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INSIGHT

The Distribution of IRS Enforcement Activity Funded by the Inflation Reduction Act of 2022

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P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022 (IRA 2022), provides $79.6 billion to the Internal Revenue Service (IRS) and related agencies through FY2031, which is intended to supplement normal annual appropriations. Of that amount, the law dedicates $45.6 billion to bolstering enforcement activities. This funding represents a 69% increase over the amount of funding the Congressional Budget Office (CBO) estimated the IRS would receive for enforcement through annual appropriations for fiscal years 2022-2031. (For more information, see CRS Insight IN11977, *IRS-Related Funding in the Inflation Reduction Act*.)

On August 10, Secretary of the Treasury Janet Yellen directed the IRS not to use any of these additional resources "to increase the share of small business or households below the $400,000 threshold that are audited relative to historical levels." Under such a policy, the share of tax returns subject to audits—also called "examinations"—would not rise "relative to historical levels" for 98-99% of individual income tax filers.

The Tax Gap

Audits are meant to ensure compliance with the tax code. The IRS estimated that the average annual unpaid tax burden from 2011 to 2013 (the most recent estimate)—also known as the "tax gap"—was $381 billion, or 14.2% of the true total tax liability, after accounting for enforcement activity and other late payments. That sum includes $271 billion in individual income taxes, $77 billion in employment taxes, $32 billion in corporate income taxes, and $1 billion in estate taxes.

About 80% of the gross tax gap (before enforcement and late payments) results from misreporting income. The IRS estimates that about 1% of income subject to substantial information reporting and withholding is misreported to the IRS. This category includes wage and salary income, as employers withhold taxes from workers' paychecks and report workers' earnings to the IRS. In contrast, filers misreport about 55% of income that is not subject to withholding or third-party reporting, such as earnings from sole proprietorships, rents, and royalties. Academic research suggests that high-income taxpayers misreport more of their income than lower-income filers, but data limitations make such estimates highly uncertain.

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Trends in Audit Rates

In FY2019—the last fiscal year prior to the COVID-19 pandemic—the IRS spent 28% less in inflation-adjusted dollars on enforcing the tax code than it had in FY2010. It also employed 34% fewer enforcement staffers, measured in full-time equivalents. (Between FY2019 and FY2021, inflation-adjusted enforcement spending rose by 3% and staffing by 5%.)

The Government Accountability Office (GAO) determined that the share of individual income tax filers who faced audits fell from 0.9% in calendar year 2010 to 0.25% in 2019, which the IRS attributes to the decline in funding and staffing. Audit rates declined for filers of all income levels. However, the likelihood of an audit fell by 86% for those with positive income over $500,000, 61% for households with income below $25,000, and 58% for filers who claimed the Earned Income Tax Credit (EITC). The likelihood of facing an audit still generally rose with income after these changes, except that predominantly low-income EITC claimants faced a higher audit rate in 2019 (0.77%) than filers with $500,000-$1 million in positive income (0.53%).

GAO found that the revenue raised per work-hour of an audit is lower for most high earners than it is for EITC recipients. This estimate accounts for the revenue collected and the cost of the audit itself, but not for the cost of the collections process or the potential for audits to encourage voluntary compliance.

The IRS told GAO that audits of high-income filers are typically more complex than audits of lower earners. The auditing process for higher-income filers can also take longer, as they are more likely to respond to requests for information than lower earners. Recommended tax bills resulting from audits of high-income filers are often harder to collect and more likely to get abated than for other audits due to their size.

Implementation of the $400,000 Threshold

One question that Secretary Yellen's order poses is how to define the "historical level" of audit rates. Since audit rates have fallen over the past decade, a range of rates could be considered a consistent benchmark.

Another question is whether the $400,000 threshold applies to the amount a filer claims to have earned, or the amount of "true" income the IRS concludes the filer earned after conducting enforcement activity. If taxpayers believe they are less likely to face an audit if they report an income below $400,000, they may have a stronger incentive to do so. However, the IRS could inadvertently fail to comply with this directive if it audits more people reporting less than $400,000 in income and finds less underreporting than expected.

The IRS may struggle to quickly hire and train specialized agents to audit high-income taxpayers. CBO lowered its estimate of the revenue that enforcement spending in IRA 2022 will raise through FY2031 from $204 billion to $180 billion to account for the Secretary's directive and the removal of IRS hiring flexibilities from the law before its passage. The interaction between these two changes had a larger revenue effect than either did individually.

Other Potential Effects on Filers Below the Threshold

Even if the IRS does not increase the rate of audits against those earning less than $400,000, it could increase the amount of nonaudit enforcement actions it performs. These actions include correcting math errors and verifying that filings are timely and match income reported to the IRS by third parties.

Officials have suggested that other funding included in IRA 2022 could make the IRS less likely to audit compliant taxpayers earning under $400,000 per year. IRS Commissioner Charles Rettig recently claimed that funds in the law for taxpayer services and information technology (IT) will help taxpayers comply with the tax code voluntarily, presumably by helping the agency answer taxpayers' questions before filing. Secretary Yellen also suggested investments in the IRS's IT could improve the targeting of audits, making compliant taxpayers less likely to face an examination.

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