October 1, 2020

Funding the IRS Pays Off: Preventing Tax Dodging by Wealthy Filers Is the First Step to Fixing Our Tax Code

The Internal Revenue Service (IRS) has faced harsh budget cuts over the last decade, hindering its ability to serve the American people in fundamental ways. Not only have funding cuts led to deteriorating customer service for law-abiding taxpayers, they have also weakened the IRS's ability to ensure that corporations and wealthy individuals pay their fair share of the revenues necessary to sustain vital benefits and services Americans need from their government. The twin health and economic crises stemming from the COVID-19 pandemic made the customer service problem painfully clear. After Congress passed the bipartisan CARES Act, the underfunded IRS faced challenges in delivering emergency Economic Impact Payments (EIPs) to struggling Americans. Delivering any future emergency relief will depend on the IRS's ability to act quickly and effectively.

Even before the pandemic, the underfunded IRS struggled to carry out its core functions of tax collection and enforcement. Over the last decade, the agency's backlog of delinquent accounts from filers who either did not pay the tax they owed or paid only a portion of the amount due increased, while IRS enforcement activities declined by 30 percent, undermining our tax system. **According to a recent report by the Treasury Inspector General for Tax Administration (TIGTA), due to a lack of resources, the IRS failed to audit more than 897,000 wealthy individuals who skipped out on filing tax returns over a three-year period – and these individuals owed nearly $46 billion in taxes.** Making sure wealthy taxpayers, as well as wealthy nonpayers like President Trump, who has reportedly paid no income taxes at all in 11 of the previous 18 years, pay what they truly owe will strengthen the integrity of our tax system and help close our nation's $381 billion annual net tax gap. The net tax gap is the amount of taxes that remains unpaid after the IRS has sought – through administrative or enforcement actions – to collect taxes owed. Increased investment in the IRS should be where tax reform begins.

Republicans' Political Attacks and Harsh Budget Cuts Gutted the IRS

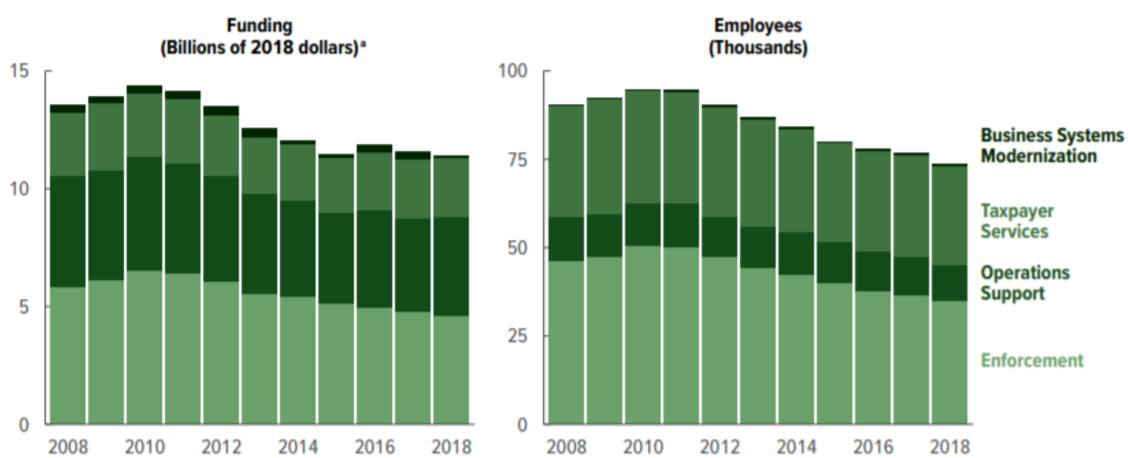
The IRS is one of the few government agencies that actually makes money. However, Republicans have politically targeted and vilified the agency for decades as part of their tax-cut agenda. After Republicans took control of the U.S. House of Representatives in 1995 and Newt Gingrich became Speaker of the House, calls to abolish the IRS became a mainstream Republican talking point. Soon after, the Republican-controlled Senate held a series of dramatic hearings on alleged abuses by the IRS (later debunked by the Government Accountability Office), followed by a new law limiting the agency's collection powers and independence.

Not surprisingly, IRS audits and collections sunk to historic lows. When Republicans took the House majority again in 2011, they pushed to cut the IRS's budget, citing the agency's implementation of the Affordable Care Act – a law that Congressional Republicans (and now President Trump) have spent years trying to sabotage and repeal. Soon, Republicans targeted the IRS again by holding hearings and launching investigations into reports about the agency targeting right-leaning nonprofits and inappropriate spending on its conferences. Despite the Obama Administration's efforts to secure sufficient funding for the IRS, Republican lawmakers continued to punish the agency and push severe funding cuts. For example, House Republicans recommended cutting the President's budget request for the agency by 30 percent for fiscal year 2014.

