United States Senate Committee on Finance
"Examining How the Tax Code Affects High-Income Individuals and Tax Planning Strategies"
November 9, 2023

Questions for the Record for Chye-Ching Huang

Senator Cortez Masto

Question 1:

Background: Historically, we have seen a significant wealth gap between white families and families of color. Many people of color are also low-income workers and recent studies showed that Black Americans were disproportionately targeted by IRS audits. I applaud the IRS for working to address this issue, yet I am still concerned that we will continue to see the racial wage gap and the overall tax gap widen.

Ms. Huang, in your testimony, you mention that "tax benefits for existing wealth increase racial wealth disparities that have been produced by historical and current barriers to wealth building."

Can you expand on how lack of action against ultra-wealthy tax cheats disproportionally hurts communities of color?

Answer:
Due to cuts to the IRS budget between 2010 and 2021, audit rates on the top 1% fell so steeply that they are audited at about the same rate as families claiming the Earned Income Tax Credit ("EITC"), even though the top 1 percent of filers contribute far more to the "tax gap" of taxes owed but not paid.[1] Audits of EITC recipients are easier and cheaper to accomplish than audits of wealthy filers, so these rates fell far less steeply over the same period as a result of budget cuts. Research has now also confirmed that the IRS's audit algorithms have effectively been treating EITC errors as "more important" than other types of tax non-compliance.[2]

Over-auditing of ETIC recipients for both of these reasons compounds existing racial disparities and contributes to the over-auditing of Black filers, in particular. Barriers to full economic participation erected by past and present policy choices and discrimination mean that people of color are disproportionately represented among low-wage workers eligible for tax credits such as the EITC and Child Tax Credit. According to data on audit rates before the recent restoration of IRS funding, the most highly audited areas of the country are rural southern counties that have predominantly Black residents. Restoring and maintaining IRS resources in a way that reduces the disparities in audit rates for wealthy filers compared to EITC recipients is critical for addressing these racial disparities.

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[1] Tax Law Center at NYU Law, *Issue Brief on Rebalancing Reporting on Sources of the Tax Gap* (Updated July 11, 2023).
[2] Tax Law Center at NYU Law, *IRS Takes Important Step to Increase Accuracy and Reduce Racial Disparities by Addressing Audits by Mail* (September 19, 2023); Kathleen Bryant and Chye-Ching Huang, *New Evidence on Racial Disparities in IRS Audit Selection Calls for Immediate Action,* Tax Law Center at NYU Law (March 2, 2023).

Furthermore, working families facing an audit overwhelmingly do not have any professional help navigating that process and can end up losing tax credits that they are eligible for just because they cannot make it through the audit. The experience of being audited may also scare them away from claiming tax credits they are in fact eligible for in the future, research shows.[3]

Follow up: *How can Congress design and monitor federal policies to promote racial and gender equity?*

Answer:

First, the IRS and lawmakers can remove barriers preventing underserved families and communities from accessing tax guidance and reliable tax preparation services. Instead of subjecting filers who do not have the resources or help to file accurately to unnecessary audits, the IRS can focus on assisting filers to more easily understand and comply with their tax obligations and claim tax credits that they are eligible for. The tax system should not be subjecting filers who are trying to file accurately to unnecessary audits when it could instead provide them the information and support needed to file accurate returns.

The IRS can do some of this by itself with restored funding and better services—an excellent example is its important move to reopen in-person taxpayer assistance centers.[4] And the IRS has also already taken commendable action to reduce reliance on correspondence audits that research shows both feed racial disparities and *increase* inaccuracy by denying credits to families who are eligible but cannot make it through a burdensome audit process.[5]

Congress can help by continuing to support the funding needed to develop better taxpayer services and approaches to compliance, including free and simplified filing tools.[6] Congress can also provide the IRS authority to require unenrolled paid tax preparers, who lack a professional credential indicating their qualification and are a large source of filing error, to meet basic standards of competence.[7]

