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The IRS's National Taxpayer Advocate Nina E. Olson released her 2012 annual report to Congress on Wednesday, identifying the need for tax reform as the overriding priority in tax administration.

The Advocate also expressed concern that the Internal Revenue Service is not adequately funded to serve taxpayers and collect tax, and identified ways in which this chronic underfunding harms taxpayers and the public fisc. She also found that the IRS is not doing enough to assist victims of tax-related identity theft and return preparer fraud.

TAX REFORM

The National Taxpayer Advocate's annual report designates the complexity of the tax code as the #1 most serious problem facing taxpayers and recommends that Congress take significant steps to simplify it. "The existing tax code makes compliance difficult, requiring taxpayers to devote excessive time to preparing and filing their returns," Olson wrote. "It obscures comprehension, leaving many taxpayers unaware how their taxes are computed and what rate of tax they pay; it facilitates tax avoidance by enabling sophisticated taxpayers to reduce their tax liabilities and provides criminals with opportunities to commit tax fraud; and it undermines trust in the system by creating an impression that many taxpayers are not compliant, thereby reducing the incentives that honest taxpayers feel to comply."

Compliance Burdens. The report states that the tax code imposes a "significant, even unconscionable, burden on taxpayers." Since 2001, Congress has made nearly 5,000 changes to the tax code, an average of more than one a day, and the number of words

own. Nearly 60 percent of taxpayers hire paid preparers, and another 30 percent rely on commercial software, with leading software packages costing $50 or more. In other words, taxpayers must spend money just to figure out how much money they owe.

Magnitude of "Tax Expenditures." To reduce taxpayer burden and enhance public confidence in the integrity of the tax system, the report urges Congress to greatly simplify the tax code. In general, this means Congress should reassess the need for existing income exclusions, exemptions, deductions and credits (generally known as "tax expenditures"). For fiscal year (FY) 2013, the Joint Committee on Taxation has projected that tax expenditures will come to about $1.09 trillion, while individual income tax revenue is projected to be about $1.36 trillion. To put these numbers in perspective, if Congress were to eliminate all tax expenditures, straight math indicates it could cut individual income tax rates by *44 percent* and still generate the same amount of revenue it collects under current rules.

Tax Policy Decisions and Revenue Decisions Should Be Made Separately and Then Married Up. The report recommends that Congress approach tax reform in a manner similar to zero-based budgeting. The starting assumption would be that all tax expenditures would be eliminated. A tax break would be retained only if a compelling case can be made that the benefits of that break outweigh the complexity burden it creates. "In performing this analysis," Olson said in releasing the report, "we should look at each provision in the code and ask questions like: 'Does this government incentive make sense?'; 'If it does, is it better administered through the tax code or as a direct spending program?'; 'However well intentioned, is it doing what it was intended to do?'; and 'If yes, can it be administered without imposing unreasonable burdens on taxpayers or the IRS?'. At the same time, Congress can separately consider how much revenue it wants to raise, and it can then marry up our optimally designed tax system with our revenue needs by setting tax rates accordingly."

Recommendations. The report recommends that Members of Congress take several

on taxpayers.

IRS FUNDING

The IRS budget has been reduced in each of the last two fiscal years, and appears likely to face further cuts in coming years. Although these cuts reflect across-the-board reductions in federal discretionary spending, underfunding the IRS makes no sense, Olson said. "The IRS is materially different from other discretionary programs in that it serves as the *de facto* Accounts Receivable Department of the federal government. Each dollar appropriated for the IRS generates substantially more than one dollar in additional revenue. It is therefore ironic and counterproductive that concerns about the deficit are leading to cuts in the IRS budget, when those cuts are making the deficit larger."

Olson added: "The plain truth is that the IRS's mission trumps all other agencies' missions, because without an effective revenue collector, you can't fund those other agencies."

