

Honorable Members of Congress:

I respectfully submit for your consideration the National Taxpayer Advocate's 2012 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.

As this report goes to press, it appears an agreement has been reached to patch the Alternative Minimum Tax. For taxpayers and the IRS, that is extremely good news. The IRS systems that process tax returns cannot generally be programmed to accommodate alternative scenarios. As the IRS Commissioner has said, the IRS made a risk-based decision to program its systems on the assumption that an AMT patch would be passed, and if a patch was not enacted, the start of the filing season would have been delayed from January to late March or possibly later for the significant majority of taxpayers. That would have brought about the most chaotic filing season in memory. I am hopeful and relieved that that near-crisis seems to have been averted.

Since the election, the dominant issue before Congress has been the so-called "fiscal cliff." While that term seems to mean different things to different people, it encompasses three critical issues from a tax administration perspective — tax complexity, the Alternative Minimum Tax, and the risk that sequestration or alternative budget cuts will further weaken the IRS's ability to serve taxpayers and collect the revenue upon which the rest of government depends.

Consider the following:

- **Tax Complexity.** An analysis of IRS data by the Office of the Taxpayer Advocate shows it takes U.S. taxpayers (both individuals and businesses) more than 6.1 billion hours to complete filings required by a tax code that contains almost four million words and that, on average, has more than one new provision added to it daily. Indeed, few taxpayers complete their returns without assistance. Nearly 60 percent of taxpayers hire paid preparers and another 30 percent rely on commercial software to prepare their returns. To inspire confidence and trust, the tax laws should be comprehensible and the computations of tax should be transparent and relatively simple, yet few taxpayers today can confidently say they understand the tax code or even that they have correctly computed their tax liabilities.¹ In this report, we identify tax complexity as the #1 most serious problem facing taxpayers, and we recommend (as we have in prior reports) that Congress vastly simplify the tax code to make tax compliance easier. We offer both conceptual and specific suggestions for Congress to consider as it moves forward.
- **Alternative Minimum Tax.** Taxpayers spent about 18 million hours for the 2000 tax year (the most recent year for which we found data) completing and filling out AMT tax forms and determining whether they owed the tax. The AMT was originally enacted to ensure that the wealthiest U.S. taxpayers pay at least some tax each year by adding back into income certain tax benefits known as "tax preferences." Yet in 2008, 87 percent of all tax preferences that

¹ See Most Serious Problem: *The Complexity of the Tax Code*, *infra*.

gave rise to AMT liabilities was attributable to the disallowance of personal exemptions and the deduction for state and local taxes. Only under the unique logic of the AMT are the acts of having a large family and living in a high-tax state viewed as a tax dodge. As we document in this report, the AMT does not seem to achieve its intended purpose. Many middle and upper-middle class taxpayers pay the AMT, while most wealthy taxpayers do not, and thousands of millionaires pay no income tax at all. At the same time, the AMT adds significant complexity to tax computations, requiring millions of taxpayers essentially to compute their tax liabilities twice — once under the regular tax rules and again under the AMT rules — and then to pay the higher of the two tax amounts. Because the AMT largely fails to achieve its objective and because it adds considerable complexity for so many taxpayers, including millions who don't even end up owing it, we identify the AMT as the #2 most serious problem facing taxpayers, and we reiterate our longstanding recommendation that the AMT be repealed.

- **IRS Funding.** In fiscal year (FY) 2012, the IRS received around 125 million calls. The IRS answered only about two out of three calls from taxpayers trying to reach a live person, and those taxpayers had to wait, on average, about 17 minutes to get through. Meanwhile, at fiscal year end, the IRS had a backlog of more than one million pieces of correspondence (up 188 percent from FY 2004), and almost half of that backlog was overage (up 316 percent from FY 2004). Is it any wonder that some taxpayers give up and stop responding to the IRS?² At the same time that the IRS is not meeting taxpayer needs, it is struggling to close a “tax gap” estimated at nearly \$400 billion a year. In this report, we designate the significant and persistent underfunding of the IRS as the #3 most serious problem facing taxpayers.

To elaborate on this funding challenge, no business would fail to fund a unit that, on average, brought in \$7 for every dollar spent. Shareholders would rebel and bring lawsuits, or at least oust the management or board of directors.

Yet this is precisely what we are doing with the IRS budget. Last year, the IRS brought in federal revenue of about \$2.52 trillion on a budget of \$11.8 billion, for a return-on-investment (ROI) of 214:1. If we cut IRS funding, the IRS Commissioner recently estimated in a letter to Congress that we can expect lower tax collections in an amount seven times as much as the budget cuts. That means fewer dollars to put toward deficit reduction, fewer dollars for military funding, fewer dollars for disaster recovery, fewer dollars for our intelligence services and embassy protection, fewer dollars for an economic safety net, fewer dollars for disaster recovery, fewer dollars for infrastructure renewal, fewer dollars for medical research — in short, fewer dollars for all the things we believe as a nation we should provide for our citizens. It means real harm to real people.

