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#1**The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes****DEFINITION OF PROBLEM**

The most serious problem facing U.S. taxpayers is the combination of the IRS's expanding workload and the limited resources available to the IRS to handle it.

Among the consequences:

1. The IRS is unable to adequately meet the service needs of the taxpaying public.
2. The IRS is unable to adequately detect and address noncompliance, requiring honest taxpayers to shoulder a disproportionately large share of the tax burden.
3. The IRS is unable to maximize revenue collection, contributing to the federal budget deficit.

Like any government agency or business, the IRS can improve its effectiveness, and this report contains many recommendations designed to help. Overall, however, the National Taxpayer Advocate believes the IRS has been an effective agency, and 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.¹

ANALYSIS OF PROBLEM

The assigned mission of the IRS is to serve U.S. taxpayers both individually and collectively. From an individual perspective, the IRS should provide taxpayers with the information they need to meet their tax obligations, answer their questions, and provide prompt and effective service when compliance problems arise. From a collective perspective, the IRS generally should collect the correct amount of tax due in order both to fund the operations of government and to ensure that compliant taxpayers are not ultimately required to pay more to subsidize noncompliance by others.² In addition, we note that the role of the IRS has expanded recently from one focused on tax collection to one that also involves distributing benefits to a variety of individuals and businesses.³

¹ For a recommendation regarding IRS funding, see National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

² We qualify the IRS's duty to collect all tax legally due because there are certain circumstances under which the IRS should not pursue some or all of a tax debt. For example, Congress has made clear that the IRS generally should release a levy that would impose an economic hardship on a taxpayer. See Internal Revenue Code (IRC) § 6343(a)(1)(D).

³ Among recently enacted benefits are the First-Time Homebuyer Credit, which is intended to encourage home ownership; the American Opportunity tax credit, which is intended to encourage higher education; and the small business tax credit enacted as part of the Patient Protection and Affordable Care Act of 2010, which is intended to encourage certain employers to subsidize health insurance coverage for their workers. The National Taxpayer Advocate has recommended that the IRS revise its mission statement to acknowledge explicitly that its traditional tax-collection mission has expanded to encompass benefits delivery as well. See National Taxpayer Advocate 2010 Annual Report to Congress 15-27 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

Background: Sources of IRS Workload Increase

The workload of the IRS has expanded substantially in recent years. Some of the main drivers of the workload increase are as follows:

a. Tax Complexity and the Frequency of Tax-Law Changes.

In prior reports, the National Taxpayer Advocate has identified the complexity of the tax code as the most serious problem facing taxpayers and the IRS alike.⁴ 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.⁵

For every provision Congress writes, the IRS must write computer code so it can process returns affected by the provision. To identify and stop improper claims, the IRS also must develop filters or other procedures to ensure return accuracy and prevent fraud.

Frequent and late-year tax law changes add to the IRS's workload and increase taxpayer burden. In late 2010, for example, Congress made significant changes that affected itemized deductions. During the 2011 filing season, the IRS therefore could not accept returns from taxpayers who itemized their deductions until February 15 — a full month beyond the start of the filing season.⁶

b. The Service Needs of an Increasingly Diverse Taxpayer Base.

As discussed later in this report,⁷ demographic changes increase the IRS's challenges in conducting outreach and education to taxpayers and in its ability otherwise to meet taxpayer needs.

- Linguistically, about one-fifth of the U.S. population speaks a language other than English at home. This means the IRS must be able to provide service in Spanish and other languages.
- Economically, 15.1 percent of the U.S. population falls below the poverty line. Many of these taxpayers qualify for the Earned Income Tax Credit (EITC) and other benefits requiring substantiation of eligibility, which can create unique obstacles in the tax return process.
- From the perspective of living arrangements, more than five percent of U.S. households consist of unmarried partners. While unmarried partners may share household expenses, the tax law requires them to file separate returns. They therefore must

⁴ 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).

⁵ See National Taxpayer Advocate 2010 Annual Report to Congress 4.

⁶ See IRS News Release, IR-2011-16, *IRS Begins Processing Tax Forms Affected by Late Tax Changes; Taxpayers Can e-File Immediately* (Feb. 15, 2011).

⁷ See *Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics* and related Most Serious Problems, *infra*.

keep — or create — separate records of their income and expenses for federal income tax purposes.

- From an age perspective, 13 percent of the U.S. population is 65 or older. This population requires information about the complex rules that govern the reporting and taxation of retirement benefits, and many must contend with computing the partial taxation of Social Security benefits.
- Geographically, 79 percent of the population lives in urban areas, while 21 percent lives in rural areas. To cite one example of differing needs, the IRS must have the capacity to provide information about the taxation of farming activities in rural areas, even though farming issues do not arise for the significant majority of the population.

