

TAX LITIGATION ISSUES

Expert Analysis

## Internal Revenue Service Budget Cuts Spell Trouble

The Internal Revenue Service describes its mission as “[p]rovid[ing] America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and enforc[ing] the law with integrity and fairness to all.”<sup>1</sup> Over the past few years, the IRS has had to fulfill this mission with shrinking resources, and in her recently released 2014 Annual Report to Congress, National Taxpayer Advocate Nina E. Olson noted that “the budget environment of the last five years has brought about a devastating erosion of taxpayer service, harming taxpayers individually and collectively.”<sup>2</sup> Unfortunately, the problems caused by underfunding the IRS are likely to get worse before they get better: the appropriations bill passed by Congress last December further reduced the IRS’s budget to the point that it raises questions regarding the IRS’s ability to enforce the Internal Revenue Code fairly.

### Budget Reductions for IRS

While the IRS’s nominal budget has increased modestly over the past 10 years, the agency has suffered substantial decreases when adjusted for inflation. In 2005, the IRS’s budget was \$10.2 billion,<sup>3</sup> which is approximately \$12.4 billion in today’s dollars. By 2010, the IRS’s appropriations had increased to \$12.1 billion,<sup>4</sup> or approximately \$13.1 billion in today’s dollars. However, the 2015 spending law slashes the IRS’s budget for the upcoming fiscal year to \$10.9 billion,<sup>5</sup> which amounts to an inflation-adjusted 12 percent reduction over the past 10 years, and a 17 percent decrease over the last five years. Indeed, IRS Commissioner John Koskinen has observed that, when adjusted for inflation, the agency’s budget has not been this low since 1998.<sup>6</sup>

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The budget cuts have resulted in substantial staff reductions. National Taxpayer Advocate Olson has noted that the IRS has cut nearly 12,000 employees from its work force and that further cuts are forthcoming.<sup>7</sup> In particular, the number of special agents in the IRS’s Criminal Investigation Division has declined approximately 8.3 percent (from 2,780 in fiscal 2010 to 2,549 in fiscal 2013, the last year for which statistics were available); the number of revenue agents, who are charged with conducting audits, decreased 11.9 percent (from 13,888 to 12,234); and the number of revenue officers, who are charged with collecting taxes, decreased by 21.4 percent (from 6,042 to 4,748).<sup>8</sup>

The IRS is unlikely to reverse the staff reduction trend anytime soon. In response to the recent budget cuts, Commissioner Koskinen warned that, with the exception of a few “mission-critical” positions, he would be forced to freeze new hiring, and he cautioned employees that the IRS would no longer be able to pay for overtime.<sup>9</sup> Moreover, the hiring freeze will be especially harmful in light of the IRS’s aging work force: approximately 40 percent of current IRS employees will be eligible to retire in the next five years.<sup>10</sup> Thus, Koskinen has explained that the cuts would have a direct effect on enforcement—that “to the extent we have fewer people to audit and enforce the tax code, that means some people cutting corners on their taxes or not complying are going to get away with it, and that is a decision that Congress has made.” And he went on to describe the new budget

as creating a “tax cut for tax cheats.”<sup>11</sup>

While the IRS’s inflation-adjusted budget and work force have decreased, its workload has mounted. The number of individual income tax returns filed increased by 11 percent in the 10 years leading up to 2013, and the number of business entity tax returns has increased by 23 percent.<sup>12</sup> The IRS has also had to devote substantial resources to new initiatives such as fighting identity theft and implementing the Foreign Account Tax Compliance Act (FATCA). And the coming tax season is poised to present the agency with additional challenges, with Olson observing that “the implementation of the Patient Protection and Affordable Care Act during the coming filing season will add a great deal of new work.” As a result of the budget and staffing cuts, Olson estimates that the IRS “is unlikely to answer even 50 percent of telephone calls it receives” in FY 2015.<sup>13</sup>

Notwithstanding its additional responsibilities and reduction in resources, between 2005 and 2013, the IRS managed to increase the number of tax returns audited by 17.3 percent (from 1,328,712 to 1,558,057)<sup>14</sup> and the number of criminal investigations initiated increased by 24.5 percent (from 4,269 to 5,314).<sup>15</sup> Moreover, during the same period, the number of prosecutions recommended increased by 52.6 percent (from 2,859 to 4,364) and the number of indictments returned rose by 60.6 percent (from 2,406 to 3,865).

