National Taxpayer Advocate Delivers Annual Report to Congress; Focuses on IRS Funding and Taxpayer Rights

IR-2012-6, Jan. 11, 2012

WASHINGTON — National Taxpayer Advocate Nina E. Olson today released her annual report to Congress, identifying the combination of the IRS's expanding workload and declining resources as the most serious problem facing taxpayers. The result, the report says, is inadequate taxpayer service, erosion of taxpayer rights, and reduced tax compliance. The Advocate expressed her continuing concern that the IRS's expanding use of automated processes to adjust tax liabilities is causing harm to taxpayers and recommended that Congress enact a comprehensive Taxpayer Bill of Rights.

THE IRS IS NOT ADEQUATELY FUNDED TO SERVE TAXPAYERS AND COLLECT TAXES
"The overriding challenge facing the IRS is that its workload has grown significantly in recent years, while its funding is being cut," Olson said in releasing the report. "This is causing the IRS to resort to shortcuts that undermine fundamental taxpayer rights and harm taxpayers – and at the same time reduces the IRS's ability to deliver on its core mission of raising revenue."

Workload Overload. The sharp increase in the IRS's workload is due to several factors, including the increasing complexity of the tax code and the code's frequent changes, the need to provide service to an increasingly diverse taxpayer population, the IRS's increasing responsibility for administering economic and social policies, a surge in refund fraud and tax-related identity theft, and the implementation of new third-party information reporting requirements.

There were approximately 4,430 changes to the tax code from 2001 through 2010, an average of more than one a day, including an estimated 579 changes in 2010 alone. The IRS must explain each new provision to taxpayers, write computer code so it can process returns affected by the provision, and train its auditors to identify improper claims.

In addition, the report says, an expansion of refundable credits in recent years – including the First-Time Homebuyer Credit, the Making Work Pay credit, the American Opportunity tax credit, the health care premium tax credit, the adoption tax credit, and the Additional Child Tax Credit – has helped spawn an increase in illegal activity that seeks to profit off the tax system by filing bogus refund claims and often by stealing and using another taxpayer's identity. While refundable credits provide valuable benefits to the target populations, they can be tempting targets for fraud because taxpayers eligible for them may claim refunds that exceed the amount of taxes they have paid. In 2011, the IRS's Electronic Fraud Detection System (EFDS) flagged 1,054,704 returns on suspicion of fraud, an increase of 72 percent over 2010. Meanwhile, the IRS's centralized Identity Protection Specialized Unit (IPSU) received more than 226,000 identity theft-related cases, an increase of 20 percent over 2010.

"Each year," Olson wrote, "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 a significant burden on honest taxpayers."

"Shortcuts" Shortcut Taxpayer Rights: "Non-Audits," IRS Math Errors, Lack of Notice, and Delays. To keep up with its rising workload, the IRS is increasingly relying on automated data-matching procedures to identify potentially inaccurate claims and adjust tax liabilities. However, automated processes are inherently imperfect, so the taxpayer's return position often turns out to be correct. Moreover, taxpayers subject to audits are entitled to established taxpayer rights protections. But an increasing number of IRS adjustments are not classified as audits, so these protections often do not apply. Throughout the report, Olson describes IRS practices that "harm taxpayers by acting on assumptions of noncompliance arrived at by automated processes that do not solicit, encourage, or allow taxpayer response."

Non-Audits and Automated Examinations. In 2010 alone, the IRS made about 15 million contacts with individual taxpayers to adjust their tax liabilities, but it treated only about ten percent (1.6 million) as audits. Thus, in the majority of cases, the IRS's actions did not give rise to traditional audit protections, including the right to avoid repetitive and unnecessary examinations and the right to seek review of the IRS's determination in the U.S. Tax Court before tax is assessed. Even where the IRS designated reviews of individual taxpayer returns as "audits," it conducted about 78 percent of them by correspondence in a highly automated campus setting where no single IRS employee was responsible for the audit, making it more difficult for the taxpayer to communicate with the IRS about his or her case.

