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## The IRS is Significantly Underfunded to Serve Taxpayers and Collect Tax

### DEFINITION OF PROBLEM

The IRS is significantly and chronically underfunded to serve America's taxpayers and collect the amount of tax due under law. Because of funding shortages:

- The IRS is unable to answer millions of taxpayer telephone calls;
- The IRS is unable to timely process taxpayer correspondence;
- The “tax gap” — the amount of tax due but uncollected — stands at nearly \$400 billion each year;
- Taxpayers believe the tax laws are not being fairly enforced against others; and
- The federal budget deficit is unnecessarily large.

In each of the last two fiscal years, the IRS budget has been reduced, and it appears the IRS budget will be cut further in the current year. The continued underfunding of the IRS poses one of the greatest long-term risks to tax administration today.

In this section of the report and in accordance with our statutory mandate, we identify at least 20 of the most serious problems facing taxpayers. Some of the problems we identify result from poor planning or execution, and it is important that the IRS not use lack of funding as a justification for failing to address these problems. Areas where the IRS must improve its strategic approach include assisting victims of tax-related identity theft,<sup>1</sup> accepting voluntary disclosures from persons who belatedly report offshore accounts without subjecting them to draconian penalties in a wider array of cases,<sup>2</sup> assisting victims of return preparer fraud,<sup>3</sup> and allowing parents who adopt children to claim the adoption credit without incurring a vastly increased risk of an audit.<sup>4</sup>

However, the lack of sufficient funding is the sole or significant cause of many of the problems identified in this report. There are practical limits to how well the IRS can respond to tens of millions of telephone calls, more than 10 million letters, and hundreds of thousands of identity theft cases each year, as well as maintain robust tax-compliance programs including outreach and education, if it lacks adequate and educated personnel, technology, and other support.

<sup>1</sup> See Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*, *infra*.

<sup>2</sup> See Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Programs Discourage Voluntary Compliance by Those Who Inadvertently Failed to Report Foreign Accounts*, *infra*.

<sup>3</sup> See Most Serious Problem: *The IRS Harms Victims of Return Preparer Misconduct by Failing to Resolve Their Accounts Fully*, *infra*.

<sup>4</sup> See Most Serious Problem: *The IRS's Compliance Strategy for the Expanded Adoption Credit Has Significantly and Unnecessarily Harmed Vulnerable Taxpayers, Has Increased Costs for the IRS and Does Not Bode Well for Future Credit Administration*, *infra*.

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.

## ANALYSIS OF PROBLEM

For purposes of the appropriations process, the IRS is treated as a domestic discretionary program, generally subject to the same funding rules as all other such programs. As Congress has curtailed discretionary spending to try to bring the federal deficit under control, the IRS budget has been cut. The IRS's budget was reduced slightly from fiscal year (FY) 2010 to FY 2011,<sup>5</sup> it was cut by an additional 2.5 percent from FY 2011 to FY 2012,<sup>6</sup> and it may be facing additional cuts (or small increases that fail to cover its rising costs) for the foreseeable future. From the standpoint of protecting taxpayer rights and maximizing revenue collection, that would be a disaster.

### A. Revenue Collection: Reduced Funding Means Reduced Revenue Collection and a Larger Budget Deficit.

From a revenue standpoint, the IRS in FY 2012 collected about \$2.52 trillion<sup>7</sup> on a budget of about \$11.8 billion.<sup>8</sup> That translates to an average return-on-investment (ROI) of about 214:1. The marginal ROI of additional spending will not be nearly so large, but virtually everyone who has studied the IRS budget has concluded that the ROI of additional funding is positive. Just over a year ago, former Commissioner Shulman estimated in a letter to Congress that proposed cuts to the IRS budget would result in reduced revenue collection of *seven times* as much as the cuts.<sup>9</sup>

If the Chief Executive Officer of a Fortune 500 company were told that each dollar allocated to his company's Accounts Receivable Department would generate seven dollars in return, it is difficult to see how the CEO would keep his job if he chose not to provide the department with the resources it needed to collect its receivables. Yet that is exactly what has been happening with respect to IRS funding for years, and there has been little effort to fix this obvious problem.