The extraordinary diversity of the taxpaying population means that a one-size-fits-all approach to taxpayer service does not suffice. To maximize public awareness of federal tax requirements and improve tax compliance, the IRS must continually keep up with demographic changes and find new ways to reach and assist all taxpayer segments.

c. A Surge in Tax-Related Identity Theft.

The IRS reports that it has identified more than 404,000 taxpayers who have been affected by identity theft since 2008.⁸ In fiscal year (FY) 2011 alone, the IRS's centralized Identity Protection Specialized Unit (IPSU) received more than 226,000 cases, an increase of 20 percent over FY 2010.⁹ Moreover, despite the creation of the IPSU, TAS received more than 34,000 identity theft cases in FY 2011, a 97-percent increase over FY 2010.¹⁰

In most cases, an identity thief files a return using the Social Security number (SSN) of another individual, either as the primary taxpayer or as the spouse or a dependent claimed on the return. The return claims a refund and requests a debit card, a refund check, or direct deposit into a bank account. A single thief often submits a large number of returns using stolen SSNs early in the filing season. By the time the legitimate taxpayers get around to filing, their returns may be blocked because their SSNs have previously been used for the same tax year.

As we discuss elsewhere in this report,¹¹ the IRS has made significant progress in improving its procedures to aid victims of identity theft. Identity theft cases have continued to

⁸ *Identity Theft and Tax Fraud: Growing Problems for the Internal Revenue Service: Hearing Before the Subcomm. on Government Organization, Efficiency and Financial Management of the H. Comm. on Oversight and Government Reform, 112th Cong. (2011)* (statement of Steven T. Miller, Deputy Commissioner for Services and Enforcement, Internal Revenue Service).

⁹ IRS, *IPSU Identity Theft Report* (Oct. 1, 2011); IRS, *IPSU Identity Theft Report* (Oct. 2, 2010); IRS, *IPSU Identity Theft Report* (Oct. 3, 2009). This inventory includes all identity theft cases controlled by the IPSU paper unit, including self-reported non-tax-related identity theft cases, cases the IPSU monitors, and cases undergoing global account review. It does not include 26,695 cases that meet TAS's "systemic burden" case criteria, which the IPSU tracks separately.

¹⁰ In FY 2010, TAS opened 17,291 stolen identity cases (primary issue code (PIC) 425). In FY 2011, the number jumped to 34,006. Taxpayer Advocate Management Information System (TAMIS), FY 2010, FY 2011 (Oct. 31, 2011).

¹¹ See Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*, *infra*.

increase, however, and the IRS does not have sufficient procedures or personnel in place to help victims to the extent required. The process of assisting identity theft victims cannot generally be automated. IRS personnel must work directly with victims to understand what has happened, verify that they are the correct taxpayers, and take the actions required to resolve their problems. This work is generally time-consuming.

d. More Fraudulent Refund Claims.

The IRS is receiving an increasing number of fraudulent tax returns claiming refunds. Some of this trend overlaps with the identity theft problem described above, but general fraud is more widespread. To protect the fisc, the IRS has been devoting significant enforcement resources to trying to identify and block improper claims. Because filters are inherently imperfect, the IRS must also devote additional taxpayer service resources to assist persons whose refunds are blocked in error.

The increase in questionable claims is attributable to at least two sources. First, the growth in e-filing, while generally positive for taxpayers and the IRS alike, has created more opportunities for criminals to submit multiple returns that report false wages and withholding credits in an attempt to generate refunds. The IRS's Electronic Fraud Detection System (EFDS) is a data-mining program that screens all tax returns claiming refunds to try to identify questionable wages or withholding credits. In calendar year (CY) 2011, EFDS flagged 1,054,704 returns for further review, *an increase of 72 percent over CY 2010*.¹² The IRS has the authority to correct overreporting of withholding credits without conducting examinations and issuing notices of deficiency.¹³ These cases are processed by the IRS's Accounts Management Taxpayer Assurance Program (AMTAP).

As noted, however, there is no easy way to distinguish proper claims from improper ones. Filters are, at once, both under-inclusive and over-inclusive, and inevitably block large numbers of proper refund claims. When that happens, the IRS must have sufficient personnel to assist the legitimate taxpayers who are harmed. If, for example, the IRS stops one million refund claims and has a 90-percent accuracy rate, it would need sufficient personnel to quickly work through the claims of 100,000 legitimate taxpayers who were inadvertently caught up in the net.

