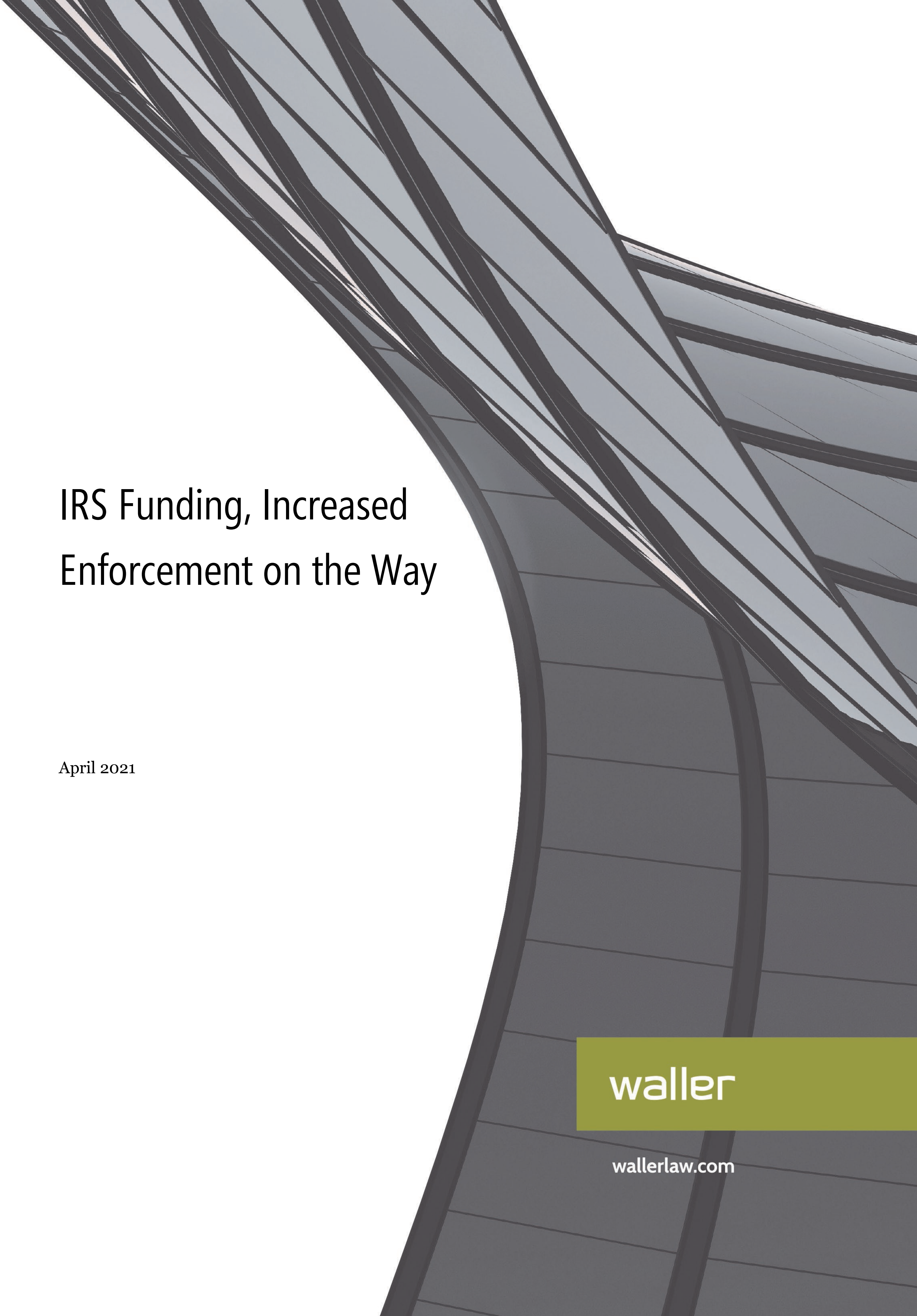
IRS Funding, Increased Enforcement on the Way

April 2021



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For the last several years, IRS audit rates have been on the decline. The IRS has 17,000 fewer auditors now than it did in 2010, and more demands have been placed on the IRS to distribute funds or credits that have little to do with collecting tax. As a result, the audit system has broken down, and fair audit coverage has largely collapsed. In 2012, the audit rate on incomes between $1 million and $5 million was 12 percent; in 2018, that number had dropped to 0.05 percent.

However, audit coverage is expected to increase dramatically in the near future, especially for upper income taxpayers.

Demonizing the high income

In March of this year, a report entitled "Tax Evasion at the Top of the Income Distribution: Theory and Evidence" was released by the National Bureau of Economic Research and concluded among other things that "noncompliance" is rampant. The report found that 36 percent of federal income taxes unpaid are owed by the top 1 percent and that collecting all unpaid federal income tax from this group would increase federal revenues by about $175 billion annually.

The report also stated that unreported income as a fraction of true income rises from 7 percent in the bottom 50 percent to more than 21 percent in the top 1 percent, of which 6 percent corresponds to undetected, sophisticated evasion. Per the report, "Accounting for tax evasion increases the top 1% fiscal income share significantly."