IRS Funding Decisions Fail to Take Into Account "Return on Investment." On a budget of $11.8 billion, the IRS collected $2.52 trillion in FY 2012. That translates to an average return-on-investment (ROI) of about 214:1. Yet the appropriations process treats the IRS like any other discretionary spending program, with no explicit recognition that each dollar appropriated for the IRS generates substantially more than one dollar in additional revenue. Last year, the IRS Commissioner estimated in a letter to Congress that proposed reductions in the IRS budget would cause tax collections to fall seven times as much.

"No business would fail to fund a unit that, on average, brought in $7 for every dollar spent. Shareholders would rebel and bring lawsuits, or at least oust the management or board of directors," Olson wrote in her preface to the report. "Yet this is precisely

the IRS received over 10 million letters in response to proposed tax adjustments, and at the end of the year, 48 percent of all taxpayer correspondence in its inventory had not been processed within established timeframes – up dramatically from 12 percent in FY 2004.

"Congress has enacted laws that now require more than 140 million individuals to file income tax returns," Olson said. "When taxpayers are attempting to comply with laws that require them to turn over a significant portion of their incomes to pay our nation's bills, they have a right to expect that their government will do a better job of taking their telephone calls and answering their letters."

Lack of Funding Impairs Taxpayer Rights and Increases Taxpayer Burden. The report identifies numerous areas where lack of funding is causing taxpayer problems. "Nowhere is this more apparent than in the IRS's increasing use of automated enforcement procedures," Olson said. "To conserve resources, the IRS has largely automated its correspondence audits and its issuance of liens and levies. It typically moves forward with tax assessments without first talking to taxpayers to give them a chance to substantiate their return positions, and it proceeds with liens and levies before having a conversation to find out whether a tax delinquency is due to financial hardship, which would suggest that an installment agreement or offer-in-compromise should be considered." The report notes that the IRS's limited resources to conduct outreach and education to taxpayers (particularly small businesses) and to enforce the laws also contribute to its inability to close the annual tax gap, which was most recently estimated at nearly $400 billion in 2006. The report points out that noncompliance violates the rights of compliant taxpayers, who indirectly pay more tax to make up the shortfall. Based on Census Bureau data, the average household effectively paid an extra $3,300 in tax in 2006 to subsidize noncompliance by others.

Recommendations. The report recommends that Congress:

TAX-RELATED IDENTITY THEFT

The number of tax-related identity theft incidents has increased substantially in recent years. Within TAS, identity theft case receipts increased by more than 650 percent from FY 2008 to FY 2012. At the end of FY 2012, the IRS had almost 650,000 identity-theft cases in its inventory servicewide. The problem has grown worse as organized criminal actors have found ways to steal the Social Security numbers (SSNs) of taxpayers, file tax returns using those taxpayers' names and SSNs, and obtain fraudulent tax refunds. Then, when the real taxpayer files a return claiming the refund, that return is rejected. The impact on victims is significant. More than 75 percent of taxpayers filing returns are due refunds, which average some $3,000 and are not paid until the IRS fully resolves a case.

IRS Commitments. In 2008, the IRS Commissioner testified about identity theft before a Senate Finance Committee hearing. He stated: "My overall goal as the IRS Commissioner is that when a taxpayer [who is an identity theft victim] contacts us with an issue or concern, we have in place a seamless process that gets the issue resolved promptly." Later that year, the IRS established an "Identity Protection Specialized Unit" (or "IPSU"), which was designed to provide centralized assistance to victims of identity theft. The National Taxpayer Advocate supported the commitment to centralized and prompt victim assistance.

IRS Performance. The report says the IRS has created numerous task forces and other teams in recent years in an attempt to improve its identity theft processes, yet victims still face the same "labyrinth of procedures and drawn-out timeframes for resolution" that they faced five years ago. The IRS is instructing its employees to advise identity theft victims that it will take 180 days – half a year – to resolve their cases. Complicated cases inevitably will take longer. Thus, the IRS's procedural changes are not providing faster relief.

