PILLA TALKS TAXES

DAN PILLA'S MONTHLY TAX AND FINANCIAL BULLETIN

June 2023
Vol. 35 Issue 5

Update On IRS Spending Plans

IRS Reveals Spending Plans for Its Windfall

In April the IRS released its long-awaited Strategic Operating Plan for how it intends to spend the $80 billion in supplemental funding granted by the Inflation Reduction Act of 2022. The making of this plan was one of the first tasks charged to new Commissioner Danny Werfel after taking office. See IRS Publication 3744 (April 2023).

The 146-page plan lays out how the funds are to be allocated and the timelines for accomplishing the various initiatives (discussed below). Ironically, the plan came just in time for Congress to *cut* $21 billion from the total appropriation under the budget deal struck by President Biden and House Speaker Kevin McCarthy in late May.

McCarthy claimed that shaving the appropriation will stop the agency's planned hiring of about 87,000 new employees over ten years. I don't see how that can be the case, since the IRS will simply front-load its plans, then come back to Congress in future years to ask for more money. Still, House Republicans count the $21-billion claw-back as a win, despite the fact that they twice voted to cut $70 of the $80 billion appropriation.

The agency continues to sing the tune that none of the new enforcement weapons the IRS is amassing will be pointed at anybody earning less than $400,000 per year. Werfel parroted a statement made by former Commissioner Rettig last summer, saying that, "The IRS has no plan to increase the most current audit rate we have for

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households making less than $400,000." Treasury Secretary Janet Yellen previously directed the IRS to not increase audit rates for households and small businesses making $400,000 or less, relative to historical levels.

But, there is the catch. Historically, small businesses and self-employed people have accounted for about 60 percent of the IRS's audit and enforcement load. For details on this, see my article titled, "IRS to Get $80 Billion," *PTT*, August 2022. That article includes a chart showing IRS Chief Counsel workload for tax year 2021. Per that data, the IRS's Small Business and Self-Employed division generates 60 percent of the enforcement cases, while the remaining 40 percent is spread throughout the other fourteen categories of taxpayers.

STRATEGIC OPERATING PLAN – OVERVIEW

The Strategic Operating Plan sets forth the spending agenda, broken down into four broad categories: taxpayer services, enforcement, business systems modernization, and operations support. Note that the report has not been amended since the budget deal shaved $21 billion from the appropriation. But as I said, there is little doubt but that they will front-load the money for new employees, and come back to Congress for more money latter.

The agency estimates it will spend $47.4 billion (the majority of the money) on enforcement. This includes $41.7 billion of the direct enforcement funds, $5.5 billion of the operations support funds, and $200 million of the taxpayer services funds.

An estimated $4.3 billion is targeted at taxpayer services, $3.2 billion to problems resolution, and $12.4 billion on business systems modernization. Another $8.2 billion is pointed at employee hiring and retention.

The IRS is hoping to hire 19,545 full-time equivalent employees in fiscal 2024. Future hiring targets will be evaluated on the basis of a three-year window.

The plan assumes that the IRS's normal annual appropriations remain at fiscal 2022 levels plus inflation adjustments. In that case, the agency will see a 2024 appropriation of about $22 billion.

A more detailed breakdown of the plan follows.

1. Taxpayer Services. Taxpayer assistance and case resolution have long been problems for the IRS, and the problems were only exacerbated (not caused) by the pandemic. And though the agency is working through processing backlogs, it remains overloaded in a number of areas. See my article titled, "Werfel Confirmed as IRS Chief," *PTT*, March

2023. This is the one area where I am convinced that the dedication of additional resources is warranted and may be helpful.

The plan spells out various goals to improve services. These include making customer service more accessible through web-based systems, increasing the types of forms that can be filed electronically and that can be scanned when paper-filed, and allowing citizens better access to their files and case histories over the Internet.

The focus here is on expanding online accounts for individuals, businesses, and tax professionals. The agency is also aiming to expand its online payment features and, by 2025, to enable citizens to see notices and letters through their online accounts.

Several outreach initiatives are on the drawing board. These include a system whereby citizens can elect to receive email alerts about tax issues, and preemptively provide their personal information about life changes (sale of home, birth of a child, etc.) to learn about the tax implications of these new circumstances. It also wants to expand efforts to educate the public about tax incentives that may apply.

Additionally, the plan calls for hiring more employees in the Chief Counsel's Office and the Treasury Tax Policy Office. This will allow the IRS to more promptly issue formal and informal guidance to the public in an effort to quickly clarify tax law changes. Congress changes the law with relentless regularity and they are not slowing down. It can only help to have prompt and accurate public guidance issued so people know how to comply.

