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National Taxpayer Advocate Delivers Annual Report to Congress; Urges IRS Reform and Tax Reform

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WASHINGTON — National Taxpayer Advocate Nina E. Olson today released her [2016 annual report to Congress](#), recommending that the IRS revamp its “*Future State*” plan to adopt a taxpayer-centric focus and urging Congress to emphasize simplification when it considers tax reform later this year.

In assessing the compliance burdens of the current tax code, the Taxpayer Advocate Service (TAS) analyzed IRS data and determined that individuals and businesses spend about six billion hours a year complying with the code’s filing requirements – not including the millions of additional hours spent responding to IRS audits or notices. “If tax compliance were an industry, it would be one of the largest in the United States,” the report says. “To consume six billion hours, the ‘tax industry’ requires the equivalent of three million full-time workers.” (More on tax reform below.)

NATIONAL TAXPAYER ADVOCATE VISION FOR A TAXPAYER-CENTRIC 21ST CENTURY TAX ADMINISTRATION

Background

In the National Taxpayer Advocate’s 2015 report, Ms. Olson raised concerns about the IRS’s development of a comprehensive *Future State* plan describing how the agency will operate and interact with taxpayers in five years and beyond. In particular, the report criticized the IRS for developing the plan without public consultations and for placing heavy emphasis on transitioning taxpayers from telephone to online services without considering significant evidence that taxpayers often need or prefer to speak with an IRS employee.

In her new report, Ms. Olson says the IRS has been responsive to her concerns. It has made considerable information about its *Future State* plan available on IRS.gov, it has discussed details of the plan with stakeholder groups, and the Commissioner has personally provided public assurances that the IRS will continue to provide telephone and face-to-face services to taxpayers who prefer to interact with the IRS in those ways. In addition, the IRS has said the *Future State* is more an evolving approach than a static plan and will be modified over time.

While the National Taxpayer Advocate is pleased with the steps the IRS has taken, she recommends the IRS adopt a fundamentally different approach to tax administration. Last

year, Ms. Olson announced she would gather broader perspectives about taxpayer needs and preferences and then present her own recommendations for the IRS's future state. During 2016, she held 12 public forums around the country, most along with Members of Congress who have a strong interest in tax administration, to hear from taxpayers and other stakeholders. In addition, TAS held focus group interviews with practitioners and preparers at each of the five Nationwide Tax Forums, and commissioned a nationwide survey of taxpayers to collect statistically representative data. Based on this information, she presents a "Special Focus" in this year's report that sets out her own vision for the tax agency. "This is arguably the most important piece I have written about the IRS in my fifteen years serving as the National Taxpayer Advocate," Ms. Olson wrote.

Putting Taxpayers First

Ms. Olson presents a series of proposals to improve tax administration, placing particular emphasis on changing the culture of the IRS. "To create an environment that encourages taxpayer trust and confidence, the IRS must change its culture from one that is enforcement-oriented to one that is service-oriented," she says.

Ms. Olson says the IRS for decades has viewed itself first and foremost as an enforcement agency, and she expresses concern that its "enforcement first" approach continues to predominate even as the agency is developing its *Future State* plan:

- Of the IRS's current appropriated budget of \$11.2 billion, 43 percent is allocated to enforcement, while less than six percent is allocated to taxpayer outreach and education activities. Despite this imbalance, [the IRS budget request for FY 2017](#) sought an increase in enforcement funding of 7.2 percent, as compared with just 3.1 percent for taxpayer services.
- The IRS's proposal to increase enforcement funding by more than taxpayer services funding was made against a backdrop in which the agency has been unable to meet basic taxpayer needs. Of particular note, the IRS annually receives more than 100 million telephone calls. Yet among calls routed to its telephone assistants, the IRS was able to answer only 38 percent in FY 2015 and 53 percent in FY 2016, and taxpayers who managed to get through were kept on hold for an average of 30 minutes and 18 minutes, respectively, in those years.
- The IRS for more than a decade has published annual "[Enforcement and Service Results](#)" on its website. These consist of five pages of enforcement data (including audit rates for individuals and business entities, enforcement dollars assessed, enforcement dollars collected, liens filed, levies issued, and criminal indictments and convictions), as compared with one page of taxpayer service data at the end. The report points out that in a large organization, "you get what you measure."
- Each of the IRS's four business operating divisions began by developing its own *Future State* plan and an accompanying "[taxpayer vignette](#)" that the IRS has posted on its website to illustrate how its vision of the future state will work. Each vignette shows the IRS contacting a taxpayer to conduct an audit or otherwise challenge a

taxpayer's return, and in every case, the vignette shows the taxpayer ultimately conceding the IRS is correct and consenting to the IRS's proposed adjustment – all in a digital environment. That all four operating divisions chose to illustrate their *Future State* by showing that they were right and the taxpayer was wrong is concerning, the report says. “Nowhere did [any] vignette demonstrate how the taxpayer could prevail in the system of the future,” it adds.