¹² The number of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011. W&I response to TAS information request (July 27, 2011, as updated Nov. 4, 2011). CY 2011 data is only through October 15, but relatively few returns are received after that date.

¹³ IRC § 6201(a)(3) authorizes the IRS to assess overstatements of income tax withholding and overstatements of estimated income tax payments in the same manner as in the case of mathematical or clerical errors described in IRC § 6213(b), except that the taxpayer is not given an opportunity to file a request for an abatement of a tax assessment or challenge the assessment in the Tax Court.

As discussed elsewhere in this report,¹⁴ TAS alone received more than 21,000 pre-refund cases in FY 2011, *an increase of 504 percent over FY 2010*.¹⁵ A TAS study found that 75 percent of these taxpayers ultimately were found eligible for the blocked refunds, that the amount of the blocked refunds averaged more than \$5,600, and that the taxpayers had to wait an average of nearly six months to receive them. The IRS must do a better job of assisting these taxpayers quickly.

A second cause of the increase in improper claims is the expansion of spending programs administered through the tax code. As an alternative to direct spending, Congress has enacted a substantial number of refundable tax credits in recent years. Historically, the EITC was the main significant refundable credit,¹⁶ but Congress recently has enacted the First-Time Homebuyer Credit,¹⁷ the Making Work Pay credit,¹⁸ the American Opportunity tax credit,¹⁹ and the health care premium tax credit.²⁰ It has also made the adoption tax credit fully refundable,²¹ and the child tax credit partially refundable.²²

Refundable credits are often complex and lead to inadvertent error. They also present tempting targets for fraud. Whereas nonrefundable credits, deductions, exclusions, and the like can do no more than reduce a taxpayer's liability to zero, a taxpayer claiming a refundable credit may receive a substantial cash payment.²³

¹⁴ See Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*.

¹⁵ TAS, Business Performance Review (4th Quarter FY 2011). The 21,286 pre-refund wage verification cases (PIC 045) actually represent a 571 percent increase over the 3,171 PIC 045 cases received in FY 2010. Because TAS did not use PIC 045 until March 24, 2010, however, a more appropriate comparison is between PIC 045 case receipts from the last two quarters of FY 2011 (18,018 cases) and PIC 045 case receipts from the last two quarters of FY 2010 (2,981 cases), which represents a 504-percent increase. See TAS, Business Performance Review (4th Quarter FY 2010 and 4th Quarter FY 2011).

¹⁶ IRC § 32. The EITC is effectively a wage supplement for low income workers.

¹⁷ IRC § 36. The First-Time Homebuyer Credit, as modified, most recently provided up to \$8,000 to certain first-time or long-time homeowners for qualifying 2010 purchases.

¹⁸ IRC § 36A. The Making Work Pay credit expired on Dec. 31, 2010.

¹⁹ IRC § 25A(i). The American Opportunity tax credit is partially refundable and may be used to offset the costs of college tuition, fees, and course materials. See IRC § 25A(i)(6).

²⁰ IRC § 36B. The health care premium tax credit is designed to help low income individuals purchase coverage under a qualified health plan beginning in 2014.

²¹ IRC § 36C. The adoption credit, which offsets the costs of adoptions, is scheduled to become non-refundable after tax year (TY) 2012 unless Congress extends its refundable status.

²² IRC § 24(d). The refundable portion is known as the Additional Child Tax Credit, and eligibility is dependent on earnings.

²³ Despite the risk of fraud, the National Taxpayer Advocate has repeatedly noted that refundable credits may also be an effective means of delivering benefits to target populations. In prior reports, we have recommended certain criteria for Congress to consider when deciding whether the advantages of administering particular benefits through the tax code outweigh the disadvantages. See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75-104 (Analysis: *Running Social Programs Through the Tax System*); see also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 101-119 (Analysis: *Evaluate the Administration of Tax Expenditures*). We have also emphasized that the IRS should not overreact to the publicity about refund fraud by pulling significant resources from its other audit programs. IRS National Research Program (NRP) data for tax year (TY) 2001 suggest that approximately 55 percent (\$109 billion) of the individual underreporting gap (totaling approximately \$197 billion) came from understated net business income, such as unreported receipts and overstated expenses for self-employed taxpayers. By contrast, only about nine percent (\$17 billion) came from overstated tax credits. Yet the IRS audits individual taxpayers claiming the EITC at more than twice the rate of other taxpayers and EITC audits constitute about one-third of all IRS examinations, even though EITC audits on average yield only about one-third as much tax as other audits. See IRS Pub. 55-B, IRS Data Books (2006-2010), Table 9a; EITC Program Office response to TAS information request (May 18, 2011).