Second, the IRS can invest in research and transparency. The IRS has not, to my knowledge, publicly committed to regularly reporting on its progress eliminating audit disparities and should do so. Additionally, the IRS has answered some, but not all, of the questions experts have posed about the root causes of the racial disparities in audit. This is also something the IRS should quickly address.[8]

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[3] John Guyton, Kara Leibel, Day Manoli, Ankur Patel, Mark Payne, and Brenda Schafer, *The Effects of EITC Correspondence Audits on Low-Income Earners*, IRS SOI Working Paper (December 2019).
[4] IRS, IR-2023-127, IRS Continues Reopening Closed Taxpayer Assistance Centers; Begins Special Serious of Community Assistance Visits to Help Taxpayers in 8 States to Expand Service for People Who Aren't Near Agency Offices (July 14, 2023).
[5] Tax Law Center at NYU Law, *IRS Takes Important Step to Increase Accuracy and Reduce Racial Disparities by Addressing Audits by Mail, supra* note 2.
[6] David Kamin and Mike Kaercher, *Finally, Americans Could Soon 'Direct File' Taxes Online Without a Middleman,* Tax Law Center at NYU Law (June 15, 2023).
[7] John Wancheck, *IRS Needs Authority to Regulate Tax Return Preparers,* Center on Budget and Policy Priorities (May 5, 2021).
[8] Kathleen Bryant, *Unanswered Questions Remain on Causes of Racial Disparities in Audit Selection and the IRS's Plans for Further Evaluation,* Tax Law Center at NYU Law (May 26, 2023).

It is notable that IRS data and research by Treasury Department officials, in collaboration with external researchers, confirmed racial disparities in audits that have been long suspected by independent researchers.[9] Lawmakers can ensure that the IRS uses some of its restored funding to continue to invest in the types of research that shone light on these disparities. The divisions of the IRS that perform that research should also be enabled to continue to pursue it even when it puts an uncomfortable spotlight on IRS practices that are not working well or that are inequitable.

The IRS Strategic Operating Plan acknowledges that research and evaluation, including on racial disparities, is needed to ensure that the restored funding is used most effectively and efficiently, and this is a good start. Lawmakers can help hold the IRS accountable for following through by ensuring that it makes concrete commitments of resources and staff to research and evaluation on IRS services and compliance efforts. This work is important, but is not likely to generate "quick wins," may lead to uncomfortable but necessary criticism, and can be easily neglected in a major and complex transformation project.

Third, the IRS can make sure it is hearing from all families affected by the tax system. The IRS gets a lot of input from sophisticated, high-income filers who are lobbying for certain regulations, but low- and moderate-income filers do not have the same level of access.[10] In response, the IRS should make certain that the stakeholder engagement practices it relies on to inform its work enables it to get and consider input from all of the people affected by the tax system, not just those with the most resources. For example, the IRS can more actively work to guarantee that the Advisory Committees that it relies on to hear from stakeholders are more representative. There are a wide range of options for improvement in this area, and it is also promising that the IRS and Treasury have started to adopt some innovative approaches to broadening input. [11]

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[9] Hadi Elzayn, Evelyn Smith, Thomas Hertz, Arun Ramesh, Robin Fisher, Daniel Ho, and Jacob Goldin, *Measuring and Mitigating Racial Disparities in Tax Audits*, Stanford Institute for Economic and Policy Research (January 30, 2023).

[10] *See* Shun-Yi Oei and Leigh Osofsky, *Legislation and Comment: The Making of the § 199A Regulations*, 69 Emory Law Journal 209 (2019); Clint Wallace, *Congressional Control of Tax Rulemaking*, 71 Tax Law Review 179 (2017).

[11] Chye-Ching Huang, *Modernizing Tax Regulatory Review*, Yale Journal on Regulation: Notice and Comment (June 29, 2023).