Finally, the plan calls for increasing the options by which people may verify their identities for purposes of using online tools.

2. Enforcement. While the IRS continues to insist that enhanced enforcement will focus on only those taxpayers earning more than $400,000 per year, as well as large corporations, I simply do not believe it. The IRS has and always will target citizens and businesses for enforcement where there is the greatest likelihood of collecting additional revenue. It is a waste of time and resources for the government, and a glorious waste of time (not to mention the factors of cost, hassle and anxiety) for the public to be audited only to find that very little or no additional tax is due.

High income individuals and large businesses have full-time tax professionals on staff precisely to ensure compliance. CPAs and attorneys have an affirmative legal and ethical duty to follow the law regarding tax compliance, not teach or even encourage people to cheat on their taxes. Thus, it's small businesses and self-employed people who generally cannot afford hot-shot tax and legal counsel, who end up making mistakes. This is why the IRS has, and in my opinion will continue, to focus on small businesses in the audit world.

To this end, the agency intends to use new money to hire more than 1,500 full-time equivalent enforcement employees in 2023, and another 7,239 enforcement employees in 2024. Some of these new employees will work in the Office of Appeals and the Office of the Chief Counsel. These are the functions of the IRS that work to resolve audit and collection appeal cases, as well as Tax Court cases.

The plan calls for the creation of "a more centralized approach" to the selection of enforcement cases. Compliance prioritization and case selection currently is decentralized across the IRS.

The IRS intends to set up a more comprehensive "soft-contact notice" system under which it notifies citizens about problems with their returns at the time of filing, and seeks a corrected return from the citizen, even before it's processed. This will reduce the number of after-the-fact "hard-contact notices" under which the taxpayer learns of problems only after additional taxes and penalties are proposed or assessed.

3. Business Systems Modernization. Since the late 1990s, the IRS has spent tens of billions on computer systems and data-gathering and processing upgrades. In fact, former Commissioner Charles Rossotti was named IRS Commissioner in 1997 specifically to fix the agency's computer problems. Rossotti is the only commissioner to my knowledge ever brought in from outside of government to do the job. He was commissioner for five years, over-seeing massive upgrades in computer capabilities.

Despite this, the IRS continues to claim that its technology infrastructure is woefully outdated. They assert that some parts of the system, including the Individual Master File systems, date to the 1960s. I've heard critics say the IRS is operating on "Beatles-era technology." I find this strikingly hard to believe, given the technology advances I've seen with my own eyes over the past twenty years, not the least of which is: 1) electronic filing capabilities, 2) a very simple and effective online payment system, and 3) the ability to download clients' Master File data in a matter of seconds through a direct portal link with IRS's computers. None of that was even imaginable in the 1960s.

Regardless, the proposal calls for investing $9.2 billion in operations support and $3.1 billion in business systems modernization, which would also include the addition of hundreds of full-time-equivalent workers in the data process centers.

The IRS plan sets a series of initiatives beginning in 2023 and running through 2028 that are intended to eliminate all paper-processing and manual data-entry from the landscape.

The goal is to make it easier for IRS employees to interact with citizens by integrating under, one roof, information that's currently stored in multiple data systems. This would involve the phase-out over time of certain legacy systems now in operation.

4. Operations Support. The concept of operations support cuts across all aspects of the agency. However, one of the key elements is cyber security. The IRS has been hacked in the past and millions of individual accounts were compromised. Thus, given the massive (and uninterrupted) river of data that flows into the IRS every year, it's no surprise that protecting against cyber attacks as a major concern.

According to the report, the IRS already "prevents and blocks billions of unauthorized access attempts, scans attacks, and probes every year." The plan is to beef up its security by 2026. The measure of success is that all tax data would be "internally encrypted and segmented to limit exposure to threats and compliant with all federal standards and guidelines."

CONCLUSION

Despite the claw-back of $21 billion, the IRS is still getting money – and plenty of it. And whether you believe the nonsense about auditing only the top 1 percent of income-earners or not, the agency most certainly will be enhancing enforced collection for those who already owe delinquent taxes. Most of those people are middle-income Americans and small business owners, so make no mistake about it — the agency is gearing up for enforcement action that will touch all Americans.

The Tax Return-Filing Twilight Zone

Imagine a World Where Nobody Can Find Your Tax Return

BY SCOTT MACPHERSON *

Imagine you get a letter from an IRS official saying that the agency never received the tax return you thought you filed four years ago. In response, you fax a copy of your return to the IRS official. Two years go by, and you then talk with an IRS lawyer, who again asks you for the same return. After that conversation, you send another copy of the return.