<sup>5</sup> See Department of Defense and Full-Year Continuing Appropriations Act, 2011, Pub. L. No. 112-10, § 1119, 1125 Stat. 38, 107 (2011), at <http://www.gpo.gov/fdsys/pkg/PLAW-112publ10/pdf/PLAW-112publ10.pdf>.

<sup>6</sup> See Department of the Treasury, *FY 2013 Budget in Brief*, at [http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.%20IRS\\_508%20-%20passed.pdf](http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.%20IRS_508%20-%20passed.pdf) (showing a decline in enacted appropriations levels from FY 2011 to FY 2012).

<sup>7</sup> Government Accountability Office (GAO), GAO-13-120, *Financial Audit: IRS's Fiscal Years 2012 and 2011 Financial Statements* 65 (Nov. 2012), at <http://www.gao.gov/assets/650/649881.pdf>.

<sup>8</sup> Department of the Treasury, *FY 2013 Budget in Brief*, at [http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.%20IRS\\_508%20-%20passed.pdf](http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.%20IRS_508%20-%20passed.pdf).

<sup>9</sup> Letter from Douglas H. Shulman, Commissioner of Internal Revenue, to the chairmen and ranking members of the House Committee on Ways and Means (and its Subcommittee on Oversight) and the Senate Committee on Finance (Oct. 17, 2011), at [http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/media/pdf/112/Rep\\_Lewis\\_IRS\\_Letter.pdf](http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/media/pdf/112/Rep_Lewis_IRS_Letter.pdf).

This is not a new issue. In our 2006 Annual Report to Congress, we discussed this issue in detail and recommended, among other things, that Congress consider revising its budget rules in a manner that allows the relevant congressional committees to consider and decide: “What level of funding will maximize tax compliance, particularly voluntary compliance, with our nation’s tax laws, with due regard for protecting taxpayer rights and minimizing taxpayer burden?” and then set the IRS funding level accordingly, without regard to spending caps.<sup>10</sup>

In the course of developing and presenting that recommendation, the National Taxpayer Advocate or her senior advisor met with 14 separate congressional staffs — specifically, the House and Senate majority and minority staffs of the tax-writing committees, appropriations committees, and budget committees as well as tax counsel for the House and Senate majority leaders. In our discussions, there appeared to be no significant disagreement with the premise that the IRS generates a positive return-on-investment and is underfunded. However, we were repeatedly told that creating a new set of rules to establish IRS funding levels would be a “heavy lift.” The last three IRS Commissioners have also raised this issue.<sup>11</sup> So have the former chairman and ranking member of the Senate Budget Committee.<sup>12</sup> In our view, the time to attempt the “heavy lift” is now.

### **B. Taxpayer Services: Reduced Funding Means Taxpayer Needs Are Not Being Met.**

We recognize that few people enjoy paying taxes, and for that reason, recommending that Members support more funding for the IRS is not necessarily an easy sell. But there are multiple reasons why adequate IRS funding is important and why we think taxpayers would see it that way as well. The National Taxpayer Advocate is particularly concerned that the IRS is not receiving sufficient funds to meet the basic needs of taxpayers seeking to comply with the law. As we discuss elsewhere in this report, the IRS has received more than 115 million calls in each of the last two fiscal years.<sup>13</sup> That is a staggering volume of calls, and the IRS cannot come close to handling them all. Last year, the IRS answered only about 68 percent of calls from taxpayers seeking to speak with a telephone assistor,

<sup>10</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*), at [http://www.irs.gov/pub/irs-utl/2006\\_arc\\_section2\\_v2.pdf](http://www.irs.gov/pub/irs-utl/2006_arc_section2_v2.pdf).

<sup>11</sup> See, e.g., Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 278 (2005) (“When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of the job, by far, was dealing with the IRS budget. The reaction was usually ‘Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn’t you be able to get it?’”).

<sup>12</sup> In 2006, Senator Judd Gregg acknowledged that the existing budget procedures have the effect of shortchanging the IRS. He said: “We’ve got to talk to the [Congressional Budget Office] about scoring on [additional funding provided to IRS]. Clearly there’s a return on that money.” Dustin Stamper, *Everson Pledges to Narrow Growing Tax Gap*, 110 Tax Notes 807 (Feb. 20, 2006). Similarly, Senator Kent Conrad stated: “Rather than a tax increase, I think the first place we ought to look . . . is the tax gap. If we could collect this money, we’d virtually eliminate the deficit.” Emily Dagostino, *Senate Budget Resolution Would Increase IRS Enforcement Funding*, 110 Tax Notes 1129 (Mar. 13, 2006).

