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Examining IRS Commissioner Werfel's remarks on audit rates – and what the IRS should do next

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The Inflation Reduction Act (IRA) provides $80 billion to rebuild and improve the tax system after more than a decade of deep cuts to the IRS budget. Treasury Secretary Janet Yellen and IRS Commissioner Daniel Werfel have pledged that the IRA's funding stream will "not be used to increase the share of small businesses or households below the $400,000 threshold that are audited *relative to historical levels*." The Administration has understandably made that pledge to help assure Americans that the investment in tax enforcement will be focused on "high-income and high-wealth individuals, complex partnerships, and large corporations that are not paying the taxes they owe."

In a hearing on April 19th before the Senate Finance Committee, Commissioner Werfel provided additional detail on audit rates for those making less than $400,000 as the IRS puts the funding to use. While he indicated that the IRS might eventually bring audit rates for that group toward historical levels, he suggested that, as an operational matter and "for the next number of years" the IRS is "going to be so focused on increasing capacity for high wealth taxpayers, individuals, corporations, and partnerships" that, for tax filers falling below the threshold, there will be "no change […] to the most recent audit rate," which is for tax year 2018 since that is the last year with complete data available.

Werfel's remarks indicate that in the near term and as an operational matter, the IRS will maintain audit rates on filers with incomes below $400,000 at 2018 levels. Commissioner Werfel and Deputy Treasury Secretary Adeyemo describe this as a practical constraint, noting the primary immediate enforcement focus on high-income, high-wealth taxpayers, along with the fact that "it takes time to train a good auditor." But audit rates for 2018 tax returns are a bad guide for what fair, effective tax enforcement should look like given the effects of IRS underfunding and an unprecedented global pandemic. Instead, the IRS should aim to return to *representative* historical levels of audit rates as quickly as possible. This would be entirely consistent with the administration's pledge and its goal of focusing enforcement efforts from the new funding on high-income Americans and large, complex business entities.

Below we explain why this is the case and the steps that the IRS should take next.

Audit rates for 2018 tax returns were exceptionally low due to a decade of budget cuts and a pandemic

Audit rates in tax year 2018 are abnormally low. The overall audit rate for individual income tax returns is almost 30 percent lower than for just the previous year of 2017. In fact, the overall audit rate for 2018 is more than 50 percent lower than the average from 2010 to 2017. The very low audit rates for 2018 likely reflect the combined effects of years of funding cuts as well as the significant effects of the pandemic on IRS operations.

Funding cuts led to a substantial reduction in audit rates after 2010. Between fiscal years 2010 and 2021, the IRS's overall budget was cut by about a fifth and the part of the budget dedicated to tax enforcement was cut by about 23%, after adjusting for inflation. Over the same time frame, the number of tax enforcement staff declined by about 30%. These resource constraints caused the overall audit rate for individual income tax returns to fall from 1.0% in tax year 2010 to 0.5% in tax year 2017. The overall audit rate fell even further to just 0.3% in tax year 2018. Audit rates have fallen most steeply for filers with very high incomes, but they also dropped sharply for upper-middle income tax filers. The audit rate on tax filers reporting incomes between $100,000 and $500,000 fell from 1.2% in 2010 to 0.4% in 2017, and plummeted to just 0.2% in 2018.

Low audit rates in 2018 reflect, at least in part, the cumulative damage of more than a decade of IRS budget cuts. However, dramatic changes in audit rates between 2017 and 2018 cannot be explained by the effects of IRS funding cuts alone.

The audit rate for tax year 2018 is also likely "artificially depressed" because of the effects of the COVID-19 pandemic, as we have previously noted. Tax returns for 2018 were typically filed in 2019, and then would have been processed and audited in subsequent years. But the IRS suspended virtually all compliance activities between March and July 2020, and even once enforcement programs resumed, the agency faced significant backlogs of correspondence and staffing shortages that delayed opening new cases. Since the IRS generally has a three-year statute of limitations for audits and assessment after a tax return is filed, the suspension of compliance activity fell squarely during the audit period for the 2018 tax year. Moreover, throughout the pandemic, the IRS had to reshuffle staff and resources to meet other urgent needs, including delivering economic impact payments, advance child tax credit payments, and more. This may have also reduced audit rates in subsequent tax years, although complete audit data for tax years 2019 and beyond are not yet available.