Distinguishing between valid claims, overclaims attributable to error, and overclaims attributable to fraud is resource-intensive. Moreover, the IRS generally may not reject claims for tax credits using math error authority. It typically must issue a notice of deficiency when it believes a claim is improper, and doing so generally involves an audit (although as we discuss elsewhere in this report, the IRS is experimenting with procedures that undermine this important taxpayer protection).²⁴ In attempting to address the suspected surge in questionable refundable credit claims, the Examination function has been stretched thin. Since FY 2009, for example, Examination has closed about 526,000 audits of First-Time Homebuyer Credit claims, including some 303,000 in FY 2010 alone.²⁵ The total number of non-EITC correspondence audits closed in FY 2010 was 686,796, which means that 43 percent of the non-EITC correspondence examinations closed in that year pertained to the First-Time Homebuyer Credit.²⁶ That was new work that limited the IRS's capacity to audit other high-risk returns and may have diverted resources from other programs.

e. Implementation of New Third-Party Information Reporting Requirements.

Congress has enacted several new third-party information reporting requirements in recent years. Most notably, credit card issuers generally will be required to report the aggregate amount of reportable payments they process for businesses,²⁷ and brokerage firms generally will be required to report the cost basis (as well as gross proceeds) of stock, bond, and mutual fund sales.²⁸ The purpose of these requirements is to improve tax compliance, but the provisions are not self-executing. The IRS has been devoting significant resources to build systems that are capable of comparing the data received from third parties against information reported on tax returns to identify inconsistencies. The new reporting regime remains a work in progress, and the IRS will be required to continue to devote resources to refine the system and make sure it is able to utilize the data it receives productively.

It is important to emphasize that document-matching programs, and the automated anti-fraud programs discussed above, simply identify data discrepancies. In many cases, the taxpayer's return position turns out to be the correct one. Therefore, the use or expansion of any automated compliance program generates additional downstream work when taxpayers write or call to dispute a proposed adjustment or simply to inquire about it. If the IRS does not have the resources to assist taxpayers who respond properly, it cannot implement or expand the use of such a program without adverse taxpayer impact.²⁹

²⁴ See Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*; Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *infra*; *An Analysis of the IRS Examination Strategy: Proposals to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*, *infra*.

²⁵ IRS, *First-Time Homebuyer Credit Enforcement Report FY 2009 – FY 2012* (Dec. 2011). Since FY 2009, just over 4.3 million First-Time Homebuyer Credit claims have been filed.

²⁶ See IRS Pub. 55-B, *Data Book* (2010), Table 9a.

²⁷ IRC § 6050W.

²⁸ IRC § 6045(g).

²⁹ For an example of the consequences of inadequate staffing in an enforcement program, see 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*, *infra*.

Effect of Inadequate Resources on Taxpayer Services

While the IRS has experienced a significant increase in its workload, it has not received a corresponding increase in its resources. To the contrary, the IRS's budget was reduced slightly from FY 2010 to FY 2011,³⁰ and has been cut by an additional 2.5 percent for FY 2012.³¹ These reductions are affecting the IRS's operations generally, and are particularly likely to impact taxpayer service.

Two key indicators of taxpayer service are the IRS's ability to answer taxpayer telephone calls and the IRS's ability to respond to taxpayer correspondence. From FY 2004 to FY 2011, the percentage of calls the IRS was able to answer from taxpayers seeking to speak with a telephone assistor dropped from 87 percent to 70 percent.³²

Over the same period, the IRS's ability to timely process taxpayer correspondence also declined. Comparing the final week of FY 2004 with the final week of FY 2011, the backlog of taxpayer correspondence in the tax adjustments inventory jumped by 158 percent (from 357,151 to 920,768), and the percentage of taxpayer correspondence in this inventory classified as "over-age" increased by 309 percent (from 11.5 percent to 47.0 percent of correspondence).³³ Correspondence generally is considered over-age when it is 45 days old or older and the issue it addresses has not been resolved.³⁴

The decline in these key measures is deeply disturbing. Telephone calls and correspondence are the two main ways taxpayers communicate with the IRS. Few government agencies or businesses would be satisfied if their customer service departments were unable to answer three out of every ten calls, nor would they be content if nearly half of all correspondence took more than 6-1/2 weeks to answer.

