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National Taxpayer Advocate Delivers Annual Report to Congress; Focuses on Tax Reform, Collection Issues, and Implementation of Health Care Reform

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WASHINGTON — National Taxpayer Advocate Nina E. Olson today released her annual report to Congress, identifying the need for tax reform as the number one priority in tax administration. The Advocate expressed continuing concern that the IRS's increasing use of hard-core enforcement actions, particularly tax liens, is inflicting unnecessary harm on financially struggling taxpayers. The report also examines challenges the IRS is facing in implementing the new health care law.

TAX REFORM

"There has been near universal agreement for years that the tax code is broken and needs to be fixed," Olson said in releasing the report. "Yet no broad-based attempt to reform the tax code has been made. This report documents the burdens the tax code imposes on taxpayers and explores why many taxpayers may nevertheless feel wedded to key aspects of the current system, undermining efforts at reform."

Compliance Burdens. A TAS analysis of IRS data shows that taxpayers and businesses spend 6.1 billion hours a year complying with tax-filing requirements. "If tax compliance were an industry, it would be one of the largest in the United States," the report says. "To consume 6.1 billion hours, the 'tax industry' requires the equivalent of more than three million full-time workers."

Individual taxpayers find return preparation so overwhelming that about 60 percent now pay preparers to do it for them. An additional 29 percent use tax software, with leading software packages costing $50 or more. IRS researchers recently estimated that the annual monetary tax compliance burden of the median individual taxpayer (as measured by income) is $258.

Tax Reform Challenges and Public Awareness. The report discusses why efforts at tax reform – which usually focus on eliminating tax breaks in exchange for lower rates – have not succeeded. "It is sometimes suggested that taxpayers are looking for a free lunch – that they want to see lower tax rates but keep their tax breaks and retain their government benefits, all while balancing the budget," Olson said. "But this perspective overlooks the fact that federal tax and spending policies are complex, and most people don't have the time to study these policies in detail. Our aim is to improve public knowledge of the trade-offs involved and to help policymakers and the taxpaying public conduct a more informed conversation about tax reform alternatives."

The report attempts to improve awareness of the extent to which taxpayers benefit from tax breaks by discussing the subject in detail. The report attempts to improve awareness of the connection between taxation and spending by recommending that the government provide all taxpayers with a "taxpayer receipt" each year that presents a breakdown showing how their federal dollars are spent.

"The Special Interests Are Us." The report notes there is a widespread belief that the influence of entrenched "special interests" is the biggest roadblock to comprehensive tax reform. "There is no doubt that many provisions in the tax code benefit narrow groups of taxpayers," the report says. "But the dirty little secret is that the largest special interests are us – the vast majority of U.S. taxpayers. Virtually all of us benefit from certain exclusions from income, deductions from income, or tax credits."

These tax breaks (known as "tax expenditures") now total $1.1 trillion a year. Among the largest are the exclusion of employer contributions for health care, the exclusion for retirement plan contributions and earnings, the mortgage interest deduction, reduced tax rates for dividends and capital gains, exclusions for Medicare benefits, the earned income tax credit, and the deduction for state and local taxes. Other popular benefits include the child and dependent care credits; the deductions for charitable donations and contributions to traditional IRAs; and exclusions for distributions from Roth IRAs, for distributions from Section 529 education savings plans, for contributions to Flexible Spending Accounts (both medical and dependent care), and for public transportation subsidies.

Tax Breaks Reduce Average Tax Liability by About $8,000 Per Return. A TAS analysis found that, on average, the tax liability of each individual who files a federal tax return is reduced by about $8,000 a year due to these tax breaks. Moreover, since tax is computed as a percentage of income, a taxpayer who pays a 25 percent tax rate could be benefiting from deductions or exclusions from income worth $32,000. The report presents an example of a fairly typical taxpayer who faces a 25 percent marginal tax rate on his "taxable income," yet ends up paying an average tax rate of 9 percent on his "gross income" because of tax breaks.