The report also says the IRS has decided to reverse course and decentralize victim

centralized role of the IPSU, require taxpayers to speak with multiple functions, increase the time it takes to resolve cases, and heighten the risk that some issues may not be addressed.

"Taxpayers need 'one-stop shopping' – a single point of contact they can work with to resolve all issues in their cases – and the IRS needs a 'traffic cop' to make sure that all units complete their actions and that parts of cases do not fall through the cracks," Olson said. "And six months is an unacceptable period of time to expect taxpayer-victims to wait. The IRS must do more to provide the prompt and seamless assistance to identity theft victims that Commissioner Shulman promised."

OTHER KEY ISSUES ADDRESSED

Federal law requires the Advocate's Annual Report to Congress to identify at least 20 of the "most serious problems" encountered by taxpayers and make administrative and legislative recommendations to mitigate those problems. Overall, this year's report identifies 23 problems, provides updates on six previously identified problems, makes dozens of recommendations for administrative change, makes seven recommendations for legislative change, and analyzes the 10 tax issues most frequently litigated in the federal courts.

Among the "most serious problems" addressed are the following:

- **The IRS's failure to provide tax refunds to victims of preparer fraud.** When a taxpayer is victimized by a preparer who receives a fraudulent refund by paper check, the IRS will issue a replacement refund to the taxpayer. However, the IRS will not issue a replacement refund when a taxpayer is victimized by a preparer who receives the fraudulent refund by altering the bank routing number on a direct-deposit request, even though the IRS has received legal advice that it may do so. Olson says the taxpayer-victim is legally entitled to receive the refund, and the

claim constituted nearly one-quarter of the taxpayers' adjusted gross income for the year, and the audits on average took over four months. Despite the burden, the payoff was relatively small. The IRS denied only about 10 percent of the amounts claimed in tax year 2010, and as of mid-November had denied only about 1.5 percent of the amounts claimed in tax year 2011. The excessive focus on returns claiming the adoption credit burdened many taxpayers and could have the effect of negating Congress's intent to encourage adoptions, the report says.

- **The IRS's Offshore Voluntary Disclosure programs and their failure to distinguish adequately between "bad actors" and "benign actors."** The IRS has sought to increase enforcement of Foreign Bank and Financial Accounts (FBAR) reporting requirements in recent years and has offered a series of voluntary disclosure programs designed to settle with taxpayers who had failed to file required FBAR forms. However, the report says, the programs generally applied a "one-size-fits-all" approach that required the payment of significant penalties and did not distinguish between "bad actors" and "benign actors." By generally requiring taxpayers who make voluntary disclosures to "opt out" of the disclosure program and submit to comprehensive audits in order to avoid draconian penalties, the report argues that the program has caused excessive burden and fear for taxpayers who had reasonable cause for not filing FBAR forms or whose failure to file was inadvertent.

Research Study on Factors Influencing Voluntary Tax Compliance by Small Businesses. Volume 2 of the report contains six research studies, including preliminary results of a survey of sole proprietors that TAS commissioned to better understand factors that may affect income tax reporting compliance. The Advocate's office undertook the study because the IRS has estimated that only 43 percent of sole proprietor income is reported on tax returns, representing the largest portion of the tax gap (*i.e.,* tax that is owed but is not timely and voluntarily paid). Developing a more complete picture of the attitudes of this category of taxpayers therefore could assist the IRS in improving tax compliance. Based on IRS computer scoring of the

- Respondents in the high-compliance group were more likely to use return preparers.
- Taxpayers in the low-compliance groups expressed less trust in tax preparers and were less likely to use them or follow their advice.
- Low-compliance taxpayers tended to be clustered in certain communities.

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More information about this report is at www.taxpayeradvocate.irs.gov/2012AnnualReport, including an Executive Summary, downloadable infographics on the Most Serious Problems, and videos of the National Taxpayer Advocate discussing key issues.

Related Items:

- Executive Summary: 2012 Annual Report to Congress
- Complete Report: 2012 Annual Report to Congress

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