Taxpayer service levels may decline further if additional budget reductions are enacted. In a recent letter to the chairmen and ranking members of key committees of the Congress, the Commissioner of Internal Revenue warned:

[C]uts of the magnitude contemplated in the current appropriations bills (approximately \$525 million from core IRS accounts in the Senate bill and \$650 million in the House bill) would lead to noticeable degradation of both service and enforcement and would have a serious detrimental impact on voluntary compliance for years to come. . . .

³⁰ Department of Defense and Full-Year Continuing Appropriations Act, 2011, Pub. L. No. 112-10, § 1119, 1125 Stat. 38, 107 (2011).

³¹ H.R. 2055, Consolidated Appropriations Act, 2012, Division C, Title I (112th Cong.).

³² Compare IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services - CAS* (week ending Sept. 30, 2011) with IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services - CAS* (week ending Sept. 30, 2004). These percentages reflect the number of calls that reached telephone assisters among all calls seeking to do so.

³³ Compare IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Oct. 1, 2011) with IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2004).

³⁴ W&I FY 2012 Account Management Program Letter and Operating Guidelines (Dec. 12, 2011). In some instances, the definition of over-age varies based on factors such as the type of work, the program, the site, and inventory levels. TAS conversation with Joint Operations Center Paper Inventory Analyst (Dec. 13, 2011).

Responses to taxpayers' letters (including taxpayers who have received a notice and are trying to resolve account issues) would be delayed up to 5 months. Approximately half of the nation's taxpayers attempting to call the IRS would either be unable to get through or hang up in frustration.³⁵

The Chairman of the IRS Oversight Board expressed similar concerns in a letter to the chairmen and ranking members of House and Senate Appropriations Committees. He also stated:

The private sector experience of the Board members reinforces our belief that taxpayers who contact the IRS seeking assistance deserve service, and when taxpayers experience delays in obtaining service, the results are dysfunctional. For example, taxpayers may make costly mistakes, put themselves in jeopardy of enforcement action by the IRS, and in the long term, lose confidence in the tax system.³⁶

The Internal Revenue Service Advisory Council (IRSAC), a federal advisory committee composed of members of the public, has also sounded alarm bells. In a section of its recently released 2011 annual report titled "The IRS Must Receive Consistent, Adequate and Appropriate Funding to Achieve the Proper Administrative Balance Between Service, Compliance and Tax Enforcement," the IRSAC wrote:

Limited resources are forcing the IRS to continually streamline its services. An example of this approach is the limited ability of taxpayers to interface with a local IRS representative when responding to a notice, when seeking resolution of an issue, or during the process of tax collection or the processing of offers in compromise. Instead, taxpayers and representatives often encounter numerous erroneous notices and lengthy holding periods on the telephone followed by a non-discretionary approach that sometimes fails to comprehend the unique issues involved. Every taxpayer is not alike and the need for face-to-face interaction should not be overlooked or ignored in favor of budgetary concerns. . . .

Congress should appropriately fund the IRS to assure continued success in service, compliance, and enforcement. Without adequate funding, both taxpayers and the tax system will continue to suffer.³⁷

³⁵ Letter from Douglas H. Shulman, Commissioner of Internal Revenue, to the Chairs and Ranking Members of the House and Senate Appropriations Subcommittees on Financial Services and General Government, the House Committee on Ways and Means and its Subcommittee on Oversight, and the Senate Committee on Finance (Oct. 17, 2011).

³⁶ Letter from Paul Cherecwich, Jr., Chairman of the IRS Oversight Board, to the Chairs and Ranking Members of the House and Senate Committees on Appropriations (Oct. 20, 2011).

³⁷ Internal Revenue Service Advisory Council, 2011 General Report (Nov. 16, 2011).

The National Taxpayer Advocate shares the concerns expressed by the Commissioner, the Oversight Board, and the IRSAC.³⁸

Effect of Inadequate Resources on Tax Compliance

As of this writing, the most recent comprehensive data the IRS has released on noncompliance pertains to tax year (TY) 2001.³⁹ The IRS estimated the amount of tax not timely paid for TY 2001 was \$345 billion, or 16 percent of tax due.⁴⁰ The IRS estimated that it collected about \$55 billion through late payments and enforcement action, leaving a “net” tax gap of \$290 billion. However, the IRS has acknowledged that the actual tax gap is probably larger. For example, the study did not even venture a guess as to the amount of illegal-source income that goes unreported and on which taxes are not paid.