Since FY 2010, the IRS budget has been declining each year, and absent congressional action, it is likely to be reduced more in the coming years, perhaps significantly so, by sequestration or other budget cuts that replace the sequestration mechanism. More than 90 percent of the IRS's taxpayer service and enforcement budget goes for personnel costs, so budget cuts mean that fewer employees

² See Most Serious Problem: *The IRS is Significantly Underfunded to Serve Taxpayers and Collect Tax*, *infra*.

will be available to answer phone calls from taxpayers needing assistance.³ Budget cuts mean that there will be long delays when taxpayers call or write to say there is a mistake on their IRS bill and they don't owe these taxes.⁴ Budget cuts mean that victims of identity theft will have to wait longer than six months to get resolution of their cases and receive their refunds.⁵ Budget cuts mean that because taxpayers couldn't get the assistance they needed when they needed it, they will do things incorrectly. Budget cuts mean that, because of these avoidable problems, taxpayers will face IRS enforcement actions — liens, levies, seizures, audits — that will be automated and initiated without so much as a phone call to the actual taxpayer.⁶ And budget cuts mean that the IRS will not have the trained personnel or technology required to administer the laws properly to close the tax gap.

None of this bodes well for taxpayers. But the harm from budget brinksmanship and last-minute tax law changes goes beyond the immediate impacts I've outlined above. As we report in our Volume Two study, *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*, the factors that are most highly correlated with noncompliance among sole proprietors — the single largest component of the tax gap — are distrust of government, distrust of the IRS, and disbelief in the fairness of our tax system. The fiscal cliff drama reinforces taxpayers' belief that government and the tax system are not helping them.

Under our system of government, it may be inevitable that important decisions about tax policy and federal budgeting are sometimes deferred until the last minute. But the extent of the resulting uncertainty about tax rates, people's take-home pay, the AMT, and the prospect of a delay in the delivery of tax refunds resulting from a delay in the start of the filing season produces disappointment, dismay, and cynicism among taxpayers. The IRS budget cuts likely to come about with sequestration (or replacement cuts), and the virtual freeze on hiring and training that has already occurred because of successive years of continuing resolutions and inadequate funding, erode what little taxpayer service remains in IRS operations and all but ensure that IRS technology will remain in the 20th century, hampering its ability to effectively collect tax and assist taxpayers who are trying to comply. Meanwhile, the complexity creep of the tax code and the menacing shadow of the AMT confirm taxpayers' suspicions that the tax laws are designed to entrap them and obscure what is and is not being taxed.

³ See Most Serious Problem: *The IRS Telephone and Correspondence Services Have Deteriorated Over the Last Decade and Must Improve to Meet Taxpayer Needs*, *infra*.

⁴ See Most Serious Problem: *The Automated Collection System Must Emphasize Taxpayer Service Initiatives to Resolve Collection Workload More Effectively*, *infra*.

⁵ See Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*, *infra*.

⁶ See Introduction: *The IRS "Fresh Start" Initiative Has Produced Significant Improvements in Some Collection Policies; However, Significantly More Emphasis on Service Delivery Is Necessary to Realize the Full Benefits of These Important Changes*, *infra*; Most Serious Problem: *The Diminishing Role of the Revenue Officer Has Been Detrimental To The Overall Effectiveness Of IRS Collection Operations*, *infra*; Most Serious Problem: *The Automated Collection System Must Emphasize Taxpayer Service Initiatives to Resolve Collection Workload More Effectively*, *infra*; Most Serious Problem: *Although the IRS "Fresh Start" Initiative Has Reduced The Number Of Lien Notices Filed, the IRS Has Failed To Determine Whether Its Lien Policies Are Clearly Supported by Either Increased Taxpayer Compliance or Revenue*, *infra*; Most Serious Problem: *Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance*, *infra*; Study: *Study of Tax Court Cases In Which the IRS Conceded the Taxpayer Was Entitled to the Earned Income Tax Credit (EITC)*, *infra*; and Study: *Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior*, *infra*.

The fiscal cliff also deflects attention from other priority issues in tax administration, including the 20 other most serious problems we identify in this report. At its most basic level, insufficient funding drives the IRS to reduce its meaningful interaction with taxpayers and replace it with automated enforcement mechanisms. This approach can erode fundamental taxpayer rights and protections. We see evidence of this erosion in the IRS's failure to provide adequate assistance to victims of identity theft or return preparer fraud;⁷ its insistence on draconian penalties against taxpayers with overseas accounts, irrespective of their benign purpose;⁸ its inadequate use of installment agreements and offers in compromise for taxpayers, particularly with respect to business taxpayers and taxpayers experiencing economic hardship;⁹ and its abandonment of an education and compliance presence in local communities.¹⁰ All of these are problems for which solutions exist and about which my office has made practical recommendations.