As a result, 2018 is an outlier year in terms of audit rates and sustaining such low audit rates for those with incomes below $400,000 may have several undesirable consequences. Taxes that are owed but not paid will not be discovered and recovered. Furthermore, audits encourage voluntary compliance among filers more generally, and to the extent that unscrupulous actors – including certain paid tax preparers and other would-be tax cheats – start to expect that the extremely low audit rates of 2018 are the "new normal," they may be more willing to cheat and play the "audit lottery" by underreporting income to fall below the $400,000 threshold. This risk is particularly acute for those filers – often with higher incomes – who, unlike typical wage earners, are not subject to substantial third-party reporting that makes it easier for the IRS to double check that income is reported correctly without conducting an audit.

To be fair, the IRS is so depleted after a decade of funding cuts that increasing audit rates on tax filers making below $400,000 to representative historical levels would be impossible in the short term, and Commissioner Werfel's comments may, in part, reflect this. The IRS faces serious practical limits on how many replacement enforcement staff it can hire in the near-term, especially given that the IRS faces other immediate priorities for hiring in other areas like taxpayer services, IT modernization, and more. Furthermore, it will take some time to train new

enforcement staff, and any time that existing revenue agents must spend onboarding new hires will likely reduce some of their time spent auditing returns and on other compliance activities. These types of constraints are reflected in official estimates from the Congressional Budget Office, which projected that it would take about three years for staff to "become trained and fully productive" and for the IRS to generate "peak return-on-investment" in terms of tax revenue collected per dollar of enforcement funding from the IRA.

However, as an operational matter and even as new hiring is focused on building capacity to audit high-income tax filers, it is possible that audit rates would – absent artificial constraints – rise above abnormally low 2018 levels as IRS operations normalize in the wake of the pandemic. That would still leave audit rates at or below representative historical levels as the Administration pledged.

What the IRS should do now

Looking ahead, we have several recommendations for the IRS as it operationalizes the pledge to not increase audit rates below $400,000 above historical levels:

1. **Set a quick path to an appropriate and more representative historical average.**

The IRS should allow enforcement operations to immediately normalize as the agency recovers from the effects of the pandemic. That would likely still leave audit rates well below their historical levels, and the IRS should then move to restore audit rates for filers with income below $400,000 to levels that better represent historical trends, even as they immediately focus on expanding enforcement for those with the highest incomes and for complex business entities.

In normalizing operations and then returning audit rates to historical levels, the administration will likely need to choose a specific benchmark that represents "historical levels." There are several reasonable options but using 2018 as a benchmark is not one of them. For example, the IRS could set historical levels based on audit rates from 2010, which is the most recent year before its budget began declining in inflation-adjusted terms. Another option is to use a multi-year historical average spanning the 2000s, or potentially going back even further.

The IRS should also commit to a specific timeline for adopting this more representative historical benchmark. The agency has set detailed goals, timelines, and initiatives for many other difficult operational challenges in its Strategic Operating Plan (SOP), and should do so with respect to these audit rates. In any event, the IRS should not maintain 2018 audit rates any longer than is necessary to address immediate limitations around hiring and training.

Such an approach would:

- Be consistent with the IRA's goals to *rebuild and improve* the IRS after a decade of disinvestment.
- Build trust in IRS stewardship of the $80 billion funding. The IRS should not set goals that require "bare minimum" effort to achieve, and nothing in the IRA's statutory text or prior Administration commitments (including Commissioner Werfel's statements during his nomination hearing) require audit rates to be held to artificial lows for any group of filers.

