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Partisan split over IRS funding, expanded enforcement plans as Ways and Means debates White House budget request

The roughly $80 billion in mandatory funding allocated to the Internal Revenue Service in the next 10 years under the Inflation Reduction Act of 2022 (P.L. 117-169) and the agency's plans for spending those funds dominated the discussion at an April 27 House Ways and Means Committee hearing with IRS Commissioner Daniel Werfel to consider the Biden administration's fiscal year 2024 budget request for the agency.
URL: https://www.taxnotes.com/research/federal/legislative-documents/public-laws-and-legislative-history/inflation-reduction-act-of-2022-%28p.l.-117-169%29/7dybc

As expected, the debate fell along party lines. Republican taxwriters argued that the new funds—particularly the amounts allocated to enforcement—could be used to turn the IRS into an auditing behemoth with an inordinate focus on small businesses and less affluent individuals. It's worth noting that GOP lawmakers in both chambers were united in opposing the Inflation Reduction Act as it moved through Congress last year, and House Republicans have voted twice this year to rescind the bulk of the new IRS funding: first in January in the Family and Small Business Taxpayer Protection Act and again this week in the Limit, Save, Grow Act, the debt limit legislation put forward by Speaker Kevin McCarthy of California. (See separate coverage in this issue for details on the GOP's debt limit proposal.)

Democrats, meanwhile, countered that the funding will help the agency to recover from years of congressionally mandated budget cuts and provide it with the resources it needs to address 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.

Enforcement

The Inflation Reduction Act allocated $45.6 billion of the total IRS mandatory spending package to enforcement. According to the strategic operating plan the IRS released on April 6, the agency's initiatives in this area will focus on narrowing the tax gap by increasing the ranks of revenue agents with the specialized training needed to audit those segments of the tax base that it believes present the greatest risk of noncompliance: corporations, large partnerships, and high-net-worth individuals. (For details of what's in the strategic operating plan, see *Tax News & Views*, Vol. 24, No. 14, Apr. 21, 2023.)
URL: https://www.irs.gov/pub/irs-pdf/p3744.pdf
URL: https://dhub.blob.core.windows.net/dhub/Newsletters/Tax/2023/TNV/230421_3.html

Republicans concerned about hiring plans, audit rates: Ways and Means Committee Chairman Jason Smith, R-Mo., criticized the strategic operating plan for its lack of specifics on the agency's enforcement plans and he pressed Werfel for details on issues such as how many new enforcement specialists the IRS intends to hire and how it will ensure that it adheres to a Treasury Department directive that the Inflation Reduction Act funds not be used to increase audit rates on small businesses and individual taxpayers with income of less than $400,000 "above historic levels."

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The operating plan as released includes enforcement hiring projections only for fiscal years 2023 and 2024; however, Werfel promised Smith that the IRS is working on a final set of estimates and will provide detailed information on the agency's hiring plans across the full 10-year budget window (through 2031) within "the next few weeks."

He noted that the projected staffing increases are at levels the IRS considers necessary to keep pace with the increasing complexity of the tax code and the growing number—and complexity—of tax returns being filed. The agency currently has only 2,600 examiners to cover a universe of some 360,000 large corporations and high-wealth individuals and that mismatch has resulted in an erosion in audit coverage, he said.

Werfel also pledged that audit rates for taxpayers with income below the $400,000 threshold will be capped at the level reported for tax year 2018—the most recent year that falls outside the statute of limitations for undertaking new audits—and he reiterated that the IRS intends to focus its expanded compliance scrutiny only on those segments of the tax base that present high-dollar noncompliance risks.

Less affluent taxpayers will see "no new wave of audits" for the next several years, he said.

Republican taxwriter Adrian Smith of Nebraska asked if the IRS has set a target rate for audits of high-wealth, high-net-worth individuals. (The operating plan generally states that an indicator of IRS's success in enhancing its enforcement program will be an "increase in audit rates and compliance treatments.")

Werfel replied that the IRS will use audit rates reported for 2010 as a "benchmark," saying that year marked the beginning of the decline in IRS resources as a result of congressional budget cuts; however, he stopped short of characterizing 2010 audit rates as a hard target. Instead, he said that the agency intends to measure its success in implementing the operating plan by looking at audit rates in years when the IRS was "at its healthiest" and gauging whether audit rates going forward are approaching those levels.

Democrats stress urgency of addressing tax gap: For his part, Ways and Means Committee ranking member Richard Neal, D-Mass., who chaired the panel when the Inflation Reduction Act was approved and signed into law last year, argued that the new IRS funding will "eliminate the two-tiered tax system" that has allowed "the wealthy and well-connected . . . to get away with not paying their fair share at the expense of everyday Americans."

Werfel, responding to a question from Neal about how the IRS intends to expand its enforcement operations, stated that the agency needs to address the "chasm" between the current size of the compliance and enforcement team and the growing number of large corporate and high-wealth taxpayers who have multiple sources of income and file complex returns that can run into thousands of pages.

