

# Issue Brief

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## What's the Deal with IRS Tax Enforcement and the Federal Budget?

### Introduction

As Democrats continue to mull over a smorgasbord of tax hikes to pay for their planned \$3.5 trillion spending spree, they claim they can rake in \$780 billion in new revenue over a decade by beefing up the Internal Revenue Service's (IRS) budget by \$80 billion over that same time period. With the new funding, the IRS would implement a tax enforcement regime and would double in size with an army of 87,000 new agents, financial investigators and auditors. In addition, the IRS would be given expansive and invasive authority to collect detailed financial data about millions of taxpayers.

Supporters of the plan argue that more enforcement is necessary to target wealthy taxpayers to make sure they are paying their "fair share" in taxes. But along the way, many innocent taxpayers — regardless of their income level — risk getting swept up in the IRS's net, forcing many to face grueling audits. Worse, several factors indicate that the administration will rake in less than it is counting on.

### The Justifications for Tax Enforcement

The enforcement initiative was announced earlier this year as part of the Biden administration's American Families Plan and is included in the reconciliation package currently being drafted in Congress. The administration and its allies in Congress argue that it is necessary to close the tax gap and to "improve tax progressivity," both arguments that don't hold up to close scrutiny.

### Tax Gap

The tax gap is the difference between the amount of tax revenues that the IRS collects versus how much is legally owed. A recent NTUF [paper](#) took a look at several components of the tax gap including

the rise of cryptocurrency, offshore holdings of taxpayers, and pass-through business income.<sup>1</sup> The gap largely results from noncompliance with tax laws, including people who do not file taxes and those who are attempting to defraud the Treasury by either hiding income or fraudulently claiming credits and deductions. However, there are also many filers who may be innocently mistaken regarding their net obligations or have interpreted the federal government’s complex tax laws and regulations differently than the IRS.

Just how big is the tax gap? The last [official](#) IRS calculation, released in 2019, estimated that the tax gap was \$381 billion after accounting for late payments and collections.<sup>2</sup> However, this estimate was based on tax data from 2011 through 2013, which preceded tax changes enacted in the 2017 Tax Cuts and Jobs Act (TCJA) that lowered tax rates while also [easing compliance burdens](#).<sup>3</sup> Moreover, structural economic changes such as the rapid growth of cryptocurrency over the intervening years could not have been factored into the IRS’s calculation.

It is also unclear whether the gap has been adjusted to take into consideration the Foreign Account Tax Compliance Act enacted in 2010. This law increased reporting requirements of taxpayers who live overseas. Its aggressive enforcement provisions and steep fines for noncompliance have also likely made a dent in the tax gap. Additionally, compliance burdens associated with the long reach of the IRS have also forced record numbers of Americans to renounce their citizenship.

Until the IRS completes a more formal and detailed analysis of the current tax gap, lawmakers and analysts must rely on a range of estimates. Estimating the exact size of the tax gap is inherently speculative — after all, if the exact size of the tax gap were known, the IRS would also likely know exactly how much the parties responsible owe, making closing the gap far easier than it is. Former IRS Commissioner Charles Rossotti recently estimated that the tax gap was higher than the IRS’s last analysis, but still only [\\$574 billion](#).<sup>4</sup> Treasury Secretary Janet Yellen placed the per-year figure [closer to \\$700 billion](#).<sup>5</sup> NTUF’s analysis did not attempt to provide an exact number, but concluded it was probably somewhere in the range of \$400-600 billion.

## Tax Progressivity

The administration argues that its enforcement proposals will “improve tax progressivity.” This should not lead anyone into thinking that the current tax code is anything but progressive. The most recent edition of NTUF’s annual “Who Pays Income Taxes” analysis (based on IRS data) [shows](#) that the top 25 percent of income earners pay 87 percent of all income taxes.<sup>6</sup> The bottom 50 percent of earners bear responsibility for just 3 percent of all income taxes. Many filers and households in this group are also eligible for “refundable” tax credits, which can be claimed as cash above and beyond any income tax owed, meaning that many lower-income filers actually have a negative net tax liability.