- Further the IRS's duty to faithfully apply the law and ensure that *all* filers follow the law. The SOP lays out several laudable goals to improve tax compliance across the income distribution by ensuring that more filers have access to "front end" assistance with filing and guidance that will help them comply with their tax obligations. The SOP also reflects that the IRS will concentrate on increasing audit rates and compliance activity for the high-income filers and large businesses that contribute the most to the tax gap.

  These are sound decisions, but they are not inconsistent with allowing audit rates for filers with incomes below $400,000 to reach levels that are more representative of historical trends than 2018.

It is important to understand that, by the terms of the Administration's own pledge, the historical audit rates for filers below $400,000 are a *ceiling*. If the IRS can show through the research and evaluation efforts promised in the SOP that maintaining low audit rates on filers earning less than $400,000 is the most effective and efficient way to reduce the tax gap because enforcement resources are better used elsewhere, it will remain free to continue doing so.

But the IRS should not prematurely and unnecessarily constrain itself now to a 2018 audit rate ceiling for longer than is needed, because doing so could lead to inefficient use of the $80 billion and a failure to faithfully ensure tax compliance across the income spectrum.

2. **Change how audits are distributed under the $400,000 threshold to advance equity and shrink the tax gap.**

Regardless of how the IRS chooses to approach setting an overall audit rate for those earning less than $400,000, it should take immediate steps to examine and rebalance audit rates *within* the income groups falling below that threshold. The IRS should do so in ways that further its goals of both addressing the tax gap efficiently and taking swift action to address the stark racial disparities in audit rates revealed by recent work from academic and Treasury researchers. As we have previously explained, a recent working paper found that Black tax filers are 2.9 to 4.7 times more likely to be selected for audits than non-Black tax filers and provided some possible explanations for these disparities (which exist even after controlling for factors like income and household composition).

For instance, the IRS should consider rebalancing the following:

- *Audits rates on tax filers claiming the Earned Income Tax Credit (EITC) versus those who do not.* Currently, EITC claimants are audited at about four times the rate of certain upper-middle-income tax filers, even though the latter group is responsible for a higher share of unpaid taxes. In tax year 2018, low-income tax filers claiming the EITC were audited at a rate of 0.9%, while tax filers with incomes between $100,000 and $500,000 were audited at a rate of 0.2%. The IRS has estimated that EITC filers account for 10% of the individual income tax under-reporting gap. There is no official estimate of the tax gap share for filers earning between $100,000 and $500,000, but research finds that a roughly comparable group of tax filers (those falling into the 80th to 98th percentiles of the income distribution) accounts for about 44% of that gap (when filers are ranked by their "true" incomes rather than reported incomes).

There was not always such a stark disparity in audit rates between EITC filers and upper-middle income tax filers. In tax year 2010, the audit rate on EITC filers was 1.8% and the audit rate on filers earning between $100,000 and $500,000 was 1.2%. As audit rates have fallen across the board over the last decade, audits on EITC filers have fallen by much less than audits on higher-income filers, largely because audits of EITC claims are generally cheaper and faster for the IRS to conduct. The IRS should not continue to subject EITC filers to harsher scrutiny than upper-middle income tax filers that are responsible for a substantially larger share of tax non-compliance.

Furthermore, the working paper by Treasury and academic experts found that disparate audit rates between EITC and non-EITC filers are responsible for about a fifth of the overall audit rate disparity between Black and non-Black filers, so raising audit rates on non-EITC returns relative to EITC returns is likely one necessary (though not sufficient) step for addressing racial audit disparities.

- *Audit rates on tax filers reporting business income versus those without it.* Within the population of tax filers making less than $400,000, the IRS should reallocate tax enforcement resources to the higher-income tax filers and business entities that contribute substantially to the tax gap. Pass-through business income and other types of income earned by more affluent tax filers are often not subject to significant third-party information reporting requirements, and income without information reporting tends to have higher rates of false or erroneous reporting.

