

National Taxpayer Advocate

Annual Report to Congress

2011 Annual Report to Congress

**NATIONAL
TAXPAYER
ADVOCATE**

**2011
ANNUAL REPORT
TO CONGRESS**

Volume One



YOUR VOICE AT THE IRS

December 31, 2011

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ADVOCATE
SERVICE

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*There may be a tendency
to overcentralize operations,
to overextend capabilities, and, yes,
to capitulate to
overmechanization and underhumanization
of tax administration.*

*In brief IRS must constantly weigh
machine capability
against the
actual and psychic costs
to the nation.*

— Mortimer M. Caplin —

Commissioner Caplin Reviews his Record as IRS Chief [1964]

29 VA. Tax Rev. 177, 180 (2009)

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Honorable Members of Congress:

I respectfully submit for your consideration the National Taxpayer Advocate's 2011 Annual Report to Congress. Section 7803(c)(2)(B)(ii) of the Internal Revenue Code requires the National Taxpayer Advocate to submit this report each year and in it, among other things, to identify at least 20 of the most serious problems encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems.

The scope of the Annual Report to Congress is by statute quite broad, and this year, the Report embraces the entire modern history of tax administration. The Report's expansive reach is necessary, to my thinking, because of the lack of understanding about taxation in public discourse today. We thought it would be a good idea to look at what the United States tax system encompassed when enacted in 1913, and how it has changed over the years, up to today – 2011.

Thus, the starting point for our review is actually in Volume 2 of this Report – a research study titled “From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913–2011.” This study analyzes the evolution of modern U.S. tax administration. What began as a system that focused primarily on revenue raising and affected only the most affluent and elite taxpayers grew massively during World War II to raise funds for the war effort, and drew the middle class into the taxpayer base. From the latter part of the 20th century through today, the system has grown further to encompass the low income population and have its mission expanded by Congress from being primarily the federal government's revenue collector to become a favored disburser of government payments and benefits as well.

The implications of this evolution cannot be overstated. The individual taxpayer population in 1913 was estimated at 358,000, grew to 47.1 million in 1944, and today stands at 141.2 million. Growth at this scale and pace forced the IRS to evolve from an agency mired in manual processing and political patronage to an organization driven by automated processes and organized around stove-piped operations delivered by career civil servants whose exercise of judgment and discretion is severely limited.

Moreover, the growth of the tax system has not been limited to absolute numbers. There is a parallel growth in the diversity of the population that the IRS serves.¹ The 2010 Census identifies about a quarter of the population as racial minorities, not counting Hispanics, over half of whom are identified as white.² About a fifth of the U.S. population speaks a language other than English at home,³ and the tax law now applies to low income individuals, who make up 15.1 percent of the population.⁴ Millions of individuals have experienced domestic violence and abuse in their lives, which, as we discuss in this Report, can have serious and negative impact on these individuals' tax

¹ See Introduction to Diversity Issues: *The IRS Should Do More to Accommodate Changing Taxpayer Demographics, infra* (introducing four Most Serious Problems discussing tax issues that relate specifically to the diversity of the U.S. taxpayer base).

² U.S. Bur. of the Census, *Overview of Race & Hispanic Origin*, 2010 Census Brief (Mar. 2011) Table 1 at 4, Table 2 at 6.

³ Census, 2005–09 Amer. Comm. Survey, Table S0501, *Selected Characteristics of the Native and Foreign-born Populations* (relating to population five years and older).

⁴ Census, *Income, Poverty and Health Insurance Coverage in the U.S.: 2010* (Sept. 13, 2011).

situations.⁵ Meanwhile, globalization of commerce has caused millions of U.S. citizens and non-U.S. citizens abroad and in the U.S., along with hundreds of thousands of small businesses, to become engaged in international economic activity that draws them into the Kafka-esque U.S. international tax regime.⁶

The expansion of the taxpayer base in numbers and diversity has, not surprisingly, increased the amount and difficulty of the IRS's job. But there is more. Far more. The Internal Revenue Code has been growing longer and more complicated by the year – and sometimes by the day. In prior reports, I have identified tax code complexity as the most serious problem facing taxpayers and the IRS alike.⁷ Last year we noted, for example, that a search of the tax code turned up 3.8 million words and that there had been approximately 4,428 changes to the code over the preceding ten years – an average of more than one a day, including an estimated 579 changes in 2010 alone.⁸ For every one of these changes, the IRS must explain the new provision to taxpayers, write computer code so it can process returns affected by the provision, and train its auditors so that improper claims can be identified.

In recent years, too, organized and not-so-organized criminals have sought to profit off the tax system by submitting bogus refund claims and often by stealing and utilizing the identity of another taxpayer. Each year, the IRS's task in identifying these claims has become more challenging, with the inevitable result that some fraudulent claims are never identified and many legitimate claims are mistakenly held up, imposing significant burden on honest taxpayers.⁹

And despite a huge expansion in the IRS's workload, Congress has reduced the IRS's funding in each of the last two years. As a consequence of all these factors, taxpayer service levels have declined. The IRS is now unable to answer three out of every ten calls it receives from taxpayers seeking to speak with a telephone assistor, and as of the end of fiscal year 2011, nearly half of all taxpayer correspondence in the IRS's adjustments inventory was taking more than 6½ weeks to answer.

The IRS has been a very effective agency, but as we discuss in this report, the imbalance between its workload and its resources is becoming unmanageable. It is up to Congress to ensure that the IRS continues to be effective, either by reducing the IRS's workload or by providing adequate funding to enable it to accomplish its assigned mission.

