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Success of the IRS Rebuilding and Tax Gap Reduction Effort Depends on Sufficient Funding Through Annual Appropriations

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Earlier this year policymakers took step one in a two-step funding process designed to rebuild the IRS with the goals of improving customer service and reducing the tax gap, by enacting $80 billion in supplementary, long-term mandatory funding for the agency under the Inflation Reduction Act. Now it's time for step two: Congress needs to provide annual appropriations for the IRS that are sufficient to ensure the success of this rebuilding effort. In year-end deliberations, policymakers should set the agency's funding as close as possible to the Biden Administration's request of $14.1 billion for fiscal year 2023.

Significant IRS funding boosts are necessary after a decade of steep cuts left the agency ill equipped to provide the customer service taxpayers deserve — 7 in 10 taxpayer phone calls went unanswered in 2019 — or to enforce the nation's tax laws.[1] The agency has fewer auditors who handle the most sophisticated tax returns than it has had since the early 1950s, when the economy was far smaller and less complex. This depletion of the audit staff comes at a time when an estimated $470 billion a year in legally owed taxes goes uncollected, disproportionately from high-income taxpayers.[2] Reports have shown how overmatched IRS staff is in detecting and countering tax evasion schemes of large corporations and the nation's wealthiest.[3] The audit rates for millionaires and the largest corporations fell roughly 77 percent and 56 percent, respectively, between 2010 and 2017.[4]

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[1] Taxpayer Advocate Service, "National Taxpayer Advocate Annual Report To Congress," 2021, https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2022/01/ARC21_Full-Report.pdf.

[2] IRS, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016," August 2022, https://www.irs.gov/pub/irs-pdf/p1415.pdf.

[3] Paul Kiel, "Who's Afraid of the IRS? Not Facebook," ProPublica, January 23, 2020, https://www.propublica.org/article/whos-afraid-of-the-irs-not-facebook; Jesse Eisinger and Paul Kiel, "You Can't Tax the Rich Without the IRS," ProPublica, May 3, 2019, https://www.propublica.org/article/you-cant-tax-the-rich-without-the-irs-internal-revenue-service.

[4] Preliminary audit data for tax years 2018-2019 suggest that audit rates for millionaires and the largest corporations (those with more than $1 billion in income) fell as much as 93 and 85 percent, respectively, since 2010. The statute of limitations has not yet ended for those years, so these preliminary audit rates may change or rise slightly as more audits are conducted.

The Inflation Reduction Act's funding will help the IRS fill its budget shortfall while offering a degree of certainty that will enable the agency to rebuild its depleted customer service capacity and make long-term investments in its decades-old computer systems, as well as to hire and train new staff who can conduct sophisticated audits of high-income and high-wealth tax evaders, so the agency can do more both to improve customer service and detect tax cheating. But these funds are designed to *supplement* and not to supplant the agency's regular budget, which is set each year through the annual appropriations process. The ultimate success of this effort to rebuild the IRS, improve customer service, and reduce the tax gap hinges on what Congress does starting this December, when it is scheduled to set base funding for the IRS in fiscal year 2023.

This two-pronged funding approach follows a successful model already in place in a program that targets Medicare and Medicaid fraud, and it recognizes the need for cooperation among congressional tax-writing and appropriations committees. When drafting the Inflation Reduction Act, the tax-writing committees — Senate Finance and House Ways and Means — understood the IRS' needs stemming from its ten-year budget shortfall and provided funding to help fill that gap. The Senate and House Appropriations committees, meanwhile, need to continue to provide base funding each year in the appropriations process while also continuing their valuable advisory and oversight roles traditional to the annual appropriations process, as Treasury and the IRS submit detailed information required as part of their budget request for the agency.

The Biden Administration's request for base funding of $14.1 billion for 2023, up from the $12.6 billion enacted for the agency in 2022, is an encouraging sign for the success of this effort. It, along with the Inflation Reduction Act funding, would put the IRS budget close to the funding level that would have existed if not for the cuts that began in 2011, allowing the agency to keep up both with inflation and with the expanding scope of its work in an increasingly complex and global economy.

The House and Senate appropriations bills each included $13.6 billion for the IRS, enough to keep pace with inflation over the past year. But the Administration's request would put the IRS in a better position to fix major shortfalls, not just keep them from getting worse.