These statistics, however, appear to be skewed by the IRS’s recent focus on identity theft crimes. Thus, in 2013, the IRS recommended that 1,257 individuals be prosecuted for identity theft, as opposed to 218 such recommendations in 2011. Likewise, in 2013, the IRS’s Identity Theft program resulted in 1,050 indictments.<sup>16</sup> Setting aside identity theft prosecutions, IRS enforcement actions have remained fairly flat. Thus, the increase in tax prosecutions does not necessarily mean an increase in prosecutions of more typical tax

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law violations. Indeed, even including the identity theft prosecutions, in light of the increase in the number of returns filed, the likelihood of any one return being audited is .8 percent, and the likelihood of a return leading to a criminal prosecution is approximately .002 percent. The chances of being convicted are approximately .0015 percent.

### Penny Wise, Pound Foolish

Cutting the IRS's budget is problematic from the perspective of revenue collection. Koskinen reportedly advised his staff that, with fewer people to audit and enforce the tax code, the agency could miss out on collecting \$2 billion in revenue,<sup>17</sup> and the cuts may indirectly affect revenue by undermining taxpayer faith in the voluntary compliance system on which the IRS relies.<sup>18</sup>

By any measure, investing in the IRS generates substantial incremental revenues, although estimates of the marginal rate of return on investment in the IRS vary. One measure of the IRS's effectiveness is the extent to which its efforts reduce the so-called tax gap—the difference between aggregate tax liability imposed by law for a given tax year and the amount of voluntary taxpayer payments for that year. In 2006, the most recent year for which an estimate is available, the tax gap was estimated to be \$450 billion, and IRS enforcement actions resulted in the recovery of \$65 billion of that gap on an operating budget of \$10.8 billion.<sup>19</sup>

Similarly, in 2011, former IRS Commissioner Douglas H. Shulman estimated that a previous round of proposed budget cuts would result in a reduction of revenue that was seven times the size of the budget cuts.<sup>20</sup> While the IRS's 2013 Budget in Brief estimates a 4.9 percent return on investment for all enforcement initiatives<sup>21</sup> even this lower estimate reflects the importance of funding the IRS from a revenue collection perspective.

### Cuts at Expense of Fairness

In a 2009 article, former Assistant Attorney General for the Tax Division Nathan Hochman observed that “[i]f one looks at the chances of being criminally prosecuted for tax violations, one would have to conclude that the odds are overwhelmingly in the crooked taxpayer's favor.”<sup>22</sup> Hochman calculated that “an average taxpayer has about a .003-percent chance of being criminally investigated and a .002-percent chance of being convicted.”<sup>23</sup> As noted above, these odds have become even more lopsided and, with fewer agents on staff and a freeze on hiring and overtime, the chances of being audited and prosecuted are only likely to decrease in FY 2015.

The IRS and Department of Justice frequently argue that tax prosecutions are necessary to deter non-compliance by others. Indeed,

in weeks leading to April 15, the IRS increases its press releases about criminal tax enforcement,<sup>24</sup> and empirical analyses have demonstrated that “audits have a strong, positive impact on reporting compliance.”<sup>25</sup>

At some point, however, the deterrent effect of singling out a narrow subset of violators to send a message to the public at large is undermined by the realization that the chances of detection are infinitesimal. Moreover, the IRS's focus on deterrence may sacrifice fairness if the budget cuts prevent the agency from auditing a wide sample of tax returns and identifying a representative class of violators. At some point, enforcement may become so uneven that it becomes unfair to single out for punishment the few who are unlucky enough to get caught.

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### Conclusion

While some have hailed the budget cuts as a just punishment for an agency that has been accused of unfairly targeted Tea Party organizations,<sup>26</sup> the recent budget cuts are unlikely to ameliorate problems of unequal enforcement because they deny the agency the resources it needs to audit a fair sample of returns. As we have seen in the long wake of the scandal, short-cuts—even when arguably well-intentioned—undermine the public confidence in the IRS, which certainly cannot be good for tax compliance overall.