"If tax rates are to be substantially lowered, many existing tax breaks will have to be eliminated immediately and others will be phased out," Olson said. "But I believe most taxpayers will conclude this is a worthwhile trade-off. If tax reform proceeds on a revenue-neutral basis, the average taxpayer's liability will not change, and we will end up with a tax system that is simpler, more transparent, and easier and cheaper for taxpayers to navigate."

The report acknowledges that Congress may at some point raise tax revenues to address the nation's long-term fiscal challenges. However, the report suggests that Congress first enact structural tax reform on a revenue-neutral basis and keep separate the decision whether to adjust tax rates.

"Zero-Based Budgeting" Approach Recommended. The report recommends that Congress approach tax reform in a manner similar to zero-based budgeting. The starting assumption should be that all tax breaks would be eliminated; a tax break would then be retained only if a compelling case can be made that the benefits of providing the tax break outweigh the complexity burdens it creates. The report suggests additional core principles for tax reform and summarizes key simplification proposals the Advocate's office has made in past reports, including repealing the Alternative Minimum Tax for individuals and consolidating the number of incentives that encourage taxpayers to save for education and retirement.

Tax Reform Suggestion Box. The National Taxpayer Advocate is today launching a web page to solicit taxpayer suggestions regarding tax reform. "What would taxpayers be willing to give up if they knew that others are giving up their breaks and the end result would be a much simpler system?" Olson asked. "What particular provisions of the existing tax system are especially burdensome or seem particularly unfair?" Suggestions may be submitted at http://www.TaxpayerAdvocate.irs.gov. TAS will track suggestions and post results periodically.

IRS USE OF HARD-CORE ENFORCEMENT TOOLS, ESPECIALLY TAX LIENS

The report describes the Advocate's continuing concern that IRS collection practices inflict unnecessary harm on financially struggling taxpayers and fail to achieve the IRS's overriding objective of increasing long-term voluntary compliance with the tax laws.

"Tax collection requires a delicate balancing of the government's interest in collecting revenue and ensuring that all taxpayers pay their fair share of tax, on the one hand, and protecting financially struggling taxpayers from unnecessary harm, on the other," Olson said. "Current IRS policies do very little balancing. For example, IRS lien filing policies are all about 'protecting the government's interest' and don't consider the impact on the taxpayer."

Financial Impact of Tax Liens. In FY 2010, the IRS filed liens against 1.1 million taxpayers. When the IRS files a notice of federal tax lien, the taxpayer's creditworthiness can be badly damaged for the long term. Lien filings are picked up by the three credit rating agencies and remain on the taxpayer's credit report for seven years from the date a tax liability is resolved, or longer if it is not resolved. "Increasingly, employers, mortgage lenders, landlords, car dealerships, auto insurance companies, and credit card issuers utilize credit reports, so a tax lien has the potential to render someone unemployable, unable to obtain housing (owned or rented), and unable to obtain car insurance or a credit card, at least at reasonable rates, for many years into the future," Olson said. A tax lien can be particularly devastating to small businesses, as it often cuts off their access to credit.

Several Million Taxpayers Affected. Over the past seven years, the IRS has filed more than five million tax liens. The report says that despite the high unemployment rate and the unusually large number of Americans who are experiencing financial difficulties, the IRS is continuing to ramp up the number of tax liens it files each year. The 1.1 million liens filed in FY 2010 compare with 168,000 in FY 1999, an increase of 550 percent.

Revenue Benefits of Tax Liens Unknown. The IRS does not have data that show whether, or to what extent, liens further revenue collection. A TAS study conducted in 2009 suggests there is a possibility that lien filings may *reduce* long-term tax collection. Notably, over the same period that lien filings have increased by 550 percent, annual revenue collected by the IRS's Collection function on an inflation-adjusted basis has remained flat.