Since 2010, the IRS's budget and staff have been steadily cut in real terms, leaving the agency understaffed, constrained, and operating with archaic information technology (IT) systems. From 2010 through 2018, IRS funding was cut by 20 percent in inflation-adjusted dollars, resulting in the elimination of 22 percent of its staff. These cuts have gutted the agency; depleted its well-trained, specialized staff charged with auditing corporations and wealthy

Figure 6.

Funding and Number of Employees of the Internal Revenue Service, by Appropriation Account



Source: Congressional Budget Office, using data from the Internal Revenue Service.

Employees are measured as the number of full-time equivalents (FTEs). Because not all employees work full time in a given year, the Internal Revenue Service calculates the number of FTEs as the total number of hours worked divided by the number of hours that a full-time employee would work.

a. Appropriations are expressed in 2018 dollars using a combination of the employment cost index for wages and salaries and the chain-weighted gross domestic product price index, based on the share of labor and nonlabor costs.

taxpayers; and weakened its ability to carry out emergency tasks. As Chairman Yarmuth stated at the House Budget Committee's July hearing on the need for federal investments in technology, "funding cuts over the past decade have prevented the IRS from modernizing its IT systems, deteriorating the agency's ability to not only carry out its core function of tax collection and enforcement, but also needlessly prolonging the delivery of stimulus payments to workers and families during the coronavirus pandemic and recession…we have to invest in modernization now."

Underfunded IRS Faces Challenges in Serving the American People

The harsh budget cuts that led to understaffing and antiquated IT systems at the IRS also impeded the agency's ability to serve the American people. Amid the coronavirus pandemic, lack of resources and outdated systems created immense challenges for the agency to deliver EIPs to struggling Americans and carry out its core collection and enforcement functions.

Too many Americans encountered glitches and delays in receiving COVID-19 relief — While the IRS achieved an unprecedented undertaking by disseminating 159 million EIPs, worth more than $267 billion, to Americans in just two months, too many Americans in need were forced to grapple with delayed or erroneous EIPs. Glitches prevented some Americans from receiving the full amount to which they were entitled; others received payments that erroneously omitted the $500 payment per child. The agency's "Get My Payment" portal, which was set up to help people check on their payments, failed to work for many, and tens of thousands of Americans are still waiting for the relief they were promised. The IRS has tried to address some of these issues recently by implementing a non-filer tool for people who typically do not file federal income tax returns, providing catch-up payments to 50,000 people for money that was withheld due to their spouse's past-due child support, and releasing a state-by-state breakdown of the nearly nine million people who typically are not required to file federal income tax returns but may qualify for an EIP.

IRS's collection and enforcement activities shrink — Lacking staff and resources, the IRS has been forced to shrink its programs—even those that brought in billions of dollars, like pursuing individuals who do not even file tax returns. This is great news for wealthy tax cheats who have become less fearful of being audited by the IRS. **According to the IRS's budget request, "every taxpayer service and enforcement statistic has declined considerably since 2010."** Over the last decade, the agency's backlog of delinquent accounts from filers who owe back taxes has increased, and the amount of funding and staff allocated to tax enforcement activities has declined by 30 percent. Consequently, between 2010 and 2018, the share of individual income tax returns the IRS examined plummeted by 46 percent, and the share of corporate income tax returns it examined dropped by 37 percent.

Weakened IRS Enforcement Undermines the Tax System

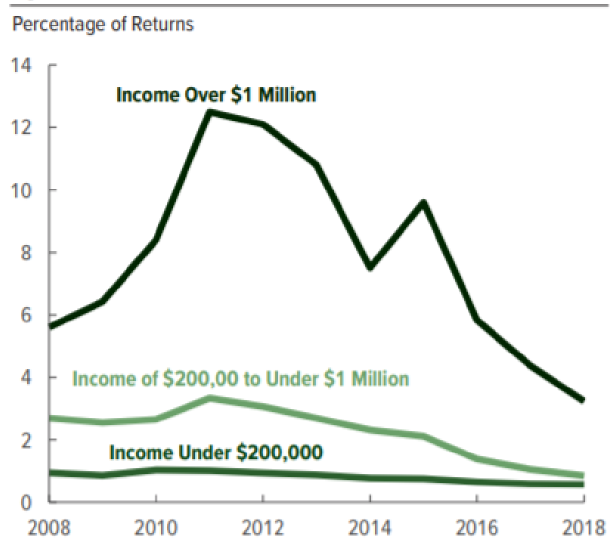
The IRS's enforcement activities affect revenues directly, by collecting billions of unpaid taxes, and indirectly, by influencing taxpayers' behavior. Taxpayers may be more likely to comply with tax laws if they perceive a higher risk of being caught, even if they are not audited themselves. Researchers have found that for several years following an individual income tax audit, people tended to increase the amount of taxable wage and self-employment income they report on their tax returns. Among corporate taxpayers, an increase in the overall examination rate increased all taxpayers' reported effective tax rate. Studies have shown that people who undergo audits are less likely to evade taxes in the future, just as nonfilers who are caught are more likely to file voluntarily. Without enforcement, tax evaders are emboldened and will grow in number.