Yet throughout this report, the IRS responses to our analysis and recommendations often seem to miss the basic point or are otherwise unpersuasive. What underlies these responses is the understandable IRS concern that it does not have the resources to make the improvements that are so obviously needed, so it is better to rationalize the *status quo* or commit to only those improvements it can afford currently, rather than try to make the case for more funding or for reallocating current funding. The current budget crisis and recurring continuing resolutions exacerbate this IRS tendency.

This is no way to run a tax system. What the IRS — and its taxpayers — need is a stable funding mechanism for the IRS that allows it to educate its taxpayers about their tax obligations, provide assistance to taxpayers when they need it, work with taxpayers who are trying to comply but aren't in compliance for one reason or another (including economic hardship), enforce the tax laws against those who seek to evade reporting their taxable income or paying their tax liabilities, and generally seek to increase the amount of taxes paid voluntarily.

What the IRS — and its taxpayers — have now is an unstable funding mechanism that treats the IRS like any other government spending program instead of the revenue center or accounts receivable function that it is. The IRS must compete for funding with the rest of the government agencies that rely on IRS collections to accomplish their missions. The plain truth is that the IRS's mission trumps all other agencies' missions — because without an effective revenue collector you can't fund those other agencies. Certainly, Members of Congress may disagree about the appropriate level of taxation. But whatever level is written into law, there can be little disagreement that taxpayers should receive the assistance they need to comply, and the laws should be enforced so

⁷ See Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*, *infra*; Most Serious Problem: *The IRS Harms Victims of Return Preparer Misconduct by Failing to Resolve Their Accounts Fully*, *infra*.

⁸ See Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Programs Discourage Voluntary Compliance by Those Who Inadvertently Failed to Report Foreign Accounts*, *infra*.

⁹ See Introduction: *The IRS "Fresh Start" Initiative Has Produced Significant Improvements in Some Collection Policies; However, Significantly More Emphasis on Service Delivery Is Necessary to Realize the Full Benefits of These Important Changes*, *infra*; Most Serious Problem: *The Diminishing Role of the Revenue Officer Has Been Detrimental To The Overall Effectiveness Of IRS Collection Operations*, *infra*; Most Serious Problem: *Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance*, *infra*.

¹⁰ See Most Serious Problem: *The IRS Is Substantially Reducing Both the Amount and Scope of Its Direct Education and Outreach to Taxpayers and Does Not Measure the Effectiveness of Its Remaining Outreach Activities, Thereby Risking Increased Noncompliance*, *infra*.

that everyone pays their fair share of tax and we have a level playing field. Without an effective tax collector, honest taxpayers end up paying more to subsidize noncompliance by others, and we don't raise the funds our government requires. And that state of affairs is not sustainable.

In this and previous reports, we have proposed a solution to the problem of IRS funding.¹¹ It is really very simple in concept: fence off — or “sequester,” if you will — IRS funding from the rest of the federal budget. Determine what level of revenue the IRS needs to collect for the government to do what we want it to do, and then determine what the IRS needs to collect that revenue — in a way that maximizes (voluntary) compliance, protects taxpayer rights, and minimizes taxpayer burden. The return on investment in the IRS should be guaranteed to be greater than 1 to 1. And if we simultaneously set goals for the IRS in terms of taxpayer service, victim assistance, online services, and voluntary compliance while funding research, development, and innovation, we may well exceed our ROI expectations. We might actually end up with the 21st century tax administration we deserve rather than the heroically struggling, overwhelmed one that we have.

Looking forward, the year 2013 is shaping up to be an active one from the standpoint of tax policy. As Congress moves forward on these fronts, I urge you to keep in mind the impact of various legislative proposals on the taxpayer and on the IRS's ability to administer the proposals effectively and fairly. As the National Taxpayer Advocate, I hope 2013 brings about fundamental tax simplification, repeal of the Alternative Minimum Tax, and a new approach toward funding the IRS that ensures the agency can do a better job of meeting taxpayer needs and collecting the revenue that funds virtually all other government operations. I also hope the IRS makes progress in addressing the growing problem of tax-related identity theft and particularly improves its performance in providing timely and effective assistance to identity-theft victims and preparer fraud victims as well as taxpayers who are struggling to comply with their tax obligations.

I respectfully submit this report to Congress for your consideration and action, and I stand ready to assist you in any way that I can.

Sincerely,



Nina E. Olson
National Taxpayer Advocate
31 December 2012

¹¹ See Most Serious Problem: *The IRS Is Significantly Underfunded to Serve Taxpayers and Collect Tax*, *infra*; see also National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

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