<sup>13</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (weeks ending Sept. 30, 2011 and Sept. 30, 2012); see Most Serious Problem, *The IRS Telephone and Correspondence Services Have Deteriorated Over the Last Decade and Must Improve to Meet Taxpayer Needs, infra*.

and those who got through had to wait on hold for an average of nearly 17 minutes.<sup>14</sup> That represents a sharp drop-off in performance as compared with the IRS's high-water mark in FY 2004, when it answered 87 percent of its calls and the average hold time was just over 2½ minutes.<sup>15</sup>

The IRS's ability to timely process taxpayer correspondence has also diminished in recent years. Last year, the IRS received more than ten million letters from taxpayers responding to IRS adjustment notices.<sup>16</sup> Comparing the final week of FY 2012 with the final week of FY 2004, the backlog of taxpayer correspondence in the tax adjustments inventory increased by 188 percent (from 357,151 to 1,028,539 pieces), and the percentage of correspondence classified as "overage" jumped by 316 percent (from 11.5 percent to 47.8 percent).<sup>17</sup>

Congress has enacted laws that now require more than 140 million individuals to file income tax returns. The National Taxpayer Advocate believes that 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 take their telephone calls and answer their letters. When the IRS fails to answer one out of three phone calls, makes callers wait an average of nearly 17 minutes on hold, and cannot timely process nearly half of its pending correspondence, it falls well short of providing the service that taxpayers deserve.<sup>18</sup>

The IRS in recent years has also been struggling to cope with a rising volume of tax-related identity theft cases.<sup>19</sup> As of September 30, 2012, the IRS had almost 650,000 identity theft cases in inventory servicewide.<sup>20</sup> The victims of tax-related identity theft suffer extraordinary inconveniences and, in many cases, hardships. In general, more than 75 percent of U.S. taxpayers receive refunds, with the amount averaging about \$3,000.<sup>21</sup> Identity theft victims generally cannot receive their significant and sometimes urgently needed tax refunds until the IRS resolves their cases, which is now taking six months or longer.<sup>22</sup>

<sup>14</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2012). The Accounts Management phones lines (previously known as the Customer Account Services (CAS) phone lines) receive the significant majority of taxpayer calls. However, taxpayer calls to compliance phone lines and certain other categories of calls are excluded from this total.

<sup>15</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2004).

<sup>16</sup> See, e.g., IRS, Joint Operations Center, *CAS Accounts Management Paper Inventory Reports: FY12 July-September Fiscal Year Comparison*.

<sup>17</sup> Compare IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 29, 2012) with IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2004).

<sup>18</sup> Insufficient funding affects the IRS's performance in many other areas as well. For example, the IRS has been ramping up its use of automated processes as a replacement for personnel in handling a greater share of its auditing and collection activities. While most taxpayers do not relish the prospect of being contacted by an examination or collection employee, we have documented previously that taxpayers are substantially better off communicating with a person than a programmed computer. See National Taxpayer Advocate Blog, *Are IRS Correspondence Audits Really Less Burdensome for Taxpayers?* (Feb. 6, 2012), at <http://www.taxpayeradvocate.irs.gov/Blog/are-irs-correspondence-audits-really-less-burdensome-for-taxpayers>; National Taxpayer Advocate 2011 Annual Report to Congress 336-349 (Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*). Insufficient funds also mean that IRS employees do not receive adequate training to assist taxpayers as well as they should.

<sup>19</sup> See Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*, *infra*.

<sup>20</sup> See IRS Identity Theft Advisory Council, *Identity Theft Status Update* (Oct. 24, 2012).

<sup>21</sup> See IRS Filing Season Statistics - Dec. 31, 2011, at <http://www.irs.gov/uac/Filing-Season-Statistics---Dec.-31,-2011>.

<sup>22</sup> See Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*, *infra*.

The IRS needs sufficient funding to address an important equity concern as well. Compliant taxpayers pay a great deal of money each year to subsidize noncompliance by others. According to the IRS's most recent estimate, the net tax gap stood at \$385 billion in 2006,<sup>23</sup> when there were 116 million households in the United States.<sup>24</sup> This means that each household was effectively paying a "surtax" of some \$3,300 to subsidize noncompliance by others. That is not a burden we should expect our nation's taxpayers to bear.

