agencies involved, a substantial multi-year stream of mandatory funding, and additional appropriations outside the regular limits. This three-part model would be a good approach for funding the IRS and would involve the same committees as HCFAC.

This paper focuses on IRS funding, specifically for enforcement and technology upgrades, but this multi-year rebuild is one of two essential components needed to address the nation’s large tax gap. A funding plan needs to be pursued in tandem with an effort to strengthen the legislative and regulatory regime around reducing the tax gap, including to fill in the gaping holes in required information reporting (see box, “New Process Needed to Reduce Tax Gap”).

A rebuilt IRS could restore public trust in the fairness of the tax system by responding in a timely, effective manner to taxpayer questions and enforcing the nation’s tax laws fully so that everyone pays the taxes they owe, just as the vast majority of taxpayers and businesses do voluntarily. Moreover, a rebuilt and modernized IRS, combined with enhanced reporting requirements, would

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7 Ibid.
help restore the nation’s depleted revenue base — collecting taxes that are legally owed — to fund national priorities, including as part of upcoming recovery legislation.

There is a broad consensus among relevant stakeholders — including the IRS and Treasury, the Congressional Budget Office (CBO), the Government Accountability Office (GAO), and independent analysts — that every additional dollar spent on IRS enforcement yields multiple dollars in revenue. Further, the revenue raised by each incremental dollar of enforcement funding can be greatly increased if additional funding is paired with technology upgrades and, critically, enhanced reporting requirements. Rossotti, who is also a technology expert, estimates returns over a decade of 15 to 20 times the cost and has noted that “this large ratio of gain is driven by the combination of modestly increased third-party reporting and a modernized compliance and taxpayer communications program supported by advanced technology.” This year, policymakers should pursue this combination, which would ensure robust revenue gains from closing the tax gap and collecting legally owed revenue.

**Severely Depleted IRS Urgently Needs Rebuilding**

The pandemic has highlighted and worsened the fragile state of the IRS. The agency answers just 1 in 4 phone calls from taxpayers with questions, and those who do get through often do so after significant wait times. In May 2020 the IRS reported a backlog of 20 million mail correspondences, which likely delayed taxpayers’ receipt of their refunds and may have created penalties for those unable to respond to exam or collection inquiries. To distribute Economic Impact Payments (EIPs) to millions of people across the country in 2020, the IRS had to pivot away from processing tax returns during filing season and had to use considerable resources to equip its software — which dates to the Kennedy Administration — to send much-needed EIPs to households as rapidly as possible. According to the National Taxpayer Advocate, the agency’s “antiquated” IT systems “require significant programming to prepare for each filing season and other purposes.” IRS employees have done exceptional work under trying circumstances, but neither the state of its technology nor the size of its workforce should have been allowed to deteriorate to such low levels.

Despite modest increases in recent years, the overall IRS budget is still 19 percent below its 2010 level, after adjusting for inflation. Funding for IRS enforcement, including the enforcement account and the operations support account (which covers office space, information services, and other functions that support the enforcement division) has fallen 21 percent. (See Figure 1.)

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9 Rossotti, op. cit.


Largely due to these cuts, the number of enforcement staff fell drastically between 2010 and 2019. While the number of staff rose slightly in 2020, there are still 30 percent fewer enforcement staff than there were in 2010. Worse still, the number of revenue agents — auditors uniquely qualified to process the complex returns of high-income individuals and corporations — has fallen by 39 percent. This hollowing out of the audit staff has caused audit rates to plummet, particularly of wealthy individuals and large corporations. The audit rate for millionaires fell by 71 percent between 2010 and 2019, from 8.4 percent to just 2.4 percent. (See Figure 2.)

The gutting of IRS enforcement is particularly troubling given that hundreds of billions of dollars in legally owed taxes each year go uncollected. The most recent IRS estimates of the gross “tax gap” — that is, the gap between what taxpayers owe and what they voluntarily pay on time — suggest that taxpayers failed to pay $441 billion per year from 2011 to 2013.13 (See Figure 3.) Even after taking enforcement measures into account, the IRS still failed to collect, on average, $381 billion in

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each of those years.\textsuperscript{14} (This figure is known as the net tax gap.) More recently, former IRS Commissioner Rossotti estimated the net tax gap in 2019 was $574 billion.\textsuperscript{15}

Moreover, new research from IRS and outside economists suggests that IRS tax gap estimates substantially understate the extent of wealthy households’ tax evasion because they are based on random audits, which “do not capture most tax evasion through offshore accounts and pass-through businesses, both of which are quantitatively important at the top.”\textsuperscript{16} After accounting more fully for these types of tax evasion, the researchers estimate that the top 1 percent of filers likely underreport around 20 percent of their income. This suggests that the tax gap resulting from high-end tax evasion is far larger than shown in IRS tax gap estimates.