The progressivity of the tax code has also increased a lot compared to 1980 when the top marginal tax rate stood at 70 percent. Even as tax rates have been reduced, the progressivity of effective rates has increased. In 1980, the income tax share of the top one percent of filers was 19 percent — less than

<sup>1</sup> Wilford, Andrew et al. “The Tax Gap: No Trillion Dollar Silver Bullet.” National Taxpayers Union Foundation. May 13, 2021. Retrieved from: <https://www.ntu.org/foundation/detail/the-tax-gap-no-trillion-dollar-silver-bullet>.

<sup>2</sup> Internal Revenue Service. “IRS Releases New Tax Gap Estimates.” September 26, 2019. Retrieved from <https://www.irs.gov/newsroom/irs-releases-new-tax-gap-estimates-compliance-rates-remain-substantially-unchanged-from-prior-study>.

<sup>3</sup> Brady, Demian. “Tax Complexity 2021: Compliance Burdens Ease for Third Year Since Tax Reform.” April 15, 2021. Retrieved from <https://www.ntu.org/foundation/detail/tax-complexity-2021-compliance-burdens-ease-for-third-year-since-tax-reform>.

<sup>4</sup> Rossotti, Charles O. “Recover \$1.6 Trillion, Modernize Tax Compliance and Assistance” TaxNotes, March 2, 2020. Retrieved from <https://www.taxnotes.com/tax-notes-federal/compliance/recover-16-trillion-modernize-tax-compliance-and-assistance/2020/03/02/2c5p2>.

<sup>5</sup> Griffin, Kyle. Twitter Post. May 4, 2021. Retrieved from <https://twitter.com/kylegriffin1/status/1389625873138126849>.

<sup>6</sup> Brady, Demian. “Who Pays Income Taxes: Tax Year 2018.” National Taxpayers Union Foundation. December 7, 2020. Retrieved from <https://www.ntu.org/library/doclib/2020/12/2018-who-pays-1-.pdf>.

half of what it is now. In fact, despite claims that the TCJA was a “tax giveaway to the rich,” it actually shifted more of the income tax burden to top earners, making the tax code [more progressive](#).<sup>7</sup>

While it’s difficult to estimate the distributional impact of a massive IRS funding surge, it is worth mentioning that likely targets of a comprehensive effort to close the tax gap are not always among the wealthiest Americans. For example, a good deal of current underpayment of legal tax obligations arises as a result of fraud (intentional or unintentional) with certain common credits, like the Earned Income Tax Credit and the Child Tax Credit. These credits are often claimed by low- and middle-income Americans. Additionally, many small and medium sized businesses are organized as pass-through entities, and efforts to get a better handle on business income would surely target operations of modest scale with intrusive and expensive audits.

## The Impacts of Greater Tax Enforcement

Increased enforcement is ostensibly a way to boost revenues without increasing tax rates. An effective, targeted enforcement regime would incentivize taxpayers to comply with tax laws to the best of their ability so as to avoid a dreaded audit process.

But recent history shows that innocent taxpayers would get swept up in the audit net. The Department of the Treasury [argues](#) that its budget increase “would make up the ground that the IRS has lost over the last decade” when its budget was reduced by 20 percent.<sup>8</sup> But Treasury leaves out the fact that the enforcement budget was cut because of [abuses against taxpayers](#) that were detailed in rounds of congressional hearings.<sup>9</sup> Those cases and reports should give pause to lawmakers considering vast amounts of new IRS funding without structural reforms to fix flaws in the agency.

While it is important to make sure that people are obeying the laws and not cheating on their taxes, NTUF recently pointed out enforcement is no [silver bullet to eliminate the tax gap](#) and would impose huge administrative and privacy burdens on taxpayers.<sup>10</sup>

## What the Administration Is Proposing in Its Enforcement Agenda

There are two main components of the administration’s enforcement initiative: a big boost in the IRS’s budget and expansive new reporting requirements.