<u>Senator Warren</u>

Question:

Congressional Republicans are working to extend and revive three expiring business provisions from the 2017 Tax Cuts and Jobs Act (TCJA) – 100% bonus depreciation, R&E expensing, and the net interest deduction – which help giant corporations cut their tax rates to the bone. Just like they did in 2017, Congressional Republicans are pushing for a short-term extension to hide just how expensive these provisions really are, despite having every intention of extending them indefinitely.

According to your testimony, extending 100% bonus depreciation for three years appears to only cost $3 billion over the next decade, but permanently extending the provision would cost a staggering $325 billion over the next decade.

How do the revenue projections differ between a short-term (e.g., three year) extension and a permanent extension for all three provisions? What accounting gimmicks have Congressional Republicans used to make corporate tax breaks appear drastically less expensive than they actually are?

Answer:

The TCJA prioritized making permanent large net cuts to corporate taxes, including cutting the corporate tax rate from 35 percent to 21 percent and slashing the default rate on multinationals' foreign profits even lower. To partially offset the large cost, the law scaled back certain tax breaks for businesses starting in 2023, including requiring businesses to deduct research and experimentation (R&E) expenses more gradually over time and tightening limitations on interest deductions. Furthermore, while the law initially allowed businesses to fully expense their capital investments ("full bonus depreciation"), it set this provision to gradually phase out.

Those three changes allowed proponents to claim $292 billion in "savings" in the last half of the budget window, enough to offset about 40 percent of the cost of cutting the corporate tax rate in those years. Corporate lobbyists now want policymakers to reverse those offsets by reinstating the underlying tax breaks temporarily—but without enacting a corresponding increase in the corporate tax rate or otherwise reversing any of the law's large permanent tax cuts for corporations.

Doing so would be a gimmick upon a gimmick upon a gimmick.

First, undoing "offsets" without also undoing the net tax cuts that they purportedly paid for just richens the already large permanent corporate tax cuts in the TCJA.

Second, doing so in small increments by "temporarily" enacting corporate tax breaks masks the true permanent cost of these tax breaks, which many businesses and lawmakers are seeking to ultimately make permanent.

For example, loosening the limitation on net interest deductions would cost roughly $19 billion over ten years if enacted "temporarily" for three years,[12] while the permanent provision would cost roughly $50 billion over ten years.[13]

Third, and worse, full bonus depreciation and R&E expensing involve shifts in the timing of when tax breaks are claimed, so the apparent cost of these temporary cuts is even more unrepresentative of the true cost of making these provisions permanent. Official estimates of a temporary restoration of full bonus depreciation and R&E expensing tax breaks show revenue losses for both provisions while the temporary tax break is in effect, but then show revenue increases (above current law levels) after the tax break is assumed to expire. Three-year temporary full bonus depreciation is estimated to cost only $3 billion over ten years,[14] but the cost of permanent bonus depreciation is $325 billion over ten years.[15] Three-year R&E expensing is estimated to cost $25 billion over ten years,[16] while the permanent provision costs more than $150 billion over ten years.[17]

Because businesses and some lawmakers see "temporary" reinstatement of these three provisions as a way to make the provisions permanent, we should be looking at the permanent cost of provisions like full bonus depreciation and R&E expensing over ten years. That is also why these provisions may be better addressed as part of a discussion about permanent changes to the tax code in 2025.

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[12] Joint Committee on Taxation (JCT), JCX-29-23, Estimated Revenue Effects OF H.R. 3938, The "Build It In America Act" (June 9, 2023).
[13] Committee for a Responsible Federal Budget, *Tax Cut Extensions Cost Over $3.3 Trillion* (August 14, 2023).
[14] JCT, *supra* note 12.
[15] Congressional Budget Office (CBO), Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues (May, 2023).
[16] JCT, *supra* note 12.
[17] Committee for a Responsible Federal Budget, *supra* note 13.