

LEGAL UPDATES

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Service

Tax

Professionals

MICHAEL DANA
WASHINGTON:
202.378.2300
MICHAEL.DANA@
HUSCHBLACKWELL.COM

DOUG JONES
AUSTIN:
512.479.1178
DOUG.JONES@
HUSCHBLACKWELL.COM

ROBERT M. ROMASHKO
WASHINGTON:
202.378.2310
ROBERT.ROMASHKO@
HUSCHBLACKWELL.COM

ANDREW EASTMAN
ST. LOUIS:
314.345.6214
ANDREW.EASTMAN@
HUSCHBLACKWELL.COM

MICHAEL BLACKWELL
WASHINGTON:
202.378.2300
MICHAEL.BLACKWELL@

Inflation Reduction Act to Greatly Increase IRS Funding

The Inflation Reduction Act of 2022 (IRA) includes increased Internal Revenue Service (IRS) funding in the amount of approximately \$80 billion over ten years. According to a Congressional Research Service report, the law includes \$45.6 billion for tax enforcement (an increase of 69%), \$25.3 billion for operations support (an increase of 53%), \$3.2 billion for taxpayer services (an increase of 9%) and \$4.8 billion for business systems modernization (an increase of 153%). For most taxpayers, the enforcement and operations funding is likely to most affect how they interact with the IRS in the future. We detail those provisions below:

Enforcement Funding Will Likely Most Affect High Earners and Large Corporations

For many taxpayers, the greatest source of concern with the IRA is likely the increased IRS enforcement budget. Politicians and some media outlets have taken out of context a Treasury Department report which stated that the increased funding could lead to 87,000 new IRS agents; in reality, the majority of new IRS hires over the next decade are expected to replace retiring personnel—IRS estimates as many as 50,000 of its employees may retire over the next five years. In fact, the increased enforcement funding will most likely affect high-earning individuals and large corporations; but even then, it is likely that audit rates, which in recent years have fallen dramatically, will remain below historical levels.

On August 10, 2022, Secretary of the Treasury Janet Yellen sent a letter to Commissioner of Internal Revenue Charles Rettig, directing him with respect to the IRA as follows:

Audit rates on households making \$400,000 annually are not to rise and additional resources from the IRA are not to be used to increase the share of small businesses or households below the \$400,000 threshold that are audited.

Enforcement measures undertaken with the new funding are to focus on “high-end compliance.” Yellen’s letter identifies large corporations, high-net-worth individuals and complex pass-through entities as the primary areas of enforcement.

Enforcement measures are to improve targeting of audits; for regular taxpayers, Yellen’s letter notes that the likelihood of audit may actually decrease as resources are devoted to better targeting audits at noncompliant taxpayers.

Relatedly, resources are to be spent on the creation of digital tools allowing taxpayers to get information from IRS instantaneously and improving taxpayer services.

The government has signaled that the average individual taxpayer, then, can expect little or no change in tax enforcement. It is likely that the audit rates will rise, however, on high-net-worth individuals and large corporate taxpayers in the coming years (although it will take time for IRS to staff up and train new employees). Even then, most taxpayers will not be audited in any given year. The IRS’s audit capabilities have dropped in recent years—in 2010, 8.2% of taxpayers who had positive income of \$1,000,000 to \$5,000,000 were audited; by 2017 the number had dropped to 1.8%; it is unlikely that even with new tools and increased staffing, the IRS will audit as large a percentage as it did little more than a decade ago.

One area where taxpayers should be careful, however, is that they may be more likely to be audited if they engage in certain transactions that are likely to be targeted for enforcement, as the IRS will spend money actively improving its audit targeting. The IRS regularly publishes lists of issues for increased enforcement, and certain other areas, such as cryptocurrency and other digital assets, are understood to be areas where additional enforcement is expected. In light of the foregoing, taxpayers engaging in transactions in these areas should be careful to seek competent tax advice and to maintain excellent records to be prepared for any possible audits.

Taxpayer Services

The \$3.2 billion in the IRA for taxpayer services is likely to be to the benefit of many taxpayers. The IRS has a historic backlog of paper returns—as of May 2022, the National Taxpayer Advocate reported that the IRS had a backlog of 21,300,000 paper returns to process.

It has been our experience that this backlog has led to significant client confusion. The IRS has been slow to deliver Employee Retention Credit payments from the CARES Act due to these processing delays. Increased taxpayer services funding should lead to more timely process returns, delivering to taxpayers the refunds which they are owed in a faster and hopefully more accurate manner. However, there will be delays between the enactment of the law and the hiring and training of new staff; it is unlikely that the IRA will result in immediate relief for taxpayers dealing with IRS backlogs.

Further, the IRA provides \$15 million to fund a task force on the feasibility and cost of creating a direct e-file program to allow individuals to file returns without a third-party provider. Although the bill does not directly fund implementation of such a system, the implementation of such a system could significantly change how individuals interact with the IRS at return filing time.

What this means to you

Almost certainly, the new IRS funding will result in an increase in audit activity over time, although the IRA's funding and enforcement provisions will be felt mostly by high-net-worth individuals, larger businesses and complex pass-through entities. These individuals and enterprises should consult immediately with tax-planning professionals to determine how best to address their individual tax issues and prepare for potential audits.

Contact us

Husch Blackwell will continue monitoring developments surrounding the implementation of the Inflation Reduction Act. Please contact our team of tax law professionals if you have any related questions.