### Enforcement Funding

The proposal would increase funding to the IRS by ten percent per year for a net \$80 billion increase over a decade. This would be used to upgrade the IRS technological systems and databases and to hire 87,000 new agents — ultimately more than doubling the size of the tax collecting agency.

Treasury’s [enforcement brief](#) pays lip service to upgrading services for taxpayers as they navigate the tax system, noting that they “would benefit from effective communication with the IRS ... and competent assistance as they file their taxes.”<sup>11</sup> But taxpayers deserve more than lip service from the IRS. NTU and NTUF have pointed out how poor service including long waits for telephone assistance, unanswered calls, privacy breaches, and mail correspondence delays leave taxpayers in the lurch.

<sup>7</sup> Brady, Demian. “Trump’s Tax Cuts Made the Tax Code More Progressive.” National Review. February 8, 2021. Retrieved from <https://www.nationalreview.com/2021/02/trumps-tax-cuts-made-the-tax-code-more-progressive/>.

<sup>8</sup> U.S. Department of the Treasury. *The American Families Plan Tax Compliance Agenda*. May, 2021. Retrieved from <https://home.treasury.gov/system/files/136/The-American-Families-Plan-Tax-Compliance-Agenda.pdf>.

<sup>9</sup> Brady, Demian. “When Counting on IRS Enforcement Revenues, Don’t Forget to Count on IRS Overreach.” National Taxpayers Union Foundation. Retrieved from <https://www.ntu.org/foundation/detail/when-counting-on-irs-enforcement-revenues-dont-forget-to-count-on-irs-overreach>.

<sup>10</sup> Wilford, Andrew et al. *Ibid*.

<sup>11</sup> U.S. Department of the Treasury. *Ibid*.

Moreover, when Americans calling for help actually get through to an agent, there are huge swaths of the tax code that the IRS has deemed “out of scope” for assistance, leaving taxpayers to try and figure out the answers on their own — and risk getting a letter of deficiency (and being counted as part of the “tax gap”) if the IRS disagrees with their filing. The only other option is to incur out-of-pocket expenses getting advice from a tax professional.

But the main thrust of the enforcement initiative is to increase the IRS’s capacity to scrutinize taxpayers’ information, increase the number of audits, and to increase collection of taxes. The Congressional Budget Office (CBO) [analyzed](#) the proposal and estimated that \$60 billion of the increase would go towards enforcement while the rest would go to operations support, business-systems modernization, and taxpayer services.<sup>12</sup>

### **How Much Revenue Would This Raise?**

Treasury estimates it would raise an additional \$316 billion in tax revenues over the decade. This is likely an optimistic figure — CBO’s analysis estimated that the changes would boost revenues by \$200 billion, more than a third lower.

CBO assumed that it would take three years for the new staff to be trained and fully productive. At that point, it based revenue increases on recent returns on investment reported by the IRS, *i.e.*, data showing that each additional dollar spent on enforcement would generate \$5 to \$9 in new revenues.

CBO also expects that the IRS would “prioritize the enforcement activities that it thinks will have the highest average return; additional enforcement spending would therefore have lower returns than previous spending.” Akin to [dynamic scoring models](#) that take into account economic responses to tax changes, CBO also assumes that taxpayers will adapt to the IRS enforcement activities and find new ways to minimize taxes.<sup>13</sup>

There are numerous points of uncertainty in the revenue estimate. For example, the estimate is contingent on the IRS meeting hiring targets and properly training the new staff regarding tax laws, administrative procedures, and taxpayer rights. That might be difficult: CNBC [reports](#) that the IRS is currently falling short of staff hiring targets for the simpler administrative task of processing returns, noting that it has only hired 63 percent of its recruitment goal for processing returns as of July. This could mean that the IRS may have to offer higher salaries to attract enough new hires or spend more money — and staff time — on training than anticipated.

The estimate also depends on the IRS’s ability to modernize its technological infrastructure. This may be a tall order, as the agency maintains the oldest computer databases in the federal government. The Individual Master File and the corresponding Business Master File tracking the data of hundreds of millions of tax accounts and were coded on an outdated, low-level assembly language from the 1950s. The IRS also manages at least 60 different case management systems, further complicating taxpayer services.