And while some Republican lawmakers have made reckless statements regarding the agency's rebuilding effort in recent months,[5] there's also been bipartisan interest in ensuring the IRS can improve its enforcement function. The Trump Administration's 2020 and 2021 budgets proposed additional funding "for new and continuing investments to expand and strengthen tax enforcement."[6] And during negotiations over how to pay for proposed infrastructure legislation in 2021, a group of Senate Republicans supported a separate mandatory funding stream for the IRS to boost tax enforcement and reduce the tax gap.[7] In addition, key Republicans have made helpful

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[5] Alan Rappeport and Tiffany Hsu, "More Money for I.R.S. Spurs Conspiracy Theories of 'Shadow Army,'" *New York Times*, August 19, 2022, https://www.nytimes.com/2022/08/19/us/politics/more-money-for-irs-spurs-conspiracy-theories-of-shadow-army.html.

[6] GovInfo, "A Budget for a Better America. Promises Kept. Taxpayers First," 2020, https://www.govinfo.gov/content/pkg/BUDGET-2020-BUD/pdf/BUDGET-2020-BUD.pdf.

[7] Jim Tankersley and Emily Cochrane, "Biden and Senators Close In on Bipartisan Infrastructure Deal," *New York Times*, June 24, 2021, https://www.nytimes.com/2021/06/23/us/politics/biden-infrastructure-plan.html.

observations noting the IRS' inability to answer taxpayer phone calls.[8] The upcoming base funding appropriations deliberations provide the opportunity to address this problem through adequate customer service funding.

At issue is whether policymakers will side with honest taxpayers and provide the resources the IRS needs to give taxpayers the customer service they deserve — including making it easier to file a tax return, answering taxpayer questions, and providing timely refunds — while ensuring that wealthy people and large corporations that may be inclined to game the tax system are paying the taxes they legally owe. If policymakers stay committed to the IRS rebuilding plan, the nation will have a fairer, more user-friendly, and responsive tax system, and the agency will be far better equipped to perform a basic function of government: to enforce the tax laws Congress enacts to raise the revenue to pay for our military, for key benefit programs such as Social Security, and for the rest of the federal government's operations.

Severely Depleted IRS Urgently Needs Rebuilding

Appropriations for the IRS — referred to in this piece as "base funding" in contrast to the $80 billion of multi-year mandatory funding in the Inflation Reduction Act — were repeatedly cut in real terms over the last decade-plus and remain more than 20 percent below their 2010 level, after adjusting for inflation. As a result, the agency has been forced to cut more than a fifth of its staff.[9]

This funding decline has significantly undermined the agency's capacity to fulfill its core responsibilities of helping taxpayers navigate the tax system and enforcing the nation's tax laws. The IRS is unable to answer many taxpayers' phone calls (roughly 7 in 10 of went unanswered in 2019),[10] relies on computer software dating back to the Kennedy Administration,[11] and has fewer auditors than it did more than six decades ago.

The part of the IRS budget that pays for *enforcement* has faced the deepest cuts of any major part of the agency, at 23 percent between 2010 and 2021, after adjusting for inflation. (See Figure 1.) That includes the enforcement budget account (or line item) itself and the operations support account, which covers office space, information services, and other functions that support enforcement. The number of enforcement staff over that period has fallen by 31 percent, even after a small increase in 2020. Worse still, the number of revenue agents — auditors uniquely qualified to process the complex returns of high-income individuals and corporations — fell by 40 percent between 2010 and 2021, to levels not seen since 1953 despite an economy that is seven times larger and far more complex.

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[8] Office of Senator John Thune, "Thune: We Must Hold the IRS Accountable and Protect Taxpayer Dollars," November 30, 2022, https://www.thune.senate.gov/public/index.cfm/2022/11/thune-we-must-hold-the-irs-accountable-and-protect-taxpayer-dollars.

[9] Samantha Jacoby, "Added IRS Funding Would Help Ensure High-Income Households, Businesses Pay Their Taxes," CBPP, August 12, 2022, https://www.cbpp.org/blog/added-irs-funding-would-help-ensure-high-income-households-businesses-pay-their-taxes.