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1. Internal Revenue Service, “The Agency, its Mission and Statutory Authority” (available at <http://www.irs.gov/uac/The-Agency-its-Mission-and-Statutory-Authority>).

2. National Taxpayer Advocate, Annual Report to Congress 2014, Executive Summary at vii (available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/2014-Annual-Report-to-Congress-Executive-Summary.pdf>) (hereinafter “2014 Taxpayer Advocate Report”).

3. Department of the Treasury, “Internal Revenue Service: FY 2006 Budget in Brief,” at 11 (available at [http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/appropriated\\_accts.pdf](http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/appropriated_accts.pdf)).

4. National Taxpayer Advocate, Annual Report to Congress 2013, Volume One, at 25 (available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/Volume-1.pdf>) (hereinafter “2013 Taxpayer Advocate Report”).

5. Kelly Phillips Erb, “With Shutdown Avoided, Who Are Winners (And Losers) in 2015 Budget?,” *Forbes.com* (Dec. 14, 2014) (available at <http://www.forbes.com/sites/kellyphillips-erb/2014/12/14/with-shutdown-avoided-who-are-winners-and-losers-in-2015-budget/>).

6. Stephen Ohlemacher, “IRS Head Says Budget Cuts Could Force 2-Day Agency Shutdown,” Associated Press (Jan. 13, 2015) (available at [http://hosted.ap.org/dynamic/stories/U/US\\_IRS\\_SHUTDOWN?SITE=AP&SECTION=HOME&TEMPLATE=DEFAULT](http://hosted.ap.org/dynamic/stories/U/US_IRS_SHUTDOWN?SITE=AP&SECTION=HOME&TEMPLATE=DEFAULT)). The cuts are especially troubling because, unlike many other federal agencies, the IRS did “not have its funding restored to pre-sequestration levels under the Consolidated

Appropriations Act of 2014.” IRS Oversight Board, “FY2015 IRS Budget Recommendation Special Report,” at 5 (available at <http://www.treasury.gov/IRSOB/reports/Documents/IRSOB%20FY2015%20Budget%20Report-FINAL.pdf>) (recommending a 2015 IRS budget of \$13.59 billion).

7. 2014 Taxpayer Advocate Report, supra note 2, at 2.

8. Internal Revenue Service, Fiscal Year 2013 Enforcement and Service Results (available at <http://www.irs.gov/PUP/newsroom/FY%202013%20Enforcement%20and%20Service%20Results%20-%20WEB.pdf>). Cuts to other positions have resulted in fewer people to answer taxpayer phone calls and longer wait times for those who do call the IRS. William Hoffman, “Koskinen's Tough Job Likely To Get Tougher in 2015,” *Tax Notes* (Jan. 5, 2015). The IRS has also stopped assisting taxpayers in the preparation of tax returns at local Taxpayer Assistance Centers. 2014 Taxpayer Advocate Report, supra note 2, at 6.

9. Richard Rubin, “IRS Freezes Hiring, Warns of Busy Signals After Budget Cuts,” *Bloomberg* (Dec. 17, 2014) (available at <http://www.bloomberg.com/news/2014-12-17/irs-freezes-hiring-warns-of-busy-signals-after-u-s-budget-cuts.html>).

10. Hoffman, supra note 8.

11. David Lazarus, “GOP's cuts to IRS budget will tax our patience” *L.A. Times* (Jan. 15, 2015) (available at <http://www.latimes.com/business/la-fi-lazarus-20150116-column.html>).

12. 2013 Taxpayer Advocate Report, supra note 4, at 23. According to an IRS Bulletin, the increase in individual tax returns is primarily tied to the growth of the U.S. labor force. Brett Collins, “Projections of Federal Tax Return Filings: Calendar Years 2009–2016,” *Statistics of Income Bulletin* (Winter 2010), at 109 (available at <http://www.irs.gov/pub/irs-soi/10winbulreturnfilings.pdf>). The number of business tax returns is also driven in part by labor force growth; in addition, the number of business tax returns tends to correspond to growth in real gross domestic product. *Id.* at 109–110.