It will never be possible to eliminate the tax gap entirely, of course, but even modest improvements would help to reduce the federal budget deficit. Moreover, even apart from the fiscal implications, the size of the tax gap raises important equity concerns. Compliant taxpayers pay a great deal of money each year to subsidize noncompliance by others. Dividing the estimated 2001 net tax gap of \$290 billion by the estimated 108,209,000 households that existed in the United States in that year⁴¹ suggests that the average household was assessed a “surtax” of about \$2,680 to enable the federal government to raise the same level of revenue it would have collected if all taxpayers had reported their income and paid their taxes in full. That is not a burden we should expect our nation’s taxpayers to bear lightly.⁴²

³⁸ For additional discussion of these concerns, see the following Most Serious Problems discussed in this report: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*; *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*; *The IRS Procedures for Replacing Stolen Direct Deposit Refunds Are Not Adequate*; *The IRS’s Failure to Consistently Vet and Disclose Its Procedures Harms Taxpayers, Deprives It of Valuable Comments, and Violates the Law*; *After Refund Anticipation Loans: Taxpayers Require Improved Education About Refund Delivery Options and the Availability of a Government-Sponsored Debit Card*; *The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance*; *Accelerated Third Party Information Reporting and Pre-Populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration*; *The IRS Does Not Sufficiently Recognize and Address Domestic Violence and Abuse and Its Effects on Tax Administration*; *Reinstatement of a Modernized Telefile Would Reduce Taxpayer Burden and Benefit Tax Administration*; *The New Income Filter for the Federal Payment Levy Program Does Not Fully Protect Low Income Taxpayers from Levies on Social Security Benefits*; *The IRS Has Failed to Stem the Tide of Transfers to Its Excess Collection File, Which Contains Billions of Dollars in Payments, and Makes Disproportionately Little Effort to Prevent Transfers from Low Income Taxpayers*; *Introduction: Compliance Challenges Increase International Taxpayers’ Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives in the International Arena*; *U.S. Taxpayers Abroad Face Challenges in Understanding How the IRS Will Apply Penalties to Taxpayers Who Are Reasonably Trying to Comply or Return into Compliance*; *Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance*; *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences*; *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service*; *Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations*; *The IRS Makes Reinstatement of an Organization’s Exempt Status Following Automatic Revocation Unnecessarily Burdensome*; *The IRS Has Removed the Two-Year Deadline for Requesting Equitable Innocent Spouse Relief, but Further Adjustments to Its Procedures in Innocent Spouse Cases Are Warranted*; *The IRS Has Significantly Improved the Accuracy of Restricted Interest Computations, but Problems with Failure-to-Pay Penalty Computations Continue to Cause Interest Errors, infra.*

³⁹ The IRS is expected to release an updated estimate of the tax gap in the near future.

⁴⁰ See IRS, *Tax Gap Map for Tax Year 2001* (Feb. 2007), available at http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf.

⁴¹ U.S. Census Bureau, Population Division (data as of Mar. 2001).

⁴² Significantly, the IRS Oversight Board reports there is substantial public support for an enhanced IRS compliance program, provided that it is balanced. The Oversight Board conducts an annual survey of taxpayer attitudes which consistently finds that a substantial majority of taxpayers supports additional funding for both IRS assistance and enforcement. See, e.g., IRS Oversight Board, *2010 Taxpayer Attitude Survey* 15 (Jan. 2011).

As the statutorily designated advocate for taxpayers collectively as well as for taxpayers with specific account problems, the National Taxpayer Advocate is concerned about the economic and social costs that this noncompliance imposes. Since our 2003 Annual Report to Congress, we have frequently raised concerns about the tax gap and offered balanced proposals designed to reduce it.⁴³

IRS Funding Principles

The National Taxpayer Advocate has previously expressed the view that the IRS, as the nation's tax collector, should generally be exempt from any budget freeze or reduction.⁴⁴ We hold this view for two reasons. First, the IRS is the one agency of the federal government with which most Americans interact every year. To a significant extent, the public's perception of the fairness and effectiveness of their government is shaped by their experience in dealing with the IRS. While few people enjoy paying taxes, most recognize it is a necessary requirement to provide for a civilized society. Yet the public expects — and has a right to expect — that the government will make the process of paying taxes as painless as possible. If taxpayers experience unnecessary hassles in trying to do their civic duty, their cynicism about the competence and fairness of the government will increase. To maximize public confidence, the tax collector should be staffed at a level that enables it to meet the needs of all taxpayers.