Some "Math Errors" May Be Corrected Using IRS Data. In 2010, the IRS issued notices correcting 10.6 million "math errors," up from four million in 2005. These notices are tax assessments that presumably result from mathematical or clerical errors. Unless a taxpayer disputes the IRS assessment within a limited timeframe, it may not be appealed to the Tax Court. The report notes that math error authority is increasingly used where there is disagreement over a facts-and-circumstances issue. The report says that math error notices are often vague and do not state the perceived error with specificity, making it difficult, if not impossible, for affected taxpayers to determine what has changed on their returns and whether to accept or contest the adjustments. Taxpayers whose returns are correct sometimes do not respond because they do not know what is being asked of them. IRS math error notices also are sometimes inaccurate. When the IRS used math error authority in 2010 to disallow exemptions for dependent children on about 300,000 returns, it ultimately had to reverse about 55 percent of the adjustments. Of the 184,000 corrected math errors, a Taxpayer Advocate Service (TAS) sample showed the IRS had internal data to immediately resolve 56 percent of these reversals, and thus could have avoided denying eligible taxpayers their dependency exemptions and related tax credits and refunds.

The IRS Determines Some Taxpayers Have Committed Fraud Without Notifying Them and Giving Them an Opportunity to Respond. Under a program designed to detect returns relating to a scheme known as "Operation Mass Mail," the IRS declined to process about 900,000 returns in 2011. In most situations where the IRS identifies questionable claims, it sends notices to the affected taxpayers to give them an opportunity to contest the IRS's position. In these cases, however, the IRS simply "auto-voided" the returns, providing the individuals who had submitted them with no notice of the IRS action. Yet in tens of thousands of these cases, the IRS later marked the accounts with a code that indicates it had erred and the return had been submitted by a legitimate taxpayer. The report expresses concern that this "auto-void" procedure violates fundamental notions of due process, as individuals whom the government suspects of fraud – a serious charge – normally are given notice and an opportunity to respond before the government takes adverse action.

Substantial Delays to Receive Large Refunds. Among taxpayers who sought assistance from TAS after their refunds were withheld on a suspicion of fraud, 75 percent received relief. These taxpayers had to wait an average of nearly six months overall to receive their refunds. The average refund amount was $5,600, a significant sum for most households. Thus, these delays can create significant financial hardships.

"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," Olson wrote, "the IRS is increasingly in danger of judging taxpayers as noncompliant when in fact they are not."

Taxpayer Service Concerns: Delays and Non-Responses to Taxpayer Inquiries. 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 that the IRS answered from taxpayers seeking to speak with a telephone assistor dropped from 87 percent to 70 percent.

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 correspondence in the tax adjustments inventory jumped by 158 percent (from 357,151 to 920,768), and the percentage of correspondence in this inventory classified as "over-age" (i.e., 45 days or older, with issues that have not been resolved) increased by 309 percent (from 11.5 percent to 47.0 percent of correspondence).

"The decline in these key measures is deeply disturbing," the report says. "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 when nearly half of all correspondence takes more than 6½ weeks to answer."

Increased Diversity of the Taxpayer Population Presents Challenges. When the federal individual income tax was enacted in 1913, it applied to high-income taxpayers. The individual taxpayer population in 1913 was estimated at 358,000, grew to 47.1 million in 1944, and stands at 141.2 million today. The taxpayer population has become more diverse over time due to demographic developments as well as expansions in the scope of the tax law. With one tax return filed for about every two people in the United States each year, demographic trends – including ethnicity, economics, gender, age, and geography – are having an impact on both taxpayer service needs and IRS compliance initiatives.

Revenue Consequences of IRS Underfunding. The report says inadequate funding for the IRS contributes to many of these problems and means the IRS cannot adequately pursue unpaid tax liabilities. The report points out that the IRS functions as the "accounts receivable" department of the federal government, as it collects more than 90 percent of all federal revenue and therefore provides the funds that make almost all other federal spending possible. On a budget of $12.1 billion, the IRS collected $2.42 trillion in FY 2011. In other words, for every $1 that Congress appropriated for the IRS, the IRS collected about $200 in return. However, current federal budgeting rules do not take into account that a dollar appropriated for the IRS typically generates substantially more than a dollar in additional tax collections, leaving the agency substantially underfunded to do its job and limiting its ability to close the tax gap and thereby help reduce the federal budget deficit.

The report points out that the size of the tax gap raises important equity concerns, because compliant taxpayers end up carrying a disproportionate share of the tax burden. For 2001, the most recent year for which a complete tax gap estimate existed when the report was written, the IRS estimated it was unable to collect $290 billion in taxes. Since there were then 108 million households in the United States, the average household paid a "noncompliance surtax" of almost $2,700 to enable the federal government to raise the same 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," the report says. [Last week, the IRS released updated tax gap estimates. For 2006, the IRS estimated it was unable to collect $385 billion in taxes when there were 114 million households, producing an updated "noncompliance surtax" of nearly $3,400 per household.]