"We have to up our game," Werfel said, explaining that the IRS needs to hire auditors, data scientists, and technology specialists with the skill sets to determine more precisely where the gaps are in our revenue collections and recoup the money legally owed to the government. (Werfel made a similar point when asked by Republican Michelle Steel of California about a recent *Politico* story citing a relatively large percentage of

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audits of high-wealth returns that result in no additional tax due: “The reason why you see zero-balance-due audits is because we don’t have the right capacities today to unlock these complex returns. We need to tap into the people that know how these returns were constructed,” he said.)

When Neal asked about the impact of rescinding the additional enforcement funds as proposed by House Republicans, Werfel replied that the resources provided under the Inflation Reduction Act represent “the difference between [providing] basic services and advanced services.” Without that funding, he said, the IRS would be unable to assure the public that “we can assess wealthy taxpayers in the same way we assess middle- and low-income taxpayers.”

Democratic taxwriter Brian Higgins of New York also emphasized the issue of equitable enforcement of the nation’s tax laws and said that the House GOP’s proposal to rescind the Inflation Reduction Act funding in its debt limit measure is at odds with the party’s stated goal of shrinking the federal deficit. (The nonpartisan Congressional Budget Office has estimated that rescinding the funding as proposed in the Limit, Save, Grow Act would, on net, increase the deficit by roughly $120 billion over the 10-year budget window through the combined effect of $191 billion in foregone tax collections and $71 billion in direct spending reductions.)
URL: https://www.cbo.gov/system/files/2023-04/59102-Arrington-Letter_LSG%20Act_4-25-2023.pdf

“You can’t talk about debt and deficit with any credibility and not be bullish about collecting money that is fairly [assessed] against corporations for income taxes that are reporting billions of dollars in profits,” Higgins said.

FY 2024 budget request

President Biden’s fiscal year 2024 budget blueprint, which was released last month, proposes to increase the IRS’s regular operating budget—determined as part of the annual congressional appropriations process—to $14.1 billion for the coming fiscal year, a $1.8 billion increase over its fiscal year 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

In response to several questions from taxwriters in both parties about the distinction between the IRS’s discretionary budget allocation and the mandatory spending enacted under the Inflation Reduction Act, Werfel explained that the administration’s discretionary spending request for the agency would allow it to continue providing the base level of services it currently offers, noting that its day-to-day operations have been hampered by a decade of congressionally mandated budget cuts. He also cautioned against diverting mandatory Inflation Reduction Act funds to pay for basic agency functions—an issue also highlighted in the strategic operating plan. The new mandatory funding, he said, is intended to enable the IRS to enhance its service offerings, enforcement programs, and technical capabilities above and beyond current levels.

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1099-K filing thresholds

Turning to issues outside of the agency's budget, Democratic taxwriter Linda Sanchez of California and Republican Carol Miller of West Virginia asked Werfel about challenges for taxpayers stemming from the more stringent Form 1099-K reporting thresholds imposed on third-party settlement organizations under the American Rescue Plan in 2021. That legislation reduced the dollar threshold for the reporting requirement from $20,000 to $600 and eliminated the 200-transaction threshold, with the changes effective for calendar years after 2021; however, the Treasury Department announced late last year in Notice 2023-10 that it would delay enforcement of the new rules until after 2023. Many lawmakers had hoped to repeal or delay the new reporting requirements during last year's post-election lame duck legislative session but were unable to reach a deal on a package that included this or other tax law changes (aside from a package of retirement savings incentives known as SECURE 2.0) that had bipartisan support.
URL: https://www.irs.gov/pub/irs-drop/n-2023-10.pdf

Werfel replied that the provision as enacted was more complicated than the agency had anticipated and that IRS officials have been meeting with stakeholders to determine how the requirement can be implemented in a way that gives taxpayers the clarity they need to comply.

He also commented in response to questions from Sanchez and Miller that increasing the reporting threshold would cut the volume of filings submitted to the IRS and make the provision more administrable for the IRS, but he added that any specific judgments on how—or whether—the requirement should be modified fall under the purview of the Treasury Department.

Return filing backlogs

Taxwriters from both sides of the aisle also asked Werfel about the IRS's progress in addressing a backlog of unprocessed paper returns—largely a byproduct of pandemic-related facilities closures—and employee retention tax credit (ERTC) claims.

Werfel told the panel that with the filing season now concluded, the IRS can redeploy staff to accelerate work on these issues.

In an exchange with Rep. Don Beyer, D-Va., he said that the agency has been using Inflation Reduction Act funds to scale up its ability to scan paper returns into a machine readable format and that it is an "absolute priority" to make "an enormous dent" in the backlog of unprocessed returns by the start of next filing season.