⁵ See Most Serious Problem: *The IRS Does Not Sufficiently Recognize and Address Domestic Violence and Abuse and Its Effects on Tax Administration*, *infra*.

⁶ See Introduction to International Issues: *Compliance Challenges Increase International Taxpayers' Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives in the International Arena*, *infra* (introducing six Most Serious Problems addressing tax problems of international taxpayers).

⁷ See National Taxpayer Advocate 2010 Annual Report to Congress 3-14 (Most Serious Problem: *The Time for Tax Reform Is Now*); National Taxpayer Advocate 2008 Annual Report to Congress 3-14 (Most Serious Problem: *The Complexity of the Tax Code*); see also *Hearing on Fundamental Tax Reform: Hearing Before the H. Comm. on Ways and Means*, 112th Cong. (2011) (statement of Nina E. Olson, National Taxpayer Advocate).

⁸ See National Taxpayer Advocate 2010 Annual Report to Congress 4.

⁹ See Most Serious Problems: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS* and *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*.

In our #1 Most Serious Problem, *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, we elaborate on our concern that the IRS cannot keep pace with its workload in a declining budget environment without seriously eroding the taxpayer service that taxpayers deserve. Moreover, under pressure to “do more with less,” we note that the IRS is in danger of implementing its enforcement and compliance initiatives in a manner that fails to provide taxpayers with adequate notice to enable them to understand what actions are being proposed and the basis for those actions — and an adequate opportunity to present their own information to show the IRS has made an error.¹⁰

We have been here before. In the years before the landmark Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98),¹¹ Congress significantly cut the IRS budget while increasing pressure on it to collect revenue. We know what happened during that time — IRS employees and taxpayers were at loggerheads, with each side distrustful of the other and the IRS taking enforcement actions to meet stated or unstated quotas and failing to listen to taxpayers, who viewed the IRS as an adversary.

RRA 98 established many safeguards to prevent this breakdown from occurring again. In light of the IRS’s indiscriminate use of automation to avoid personal contact with taxpayers and the sheer volume of work to be accomplished, however, the IRS is increasingly in danger of judging taxpayers as noncompliant when in fact they are not. Throughout this Report, we describe IRS practices and procedures that harm taxpayers by acting on assumptions of noncompliance arrived at by automated processes that do not solicit, encourage, or allow taxpayer response.¹² We identify instances where the IRS, through automation, is imposing undue burden on taxpayers that it could eliminate through better use of its internal data (ironically, through automated processes).¹³

It has been 13½ years since we have had major taxpayer rights legislation. Our laws have not kept pace with our notions of procedural fairness in 21st century tax administration, particularly given the tax system’s expanded and diverse taxpayer base and duties. We thus reiterate our call for Congress to pass a Taxpayer Bill of Rights, and we include in that recommendation many of the legislative proposals we have made in previous reports, some of which have been introduced in Congress, and all of which, we believe, will provide taxpayers with needed protections and instill greater confidence in the tax system.¹⁴

To treat taxpayers fairly and provide them with due process while collecting over 90 percent of the federal government’s revenue and delivering economic and social programs to targeted

¹⁰ See, e.g., Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *infra*.

¹¹ Pub. L. No. 105-206, 112 Stat. 685 (1998).

¹² See, e.g., Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance*; Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*; and *An Analysis of the IRS Examination Strategy: Proposals to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights* (vol. 2), *infra*.

¹³ See, e.g., Most Serious Problem: *Automated “Enforcement Assessments” Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers, and Math Errors Committed on Individual Tax Returns: A Review of Math Error Notices Issued for Claimed Dependents* (vol. 2), *infra*.

¹⁴ See Legislative Recommendation: *Enact Previous Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*, *infra*.

populations – that is indeed the challenge facing the IRS. But Congress bears the responsibility here to fund the “accounts receivable” function of the federal government. Policymakers may disagree fervently about the appropriate level of taxation, but whatever the level is, the law must be enforced fairly and consistently. The IRS must communicate and engage taxpayers as it finds them, with all their diversity of characteristics. To accomplish its dual mission of tax collection and benefits administration, the IRS must be adequately funded. Failure to fund the IRS sufficiently so that it can treat taxpayers properly (which includes both service and enforcement) breaches the social contract with U.S. taxpayers upon which our voluntary compliance tax system was founded – and limits the IRS’s ability to collect much-needed federal revenue.

As noted earlier, this Annual Report to Congress covers the full waterfront of tax administration – wealthy and low income taxpayers; international, domestic, and tax-exempt taxpayers; personal contact and automation; collection and examination; and the challenge to provide due process to taxpayers in an era of “real time” use of third-party information reporting, identity theft, and organized refund fraud. There is simply too much in this report to discuss in one introduction. So, the National Taxpayer Advocate herself is belatedly entering the 21st century by inaugurating a blog. In each blog posting, I plan to highlight one aspect of this Report and summarize our concerns, describe what the IRS is doing to address the issue, and provide updates. The Office of the Taxpayer Advocate and I personally are grateful for the consideration Congress gives our perspective each year, and through a periodic blog, we hope to make the Annual Report to Congress a living document by providing status updates on important issues throughout the year as well as for informing and engaging the taxpaying public about the role of taxation and the IRS in our national life. I hope to see you online at www.TaxpayerAdvocate.irs.gov!

Respectfully submitted,



Nina E. Olson
National Taxpayer Advocate
31 December 2011

National Taxpayer Advocate 2011 Annual Report to Congress

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