Three more years pass. You then get a notice that the IRS has decided to adjust your tax liability. The result: you owe the IRS a lot more money.

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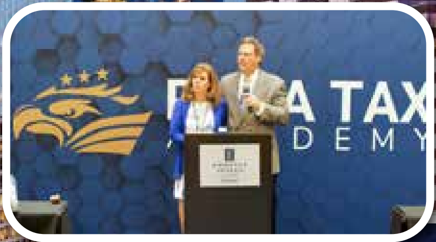

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In light of the assessment statute of limitations, you wonder out loud, “How can this be?” The IRS normally has only three years to adjust your taxes after you’ve filed your return. Not so fast, says the IRS. The two times you sent copies of the return to its officials didn’t count. You never mailed a return to an IRS *service center*; so, the return was never “filed.” And since you never “filed” a return, the IRS explains that it can still come after you at any time.

The above paragraphs constitute the opening language of the majority opinion in *Seaview Trading, LLC v. Commissioner*, 34 F.4th 666 (9th Cir. 2022) (“*Seaview II*”). The scenario sounds profoundly unfair, doesn’t it? What did that first IRS agent do with the tax return? And wait –didn’t the IRS say that citizens can file their returns by giving late returns to an IRS official who asks for them?

Yes, the IRS did say so, the Ninth Circuit majority pointed out. In a remarkably clear piece of writing the two majority judges explained that the return was “filed” when the taxpayer gave it to the revenue agent who requested it, and at the same time they gave a fierce verbal spanking and a “Tax Law 101” remedial course to the Tax Court judge who apparently didn’t know that. The breakdown of the lower court’s decision is harsh yet pristine and thorough.

The facts in *Seaview* are simple and concern only the tax year 2001. Petitioner Seaview Trading was classified as a partnership for federal income purposes. As such it was required to file a Form 1065. If that tax return was in fact filed, the IRS would have just three years thereafter to assess a tax liability, per code § 6229(a). If no return was filed, the IRS could assess at any time, per § 6229(c)(3).

Seaview maintained that it mailed a tax return in July 2002, and Seaview presented a mailing receipt with that date reflecting the address of the correct service center. Seaview did not have confirmation of delivery, however, and the IRS insisted that no tax return was received at that service center.

The IRS later commenced an audit, and in 2005, Seaview gave a copy of said tax return to the auditor. In 2007, Seaview sent a second copy of the tax return to the IRS counsel attorney. In 2010, the IRS assessed Seaview. The assessment would be untimely if either the 2002 original or the 2005 copy counted as a filed return. For reasons not stated, Seaview did not argue that a return was filed in July 2002 at the service center. Instead, Seaview argued that the copy it gave to the revenue agent in 2005 counted as “filing a return.” The argument is that 2010 - 2005 = 5 years, and the statute of limitations is only three years, so the assessment was barred.

The Tax Court in *Seaview Trading, LLC v. Commissioner*, T.C. Memo. 2019-122 (“*Seaview I*”), purported to debunk that argument on two fronts. First, it noted that Treasury Regulation § 1.6031(a)-1(e)(1) designates places where a taxpayer can “file” a tax return. Seaview did not deliver its copy to any place designated by that regulation. “Additionally, there is a plethora of case law holding that a revenue agent is not a designated filing place.” *Seaview I* at *3.

Seaview cited *Dingman v. Commissioner*, T.C. Memo. 2011-116, for the contrary holding, that giving a tax return to a special agent counted as “filing” the return, and so by analogy giving a tax return to this revenue agent counted as “filing.” The Tax Court retorted that *Dingman* was decided on its narrow fact pattern and “did not create a blanket rule that a taxpayer can file a return by whatever method he chooses, nor did it create an additional place for taxpayers to file returns beyond the places specifically designed in the Code or the regulations.” *Seaview I* at *3.

Second, the Tax Court held that the copy of the return was not a “return” because it failed the test of *Beard v. Commissioner*, 82 T.C. 766 (1984), insomuch as it identified itself as a copy of “the return that had been previously filed in 2002.” As such, “Seaview did not intend to file a return when it faxed a copy to [the revenue agent].” The Tax Court did not specify which element of the *Beard* test its analysis nullified. For details on the *Beard* test, see Dan’s book, ***How to Win Your Tax Audit***.

