IRS's strategic plan for spending Inflation Reduction Act funds includes familiar enforcement goals

The Internal Revenue Service's recently released strategic operating plan for spending the roughly $80 billion in mandatory funds it will receive over the coming 10 years under the Inflation Reduction Act of 2022 (P.L. 117-169) largely aligns with public pronouncements from Treasury and IRS officials in the months since the massive tax, spending, and deficit-reduction package was signed into law, particularly on the issue of expanding the agency's enforcement capacity. But certain key questions around how the IRS intends to achieve some of its stated goals and how it will measure its success in achieving them are addressed only in broad strokes.
URL: https://www.irs.gov/pub/irs-pdf/p3744.pdf
URL: https://www.congress.gov/117/plaws/publ169/PLAW-117publ169.pdf

Focus on the 'tax gap'

The Inflation Reduction Act generally spread the new mandatory funding boost across all of the IRS's program areas, albeit unevenly, with over half of the total allocation—$45.6 billion—earmarked for beefing up the agency's enforcement activities. Specific decisions for deploying those funds were left to the IRS.

On enforcement, the 150-page operating plan, which was released April 6, explains that the IRS intends to generate revenue by addressing the key drivers of the "tax gap"—the difference between the amount of money owed to the government and the amount actually paid and collected on a timely basis. The IRS's most recent official estimate of the tax gap, covering tax years 2014 through 2016, puts the gross annual amount of foregone revenue at $496 billion and the net amount, which reflects late payments and collections through enforcement actions, at $428 billion. Additional projections included with the official estimate suggest that the tax gap could climb to $540 billion for tax years 2017-2019.
URL: https://www.irs.gov/pub/irs-pdf/p1415.pdf

The nonpartisan Congressional Budget Office has estimated that the new spending mandated under the Inflation Reduction Act will net some $180 billion in additional tax collections. (For prior coverage, see *Tax News & Views*, Vol. 23, No. 31, Sep. 9, 2022.)
URL: https://dhub.blob.core.windows.net/dhub/Newsletters/Tax/2022/TNV/220909_2.html

Targeted taxpayer groups: As expected, the plan states that the IRS will step up its audit focus on high-dollar noncompliance activities among those segments of the tax base that have "complex issues and complex returns" but who have been subject to a "minimal" level of audits in recent years as a result of congressionally mandated cuts to the agency's budget.

Taxpayers that will be subject to heightened audit scrutiny include:

- **Large corporations:** The plan calls for increasing audit rates and compliance activities in the corporate sector with a particular focus on "the largest corporate taxpayers where audit rates have been the lowest." (The term "largest corporate taxpayers" is not defined.) These entities "have complicated, voluminous tax filings that involve a variety of tax issues such as cross-border activities, financial product issues, and transfer-pricing transactions," the plan states, but audit rates for corporate returns generally have fallen from 10.5 percent in 2011 to 1.7 percent in 2019.

- **Large partnerships:** According to the plan, the number of taxpayers filing as partnerships has jumped from 3.2 million to 4.3 million between 2010 and 2020, and partnerships with assets greater than $5 million have increased by 75 percent over the same period. The size and complexity of many partnership structures makes these entities particularly difficult to audit and the overall audit rate for partnerships was only 0.05 percent as of 2019, the plan says.
- **High-income, high-wealth individuals:** The plan notes that individuals with annual income of $1 million or more often file complex returns that require highly specialized audit approaches, but the relative lack of enforcement resources at the IRS over the past decade has meant the audit rate for these taxpayers has fallen from 7.2 percent in 2011 to 0.7 percent in 2019.

Issue-focused areas of investigation: The IRS also intends to expand its audit and enforcement efforts to address a number of specific compliance issues that arise across different sectors of the tax base:

- **Employment taxes, excise taxes, estate and gift taxes:** The plan states that resource constraints at the IRS over the past decade have caused audit coverage in these areas to decline to "levels that erode voluntary compliance."
- **High-risk and emerging tax issues:** Also on the IRS's radar are "high-risk" issues that "arise in multiple taxpayer segments" and present "a higher potential for noncompliance." These include digital assets, listed transactions, and "certain international issues" that may not be fully accounted for in current estimates of the nation's revenue shortfall.