Need for Revenue

At a Senate Finance Committee hearing on April 13, IRS Commissioner Charles Rettig estimated regarding the 2021 filing season, "it would not be outlandish to believe that the actual tax gap could approach, and possibly exceed, $1 trillion per year."

Rettig's tax gap estimate is more than double the gross $441 billion annually that the IRS calculated it lost to taxpayer noncompliance from 2011 to 2013, the last time the gap was assessed between what taxpayers owed and what the IRS collected. It is also around $400 billion higher than a previous worst-case estimate by former IRS Commissioner Charles O. Rossotti published in March 2020.

Noting that Rettig's $1 trillion tax gap is in line with the committee's own analysis, Chair Ron Wyden, D-Ore., said that "it's time to throw out business as usual on this" because that "has proven to be a rainmaker for cheaters and criminals, and unfair to everybody else."

Opposition

Nina Olson, the former head of the Taxpayer Advocate Service and better known for efforts on behalf of the average and lower income American taxpayer and identifying systemic problems in the operation of the IRS and the tax law, has challenged Commissioner Rettig's "jaw dropping" estimate of a $1 trillion tax gap and what she characterized as counterproductive media endorsements of that number. She argued that "equating the entire tax gap [with] tax evasion is just so disingenuous," as true tax evasion requires criminal intent. She said much of it is inadvertent, and some of it is facilitated by third parties, like unscrupulous return preparers.

Legislative proposals

Legislatively, the IRS will receive more money for enforcement, likely to be targeted at large corporations and the wealthy. It may even be statutorily dictated, but perhaps more likely will be back room quotas, as IRS will have to report, which they have been doing for decades. Four specific proposals are discussed below.

The Biden administration is proposing a $1.2 billion increase in the IRS budget for FY 2021 with $900 million increased resources for tax enforcement. This money is to "increase oversight of high-income and corporate tax returns." Compare the 900 million increase to the 2020 FY IRS budget for audit and collection of $5.2 B, an 18% increase. On April 27, Bloomberg reported that President Biden is expected to propose giving the IRS an extra $80 billion along with more authority over the next ten years to combat *evasion* by high-earners and big companies.

Elizabeth Warren, D-Mass., proposes funding the IRS an additional $10 billion per year for 10 years, with $7 billion per year on enforcement and $2 billion per year on computer system modernization.

Peter DeFazio, D-Ore., who is the Chair of House Transportation Committee and founder of the Congressional Progressive Caucus, proposes $5 billion per year for audit and collection functions, requiring audit targets with a minimum audit of 50% of taxpayers with gross income of $100 million or more, and 90% of corporations with gross income of $20 billion or more.

Ro Khanna, D-Cal., proposes 10 annual IRS increases from $2 to 8.5 billion for enforcement and $1 billion for technology, with the following mandatory audits:

- 50% of those with total income of $10 million or more
- 33% of those with total income of $5 million but less than $10 million
- 20% of those with total income not less than $1 million but less than $5 million
- 95% of corporations with more than $20 billion of assets
- 40% of returns of estates larger than $10 million
- 1.2% of returns reflecting taxes related to gifts
- 0.22% of returns filed by employer with respect to employee compensation

What's coming

The political theory, or at least the rhetoric, is that the rich will pay for all of the trillions that are being spent in the new America vision. The IRS budget for enforcement will go up, and new third party and other reporting requirements will go into place. Rates will rise, and enforcement will be aggressive.

Passed in January, the Corporate Transparency Act, which is part of the National Defense Authorization Act, requires a federal disclosure to a non-public federal data base for the ultimate identity of individual owners (trusts and their beneficiaries included) of private non-public entities, including LLCs and corporations.

Additionally, the Financial Crimes Enforcement Network issued an advance notice of proposed rulemaking for "Beneficial Ownership Information Reporting Requirements" on Monday April 5, 2021, with the goal of having rules out by the end of this year.

How to prepare

It's important to prepare for the changes that are coming—and coming quickly. Following the recommendations below, and ensuring you have a team of professionals on your side who know which parties will be responsible for various types of requests, is key.

Review and perhaps recalibrate your risk tolerance for tax strategies.

- **Collect and maintain good records to defend your position.** Spending money now on filing and retrieval systems will save you a lot of stress and cost.
- **Conduct a self-audit.** This will allow you to identify and deal with your high risk areas.
- **Hire good CPAs and good tax lawyers.** If your CPA says you do not need a tax lawyer, consider firing them and getting another. Likewise, if your tax lawyer says you do not need a good CPA, consider firing them and getting another. It will take a few years, but the IRS will have a lot of people with different skill sets and a lot of data being matched. You need a team: you need an offense and a defense.
- **Maintain attorney client privilege.** Don't take short cuts on lawyer involvement and on who is in the loop. Accounting firms and others that refer to the taxpayer as their client have a tendency to have communications that do not involve attorneys, which has potential to blow the privilege.
- Independent of the audits, pay attention to what is going on in Washington. Developments are occurring very quickly, and this is well orchestrated.

To learn more about the coming changes, listen to this podcast recording with Waller's Leigh Griffith.

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