National Taxpayer Advocate Recommendation. In light of the IRS's unique role as the federal revenue collector, the National Taxpayer Advocate recommends that Congress develop new budget procedures designed to fund the IRS at a level that will enable it to meet taxpayer needs and maximize tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden.

TAXPAYER BILL OF RIGHTS

The report urges Congress to codify a Taxpayer Bill of Rights that would clearly list the major rights and responsibilities of taxpayers. "The U.S. tax system is based on a social contract between the government and its taxpayers," Olson wrote. "Taxpayers agree to report and pay the taxes they owe and the government agrees to provide the service and oversight necessary to ensure that taxpayers can and will do so."

Most Taxpayers Don't Know Their Rights. Over the past two decades, Congress has enacted three significant taxpayer rights' bills, but the number of bills and the lack of publicity have muddled the message. The report describes a recent taxpayer survey in which 55 percent of respondents said they did not believe they had rights before the IRS and 61 percent did not know what their rights are.

"I believe taxpayers and tax administration will benefit from an explicit statement of what taxpayers have a right to expect from their government and what the government has a right to expect from its taxpayers," Olson said.

10 Taxpayer Rights. The report recommends that Congress organize taxpayer rights under the following ten broad principles: (1) right to be informed; (2) right to be assisted; (3) right to be heard; (4) right to pay no more than the correct amount of tax; (5) right of appeal; (6) right to certainty; (7) right to privacy; (8) right to confidentiality; (9) right to representation; and (10) right to a fair and just tax system.

5 Taxpayer Responsibilities. To help taxpayers understand what the law requires of them, the report further recommends that Congress organize taxpayer responsibilities under the following five principles: (1) obligation to be honest; (2) obligation to be cooperative; (3) obligation to provide accurate information and documents on time; (4) obligation to keep records; and (5) obligation to pay taxes on time.

The report summarizes recommendations the Advocate has made in past reports to create additional taxpayer rights and recommends that those rights be incorporated into Taxpayer Bill of Rights legislation. "It has been 13½ years since we have had major taxpayer rights legislation," Olson wrote. "Our laws have not kept pace with our notions of procedural fairness in 21st century tax administration, particularly given our tax system's expanded and diverse taxpayer base and duties."

OTHER KEY ISSUES ADDRESSED

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 22 problems, provides updates on four previously identified issues, makes dozens of recommendations for administrative change, proposes 13 recommendations for legislative change, and analyzes the 10 tax issues most frequently litigated in the federal courts.

Among other things, the report contains:

- A comprehensive overview of the nearly 100-year history of the U.S. tax system, which details how the income tax expanded from a "class tax" to a "mass tax," how the IRS has changed from focusing on personal, local service to automated, centralized processes, and how the mission of the IRS has expanded from pure tax collector to disburser of federal benefits as well.

- An analysis of the IRS's current examination strategy that discusses the IRS's increasing use of automated procedures not technically classified as audits to adjust tax liabilities. The report argues that these procedures deprive taxpayers of traditional audit rights and make it difficult for taxpayers to discuss their cases directly with an IRS examiner.

- A research study on the impact of tax liens on taxpayer compliance behavior. The results suggest the overuse of liens may undermine tax collection by reducing payment compliance, reducing filing compliance, and reducing the amount of income earned (and thus the amount of tax due) by taxpayers against whom liens have been filed.

- A recommendation that Congress modify the circumstances under which the personal information of decedents, including their names, Social Security numbers, and dates of birth, are made available to the public shortly after their deaths. Such information is used by identity thieves to commit tax fraud.

- A "Most Serious Problem" discussing the IRS's policy change in applying key terms of the IRS's 2009 Offshore Voluntary Disclosure Program more than a year after the application deadline had passed. The report states that the policy change contravenes the IRS's written pledge that "under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes."

- An update on the IRS's progress in developing and implementing a system to register and test federal tax return preparers.

- A recommendation that Congress authorize the IRS to issue refunds in hardship cases during a government shutdown. When a government shutdown seemed imminent during the 2011 filing season, the IRS and the Treasury Department concluded that the IRS would have been legally barred from paying certain refunds or taking other actions that would benefit or minimize harm to taxpayers during the shutdown.

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 taxpayers 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 1-877–777–4778 (toll-free). For more information, go to www.TaxpayerAdvocate.irs.gov or www.irs.gov/advocate.

Page Last Reviewed or Updated: January 13, 2012