A recent audit report from the Treasury Inspector General for Tax Administration suggests that the IRS's current practices for measuring the tax gap fail to capture revenue shortfalls attributable to noncompliance in several of these issue areas. (For prior coverage, see *Tax News & Views*, Vol. 24, No. 12, Mar. 31, 2023.) With respect to digital assets specifically, then-IRS Commissioner Charles Rettig told Senate Finance Committee members last year that virtual currency transactions alone could be responsible for a tax gap well in excess of current official estimates. (For prior coverage, see *Tax News & Views*, Vol. 23, No. 14, Apr. 8, 2022.)
URL: https://www.tigta.gov/sites/default/files/reports/2023-03/202310016fr.pdf
URL: https://dhub.blob.core.windows.net/dhub/Newsletters/Tax/2023/TNV/230331_2.html
URL: https://dhub.blob.core.windows.net/dhub/Newsletters/Tax/2022/TNV/220408_1.html

Small businesses, less affluent individuals not in scope: As expected, the plan states that the IRS intends to adhere to a directive from Treasury Secretary Janet Yellen issued last August that Inflation Reduction Act funds will not be used to "increase the share of small businesses or households earning $400,000 or less that are audited relative to historic levels."

High-level discussion of next steps

The plan broadly states that the IRS intends to achieve its goal of expanding its enforcement activities through a combination of:

- Centralizing the enforcement and compliance operations within the agency to "to set strategic compliance priorities and route select cases for compliance treatments" and
- Recruiting, hiring, and training additional audit specialists with the requisite skill sets to address the complex issues presented by the taxpayer groups that the agency believes are the greatest contributors to the tax gap. That hiring surge will be bolstered by an expansion of professional staff at the IRS's Independent Office of Appeals and the Office of Chief Counsel to address tax controversy and litigation issues arising from the enhanced compliance program.

Underpinning those efforts will be the use of enhanced data and analytics to, among other things "assist in the selection of compliance cases based on the highest risk of noncompliance" and "improve [the IRS's] understanding of voluntary compliance by enhancing the timeliness, granularity, and comprehensiveness of tax gap measurement." The increased reliance on data and analytics will be made possible through a separate allocation of Inflation Reduction Act funds to overhaul the IRS's current antiquated information technology systems.

The plan calls for the IRS to set up its centralized compliance operations in fiscal year 2024. Expansion of the agency's enforcement ranks is already underway. The plan notes that the IRS has budgeted for 1,543 new full-time equivalent enforcement positions for fiscal year 2023 and 7,239 in fiscal year 2024, with additional hiring expected over the 10-year budget window. "Refined approaches and treatments" tailored to the specific compliance issues presented by large corporations, large partnerships, and high-income and high-wealth individuals are scheduled to be implemented in fiscal year 2025, and a new analytics-driven process for selecting compliance cases is expected to be in place in fiscal year 2026, the plan says.

Some unanswered questions

The plan as released lacks some details on issues that have been of concern to lawmakers in Congress—particularly among Republicans, who uniformly opposed the Inflation Reduction Act and in the wake of its enactment have objected to what they contend are plans for creating a "super-sized IRS."

It's worth noting, for example, the plan does not cite target audit rates for corporations, large partnerships, and affluent individuals that could be used to measure the success of an expanded IRS enforcement program. Instead, it generally states that an indicator of success will be an "increase in audit rates and compliance treatments" for these taxpayer groups.

Moreover, although the plan includes hiring projections on the enforcement side for fiscal years 2023 and 2024, it does not provide a projected headcount for enforcement personnel over the remainder of the budget window (through 2031).

Also not included in the plan are specific actions the IRS intends to take to ensure that small businesses and individuals with income below $400,000 are held harmless from stepped-up audit scrutiny, although it reiterates the agency's commitment to the Treasury Department's directive and states generally that the agency's increased reliance on data and analytics will help it to "better identify high-dollar noncompliance while minimizing audits of compliant taxpayers."

IRS Commissioner Daniel Werfel elaborated on some of these issues during an April 19 Senate Finance Committee hearing on the Biden administration's fiscal year 2024 budget request for the agency.

Addressing audits of small businesses and less affluent individuals, Werfel told the panel that the IRS will use 2018 audit rates as the benchmark for defining "historic" levels of audit activity and would base the $400,000 income threshold on "total positive income."

On the issue of the IRS's long-term staffing plans, Werfel indicated that details on "expected hiring across the full 10-year window" should be released "within the next three to six weeks." (See separate coverage in this issue for additional details on Werfel's comments at the hearing.)

The plan document itself also notes that the IRS will be monitoring its progress in implementing the spending blueprint and will make revisions as the agency "learn[s] more about what works and as the operating environment changes." Updates on revisions and the IRS's general progress in implementing the plan will be reported to Congress.