Even using the IRS estimates, the tax gap’s single largest source is the underreporting of pass-through income (income from sources such as S corporations, partnerships, and sole proprietorships).\textsuperscript{17} The IRS estimates, for example, that sole proprietors misreport a staggering 56 percent of their income.\textsuperscript{18} S corporations and partnerships also have a high misreporting rate of 11 percent.\textsuperscript{19} In contrast, wages and salaries — which employers report to the

\begin{figure}[h]
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\caption{Audits of Millionaires Have Plummeted Since 2010}
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\textsuperscript{14} Ibid.

\textsuperscript{15} Rossotti, \textit{op. cit.}

\textsuperscript{16} Guyton et al., \textit{op. cit.}

\textsuperscript{17} Samantha Jacoby, “Policymakers Should Ensure Pass-Throughs Pay More of Taxes They Owe,” CBPP, November 22, 2019, \url{https://www.cbpp.org/blog/policymakers-should-ensure-pass-throughs-pay-more-of-taxes-they-owe}. Pass-through businesses constitute a disproportionate share of the tax gap largely because they and their owners are responsible for reporting their own income to the IRS, with little independent verification by the government compared to other income sources. There is widespread agreement among the IRS, other parts of Treasury, CBO, GAO, and outside experts that increasing third-party information reporting — that is, information the IRS can use to independently verify information in tax returns — is central to reducing the tax gap. See box, “New Process Needed to Reduce Tax Gap.”

\textsuperscript{18} Johnson and Rose, \textit{op. cit}. The rate of income misreporting is a measure of tax compliance and represents the amount of income that is incorrectly reported to the IRS.

\textsuperscript{19} Ibid. In addition, \textit{Accounting Today}'s 2019 round-up of “10 major trends in IRS audits” advises, “Want your business to escape audit? Be an S corp or partnership,” noting that “audit rates for S corps and partnerships are both 0.22 percent — or, put another way, one in every 455 passthrough entities were examined in 2018.” Jim Buttonow, “10 major trends in IRS audits,” \textit{Accounting Today}, November 22, 2019, \url{https://www.accountingtoday.com/list/ten-major-trends-in-irs-tax-audits}. 
IRS and on which they withhold income and payroll taxes — have a misreporting rate of only 1 percent.20

FIGURE 3

Components of the Annual Gross Tax Gap
Averages for tax years 2011-13

Note Totals may not add due to rounding. The gross tax gap is the difference between what taxpayers owe and what they voluntarily pay on time.

Annual Appropriations Process Insufficient to Rebuild IRS

The IRS is funded almost entirely by annual discretionary appropriations.21 For fiscal year 2021, the IRS received appropriated funding totaling $11.9 billion: $5.2 billion for enforcement, $3.9 billion for operations support, $2.6 billion for taxpayer services, and $0.2 billion for business systems modernization. Annual appropriations should remain the foundation of the IRS budget and a key part of any plan to rebuild and modernize the agency.

Funding through appropriations is not only necessary but also desirable because of the oversight and accountability the annual appropriations process brings. The House and Senate Appropriations committees require detailed information from the IRS about its operations, performance, and funding needs. Each year the IRS Commissioner and the Treasury Secretary typically appear before the relevant appropriations subcommittees, explain what the IRS did with its previous budget, and

20 Johnson and Rose, op. cit.
21 The IRS also collects some user fees and reimbursements and occasionally receives additional funding through legislation outside its annual appropriation, such as the funding it received through the Coronavirus Aid, Relief, and Economic Security (CARES) Act to distribute Economic Impact Payments.
present their request for the coming fiscal year. When needed, annual appropriations legislation can provide congressional direction along with funding. The base of regular annual appropriations must remain strong if the rebuilding of IRS capacity is to succeed.

However, the regular annual appropriations process alone cannot fully address the IRS’s funding shortfall. One reason is the size of the shortfall, for the IRS in general and tax enforcement in particular. With the end this year of the 2011 Budget Control Act (BCA) caps, which have constrained overall non-defense discretionary funding for the past decade, the IRS will compete with many other important — and currently underfunded — priorities for any increased funding.22 Also, though the annual appropriations process facilitates oversight and provides flexibility to respond to changing circumstances, rebuilding IRS capacity will require some funding that is predictable and sustained over several years so the agency can undertake the multi-year process of hiring and training staff, making badly needed technology updates, and restoring taxpayer service to acceptable levels.