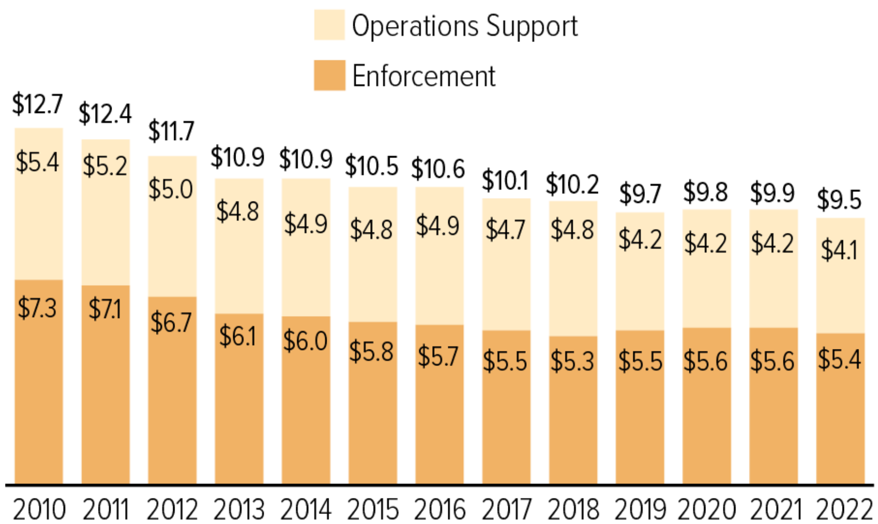
[10] Taxpayer Advocate Service, 2021.

[11] Taxpayer Advocate Service, "Taxpayer Advocate Directive 2022-1," May 31, 2022, https://www.irs.gov/pub/irs-utl/tad-2022-1-memo-from-nta.pdf.

FIGURE 1

Funding For IRS Enforcement and Operations Support Has Eroded

In billions of 2022 dollars



Note: Totals may not add due to rounding. Does not include funding from Coronavirus relief legislation enacted in April and December of 2020 or funding from the COVID-related Tax Relief Act of 2020 enacted for fiscal year 2021. Operations Support includes office space, information services, and other functions that support the enforcement division.

Source: CBPP analysis based on Office of Management and Budget and Congressional Budget Office data

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The gutting of IRS enforcement is particularly troubling given the roughly $470 billion average estimated *annual* gap between federal taxes legally owed and taxes paid from 2017 to 2019[12] — a gap reflecting non-compliance with the nation's tax laws that is disproportionately from those at the top of the income distribution.

The tax returns of high-income and high-wealth people and large businesses are complex, and auditing them is labor intensive. For example, the income of partnerships (which include most investment funds, real estate businesses, and law and accounting firms) is concentrated at the top of the income spectrum and is especially hard to trace to a specific individual because of complex, multi-layered ownership structures.[13] A significant share of partnership income — around 12

[12] IRS, August 2022.

[13] Michael Cooper *et al.*, "Business in the United States: Who Owns It, and How Much Tax Do They Pay?" NBER, 2016, https://scholar.princeton.edu/sites/default/files/zidar/files/cmppsyzz-2016.pdf.

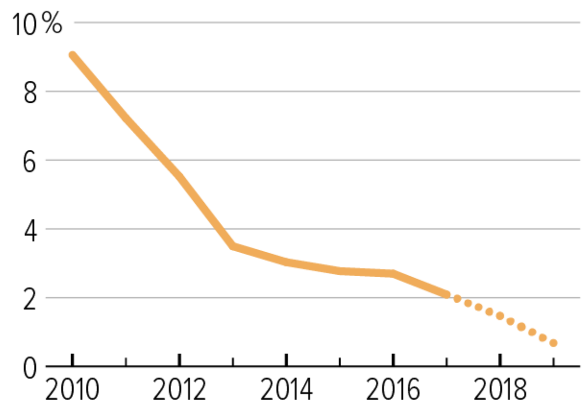
percent, according to the IRS — is misreported,[14] but the IRS audits less than 1 percent of partnerships each year.[15]

The hollowing out of the audit staff has caused audit rates to plummet for wealthy individuals and large corporations. For the largest corporations (those with more than $1 billion in assets), the audit rate declined by more than half between 2010 and 2017. The audit rate for millionaires fell by roughly 77 percent between 2010 and 2017. Preliminary audit data for 2018 and 2019 also suggest that the audit rate may have declined over 90 percent between 2010 and 2019.[16] (See Figure 2.)