While there have been plans in the works for decades to upgrade and modernize these systems, the problem remains. Technological limitations present challenges for governmental agencies in general but have been especially difficult for the IRS, given the massive number of records it collects every year. Its information technology workforce is also pulled in different directions and often must work

<sup>12</sup> Swagel, Phill. “The Effects of Increased Funding for the IRS.” Congressional Budget Office. September 2, 2021. Retrieved from: <https://www.cbo.gov/publication/57444>.

<sup>13</sup> Perez, Sophia. “The Rise of Dynamic Scoring.” National Taxpayers Union Foundation. July 30, 2021. Retrieved from <https://www.ntu.org/foundation/detail/the-rise-of-dynamic-scoring>.

on the fly to adapt to the numerous changes to the tax code implemented each year (which require computer coding updates in addition to tax form changes), deal with issues like the website crash on Tax Day in 2018, or adapt to decisions to delay filing dates (as has happened the last few tax seasons).

The administration plans on increasing enforcement to target non-filers and using audits to identify tax cheats who are committing fraud. But as NTUF noted in a [recent paper](#), there will also be many disputes between the IRS and certain taxpayers over the interpretation of tax laws.<sup>14</sup> As taxpayers appeal IRS decisions through judicial proceedings, cases can drag out for years, and the IRS is not guaranteed to win. These disputes could decrease revenue collections while also increasing financial burdens on taxpayers for the expense of challenging incidents where they feel they've been treated unfairly in the audit process.

CBO also noted a point of uncertainty that gets to the heart of the troubles with the IRS: the complexity of the tax system. CBO reasons that if taxpayer services are increased and that makes it easier for taxpayers to determine their tax liability, then there would be fewer noncompliant taxpayers. Unfortunately, the tax code is very complex, and the IRS does not provide advice to taxpayers on huge chunks of the tax code because of this complexity. Simplifying the tax code and providing some semblance of consistency in tax laws — rather than frequent major revisions of the tax code — would ease compliance hassle as well as administrative challenges.

## Scorekeeping Challenges

Lawmakers might not only get less revenue than they are counting on, but they might also not be able to officially count them as offsets under congressional scorekeeping rules. Congress has established several scorekeeping guidelines for CBO to follow when estimating the budgetary impact of legislative proposals. Congress then uses these estimates for enforcing statutory limits to spending and revenue levels set in budget resolutions or other legislation. Guidelines prohibit CBO from scoring changes in revenues that would result from spending increases. For example, CBO produces a biennial *Budget Options* report on ways to reduce the deficit. The 2020 report included an [option](#) to boost IRS enforcement budget by \$20 billion over a decade resulting in \$61 billion in new tax revenues.<sup>15</sup> A footnote in the report notes the following:

Because of the budget scorekeeping guidelines used by the Congress, the revenue changes attributable to this option would not be counted for budget enforcement purposes.

CBO's cost estimates for these program integrity changes will often indicate the revenue changes that it estimates would occur, but these are provided for informational purposes only. They are not included in the official cost estimate.<sup>16</sup> This means that a major portion, if not all the expected revenue boost resulting from the enforcement budget increase, will not be usable as an offset to the spending for enforcement purposes of the reconciliation measure.

## Mandate Increased Reporting of Financial Transactions

The administration's largest revenue raiser in its enforcement initiative results from vastly increasing the amount of [taxpayers' financial data](#) reported to the IRS:

<sup>14</sup> Brady, Demian. "When Counting on IRS Enforcement Revenues, Don't Forget to Count on IRS Overreach." *Ibid.*

<sup>15</sup> Congressional Budget Office. *Budget Options: Increase Appropriations for the Internal Revenue Service's Enforcement Initiatives*. December 9, 2021. Retrieved from <https://www.cbo.gov/budget-options/56878>.

<sup>16</sup> If the proposal were to become law, CBO would then adjust its baseline to account for the expected changes.