Yet because of funding constraints, the IRS's ability to ensure that all taxpayers pay their fair share of taxes is limited. The IRS now audits just about one percent of individual taxpayers, and because traditional face-to-face audits are relatively expensive, it performs many audits by automated correspondence. About three out of four audits of individual taxpayers are now limited-issue examinations conducted by mail.<sup>25</sup> Thus, the IRS in FY 2011 conducted traditional face-to-face audits of just one out of every 360 taxpayers.<sup>26</sup>

### C. The "Program Integrity Cap Adjustment" Mechanism Has Significant Drawbacks.

For the reasons described above, the National Taxpayer Advocate recommends that Congress increase funding for the IRS.

In making this recommendation, however, we emphasize that the IRS must maintain a balanced compliance program that places priority emphasis on promoting voluntary front-end compliance and does not place excessive weight on back-end enforcement. Several Appropriations acts in recent years have given the IRS additional funding using a mechanism known as a "program integrity cap adjustment." Under this mechanism, new funding appropriated for IRS enforcement programs generally does not count against otherwise applicable spending ceilings provided:

1. The IRS's existing enforcement base is fully funded; and
2. A determination is made that the proposed additional expenditures will generate a return on investment of greater than 1:1 (*i.e.*, the additional expenditures will increase federal revenue on a net basis).

Funding for taxpayer service activities has been excluded from this enhanced funding mechanism. The rationale is that the IRS is able to measure the direct ROI of its enforcement activities — *i.e.*, it can compute to the dollar the amounts collected by its Examination, Collection, and document-matching functions — but at present it is unable

<sup>23</sup> See IRS News Release, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study*, IR-2012-4 (Jan. 6, 2012), at <http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study>. The "net" tax gap reflects the amount by which tax liabilities exceed tax collection after accounting for late payments and enforced collections. The "gross" tax gap — the amount unpaid timely and before enforced collections — was estimated to be \$450 billion.

<sup>24</sup> U.S. Census Bureau, Table H-1, *Income Limits for Each Fifth and Top 5 Percent of All Householders: 1967 to 2011*, at <http://www.census.gov/hhes/www/income/data/historical/household/index.html>.

<sup>25</sup> IRS, *Fiscal Year 2011 Enforcement and Service Results*, at [http://www.irs.gov/pub/newsroom/fy\\_2011\\_enforcement\\_results\\_table.pdf](http://www.irs.gov/pub/newsroom/fy_2011_enforcement_results_table.pdf).

<sup>26</sup> *Id.*

to quantify the ROI of taxpayer services. Thus, it is not currently possible to document whether or the extent to which its taxpayer services generate an ROI greater than 1:1.

Although we recognize that the program integrity cap adjustment mechanism is a well-intentioned attempt to provide the IRS with increased funding, we think such an “enforcement-only” cap adjustment is an impeccably poor workaround for two reasons. First, common sense tells us that taxpayer services are a significant driver of tax compliance and generate a very high ROI. Publishing tax forms and instructions, conducting outreach and education to taxpayers, tax preparers, and tax software manufacturers, and otherwise administering the tax filing season are absolute prerequisites for tax compliance. In general, the ROI of these service activities is almost surely greater than the ROI of enforcement actions, and as we document in this report, the IRS could do a lot to improve its taxpayer services if it received additional funding for that purpose.

Second, an enforcement-only cap adjustment will inherently push the IRS to become more of a hard-core enforcement agency. It should be emphasized that in FY 2011, direct enforcement revenue came to only \$55.2 billion,<sup>27</sup> or 2 percent, of total IRS tax collections of \$2.42 trillion.<sup>28</sup> The remaining 98 percent of IRS tax collections resulted from voluntary front-end tax compliance. If cap adjustments are applied solely to bolster enforcement funding, the relative allocation of the IRS budget between enforcement and taxpayer service will shift over time in a direction that causes taxpayers to fear the IRS more and voluntarily cooperate less. In our effort to enforce the laws against noncompliant taxpayers, we must take care to avoid steps that may alienate compliant taxpayers and thereby jeopardize the existing tax base.