“By filing a lien against a taxpayer with no money and no assets, the IRS often collects nothing, yet it inflicts long-term harm on the taxpayer by making it harder for him to get back on his feet when he does get a job,” Olson said. “Absent data that show liens make a meaningful contribution to revenue collection and especially in this economy, I find it unacceptable that the IRS continues to torment financially struggling taxpayers in this way.”

Broader Use of Collection Alternatives Recommended. The report states that the IRS has taken steps in the last year to reassess its collection policies but concludes that more steps should be taken quickly. The report reiterates the Advocate’s longstanding suggestion that the IRS make greater use of collection alternatives, such as offers in compromise, when dealing with taxpayers who cannot afford to pay their liabilities in full. A comprehensive assessment of the IRS’s collection policy and a suggested roadmap toward a more effective approach are presented in Volume 2 of the report.

IRS CHALLENGES IN ADMINISTERING BENEFITS PROGRAMS, INCLUDING HEALTH CARE REFORM

IRS as Tax Collector. Historically, the IRS’s mission has been to collect taxes, but in recent years, Congress has directed the IRS to administer an increasing number of social benefits programs, including Economic Stimulus Payments, the First-Time Homebuyer Credit, and the Making Work Pay Credit. The recent directive to administer major aspects of the new health care law will add significantly to the IRS’s workload. “I am confident the IRS can succeed in its implementation of health care reform,” Olson said. “But a comprehensive assessment of the issues and challenges that lie ahead is a prerequisite for success.”

IRS as Benefits Administrator. The IRS will administer four key provisions of the new law: the Small Business Tax Credit, the Premium Assistance Credit, the Individual Responsibility Requirement, and the Employer Requirement. Among the challenges the IRS faces is determining the types of new information it needs to gather, determining the new entities it needs to work with, resolving privacy issues, and implementing a new definition of income, the report says.

“From an organizational standpoint, there are substantial differences between benefits agencies and enforcement agencies in terms of culture, mindset, and the skill sets and training of their employees,” Olson said. “As the IRS prepares to administer large portions of the health care legislation, it will have to shift from being an enforcement agency that primarily says, in effect, ‘you owe us’ to an agency that places much greater emphasis on hiring and training caseworkers to help eligible taxpayers receive benefits and work one-on-one with taxpayers to resolve legitimate disagreements.”

Revision to IRS Mission Statement Recommended. The report points out that the IRS has a “mission statement” that should serve as its foundation and around which its strategic plan, operational priorities, budget, and performance measures should be built. In light of the IRS’s expanded responsibilities, the report recommends that the IRS revise its mission statement to recognize explicitly its dual roles as tax collector and benefits administrator. Greater recognition of this dual role will enable the IRS to plan more effectively to handle health care and will make explicit to Congress that the agency will require sufficient funding to perform both of its functions effectively, the report says.

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Federal law requires the National Taxpayer Advocate to submit an Annual Report to Congress that identifies at least 20 of the most serious problems encountered by taxpayers and makes administrative and legislative recommendations to mitigate those problems. Overall, this year's report identifies 21 problems, provides updates on four previously identified issues, makes dozens of recommendations for administrative change, proposes 11 recommendations for legislative change, and analyzes the 10 tax issues most frequently litigated in the federal courts.

About the Taxpayer Advocate Service

The Taxpayer Advocate Service is an independent organization within the IRS. TAS employees help taxpayers who are experiencing economic difficulties, such as not being able to provide necessities like housing, transportation, or food; taxpayers who are seeking help in resolving problems with the IRS; and those who believe an IRS system or procedure is not working as it should. If you believe you are eligible for TAS assistance, you can reach TAS by calling the TAS toll-free number at 877–777–4778 or TTY/TDD 800-829-4059. For more information, go to http://www.TaxpayerAdvocate.irs.gov.

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- Complete Report: 2010 Annual Report to Congress