This proposal would create a comprehensive financial account information reporting regime. Financial institutions would report data on financial accounts in an information return. The annual return will report gross inflows and outflows with a breakdown for physical cash, transactions with a foreign account, and transfers to and from another account with the same owner. This requirement would apply to all business and personal accounts from financial institutions, including bank, loan, and investment accounts ...<sup>17</sup>

This would create massive pipelines of information pumped directly into the IRS with hundreds of millions of transactions by millions of taxpayers from across the income spectrum. The financial institutions would have to report transactions on any account with inflows and outflows totaling at least \$600 a year.

The Treasury's enforcement brief did not specify the amount that would be raised from this but the Department's latest *Green Book*, which summarizes administrations' revenue proposals, says that they expect to raise \$463 billion over the decade.<sup>18</sup> The Joint Committee on Taxation has not yet produced its score of this proposal.

Unlike the program integrity changes discussed above, it appears that this part of the enforcement proposal would be countable in official estimates because the revenues result from increased reporting requirements and are not a direct result of the program integrity funding.

In fact, the proposal may sound somewhat familiar. A similar provision impacting online sellers was enacted earlier this year in the American Rescue Plan Act of 2021 (ARPA). Under current laws, people who sell online through platforms like eBay or Etsy would get a 1099-K tax form if they had more than 200 individual payments and over \$20,000 in total payments. A copy of the form is also sent to the IRS. Under ARPA, starting in 2022 the threshold for getting a 1099-K will drop to total payments of at least \$600 regardless of the number of transactions. This may cause some tax anxiety for people who sell used goods online like an ongoing garage sale.

The new reporting requirement more closely resembles a data reporting mandate that was enacted as part of the Patient Protection and Affordable Care Act of 2010 and repealed soon after. That law required that starting in 2012, all businesses, nonprofits, and federal, state, and local governments report to the IRS about all purchases made from any vendor totaling more than \$600 in a year. The Joint Committee on Taxation estimated that this would increase revenues by **\$17 billion** through 2019.<sup>19</sup> This figure was incorporated into CBO's *score*.<sup>20</sup>

This burden led to a huge backlash from businesses across the country because of the compliance costs associated with the reporting requirement. Its repeal was supported by the Small Business Administration which *warned* that it would present an "undue barrier to small business growth."<sup>21</sup> Even President Obama *conceded* that this part of his signature legislation was "too burdensome for small businesses. It just involves too much paperwork, too much filing. It's probably counterproductive."<sup>22</sup>

<sup>17</sup> U.S. Department of the Treasury. *Ibid*.

<sup>18</sup> U.S. Department of the Treasury. *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals*. May 2021. Retrieved from <https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf>.

<sup>19</sup> Joint Committee on Taxation. *Estimated Revenue Effects of the Amendment in the Nature of a Substitute to H.R. 4872, The Reconciliation Act Of 2010, as Amended, in Combination with the Revenue Effects of H.R. 3590, The Patient Protection And Affordable Care Act ("PPACA")*, as Passed by the Senate, and Scheduled for Consideration by the House Committee on Rules On March 20, 2010. March 20, 2010. Retrieved from <https://www.jct.gov/publications/2010/jcx-17-10/>.

<sup>20</sup> Congressional Budget Office. *Manager's Amendment to Reconciliation Proposal*. March 20, 2010. Table 2. Retrieved from <https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/costestimate/amendreconprop.pdf>.

<sup>21</sup> Mills, Karen. "Repealing the 1099 Reporting Requirement: A Big Win for Small Business." Executive Office of the President. April 14, 2011. Retrieved from <https://obamawhitehouse.archives.gov/blog/2011/04/14/repealing-1099-reporting-requirement-big-win-small-business>.

<sup>22</sup> Small Business Administration. "SBA Backs Repeal of 'Burdensome' 1099 Reporting Requirements on Small Business Transactions." November 22, 2010. Retrieved from <https://www.sba.gov/about-sba/sba-newsroom/press-releases-media-advisories/sba-backs-repeal-burdensome1099-reporting-requirements-small-business-transactions>.