13. 2014 Taxpayer Advocate Report, supra note 2, at 1–2.

14. 2005 Internal Revenue Service Data Book (available at <http://www.irs.gov/pub/irs-soi/05databk.pdf>); 2013 Internal Revenue Service Data Book (available at <http://www.irs.gov/pub/irs-soi/13databk.pdf>).

15. Internal Revenue Service Enforcement Statistics (available at [http://www.irs.gov/uac/Enforcement-Statistics-Criminal-Investigation-\(CI\)-Enforcement-Strategy](http://www.irs.gov/uac/Enforcement-Statistics-Criminal-Investigation-(CI)-Enforcement-Strategy)).

16. Internal Revenue Service Criminal Investigation, “Fiscal Year 2013 Annual Business Report,” at 10 (<http://www.irs.gov/pub/foia/ig/ci/REPORT-fy2013-ci-annual-report-02-14-2014.pdf>).

17. Rubin, supra note 9.

18. See New York Times Editorial Board, “The Dangerous Erosion of Taxation,” *The New York Times* (Jan. 17, 2015) (available at [http://www.nytimes.com/2015/01/18/opinion/sunday/irs-already-hobbled-likely-to-be-further-damaged.html?\\_r=0](http://www.nytimes.com/2015/01/18/opinion/sunday/irs-already-hobbled-likely-to-be-further-damaged.html?_r=0)) (arguing that “[i]f more resources are cut, that will only encourage taxpayers' noncompliance.”).

19. James M. Bickley, Cong. Research Serv., R42739, *Tax Gap, Tax Compliance, and Proposed Legislation in the 112th Congress 2012* (available at [http://www.law.umaryland.edu/marshall/crsreports/crsdocuments/r42739\\_09202012.pdf](http://www.law.umaryland.edu/marshall/crsreports/crsdocuments/r42739_09202012.pdf)) (estimating tax gap at \$450 billion). See also Internal Revenue Service, “Tax year 2006 Tax Gap Estimate—Summary of Estimation Methods” (January 2012) (available at [http://www.irs.gov/pub/newsroom/summary\\_of\\_methods\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/summary_of_methods_tax_gap_2006.pdf)) (addressing recovery of \$65 billion); Department of the Treasury, “Internal Revenue Service: FY 2008 Budget in Brief” at 8 (available at <http://www.irs.gov/pub/newsroom/budget-in-brief-2008.pdf>). Significantly, the net gap of \$385 billion, represented approximately 14 percent of the \$2.66 trillion in total tax liability for 2006.

20. Letter from Douglas H. Shulman, Commissioner of Internal Revenue, to the chairman and ranking members of the House Committee on Ways and Means and the Senate Committee on Finance (Oct. 17, 2011) (available at [http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/media/pdf/112/Rep\\_Lewis\\_IRS\\_Letter.pdf](http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/media/pdf/112/Rep_Lewis_IRS_Letter.pdf)).

21. Department of the Treasury, “Internal Revenue Service: FY 2013 Budget in Brief,” at 8 (available at <http://www.irs.gov/pub/newsroom/budget-in-brief-fy2013.pdf>).

22. Nathan J. Hochman, “Everything You Wanted to Know About How to Obtain a Prosecutorial Declination of a Federal Tax Case but Were Afraid to Ask,” *Journal of Tax Practice & Procedure* 31, 32 (December 2009–January 2010).

23. *Id.*

24. Joshua D. Blank and Daniel Z. Levin, “When Is Tax Enforcement Publicized?,” 30 *Va. Tax Rev.* 1, 24 (2010).

25. Alan H. Plumley, “The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results,” *National Tax Association* (available at <http://www.irs.gov/pub/irs-soi/irsvtc.pdf>). See also Jeffrey A. Dubin, “Criminal Investigation Enforcement Activities and Taxpayer Noncompliance” (available at <http://www.irs.gov/pub/irs-soi/04dubin.pdf>);

26. Hoffman, supra note 8.