FIGURE 2

IRS Audits on Millionaires Have Plummeted

Audit rate, by fiscal year



Note: Millionaires = filers with adjusted gross incomes greater than $1 million. Audit rates are calculated by comparing the number of closed and in-process audits in a given tax year with the number of returns filed in the same tax year. The statute of limitations hasn't ended for tax years 2018-2019, so the audit rates shown for those years may change or go up slightly.

Source: CBPP analysis of IRS Data Book, 2020-2021, Table 17

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A common problem for the IRS when it does conduct audits is that it can't compete with the high-priced lawyers and accountants hired by wealthy people and large corporations to advise them on complex tax planning approaches. To take one example, ProPublica described an out-gunned IRS auditing Facebook while being hampered by insufficient resources to hire expert audit staff and barely being able to meet deadlines imposed by statutes of limitations, with billions of dollars at stake.[17] One major factor behind the agency's struggles in this case was a significant annual cut to its budget in the years shortly following the IRS' creation of a new initiative to monitor aggressive schemes to shift profits overseas.

It is also telling that the IRS' tax gap estimates do not fully include tax non-compliance relating to activities occurring overseas, such as lost tax revenue resulting from companies illegally shifting profits to tax havens or individuals illegally holding money in foreign accounts. Paul Manafort and Richard Gates, for example, were convicted of fraudulently hiding tens of millions of dollars overseas, which was uncovered not in an audit but indirectly through a separate criminal investigation.[18] It is extremely labor intensive for auditors to follow the trails of multi-

[14] IRS, August 2022.

[15] IRS, "Statistics of Income Data Book," 2020-2021, Table 17, https://www.irs.gov/pub/irs-pdf/p55b.pdf.

[16] Audit rates are calculated by comparing the number of closed and in-process audits in a given tax year with the number of returns filed in the same tax year. The IRS generally may assess additional tax within three years of filing a return. This statute of limitations period has not yet ended for tax years 2018 and 2019, so audit rates for those years may increase in the future as additional examinations for those years are opened.

[17] Kiel, January 23, 2020.

[18] Sharon LaFraniere, "Paul Manafort, Trump's Former Campaign Chairman, Guilty of 8 Counts," *New York Times*, August 21, 2018, https://www.nytimes.com/2018/08/21/us/politics/paul-manafort-trial-verdict.html.

layered partnerships, shell corporations, and foreign bank accounts. Monitoring complex tax planning cases takes years and requires the steady funding stream that both the Inflation Reduction Act and strong annual appropriations would provide.

Step One — Mandatory Long-term Funding — Has Been Signed Into Law

Historically the IRS was funded almost entirely by annual discretionary appropriations, which policymakers decide on each year.[19] Given the depleted state of the IRS' workforce and its outdated information systems, Congress and the Biden Administration recognized that regular appropriations, while critical, could not realistically provide it with the amount or certainty it needs to rebuild after a decade of budget cuts. Rather, a fundamental restructuring of funding the IRS was needed.

Specifically, a substantial and long-term stream of "mandatory" funding (that is, funding provided directly in authorizing law) was needed to *supplement* the IRS' base budget to finance a years-long rebuilding effort.[20] Filling past budget gaps in order to rebuild requires substantial funding at a predictable level sustained over many years. Without such long-term certainty, it is difficult for the agency to undertake the years-long process of hiring and training staff and making badly needed technology updates. For example, in 2019 the IRS released a six-year plan to modernize its technology systems, but it could not begin implementing the plan without additional funding.[21]

This long-term certainty is exactly what the Inflation Reduction Act delivers. Roughly $80 billion will be available for the IRS to spend until 2031. Treasury Secretary Janet Yellen recently identified four priorities for the $80 billion in mandatory funding: clearing the backlog of unprocessed tax returns, improving taxpayer services, overhauling the IRS' outdated technology, and hiring new staff.[22]

According to Yellen, the funding "provides the I.R.S. what it has needed for years — a stable stream of mandatory funding that will allow the agency to serve American taxpayers the way they deserve and to enforce the tax laws against high-net-worth individuals, large corporations and complex partnerships who today pay far less than they owe." Yellen also directed the IRS to develop a plan by February 2023 that describes how the new funding will be spent, specifically identifying initiatives designed to "improve taxpayer service, modernize technology, and increase equity in our system of tax administration by pursuing tax evasion by those at the top who today do not pay their tax bill."[23]

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[19] 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.

