



August 25, 2022

Honorable Kevin Brady
Ranking Member
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Honorable Jason Smith
Ranking Member
Committee on the Budget
U.S. House of Representatives
Washington, DC 20515

Re: Additional Information About Increased Enforcement by the Internal Revenue Service

Dear Congressmen:

On August 16, 2022, Public Law 117-169, the 2022 reconciliation act, was enacted. As a result of increases in outlays for the Internal Revenue Service (IRS) stemming from the act, the Congressional Budget Office estimates that revenues will increase by \$180.4 billion over the 2022–2031 period. CBO projects that some of the increased revenues will be collected from taxpayers with income less than \$400,000; the amount will be a small fraction of the total increase.

This letter provides additional information about the basis for CBO's analysis and answers several questions that you asked. CBO will publish an updated cost estimate for the entire 2022 reconciliation act in the first week of September and is providing this information about the IRS's enforcement now in response to interest expressed by you and other Members.

CBO's previous estimate of the revenue increase was \$203.7 billion.¹ CBO's current estimate is about \$23 billion less than its previous estimate for two reasons. This estimate incorporates changes to the legislative language—about funding the IRS and improving taxpayers' compliance—that were made after CBO published the earlier estimate, which was based on the legislative text available on July 27, 2022. Those changes removed

¹ See Congressional Budget Office, cost estimate for H.R. 5376, the Inflation Reduction Act of 2022 (August 3, 2022; updated August 5, 2022), www.cbo.gov/publication/58366.

expedited hiring authority for the newly funded positions and the ability for the IRS to pay certain employees higher rates than those in the normal government salary structure. This estimate also incorporates the projected budgetary impact of a recent directive by the Secretary of the Treasury regarding how the additional funding will be used.

How Does the IRS Enforce Tax Laws?

The IRS relies largely on taxpayers to report their income, calculate the amount of tax they owe, and remit that amount through withholding or other payments. However, not all income is properly reported, and unpaid taxes amount to hundreds of billions of dollars annually, the IRS estimates. To collect some of those unpaid taxes, the IRS undertakes a variety of enforcement activities:

- Auditing tax returns of corporations, partnerships, and individual taxpayers;
- Collecting unpaid taxes through mailed notices, payment agreements with taxpayers, and liens or levies;
- Identifying taxpayers who did not file returns on time and obtaining those returns;
- Correcting mathematical or clerical errors;
- Using software to flag fraudulent or questionable refunds; and
- Verifying information reported by taxpayers by checking it against information from third parties.

When additional funding is provided to the IRS for enforcement, it will, in CBO's estimation, use all available productive approaches to increase revenues and raise voluntary compliance from taxpayers with all amounts of income.² In CBO's analysis, the IRS typically allocates its enforcement resources—such as hours of work by a group of employees—to maximize revenues for a given amount of spending and compliance with tax rules.

² For additional background about the IRS and how CBO analyzes its activities, see Congressional Budget Office, *Trends in the Internal Revenue Service's Funding and Enforcement* (July 2020), www.cbo.gov/publication/56422. For additional details about CBO's estimation methods, see Congressional Budget Office, letter to the Honorable Lindsey Graham regarding estimated revenue effects of increased funding for the Internal Revenue Service in H.R. 5376, the Build Back Better Act (November 18, 2021), www.cbo.gov/publication/57620.

Consequently, CBO generally estimates that if activities with higher predicted returns are restricted, the alternatives will generate lower returns. If the IRS is restricted from using additional funding to conduct certain audits, for example, it can use other enforcement activities instead, but they may not be as productive, and developing new ways of detecting noncompliance might take time. If the restriction required the IRS to use and track a specific allocation of funding for the audits it undertakes, its administrative costs would increase.

How Much Is the Funding Increase for the IRS?

Funding provided by the act is projected to make the IRS's budget 90 percent larger in 2031 than was projected in the July 2021 baseline that CBO used in its analysis of the 2022 reconciliation act. With this new funding, the IRS's budget in 2031 is projected to be about one-tenth larger than it was at its recent peak in 2010, when measured as a share of total output in the economy. Of the additional \$79 billion in funding, the act allocates \$46 billion for enforcing tax laws; the remainder is provided for other activities such as services for taxpayers, operations support, and business system modernization.

How Do Legislative Changes and Administrative Actions After July 27, 2022 Affect CBO's Projection of Revenues?

Language providing flexibility to the IRS in hiring personnel had been included in the legislative text posted on the website of the Senate Majority Leader on July 27, 2022, but it was not included in the text posted on August 6, 2022, that was subsequently enacted into law. In CBO's assessment, not including the personnel flexibility will cause the IRS to hire new personnel more slowly and could make hiring experienced candidates more difficult. CBO expects that hiring highly specialized enforcement employees who handle the most complex examinations and collections cases will be especially challenging. Also, if newly hired employees are less experienced, they will require additional training to become fully productive. As a result of the hiring challenges, the IRS will collect less revenues, CBO projects, than would have been the case if the enacted law had included the language providing personnel flexibility.

On August 10, 2022, Secretary of the Treasury Janet Yellen directed that "any additional resources—including any new personnel or auditors that are hired—shall not be used to increase the share of small business or households below the \$400,000 threshold that are audited relative to

historical levels.”³ In CBO’s projections, the IRS complies with that directive and undertakes alternative activities that generate less revenues.

The reduction in projected revenues from those two changes is about \$23 billion from 2022 to 2031, resulting in a total revenue increase of \$180.4 billion. By CBO’s estimates, the interaction between the two changes will reduce revenues more than either change would individually, because personnel flexibility would have aided the IRS in hiring the type of highly specialized employees needed to target noncompliance by large corporations, complex partnerships, and individuals with complicated tax returns. Because of delays in hiring, CBO expects that the revenues collected will be greater after 2031 (the last year in CBO’s cost estimate for the act) than they would have been otherwise.