Seaview appealed, and in a 2:1 decision the Ninth Circuit majority disemboweled the Tax Court’s opinion. The Ninth Circuit emphasized that the parties below litigated the late-filed copy given to the revenue agent, not the timely tax return that the service center never received. That distinction matters because, the Ninth Circuit pointed out, *there is no instruction in the Tax Code* *or the Treasury Regulations regarding how and where to file a late tax return!*

Strictly speaking, the Code does not even define where to file a timely tax return. Rather, Code § 6230(i) merely directs citizens to "the relevant IRS revenue procedure, publication, form, or instructions to the form." As such, the "IRS regulations expressly govern the time and place to file timely partnership returns." *Seaview II* at 672. The Tax Court based its decision on Treas. Reg. § 1.6031(a)-1(e)(1), but the Circuit Court pointed out that that regulation does not advise about *delinquent* tax returns. The Court noted:

> Section 1.6031(a)-1(e) doesn't expressly establish how taxpayers are to file delinquent returns. Nothing in the text says that the time and place requirements apply to untimely returns. Indeed, by definition, if a taxpayer files a return after April 15, the taxpayer can't comply with § 1.6031(a)-1(e) since the regulation specifies that date as when the return "must be filed." 26 C.F.R. § 1.6031(a)-1(e)(2). So, at most, the regulation is silent on filing procedures for late returns. *Seaview II* at 672.

There being no statute or regulation explaining how and where to file a delinquent/late tax return, the Ninth Circuit walked through the following: (1) case law, (2) the instructions to IRS employees in the Internal Revenue Manual, (3) IRS Policy Statement 5-133 (2006), and (4) IRS Chief Counsel Advice No. 199933039 (Aug. 20, 1999). The Court made the critical point that all four of those sources uniformly and consistently instruct that a taxpayer like Seaview can *and should* (emphasis by the court on the word "should") file a delinquent tax return with the revenue agent working its audit. *Seaview II* at 674-675. Restated: The Tax Court judge was completely wrong as a matter of law, according to these two Circuit Court judges. The court finished by saying:

> The IRS and dissent[ing judge] insist that delinquent returns delivered to IRS officials cannot be considered "filed" because of caselaw requiring "meticulous compliance by the taxpayer with all named conditions" to secure the benefit of the statute of limitations. *Lucas v. Pilliod Lumber*, 281 U.S. 245, 249, 50 S.Ct. 297, 74 L.Ed. 829 (1930). But such an argument only begs the question of what the "named conditions" are for filing delinquent returns. As discussed above, the Tax Code and regulations are silent on the proper procedures for filing a delinquent tax return. Instead, it is the ordinary meaning of "filing" under § 6229(a) that governs delinquent returns. <u>So when an authorized IRS official requests a missing return from a taxpayer, the taxpayer complies with the conditions of filing by delivering the return in the manner requested.</u> *Seaview II* at 675 (emphasis added).

That "authorized IRS official" was the revenue agent to whom Seaview gave a tax return five years before the assessment. Case closed. The nail in the coffin for the IRS was the *Dingman* case raised by Seaview in the trial and summarily rejected by the Tax Court. The Ninth Circuit, in contrast, found that case "persuasive." So, in a word, Seaview "filed" its tax return "when the IRS revenue agent requested the missing return and Seaview later delivered it to the revenue agent." *Seaview II* at 676. This is the law, said the majority.

Lastly, the Ninth Circuit had to teach the Tax Court the *Beard* test by actually walking through all four elements of the test one by one (which the Tax Court did not do), and explaining that each element was met in this situation. *Seaview II* at 677-78.

However, before we get too excited, we must note that *Seaview II* has been vacated pending an *en banc* review. See 54 F.4th 608 (9th Cir. Nov. 10, 2022).

I assume the dissenting judge, Judge Bade, instigated that vote because his opinion is vitriolic and at times plainly false. Also, unfortunately, his writing is only marginally more coherent than a press briefing by Kamala Harris. He spends his first 12 printed pages (*Seaview II*, pp. 678-697) jumping back and forth between saying that ontologically there is no such thing as a late return, and saying that a late return is a return received at the correct Service center after the filing deadline.

Also, he repeatedly misstates the argument of the majority, which is an act that smacks of dishonesty because the majority's argument is very easy to understand, so there is no excuse for mischaracterizing it. Eventually the dissent presents his own argument in chief: "A return must be delivered to the designated Service center, or else it was never filed. The End." Or, to quote him: "Therefore, even overlooking that Seaview never filed its return to the right place, the return was also never 'filed' because—as the parties do not dispute—Seaview cannot show that its return ever reached the Ogden service center, the correct location for receipt and processing of its return." *Seaview II* at 701.

We can only hope and pray that the *en banc* panel will reject the confusion and irrationality of Judge Bade's dissent, and adopt the rational and very clear presentation of the majority court.

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Will Added IRS Funding Create Value For Taxpayers?