**Allocation Adjustment Would Provide Added Appropriations**

Policymakers should use a multi-year allocation adjustment in the next budget resolution as one mechanism to rebuild the IRS. This would provide additional appropriations for the IRS, above and beyond the “base” IRS funding provided in the regular appropriations bill, that wouldn’t count toward the resolution’s overall allocation to the House and Senate Appropriations committees.

Congress has frequently adopted such adjustments, often to fund “program integrity” activities that — like IRS enforcement funding, as explained below — generate more savings than the activities cost. These activities include health care fraud detection through HCFAC, reviews of continued eligibility for Social Security and Supplemental Security Income (SSI) disability benefits, and re-employment services and eligibility assessments for unemployment insurance recipients.23 When statutory caps on appropriations were in place under the BCA, the adjustments were made to those caps as well as to allocations to the Appropriations committees. After the BCA caps expire at the end of this fiscal year, the adjustments would be made to the spending allocations under the congressional budget resolution.

An adjustment mechanism is thus familiar and generally well regarded, and is particularly well suited for the IRS for several reasons. First, Congress has adopted similar adjustments on a bipartisan basis for IRS tax enforcement in the past, including for 1991-1995 (under prior statutory appropriations caps) and 2008-2010 (when no statutory caps were in place). In addition, both Presidents Obama and Trump proposed allocation adjustments for IRS enforcement in some of their budgets. House Democrats included an adjustment similar to the Trump proposal in their version of IRS appropriations for fiscal year 2020, but the Senate did not concur. Accordingly, the Biden Administration has proposed such an adjustment as part of its 2022 discretionary request. Although the request is only for a one-year, $417 million increase in tax enforcement, the

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23 In addition to these adjustments for program integrity activities, other adjustments involve funding for basic disaster relief programs and for wildfire suppression. They also provide the mechanism for exempting funding for emergency needs and overseas contingency appropriations from statutory caps and appropriations allocations.
Administration’s proposal describes it as part of a “multiyear tax initiative that would increase tax compliance and increase revenue.”

Second, these types of adjustments typically require maintenance of a base funding level to ensure that the increment indeed adds to, rather than simply replaces, regular appropriations. A good example of this approach is, again, the adjustment for HCFAC, which has continued for many years.

Third, providing added enforcement funding outside the regular IRS appropriation would allow the committees to concentrate increases in regular appropriations on restoring customer services to acceptable levels. As former National Taxpayer Advocate Nina Olson has pointed out, the current approach of increasing enforcement funding in part by cutting taxpayer services amounts to “robbing Peter to pay Paul,” as voluntary compliance falls when taxpayers cannot easily receive information and assistance when trying to file.

Finally, Congress will need to revisit existing allocation adjustments this year, because at least three of them — and possibly more — expire at the end of 2021. This will create a legislative opportunity for Congress to add an adjustment for the IRS.

A well-designed allocation adjustment would increase the probability that regular appropriations can provide adequate base funding and that the IRS will have sufficient resources for taxpayer services. By itself, however, it is unlikely to be large enough to provide all of the additional funds needed to rebuild the IRS.

Mandatory Funding Stream Would Provide Predictable, Sustained Support

Concurrent with an allocation adjustment, therefore, policymakers should also adopt a multi-year, “mandatory” funding stream to support the IRS. This funding would be provided directly in the authorizing law (through legislation from the House Ways and Means and Senate Finance committees) and would be in addition to the funds provided to the IRS through the annual appropriations process.

The American Rescue Plan did this by giving the IRS more than $1.4 billion, available through September 2023, for the administration of EIPs, taxpayer assistance, and technology upgrades and about $400 million for the administration of the law’s Child Tax Credit expansion. This funding was, like the rest of that legislation, temporary in nature. Now policymakers should build on the Rescue Plan and enact a long-term, certain stream of mandatory funds.

Adding a long-term mandatory funding stream for IRS enforcement would produce an overall effort similar to the successful and well-regarded HCFAC program, which supports efforts to detect, control, and prevent fraud against Medicare and other federal health programs. HCFAC is largely funded by a multi-year stream of mandatory funding, in addition to a base of annual appropriations.

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25 There is some ambiguity about how current law should be interpreted on this point. Adjustments for health care fraud and abuse, Social Security and SSI continuing disability reviews, and basic disaster relief funding are definitely expiring. But other adjustments could be determined to be expiring as well, including those for emergencies, overseas contingency operations, and wildfire suppression.
and additional appropriations outside the regular limits through an allocation or cap adjustment, as discussed above. HFCAC involves the same committees involved with IRS funding and could be a good model for ensuring adequate funding to rebuild the IRS.

The recovery package that the Administration and Congress will debate this year is expected to include mandatory spending provisions and thus would be an appropriate legislative vehicle for securing a multi-year mandatory funding stream to rebuild IRS enforcement and upgrade IRS technology systems, while generating revenues to help rebuild the revenue base and pay for advancing national priorities.