What Would Have Happened If the Act Had Prohibited the IRS From Using the New Funding on Audits of Taxpayers With Income Less Than \$400,000?

When amendments to the 2022 reconciliation act were offered in the Senate on August 7, this potential change was considered and not adopted:

“At the end of section 10301, add the following: (c) LIMITATIONS RELATED TO THE INTERNAL REVENUE SERVICE.—None of the funds appropriated under subsection (a)(1) may be used to audit taxpayers with taxable incomes below \$400,000.”

If that change had been made after the removal of the language regarding personnel flexibility and Secretary Yellen’s directive on the use of the additional funds, the increase in revenues resulting from greater outlays for the IRS would have been \$176 billion over the 2022–2031 period, CBO estimates, about \$4 billion less than the amount currently projected to be collected.⁴

In CBO’s assessment, the change would have imposed restrictions on the use of appropriations by the IRS, which would have caused the agency to shift to less productive enforcement activities and to incur increased administrative costs. In addition, some taxpayers, gauging their probability

³ See Janet L. Yellen, Secretary of the Treasury, letter to Charles P. Rettig, Commissioner of the Internal Revenue Service (August 10, 2022), <https://tinyurl.com/2p9fh5tc>.

⁴ That estimate used CBO’s July 2021 baseline projections, which were used for all estimates of the 2022 reconciliation act. New legislation changing the law would be evaluated relative to CBO’s current baseline from May 2022, updated for legislative changes, which covers the 2022–2032 period.

of being audited to be lower if they report income under \$400,000, would have increased their underreporting of income.

The amendment would have imposed restrictions even though, in CBO's estimation, the IRS will comply with the Secretary's directive regarding the share of audits devoted to small businesses or households with income less than \$400,000. Under the 2022 reconciliation act and with that direction from the Secretary, audit rates for taxpayers with income less than \$400,000 will be at roughly historical amounts, CBO expects, and thus higher than those projected in CBO's baseline.⁵ The amendment would have constrained audit rates for taxpayers with income less than \$400,000, keeping them lower than historical amounts.

Some of the reduction in revenues from the proposed amendment would have stemmed from lower revenues from audits of taxpayers with income less than \$400,000, and some would have stemmed from less productive enforcement activity (and greater administrative cost of enforcement) in total. Some taxpayers reporting income of less than \$400,000 on their tax return, for whom the proposed amendment would have barred audits using the new funding, will be found to have more income than they reported—in some cases, income greater than \$400,000—if they are audited.

CBO's updated estimate presented here differs from a preliminary assessment that the agency provided to Congressional staff by email several times during August. The previous estimate was for amendment 5404, offered by Senator Crapo on August 7, which consisted of the legislative language quoted above. At that time, CBO estimated that amendment 5404 would have reduced revenues by at least \$20 billion over the 2022–2031 period. That estimate did not incorporate the effects of the Treasury Secretary's directive announced on August 10, 2022, or that directive's interaction with the change that removed legislative language providing personnel flexibility to the IRS. The updated estimate of the effects of the amendment provided in this letter is smaller mainly because, in CBO's assessment, the Secretary's directive will cause many of the effects that would have occurred under amendment 5404. After those effects are accounted for, the remaining potential effects of prohibiting the use of

⁵ In CBO's baseline projections in July 2021, the IRS was anticipated to broadly reduce its enforcement activities over the next decade. Those reductions reflected the projections of budgetary resources available to the IRS growing more slowly than income subject to taxation. As part of those reductions, the share of small businesses and households with income less than \$400,000 that was audited would have fallen below historical amounts, CBO expects.

newly appropriated funds to audit taxpayers with income less than \$400,000 are smaller.

How Will Taxpayers With Income Less Than \$400,000 Be Affected by the Act?

CBO projects that an increase in revenues collected from taxpayers with income less than \$400,000 (as reported both before and after any enforcement activities take place) will constitute a small fraction of the total increase collected from all taxpayers resulting from the increased funding for the IRS. That fraction will be small because, CBO expects, the IRS will follow the Secretary's directive, and enforcement resources will focus on what the Secretary terms high-end noncompliance.

CBO does not have a strong basis for precisely estimating the increase in revenues collected from taxpayers with income less than \$400,000 from all types of enforcement activity. The main reason is that IRS reports information on only one type of enforcement activity—audits—categorized by taxpayers' income. CBO does not have data about the distribution of revenues from other (that is, nonaudit) enforcement activities by income.

The act will affect taxpayers with income less than \$400,000 in several ways:

- Audit rates at roughly historical amounts, in accordance with the Treasury Secretary's directive, will boost audit activity and thus revenues relative to the amount in CBO's July 2021 baseline.
- Activities other than audits—such as collections and automated screening and document matching—are not constrained by the Secretary's directive, and under the 2022 reconciliation act, the amounts they generate will be greater for taxpayers with all amounts of income, CBO projects.
- Voluntary compliance will increase for all taxpayers, in CBO's estimation.
- Increased funding for nonenforcement activities such as services for taxpayers can also affect revenues if the assistance enables taxpayers to report their income and calculate their tax liability more accurately.

Honorable Kevin Brady and Honorable Jason Smith

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I hope that this information answers your questions. Please contact me if you would like to discuss these issues further.

Sincerely,

A handwritten signature in black ink, appearing to read "Phillip L. Swagel", with a long, sweeping flourish extending to the right.

Phillip L. Swagel
Director

cc: Honorable Richard Neal
Chairman
Committee on Ways and Means

Honorable John Yarmuth
Chairman
Committee on the Budget