BY CHRIS EDWARDS

The Inflation Reduction Act (IRA) of 2022 included $80 billion in added funding for the Internal Revenue Service (IRS) over the coming decade. The funding will roughly double the agency's budget by 2031 in nominal dollars, with 57 percent of the added funding for enforcement but just 6 percent for business systems (computers) and 4 percent for taxpayer services. House Republicans sought to repeal most of the new funding as part the debt negotiations. They were successful in cutting the appropriation by about $21 billion.

But let's focus on the $80 billion number for a moment. The $80 billion funding increase is projected to raise tax revenues by $180 billion over the coming decade, for a net gain of $100 billion. Supporters conclude this indicates a high "return on investment" from the funding, and thus is a beneficial policy change.

But such a return on investment is only a partial analysis. The IRS funding is a win for the government, but that does not mean it is a win for society. As best as they can, policymakers should try to compare the overall benefits to society to the overall costs.

Let's look at the cost side. Costs will include the $80 billion in resources consumed by the IRS plus possibly higher compliance costs on the private sector from raising $180 billion. Income tax compliance costs may be about 8 percent to 10 percent of tax revenues, which suggests perhaps $14 billion to $18 billion in costs. There may also be additional costs for tax planning, post-filing activities, tax lobbying, and other items. So rather than $80 billion, the IRS plan may consume close to $100 billion in resources.

Now let's look at the benefit side. The government will raise a net $100 billion to be used for added spending. But this amount is not the net benefit to society because it will displace private spending. Let's be optimistic and assume that the new federal spending will be worth 50 percent more than the private spending displaced. In that case, the plan to beef up the IRS will generate $50 billion in net benefits, above the benefits of alternate private-sector spending.

So tallying up, IRS funding and added compliance costs may total $100 billion, but the added spending that is funded may generate perhaps only $50 billion in net benefits. With these assumptions, boosting IRS funding by $80 billion to squeeze $180 billion more out of taxpayers is not worthwhile.

An additional cost of the plan may be an increase in deadweight losses from raising the $180 billion in taxes. These losses would stem from taxpayers changing their behavior in ways that undermine output, such as reducing their working and investing.

Let's look further at compliance costs. The bulk of new IRS funding goes toward enforcement, which

may increase compliance costs because individuals and businesses would be prompted to spend more on lawyers and accountants to defend themselves against the tax agency.

Compliance costs are also expected to rise because of the IRA's twenty or so new and expanded energy tax breaks, many with complex rules for eligibility, benefit amounts, labor standards, content sourcing, and other features. The new IRS Strategic Operating Plan (SOP) (see the lead article above) mentions the complexity of the energy provisions and estimates that they will cost $3.9 billion to administer. Private sector planning, compliance, and lobbying related to the energy breaks will also likely consume billions of dollars given that there is $1 trillion in benefits at stake.

However, there is some good news from the IRS SOP. The document discusses major improvements in business systems and taxpayer services. It promises faster, more convenient, and more accurate taxpayer interactions. Unlike spending on tougher enforcement, spending on these activities should reduce compliance costs. It would be a net win for society if the IRA's $8 billion for business systems and taxpayer services reduced private-sector compliance costs by a greater amount than the funding total.

In addition, improving IRS efficiency and making it easier to pay the correct tax would improve taxpayer compliance. This is a better way to reduce the tax gap than heavy-handed enforcement under our hugely complex tax system. Nina Olson, the past National Taxpayer Advocate, testified that, "Complexity begets more complexity, burden, and noncompliance, as it creates opportunities for abuse, which in turn spur more complex legislation that may alienate taxpayers." And she noted that, "Complexity promotes noncompliance and contributes to the tax gap."

For these reasons, the House Republican plan to retain funding for business systems and taxpayer services while rescinding the added enforcement funding makes sense. Improvements in the former two areas promise to save citizens time and money, while also boosting voluntary compliance and reducing the tax gap.

Indeed, providing a further funding boost for business systems and taxpayer services must be an ongoing priority. The SOP says that the current IRA funding for these two functions will not be enough: "We will need an ongoing investment on top of the allocated IRA funding to deliver all of the transformation objectives outlined in this Plan in taxpayer service improvements and information technology modernization."

Policymakers should pursue additional IRS reforms, and they should put major tax-code simplification on the agenda. In the meantime, there are worthy initiatives in the SOP that the IRS should pursue and policymakers should closely oversee.

Data Note: *The 8 percent compliance cost is based on Scott Hodge's estimates here for just the individual and corporate income taxes. Compliance costs are rough estimates, and the average costs I've cited here don't necessarily equal the marginal costs.*

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How You Can Ask Dan Pilla a Question

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