Plan assumes stable discretionary funding

The plan notes that the IRS's spending goals for the $80 billion in new mandatory funding assume that Congress maintains the agency's annual *discretionary* funding allocations—that is, funding provided under the annual appropriations process—at fiscal year 2022 levels, "including growth for inflation and pay raises." A reduction in discretionary appropriations that forces the agency to cannibalize the Inflation Reduction Act funds to cover general budget needs "would be to the detriment of the service, technology, and compliance initiatives envisioned to transform the IRS," the plan states.

On enforcement specifically, the plan notes that diverting Inflation Reduction Act funding "to cover base discretionary enforcement needs" instead of an expanded compliance program "would lead to more noncompliance, leading to decreased revenue collection and increased deficits."

The agency has already seen one cut in discretionary funding since the Inflation Reduction Act became law. The Consolidated Appropriations Act, 2023 (P.L. 117-328), the fiscal year 2023 omnibus appropriations measure that Congress approved and President Biden signed during the lame duck legislative session late last year, trimmed $275 million from the IRS's budget relative to fiscal year 2022 by zeroing out funding for business systems modernization accounts—a change that Republicans demanded in the wake of the Inflation Reduction Act. GOP lawmakers also have vowed to further trim the IRS's base discretionary appropriation in future budgets if the mandatory Inflation Reduction Act funding remains in force.

URL: https://www.congress.gov/117/bills/hr2617/BILLS-117hr2617enr.pdf

The Republican-led House approved a bill along strict party lines in January that would rescind some $71 billion of the Inflation Reduction Act funds—specifically, the portions allocated for enforcement activities and operations support—while preserving the remaining $9 billion that is set aside for taxpayer services and business systems modernization. (For prior coverage, see *Tax News & Views*, Vol. 24, No. 2, Jan. 13, 2023.) House Republican leaders released legislation this week that included a similar proposal as one of several conditions for raising the federal debt ceiling. (See separate coverage in this issue for details on developments around the debt ceiling.)
URL: https://docs.house.gov/billsthisweek/20230102/BILLS-118HRPIH-IRS-repeal.pdf
URL: https://dhub.blob.core.windows.net/dhub/Newsletters/Tax/2023/TNV/230113_1.html
URL: https://www.speaker.gov/wp-content/uploads/2023/04/LSGA_xml.pdf

The White House and Senate Democrats generally regard repeal of the new funding as a nonstarter, however.

President Biden's fiscal year 2024 budget blueprint, which was released last month, proposes to increase the IRS's regular operating budget to $14.1 billion for the coming fiscal year (a $1.8 billion increase over its fiscal 2023 level). It also would extend the agency's mandatory funding stream for two additional years beyond what was enacted in the Inflation Reduction Act, proposing allocations of $14.3 billion in fiscal year 2032 and $14.8 billion in fiscal year 2033. (For details on the administration's tax-related budget proposals for the coming fiscal year, see *Tax News & Views*, Vol. 24, No. 9, Mar. 10, 2023.)
URL: https://dhub.blob.core.windows.net/dhub/Newsletters/Tax/2023/TNV/230310_1.html

Congressional Democrats, Republicans divided

Reactions to the plan on Capitol Hill have, predictably, split along party lines. House Ways and Means Committee ranking member Richard Neal, D-Mass., who chaired the panel when the Inflation Reduction Act moved through Congress, noted in an April 6 news release that the increased funding has already yielded improvements in customer service and will "soon" make the IRS "better equipped to hold tax cheats accountable, recover taxes owed, and reduce the tax gap."

But current Ways and Means Committee Chairman Jason Smith, R-Mo., who took the gavel when the 118th Congress convened in January, criticized the plan as being short on details.

"If this is a 'plan,' why does it omit how many employees the agency seeks to hire over 10 years, fail to identify target audit rates for taxpayers, and lack specific details about how the money will be spent beyond the next two years? . . . This is a punt, not a 'plan,' and it raises more questions than answers about how Americans' tax dollars will be spent to go after working families and small businesses," Smith said in an April 6 release. (House taxwriters on both sides of the aisle likely will weigh in on the plan during an April 27 Ways and Means Committee hearing with Commissioner Werfel focusing on "accountability and transparency at the Internal Revenue Service.")

A similar split emerged between Democratic and Republican members of the Senate Finance Committee during that panel's April 19 hearing with Werfel on the 2023 tax filing season and the administration's fiscal year 2024 budget request for the IRS. (See separate coverage in this issue for details.)

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