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LEGAL ALERT

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IRS Pressures Build: Budgetary Constraints, the Aging IRS Workforce and Changes in IRS Focus

On April 10, 2013, President Obama released his proposed Fiscal Year 2014 Budget of the U.S. Government. The budget calls for an increase in funding for the Internal Revenue Service ("IRS"), which has faced budget cuts in previous years. The budget's prospects for enactment, however, seem rather bleak. Budgetary constraints, along with the IRS's aging workforce and recent changes in the IRS's focus, highlight the current challenges that the IRS faces in enforcing federal tax laws.

The Budget

In 2012, Congress set the IRS's funding level at approximately $11.8 billion, a cut of $306 million from the fiscal 2011 funding level. Congress extended the 2012 spending package into the 2013 fiscal year through continuing resolutions, which maintained the IRS's funding levels despite its request for appropriated resources of $12.8 billion. The recent budget sequestration that took effect on March 1, 2013, has further reduced the IRS's budget, triggering an additional 5% cut of approximately $600 million. Acting IRS Commissioner Steven Miller recently warned a Congressional subcommittee that these cuts will likely cause the IRS to bring in "substantially less" than the $2.52 trillion in taxes collected in fiscal 2012. Due to the sequestration and previous cuts, the IRS has seen its funding cut by more than $900 million in the past two years.

To remedy this situation, Obama's 2014 fiscal year budget proposes an approximately $1.1 billion increase in the IRS's budget compared to its 2012 levels, which would bring the IRS's funding level to $12.9 billion. IRS enforcement activities would, in particular, see a nearly 7% increase in funding from 2012 levels, resulting in a $5.66 billion budget for fiscal 2014. The White House projects that these proposed spending increases would result in stronger tax enforcement that could yield an additional $4 or more in revenue for each additional IRS dollar spent.

Since the release of Obama's proposed budget, however, several Congressional Republicans have publicly criticized its contents, and the current political climate in Washington continues to appear gridlocked. Moreover, Wisconsin Rep. Paul Ryan's recent budget contains no proposed increase in funding for the IRS. In light of these circumstances, it seems highly likely that the IRS will have to grow accustomed to its smaller budget, with few prospects for relief in the near future. As a result, the IRS has notably fewer resources to devote to enforcement of federal tax laws than it did just a few years ago.

The Workforce

The budget cuts have created an immediate impact on the IRS's workforce. In efforts to avoid layoffs, the IRS has sought to reduce its costs in other ways, such as imposing a hiring freeze and offering early retirement packages to certain employees. As a result, the IRS's total size has decreased from 91,380 employees at the close of the 2011 fiscal year to 89,551 employees at the close of the 2012 fiscal year. The impact on Examinations and Collections is felt even more so; the number of their employees at the close of the 2012 fiscal year declined by more than 2,500 from the end of the 2011 fiscal year. Comparing fiscal year 2012 to fiscal year 2008, the IRS has seen decreases of 0.68% in its revenue agent workforce and decreases of 7.95% in its revenue officer workforce.

Added to the budgetary constraints is the problem of an aging IRS workforce, which is an issue that the IRS has been concerned with for a number of years now. In 2008, the IRS convened the Workforce of Tomorrow Task Force, which sought new ways in which the IRS could address its various organizational issues. The task force issued a final report in August, 2009, recommending that agency efforts be focused on several areas, including attracting more talented employees, streamlining the hiring process, and valuing and retaining employees.

The success of these efforts is not fully clear, though it is certain that the IRS continues to face the aging of its workforce. In 2009, the task force observed that 12% of the IRS's current employees were already eligible for retirement. According to a January 11, 2013, report by the Treasury Inspector General for Tax Administration (TIGTA), this percentage will have increased to 19% by the end of fiscal year 2013. The TIGTA report also projects an increase to 37% by the end of fiscal year 2017. The figures for IRS executives and managers are even more pronounced, with 26% eligible for retirement by the end of fiscal year 2013 and a projected 49% by the end of fiscal year 2017.

As its employees continue to age and eventually retire, the IRS will lose the considerable experience of these retirees and be further weakened in its ability to meet all of its responsibilities. This trend likely has limited, and surely will continue to limit, the IRS's effectiveness in its enforcement of federal tax laws.

Changes in Focus

Recent changes both in the law and in taxpayer activity have caused the IRS to refocus its resources and attention in recent years. As the provisions of the 2010 Patient Protection and Affordable Care Act become effective, including the penalty in section 5000A of the Internal Revenue Code for a failure to maintain health insurance, the IRS finds itself administering various components of this law. In fiscal year 2012, the Department of Health and Human Services directly funded a portion of the IRS's efforts to begin implementing the law. The Department of Health and Human Services is not funding these efforts in fiscal year 2013, however, further burdening the IRS.

The recent reduction in the IRS's workforce has directly led to reduced hours dedicated to certain audits. According to an April 9, 2013, report by the Transactional Records Access Clearinghouse, the IRS anticipates spending 14% less time on audits of businesses with assets in excess of $10 million in fiscal year 2013 compared to fiscal year 2011. That report also indicated that there has been a shift over the past 20 years from face-to-face examinations of large businesses to correspondence examinations. Correspondence examinations by the Large Business and International Division have apparently tripled during that period, while face-to-face examinations have been reduced by more than half.

The past several years have seen a particular emphasis with respect to specific areas as well. The rampant increases in identity theft and refund fraud have forced the IRS to devote more and more employees to combating these abuses. According to written testimony to the Senate Finance Committee by acting Commissioner Miller given April 16, 2013, the IRS currently has more than 3,000 employees working on identity theft, which is more than double the number compared to the start of the previous filing season.

As evident by the Voluntary Offshore Disclosure Programs of the past few years, the IRS remains concerned about offshore investments. In particular, the 2012 program remains open until further notice, suggesting continuing focus on this issue. Moreover, as the growth of new partnerships and S corporations continues to outstrip the growth in new C corporations, it is expected that the IRS will continue to focus its attention on pass-through entities. In the partnership tax realm, this will likely mean more IRS activity with respect to TEFRA partnerships.

Finally, the Government Accountability Office (GAO) issued a report on April 9, 2013, in which it recommended a further reallocation of enforcement resources. The GAO estimated that had the IRS shifted $124 million of its funds from examining lower-income returns to examining higher-income returns in fiscal years 2007 and 2008, it could have increased revenue collection by $1 billion. The GAO therefore called for further use of return-on-investment analyses for the IRS's allocation of resources. In response, the IRS stated that it is in the process of developing cost-effectiveness analysis procedures for its budget formulations.

Conclusion

As time progresses and the sequestration cuts make a further impact, it will become increasingly clear just how the IRS will address its current challenges. Budget cuts may force the IRS to pick certain issues on which to focus, at the exclusion of others. Financial constraints and lesser attention on certain issues could also make the IRS more amenable to taxpayer-favorable settlements. These concerns of the IRS are further compounded as the IRS workforce continues to age and the experience of its retirees is lost. Unless the IRS can quickly learn to do significantly more with fewer resources, it will likely find it more and more difficult to effectively meet its responsibility to enforce federal tax laws.

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If you have any questions about this Legal Alert, please feel free to contact the attorneys listed below or the Sutherland attorney with whom you regularly work.

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