  The recent working paper by Treasury and academic researchers explained that returns with business income require more expertise and cost more for the IRS to conduct than returns that do not report business income. For example, audits on EITC claimants reporting business income cost nearly $400 per audit to complete while audits on EITC claimants without business income only cost about $30 per audit. The paper suggests that given the potentially higher dollar amounts of non-compliance among returns with business income, increasing audits on such returns may both be efficient and reduce racial audit disparities (because non-Black EITC claimants are more likely to have substantial business income on their returns than Black EITC claimants).

  Shifting focus towards partnerships and S-corporations for filers across the income spectrum is especially important because these entities are audited at rates that are now dramatically out of step with their contributions to the tax gap. Pass-through businesses currently account for about half of individual income tax under-reporting, but in tax year 2018, only 0.1% of partnerships and S-corporations were selected for audits. While the IRS should rightly focus tax enforcement resources and attention on the highest-income partnership and S-corporation owners, it should also consider addressing audits on such businesses across the income distribution.

In a previous report, we set out steps that the IRS should take to examine its audit selection processes across the income distribution to address racial audit disparities. For example, targeting *large dollar amounts* of under-reported tax when selecting tax filers for audits (instead of targeting the mere presence of *any* under-reported tax) may be able to improve the efficiency

of enforcement activity and reduce racial audit disparities. Such steps would help the Administration to deliver on President Biden's recent Executive Order (released on February 16, 2023) that directs federal agencies to "prevent and remedy discrimination, including by protecting the public from algorithmic discrimination" and with implementation of the Executive Order (released on December 13, 2021) requiring federal agencies to "transform federal customer experience and service delivery to rebuild trust in government."

3. **Follow through on the Administration's commitments to implement the pledge based on actual income.**

The Treasury Department has suggested repeatedly that the pledge will only apply to filers with less than $400,000 in *actual income,* or income that has been adjusted for under-reporting.

Coming out of the hearing, there has been some confusion around whether the Treasury Department will follow through on the approach of using actual income. That is because Commissioner Werfel referred to "total positive income" in the hearing, which is based on reported income. It is possible he did so only because audit rates are currently reported using that approach, and that he did not intend to imply that the IRS will use this measure of income going forward. In any case, it is critical that the IRS follow through on implementing the pledge using actual income, rather than reported income.

Using true or real income to implement the pledge will mean that the IRS will be able to ensure that tax cheats falsely reporting they earned less than $400,000 on their tax returns, even though their actual incomes exceeded that threshold, are not protected from increased audit risk and from their existing legal obligations to pay tax. Previous research indicates that many high-income filers substantially underreport their incomes on their tax returns. When tax filers are ranked based on their reported income, filers in the top 1% of the income distribution appear to be responsible for only about 6% of income tax under-reporting. But when they are ranked based on their true incomes, filers in the highest-income 1% account for about 28% of income tax under-reporting.

Of course, operationalizing this definition of income is a challenge because the IRS only knows the real incomes of tax filers selected for audits after those audits have been closed (which, as described above, can take several years given the IRS's statute of limitations). But the IRS should take on this analytical challenge to make the pledge meaningful and consistent with the agency's obligations under the IRA and the tax code.

For instance, the IRS should be able to estimate, based on its audit selection algorithms and historical audit results, how many filers that it chooses to audit with *reported* income below $400,000 will in fact turn out to have *true* income above that level. Those filers – including deliberate tax cheats that are underreporting their true incomes to falsely state on their tax returns that they earned less than $400,000 – should not be counted towards the audit rate ceiling for those falling below that threshold. Eventually, as early audits for any tax year are closed and audit results come in, the IRS may also be able to adjust how many further filers it selects for audit – and which types of filers to prioritize – based on those results (taking into account how audits closed earlier in the statute of limitations period may differ systematically from those closed later).

The IRS could aim to refine these analyses over time. As the Tax Policy Center has noted, the IRS can invest in improving its data analytics and evaluation of the effectiveness of different compliance activities. We have previously explained why IRS investment in reviewing and evaluating audit selection processes should be a priority, and the SOP commits to improving IRS research and evaluation capacity.