In April of 2011, President Obama signed [H.R. 4](#), that repealed this requirement.<sup>23</sup> The bill had been approved in both chambers with wide bipartisan support.

The largest difference between the ACA's reporting requirement and the new one is that there were potentially millions of small businesses that would have additional reporting duties under the ACA scheme; under the latest estimates there are 4,951 commercial banks and savings institutions insured by the Federal Deposit Insurance Corporation (FDIC) and there are 6,293 credit unions that would be impacted under the rule. A 2019 FDIC [survey](#) found that nearly 124 million households — representing 95 percent of all U.S. households — had bank or credit union accounts.<sup>24</sup>

The new proposal already faces a similar backlash, even though the reporting requirement was shifted to financial institutions. Ed Mierzwinski, senior director of the U.S. Public Interest Research Group, [raised concerns](#) that it is not a targeted program: “They are collecting information about everybody and I don’t know why it is necessary to collect information about everybody.”<sup>25</sup> Distrust of the IRS may also discourage the 5 percent of unbanked households from opening a savings or checking account.

Is the IRS even equipped to manage this data flow? It seems that even more so than the program integrity changes, the success of this new data reporting requirement is highly dependent on the ability of the IRS to not just upgrade its management systems, but also to address the lingering security shortfalls identified by the Inspector General for Tax Administration and the Government Accountability Office.

If this reporting requirement is implemented, it will be a massive intrusion on privacy with the IRS monitoring virtually all bank accounts. This is additionally troubling because of confidential taxpayer data in the protection of the IRS that was recently leaked to ProPublica, which was only the latest example of a long history of privacy concerns regarding IRS records.

Several banking trade associations sent a [letter](#) to the House of Representatives’ Ways and Means Committee highlighting that in addition to the long-standing privacy concerns, setting up the new reporting requirement is not as easy to implement as some may think.<sup>26</sup> The costs and burdens could easily exceed the hoped for revenue benefits:

... [T]he proposal is unlike current 1099 reporting in that the number cannot be simply inserted into the clients’ tax returns. The addition of gross receipts and withdrawals is likely to substantially increase tax preparation time and costs for a large number of taxpayers. In sum, these changes would be significant and complex.

## Conclusion

If this new enforcement regime is indeed able to raise the full \$780 billion estimated by the administration, all this money is going to be used to pay for roughly a fifth of a \$3.5 trillion splurge on new spending, rather than addressing the historically dreary annual budget deficits and skyrocketing federal debt.

But there are many reasons to believe that the hoped-for offsets will fall short of expectations. The IRS is still catching up on a massive processing backlog piled up during the pandemic and the shutdown

<sup>23</sup> United States Congress. April 14, 2011. H.R.4 Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011. Retrieved from: <https://www.congress.gov/bill/112th-congress/house-bill/4/actions>.

<sup>24</sup> Federal Deposit Insurance Corporation. October 19, 2020. How America Banks: Household Use of Banking and Financial Services. Retrieved from: <https://www.fdic.gov/analysis/household-survey/index.html>.

<sup>25</sup> ByteFederal. September 7, 2021. Biden Administration Proposes Even More Intrusive IRS Reporting. Retrieved from: <https://www.bytefederal.com/biden-administration-proposes-even-more-intrusive-irs-reporting/>.

<sup>26</sup> American Banking Association. June 10, 2021. Joint Statement for the Record to the House Ways and Means Committee for the Hearing “Minding the Tax Gap; Improving Tax Administration for the 21st Century.” Retrieved from: <https://www.aba.com/advocacy/policy-analysis/joint-statement-minding-the-tax-gap#>.

of tax processing facilities. The agency was able to quickly and largely successfully implement and deliver the rounds of stimulus payments provided through pandemic-relief legislation, but setting up the new enforcement regime is a more difficult challenge.

The record of concerns regarding the agency's information technology, protection of taxpayers' data, staffing and hiring challenges, the protracted appeals process related to audits, as well as lower CBO estimates and scorekeeping issues should all raise concerns about anyone counting on the increased revenues expected from this plan.

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