⁴³ See National Taxpayer Advocate 2010 Annual Report to Congress 373-376 (Legislative Recommendation: *Repeal Information Reporting on Purchases of Goods but Require Reporting on Corporate and Certain Other Payments*); National Taxpayer Advocate 2009 Annual Report to Congress 155-157 (Introduction to Examination Issues: *The IRS Examination Strategy Fails to Maximize Voluntary Compliance*); National Taxpayer Advocate 2009 Annual Report to Congress 158-167 (Most Serious Problem: *The IRS Correspondence Examination Program Does Not Maximize Voluntary Compliance*); National Taxpayer Advocate 2009 Annual Report to Congress 168-173 (Most Serious Problem: *The IRS Examination Function Is Missing Opportunities to Maximize Voluntary Compliance at the Local Level*); National Taxpayer Advocate 2009 Annual Report to Congress 174-179 (Most Serious Problem: *The IRS Does Not Know If It Is Using State and Local Data Effectively to Maximize Voluntary Compliance*); National Taxpayer Advocate 2009 Annual Report to Congress 180-184 (Most Serious Problem: *The IRS Lacks a Comprehensive "Income" Database that Could Help Identify Underreporting and Improve Audit Efficiency*); National Taxpayer Advocate 2009 Annual Report to Congress 185-190 (Most Serious Problem: *The IRS Does Not Have a Significant Audit Program Focused on Detecting the Omission of Gross Receipts*); National Taxpayer Advocate 2009 Annual Report to Congress 191-195 (Most Serious Problem: *The IRS Has Delayed Minor Tax Form Changes that Would Promote Voluntary Compliance and Increase Audit Efficiency*); National Taxpayer Advocate 2008 Annual Report to Congress 54-78 (Most Serious Problem: *Employment Taxes*); National Taxpayer Advocate 2007 Annual Report to Congress 213-226 (Most Serious Problem: *The IRS Should Proactively Address Emerging Issues Such as Those Arising from "Virtual Worlds"*); National Taxpayer Advocate 2007 Annual Report to Congress 35-65 (Most Serious Problem: *The Cash Economy*); National Taxpayer Advocate 2007 Annual Report to Congress 242-258 (Most Serious Problem: *Nonfiler Program*); National Taxpayer Advocate 2007 Annual Report to Congress 303-323 (Most Serious Problem: *Audits of S Corporations*); National Taxpayer Advocate 2007 Annual Report to Congress 490-502 (Legislative Recommendation: *Measures to Address Noncompliance in the Cash Economy*); National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 1-43 (*A Comprehensive Strategy for Addressing the Cash Economy*); National Taxpayer Advocate 2006 Annual Report to Congress 6-9 (Most Serious Problem: *The Tax Gap*); National Taxpayer Advocate 2005 Annual Report to Congress 55-75 (Most Serious Problem: *The Cash Economy*); National Taxpayer Advocate 2005 Annual Report to Congress 238-248 (Most Serious Problem: *Limited Scope of Backup Withholding Program*); National Taxpayer Advocate 2005 Annual Report to Congress 381-396 (Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy*); National Taxpayer Advocate 2004 Annual Report to Congress 211-225 (Most Serious Problem: *IRS Examination Strategy*); National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (Most Serious Problem: *IRS Collection Strategy*); National Taxpayer Advocate 2004 Annual Report to Congress 246-263 (Most Serious Problem: *Federal Contractors and the Federal Payment Levy Program*); National Taxpayer Advocate 2004 Annual Report to Congress 478-489 (Legislative Recommendation: *Tax Gap Recommendations*); National Taxpayer Advocate 2003 Annual Report to Congress 20-25 (Most Serious Problem: *Nonfiling and Underreporting by Self-Employed Taxpayers*); National Taxpayer Advocate 2003 Annual Report to Congress 256-269 (Legislative Recommendation: *Tax Withholding on Non-Wage Workers*) (containing proposals that the National Taxpayer Advocate has since modified).

⁴⁴ See *Hearing on FY 2012 IRS Budget: Hearing Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations, 112th Congress (2011)* (statement of Nina E. Olson, National Taxpayer Advocate); see also National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

Second, more funding for the IRS means more federal revenue. The IRS is effectively the Accounts Receivable Department of the federal government. It collects more than 90 percent of all federal revenue and therefore provides the funds that make virtually all other federal spending possible.⁴⁵ On a budget of about \$12.1 billion,⁴⁶ the IRS collected about \$2.42 trillion in FY2011.⁴⁷ In other words, for every \$1 that Congress appropriated for the IRS, the IRS collected about \$200 in return.⁴⁸ Policymakers may disagree fervently about the appropriate level of taxation, but there is little disagreement that the IRS should enforce the law fairly and consistently.