If the treatment of the IRS budget is not fundamentally revamped along the lines we are recommending and program integrity cap adjustments continue to be used as an alternative, we recommend that compliance measures be defined more broadly, so that they include both an enforcement component and a service component. Because the projected ROI of many enforcement programs is high, a more broadly constructed initiative could still produce a demonstrable ROI of greater than 1:1, even if it contained service components with a positive but unquantifiable ROI. For example, IRS data show that compliance rates among small businesses are relatively low. A portion of the noncompliance is attributable to the fact that financially unsophisticated individuals starting businesses as, for example, landscapers or plumbers do not understand and therefore find it difficult to comply with the income tax accounting rules and the complex payroll tax withholding, reporting, and payment requirements.

Common sense suggests that an initiative aimed at improving small business tax compliance should contain an outreach and education component to help these taxpayers

<sup>27</sup> IRS, Fiscal Year 2011 Enforcement and Service Results, at [http://www.irs.gov/pub/newsroom/fy\\_2011\\_enforcement\\_results\\_table.pdf](http://www.irs.gov/pub/newsroom/fy_2011_enforcement_results_table.pdf).

<sup>28</sup> Government Accountability Office, GAO-13-120, *Financial Audit: IRS's Fiscal Years 2012 and 2011 Financial Statements* 65 (Nov. 2012), at <http://www.gao.gov/assets/650/649881.pdf>.

understand the rules. Yet the costs of conducting outreach and education have not been treated as eligible for program integrity cap adjustments because the ROI of those activities cannot be precisely quantified. That should change. If the IRS were to combine the costs of outreach and education with the costs of traditional enforcement measures as part of a comprehensive “small business compliance initiative,” it could show that the initiative as a whole would generate a positive ROI based simply on the revenue the enforcement measures would generate — and the true ROI would be substantially higher, even if unquantifiably so. That approach would produce better results, and it would not require the IRS to emphasize enforcement over taxpayer service activities just to obtain funding.<sup>29</sup>

## CONCLUSION

Because the IRS is the federal government’s accounts receivable department and generates a substantially positive return on investment, it is self-defeating to treat the agency like a pure spending program. With most spending programs, a dollar spent is simply a dollar spent from a budget perspective. With the IRS, a dollar spent generates many dollars in additional revenue, and conversely, a dollar not spent translates to a greater decrease in revenue collection, thereby adding to the budget deficit. Recent cuts in the IRS budget have also limited the IRS’s ability to meet the basic service needs of the taxpaying public, which erodes public confidence in the tax system and may also lead to greater noncompliance. For these reasons, we believe the time has come for Congress to “fence off” decisions about IRS funding from the otherwise applicable spending ceilings that apply to discretionary appropriations under the budget rules.

## RECOMMENDATIONS

The National Taxpayer Advocate recommends that Congress consider the following actions:

1. Revise the budget rules so that the IRS is “fenced off” from otherwise applicable spending ceilings and is viewed more like an accounts receivable department. It should be funded at a level designed to maximize tax compliance, particularly voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden.
2. In allocating IRS resources, keep in mind that tax compliance requires a combination of high quality taxpayer service, outreach and education, and effective tax-law enforcement, and the IRS should continue to maintain a balanced approach toward that end. We are concerned that the program integrity cap adjustment procedures used in the past skew this important balance and should be avoided, but if cap adjustments

<sup>29</sup> In past reports, we have written about local compliance initiatives the IRS has undertaken that include integrated enforcement and outreach and education components. See, e.g., National Taxpayer Advocate 2008 Annual Report to Congress 176-192 (Most Serious Problem: *Local Compliance Initiatives Have Great Potential but Face Significant Challenges*). One example: In the early 1990s, the IRS launched an initiative designed to address noncompliance by fishermen in Alaska that resulted from confusion as well as community norms and attitudes. The IRS combined stepped-up enforcement activities with an extensive outreach and education campaign in remote fishing villages and on fishing vessels that included assisting with tax return preparation and training local volunteers to assist taxpayers. By the end of the initiative, the number of nonfilers among the target population declined by 30 percent. *Id.* at 177-178.

continue to be used, we recommend they be written in a manner that applies to broadly defined compliance initiatives that include both taxpayer service (including outreach and education) and enforcement components.