In response to questions from Republican Reps. Brad Wenstrup of Ohio, Lloyd Smucker of Pennsylvania, and David Kustoff of Tennessee, Werfel commented that ERTC claims pose processing challenges because they span multiple years and present a high potential for fraud. The agency's post-filing-season goal is to complete between 40,000 and 50,000 ERTC claims a week, up from 20,000 a week during the filing season, he said.

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Some unity on rolling back TCJA business offsets at Georgia field hearing

In other Ways and Means Committee developments, the panel's April 21 field hearing in Peachtree City, Ga., on economic conditions in the US south provided a glimmer of consensus between Republican and Democratic taxwriters on the question how to respond to limitations on the deductions for research expenditures and net business interest expenses and the phase-out of bonus depreciation that were enacted in the Tax Cuts and Jobs Act of 2017 (P.L. 115-97) and have recently taken effect.
URL: https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf

The Georgia hearing was the third such event Chairman Smith has convened in the new Congress to give taxwriters an opportunity to hear directly from middle-class taxpayers and small business owners about what he has described as "the challenges facing their families and communities and potential ideas to help." Previous hearings were held in West Virginia and Oklahoma. Additional hearings are possible in other regions, although dates and locations have not yet been announced and it is currently unclear whether any subsequent events will be focused on tax or other issues under the committee's jurisdiction, such as trade or health care.

Republicans seek TCJA business revenue fixes: Following the pattern of previous field hearings, Chairman Smith and the panel's Republicans argued that the TCJA played a significant role in expanding the US economy and called for a permanent extension of the provisions on the individual side of the code—particularly, the section 199A deduction for passthrough income—that are scheduled to expire after 2025. However, they also argued that Congress needs to reverse some business-focused revenue raisers enacted in the TCJA that, in their view, could hamper economic growth, including provisions to:

- Require certain research expenditures to be amortized over a number of years rather than deducted immediately, a change that took effect at the beginning of 2022;
- Tighten the rules for deducting net business interest expenses, beginning in 2022, by requiring companies to calculate their adjusted taxable income based on earnings before interest and taxes as opposed to earnings before interest, taxes, depreciation, depletion, and amortization for purposes of applying the limitation on the deduction; and
- Reduce the bonus depreciation percentage rate from 100 percent to 80 percent in 2023 and phase it down by an additional 20 percentage points each year until it reaches 20 percent in 2026 and falls to zero in 2027 and beyond.

The GOP's invited witnesses at the hearing—all of whom were local small business owners—agreed that bonus depreciation and the deductions for research and business interest expenses help mitigate the risks involved when business owners make investments in research and capital equipment and that the limitations enacted under the TCJA will inhibit businesses from innovating and expanding. They also contended that the section 199A deduction makes it easier for small businesses to invest in their communities and should be made permanent.

Democrats want TCJA business fixes—plus child tax credit enhancements: Democratic taxwriters Suzan DelBene of Washington and Don Beyer of Virginia stated that many lawmakers on their side of the aisle also

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would like to repeal or delay the TCJA business offsets—although they noted that it was Republicans who baked those limitations and phase-outs into the legislation to meet revenue constraints imposed by the budget reconciliation process. (Among those constraints is a requirement that legislation moved under budget reconciliation rules cannot increase the federal deficit outside the 10-year budget window.)

DelBene, who served as acting ranking member during the hearing, also commented that House Democrats included a four-year extension of section 179 expensing in the Build Back Better legislation—the predecessor to the Inflation Reduction Act—that cleared the chamber in 2021. (The Build Back Better bill, which moved under budget reconciliation rules, ultimately stalled in the Senate because it lacked the support of all 50 Democrats in the chamber. The Inflation Reduction Act, which cleared both chambers and was signed into law last year, did not include the fix to section 179.)

But Democrats and their invited witness—who represented a think tank promoting small business entrepreneurship among women, minorities, and residents of rural communities—flatly opposed a permanent extension of the section 199A deduction, contending that its benefits largely redound to wealthier taxpayers.

Democrats also advocated for a permanent extension of the now-expired enhancements to the child tax credit that were enacted in the American Rescue Plan Act—the emergency COVID relief legislation that moved through Congress without Republican support in 2021. Those enhancements—which, among other things, made the credit fully refundable and allowed taxpayers to receive benefits in the form of advanceable cash installments—helped to put money into the pockets of working class families, they said.

Chairman Smith has stated in recent months that he would consider an expansion of the child tax credit if it is paired with a work requirement, although he did not raise the issue during the April 21 hearing.

Uncertain prospects for action this year: Lawmakers tried without success during last year's post-election lame duck legislative session to negotiate a bipartisan agreement that combined some sort of relief from the TCJA business revenue provisions with an extension of the child tax credit enhancements. Although there has been talk within various circles in Congress about moving a similar package this year, it remains unclear whether a bipartisan agreement is possible when both chambers are so narrowly divided. Also unclear is what legislative vehicle might be available to advance such an agreement in the event one is reached.

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