Rather than recognizing the IRS's unique role as the revenue engine for the federal government, however, the congressional budget rules treat spending for the IRS exactly the same way they treat spending for all other federal agencies — a dollar spent is simply a dollar spent, with no consideration given to how many dollars the IRS will raise in return.⁴⁹

If the federal government were a private company, its management would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line.

Since the IRS is not a private company, maximizing the bottom line is not — in and of itself — the only goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Studies show that if given more resources, the IRS could collect substantially more revenue.⁵⁰

Former IRS Commissioner Charles Rossotti has written:

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

⁴⁵ See IRS Fact Sheet, FS-2011-09, *IRS FY 2012 Budget Proposal Summary* (Feb. 2011), available at <http://www.irs.gov/newsroom/article/0,,id=235959,00.html>.

⁴⁶ Department of the Treasury, *FY 2012 Budget in Brief* (showing FY 2010 enacted levels); Department of Defense and Full-Year Continuing Appropriations Act, 2011, Pub. L. No. 112-10, § 1119, 1125 Stat. 38, 107 (2011) (making 0.2 percent reduction in FY 2010 enacted levels for FY 2011).

⁴⁷ Government Accountability Office, GAO-12-165, *Financial Audit: IRS's Fiscal Years 2011 and 2010 Financial Statements* at 63 (Nov. 2011).

⁴⁸ In evaluating the likely revenue benefits of additional funding, the average return on investment (ROI) of 200:1 is less important than the marginal ROI that can be achieved for each additional dollar spent. While the marginal ROI is considerably less than 200:1 and will differ by program, studies generally show that, within reasonable limits, each additional dollar appropriated to the IRS generates substantially more than an additional dollar in federal revenue, assuming the funding is wisely spent.

⁴⁹ There is one exception to this rule. Under a mechanism known as a “program integrity allocation adjustment,” new funding appropriated for IRS enforcement programs may 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 an ROI of greater than 1:1 (i.e., the additional expenditures will reduce the deficit on a net basis). However, this mechanism has been used only a few times and only for enforcement programs, despite widespread acknowledgment that taxpayer service activities also contribute to tax compliance.

⁵⁰ The exact “multiplier” effect varies by program and is hard to measure with precision. Commissioner Shulman recently wrote that “cutting the IRS budget by the contemplated levels would mean that front-line IRS staffing levels must be substantially reduced, leading to a measureable decrease of approximately \$4 billion in revenue annually, or seven times the reduction in [the] budget.” Letter from Douglas H. Shulman, Commissioner of Internal Revenue, to the Chairs and Ranking Members of the House and Senate Appropriations Subcommittees on Financial Services and General Government, the House Committee on Ways and Means and its Subcommittee on Oversight, and the Senate Committee on Finance (Oct. 17, 2011).

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?”⁵¹

Yet obtaining a little extra money to bring in a lot of extra money remains an intractable challenge for the IRS, and that is unfortunate. Without additional resources, the IRS will be unable to provide timely and effective taxpayer service and will be unable to make much, if any, progress in reducing the tax gap.

CONCLUSION

The IRS does not have enough resources to handle its current workload. The lack of adequate funding for the IRS causes multiple problems. Taxpayers calling the IRS with tax-law questions often cannot get through, creating considerable frustration and potentially reducing compliance. Compliant taxpayers whose refunds are held up or who are audited do not receive timely responses to their phone calls and correspondence. The IRS lacks the resources to maximize revenue collection, thereby exacerbating the federal budget deficit. And compliant taxpayers who see that the IRS is not able to pursue noncompliant taxpayers adequately begin to feel like “tax chumps,” potentially making them less likely to comply in the future, particularly in the case of small business taxpayers for whom paying taxes may place them at a competitive disadvantage.

RECOMMENDATION

In light of the IRS’s unique role as the federal government’s accounts receivable department, the National Taxpayer Advocate recommends that Congress develop new budget procedures to ensure that the IRS is funded at whatever level will enable the IRS to meet taxpayer needs and maximize tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. In the short run, this approach should include carving out the IRS from discretionary budget freezes intended to reduce the budget deficit, as cuts to the IRS budget are likely to increase the deficit. Over the longer term, the National Taxpayer Advocate recommends that Congress consider exempting the IRS from spending ceilings or even taking the IRS off-budget.

⁵¹ Charles O. Rossotti, *Many Unhappy Returns: One Man’s Quest to Turn Around the Most Unpopular Organization in America* 278 (2005). On pages 278-286, Mr. Rossotti presents an interesting personal perspective on the budget process and the politics behind the chronic under-funding of the IRS.