**Multi-Year IRS Funding Would Yield Significant Revenue**

Government and independent experts agree that every additional dollar spent on IRS enforcement yields multiple dollars in revenue. The size of the revenue gain depends on several factors. First, is the increased funding, as discussed above, to hire auditors and invest in technology? Second, coupling funding increases with new requirements to expand information reporting — that is, information the IRS can use to independently verify information in tax returns — for certain types of income that tend to be underreported to the IRS would significantly boost revenues. These information reporting requirements can be implemented both by legislation and regulation. (See box, “New Process Needed to Reduce Tax Gap.”)

Third, a more robust enforcement division that effectively polices tax evasion, audits high-income people at higher rates, uses new information reporting, and employs advanced technology to flag problematic tax returns would likely increase voluntary compliance. These indirect compliance effects would further reduce the tax gap.

Past CBO estimates of boosting the IRS enforcement budget have been fairly conservative, reflecting only the impact of higher funding and just its direct effects. In contrast, for example, a recent broader proposal to rebuild the IRS by former IRS commissioners Rossotti and Fred Goldberg would also incorporate both the indirect compliance effects of increased funding for IRS enforcement and the impact of enhanced information reporting and updated technology. Rossotti and Goldberg estimate that their proposal, which would add roughly $65 billion to the IRS budget over ten years, including $12 billion for technology upgrades, along with important information reporting changes, would raise $1.4 trillion over ten years.

Treatment of the revenues raised by additional IRS funding are affected by a “scorekeeping” rule. While there is no doubt that these proposals would raise real revenue, the budget rules preclude these revenues being included in the legislation’s official cost estimates. CBO and Treasury, working with the IRS, would be expected to produce estimates of the revenue that would be generated from any IRS funding included in recovery legislation. Policymakers could use such estimates as part of deliberations around the overall fiscal impacts of the legislation.

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New Process Needed to Reduce Tax Gap

Rebuilding the IRS’s enforcement division and upgrading its outdated computer systems are essential for improving compliance and reducing the tax gap, but policymakers should pair this funding effort with specific legislative and regulatory measures to reduce the tax gap, including additional specific reporting requirements to fill gaping holes.

Require regular, accurate reporting of the tax gap. The most recent IRS tax gap estimates use data from nearly a decade ago, which don’t reflect the full extent of tax evasion techniques such as using offshore accounts and complex pass-through business structures to hide income. As GAO points out, the “IRS does not have an estimate of the revenue loss due to offshore noncompliance. However, international tax policy experts believe that the losses are in the billions of dollars annually.” Tax gap estimates need to be more frequent to enable policymakers to track the progress of enforcement efforts, and the IRS should adjust its methodology as needed to better capture the full extent of global tax evasion.

Establish clear, concrete goals and an iterative legislative and regulatory process to track progress. Natasha Sarin, Larry Summers, and Charles Rossotti recommend that new legislation “provide a framework for accountability” to ensure that increased IRS funding generates the highest return by, for example, focusing additional enforcement resources on the highest-impact audit targets.

Currently, the only notable such process focuses on the Earned Income Tax Credit (EITC) as part of the 2012 Improper Payments Elimination and Recovery Improvement Act (IPERIA). Under IPERIA, federal agencies must estimate the annual amount of so-called “improper payments” of the EITC (and certain other “high-risk programs”), set reduction targets, and implement ways to reduce such payments. No comparable process focuses on high-income tax evasion, even though underreporting of pass-through income is the largest single source of the tax gap.

An accountability framework for the tax gap could, for example, establish a goal (along with complementary Treasury regulatory authority) of increasing the IRS’s access to third-party, verifiable information on certain types of income that now are underreported. Specifically, the IRS has noted that income from partnerships, S corporations, and capital gains are subject to “some” information reporting and that income from sole proprietorships is subject to “little or no” information reporting. Moving these income categories one step higher on the IRS scale could significantly help the agency track incomes that now are disproportionately underreported.

Adopt specific measures to improve compliance and reduce the tax gap. Policymakers need to adopt specific additional information reporting requirements to help achieve the goals they set. A proposal from former IRS commissioners Rossotti and Goldberg, for example, would build on financial institutions’ existing role in reporting their customers’ interest, dividend, and capital gains information to the IRS. Rossotti and Goldberg propose requiring high-income filers with pass-through business income to designate the bank accounts they use to receive the income and requiring the banks to report summary receipts and disbursements from these accounts to taxpayers and the IRS, which taxpayers would use to file their returns and the IRS would use to identify noncompliance.

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