[20] We previously explained this two-pronged approach to funding the IRS in a 2021 report. Chuck Marr *et al.*, "Rebuilding IRS Would Reduce Tax Gap, Help Replenish Depleted Revenue Base," CBPP, April 13, 2021, https://www.cbpp.org/research/federal-tax/rebuilding-irs-would-reduce-tax-gap-help-replenish-depleted-revenue-base.

[21] IRS, "IRS Integrated Modernization Business Plan," April 2019, https://www.irs.gov/pub/irs-pdf/p5336.pdf.

[22] Alan Rappeport, "Yellen Directs I.R.S. to Embark on $80 Billion Overhaul Plan," *New York Times*, August 17, 2022, https://www.nytimes.com/2022/08/17/business/janet-yellen-irs-overhaul.html.

[23] Tobias Burns, "Yellen eyes $80B boost as 'monumental opportunity' to 'transform' IRS," *The Hill*, August 17, 2022, https://thehill.com/homenews/3605215-yellen-eyes-80b-boost-as-monumental-opportunity-to-transform-irs/.

Now It's Time for Congress to Deliver on Step Two: Base Funding

The Inflation Reduction Act's IRS funding reflects policymakers' acknowledgement that annual appropriations — while critical — cannot provide the depleted IRS with the full funding it needs to rebuild. As noted above, the mandatory funding provided the IRS with a sufficient amount of funding to help the agency rebuild after a decade of cuts by offering a degree of budget certainty to allow the agency to hire and train new staff who can transform its depleted customer service capacity and conduct sophisticated audits of high-income and high-wealth tax evaders, and to make long-term investments in its computer systems.

From the start of the process of what became the Inflation Reduction Act, policymakers on the House and Senate Appropriations and tax-writing committees understood that providing adequate base funding for the IRS through annual appropriations was an essential part of the effort to rebuild the agency. Congress has previously adopted a similar approach in a different programmatic area that requires the coordination and cooperation of the tax-writing and appropriating committees: the well-regarded Health Care Fraud and Abuse Control (HCFAC) program, as we noted last year.[24] HCFAC addresses Medicare and Medicaid fraud and is funded with a substantial multi-year mandatory funding stream on top of annually appropriated base funding.

Providing base funding through appropriations is also important 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 Treasury secretary typically appear before the appropriations subcommittees to explain what the IRS did with its previous funding, and present their request for the coming fiscal year. When needed, annual appropriations legislation can provide congressional direction along with funding.

The Biden Administration proposed $14.1 billion in annual appropriations for the IRS for fiscal year 2023, compared to $12.6 billion in 2022. The House and Senate in their respective bills provide $13.6 billion, which, while somewhat lower than the Administration's request, would maintain 2023 funding at the 2022 level adjusted for inflation. The Administration's request, in combination with the Inflation Reduction Act's mandatory funding, would put the agency's annual budget closer to the level it would have been if its budget had continued to grow at the rate it did between 1977 and 2010, roughly 2 percent per year, on average (after adjusting for inflation).[25] That is, it would put IRS funding close to what it would have been if the funding cuts had never started in 2011. This level of funding would help the IRS enforce tax laws amid growing economic complexity (for example, in emerging areas such as cryptocurrency) and keep up with the agency's growing responsibilities over time.

During year-end deliberations, policymakers should strive to set funding as close to the Administration's request as possible. Failing to provide sufficient annual base funding, especially at the outset of the effort to rebuild the IRS, would undermine the long-term certainty needed to rebuild the agency and jeopardize the entire effort.

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[24] Marr *et al.*

[25] Years 1977-2010 cover the period beginning with the earliest fiscal year, following the 1976 transition quarter, that Office of Management Budget data on IRS budget authority are available until the fiscal year in which the IRS reached its highest funding level in inflation-adjusted terms.