According to the IRS's recent report on uncollected taxes, the agency estimated an average of $441 billion (16 percent) of the taxes owed annually between 2011 and 2013 was not paid in accordance with the law. The IRS collected an average of $60 billion of those unpaid taxes annually through its enforcement activities, reducing the gap between taxes owed and taxes paid in those years to an average of $381 billion per year. Most of these unpaid taxes were due to taxpayers' underreporting their income. High-income taxpayers primarily underreport income because more of their income comes from opaque categories like dividend income, capital gains, and proprietorship income. Furthermore, the wealthy can afford to hire accountants and lawyers to help them game the system and avoid paying their fair share.

Audits of millionaires and large corporations plummet — As IRS enforcement weakened over the last decade, examination of the wealthy has declined the most. From 2010 to 2015, audits of people making more than $1 million plummeted by 72 percent, and audits of corporations worth more than $20 billion plummeted by 34 percent. Between 2010 and 2018, the number of revenue agents and revenue officers, highly specialized enforcement employees who handle the most complex examinations and collections cases, fell by 35 percent and 48 percent, respectively. As enforcement declines, the number of people who are not filing taxes has increased.

Figure 9.

Examination Rate for Individual Returns, by Amount of Income



Source: Congressional Budget Office, using data from the Internal Revenue Service.

The significant staffing losses of specialized enforcement employees who take on the complicated, in-person examinations of high-income taxpayer cases have resulted in **a perverse system where the examination rate for higher-income taxpayers fell, while the examination rate for lower-income taxpayers remained fairly stable.**

Furthermore, nearly all examinations of lower-income taxpayers were initiated because of claims for the earned income tax credit (EITC). The burden of painful tax audits has shifted unfairly onto lower-income people who work for a living.

According to the Treasury Inspector General for Tax Administration, J. Russell George, "there's no question that more lower-income people are being examined than upper-income people," because "a lot of the work that relates to poor people is the type of work that's relatively simple for the IRS to conduct, especially with the work of junior IRS employees. The more sophisticated the income tax, the more involved it is and the longer it takes." The IRS's deteriorated ability to audit the wealthy is counterproductive, because **when revenue agents do have time to pursue high-income audits, the returns are astounding.** In 2013, when the IRS agents conducted more than 6,000 audits on taxpayers who made more than $5 million, these audits resulted in *$880 million of recommended additional taxes*. This worked out to be $4,545 for every hour each agent spent on these cases.

Ferreting out fishy high-income tax practices is labor-intensive work — As an illustrative example, recent reporting on two decades of tax-return data for President Trump and his companies through 2017 reveals several dubious practices that warrant rigorous IRS oversight. The President has been in a decade-long audit battle with the IRS over the legitimacy of a $72.9 million tax refund that he claimed and received after declaring huge losses, but the reporting highlights many other questionable writeoffs that need scrutiny by experienced IRS staff. President Trump paid no federal income taxes in 11 of 18 years, largely because he reported losing much more money than he made. The President paid only $750 the year he won the presidency and another $750 in his first year in office. In 2017, President Trump paid less than those earning under just $5,000, and less than every income group earning more than $20,000, on average. The IRS's deteriorated enforcement has contributed to rampant tax avoidance and abuse by the wealthy – including our nation's 45th president.

Fully Funding the IRS Pays Off

The IRS' budget-to-revenue ratio ranks among the lowest for tax collection agencies in the world. Studies show that increasing IRS enforcement funding would increase tax collections by much more than the cost. University of Pennsylvania law professor Natasha Sarin and former Secretary of the Treasury Larry Summers have argued that increasing the IRS budget over the next 10 years by $100 billion would raise revenues by as much as $1.15 trillion over that period. The Congressional Budget Office more conservatively estimated that increasing the IRS's funding for examinations and collections over 10 years by $20 billion would increase revenues by $61 billion.

We must make smart, solid investments in core government functions so our agencies and systems work for the American people – especially in their time of need. Short-sighted calls for cutting critical government services are unwise and counterproductive to our goal of serving the American people. Increased investment in the IRS will not only strengthen its ability to carry out emergency tasks, such as providing additional EIPs to struggling Americans during the coronavirus pandemic, and improve its core collection and enforcement activities, it will also strengthen the integrity of our tax system and ensure every taxpayer—especially wealthy tax cheats—pay their fair share.