- In the IRS Restructuring and Reform Act of 1998, Congress directed the IRS to “restate its mission to place a greater emphasis on serving the public and meeting taxpayers’ needs.” In response, the IRS adopted the following mission statement: “Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and *by applying the tax law* with integrity and fairness to all.” (Emphasis added.) In 2009, with no public discussion, the IRS quietly changed its mission statement to read: “Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and *enforce the tax law* with integrity and fairness to all.” (Emphasis added.) “This shift in tone and emphasis, from ‘apply’ to ‘enforce,’ has significant consequences for taxpayers, and is closely related to the issue of agency culture,” Ms. Olson wrote.

Service Emphasis and Trust Can Increase Tax Compliance

If the IRS views its primary mission as “enforcing” the tax laws, it will design its procedures and apply its resources to “hunt down” taxpayers whom it views as noncompliant, the report says. “In an enforcement-oriented tax agency, if taxpayers don’t get the help they need to comply and they make a mistake, they are treated as if they are tax evaders. This treatment in turn breeds resentment and increases the risk that the taxpayer who was willing to comply is no longer willing to do so. In this way, the underlying assumption by the tax agency that taxpayers will evade tax becomes a self-fulfilling proposition. The agency ends up converting a compliant taxpayer into a noncompliant one.”

The report goes on to articulate an alternative vision: “What if the tax agency adopted a different approach toward taxpayers? What if it assumed that taxpayers, by and large, wanted to obey the law and that the primary mission of the tax agency was to facilitate that compliance by providing taxpayers with the assistance, education and clarity they need to meet their tax obligations? What if we started out accepting that taxpayers will make mistakes and, until proven otherwise, assume those mistakes are not attributable to a tax evasion motive? Because, after all, tax noncompliance like all of human behavior is driven by a broad spectrum of factors, from just plain carelessness to ignorance to confusion to polemics to avarice. By focusing on the source or reasons for the taxpayer’s noncompliance and not just on the end result of the taxpayer’s behavior, we have a better chance of changing the taxpayer’s behavior and improving tax compliance going forward.”

“This is not to say we should ignore those who are actively evading tax. Rather, it is to say we should *design* our tax system around the taxpayers who are trying to comply, instead of those who are actively trying not to.” This approach, Ms. Olson says, has the best chance to simultaneously meet taxpayers’ needs and improve long-term tax compliance.

The report says that significant cuts to the IRS budget since FY 2010 have limited the IRS's ability to meet taxpayers' needs and improve its technology systems. It recommends that Congress provide the IRS with additional funding and conduct more rigorous oversight so it can be assured the funding is well spent.

The full *Special Focus* discussion can be accessed here:

<https://taxpayeradvocate.irs.gov/reports/2016-annual-report-to-congress/special-focus>

SIMPLIFICATION OF THE TAX CODE

"It has now been more than 30 years since Congress enacted the Tax Reform Act of 1986 to substantially simplify the tax code," the report says, "and since that time, the code has grown more complex by the year, as evidenced by the fact that Congress has made more than 5,900 changes to the code – an average of more than one a day – just since 2001. The compliance burdens the tax code imposes on taxpayers and the IRS alike are overwhelming, and we urge Congress to act this year to vastly simplify it."

"Tax Expenditures," in Relative Terms, Harm Unsophisticated Taxpayers

The report says the tax code, which runs several million words, contains more than 200 tax deductions, credits, exclusions, and similar tax breaks, known collectively as "tax expenditures." In combination, the Treasury Department has estimated that tax expenditures in FY 2016 came to \$1.42 trillion – more than Congress appropriated to fund the entire federal government.

Complexity "rewards taxpayers who can afford expensive tax advice and discriminates against taxpayers who cannot," the report says. Given the number and complexity of tax expenditures, sophisticated taxpayers – or taxpayers who can afford to hire sophisticated tax advisors – are likely to claim most benefits for which they are eligible, while less sophisticated taxpayers often will miss them.

"The tax liability of an individual or a business should depend solely on how much is owed under the law – not on the taxpayer's or preparer's expertise in the law," the report says. "A simpler tax code would go a long way toward solving this problem and ensuring that similarly situated taxpayers pay the same tax."

Policy Trade-Offs

The report acknowledges that the most costly tax expenditures benefit large numbers of taxpayers, and simplifying the tax code requires difficult policy trade-offs.

For example, the employer exclusion for medical insurance premiums and medical care is designed to encourage employers to provide health insurance coverage for their employees. The various tax breaks for retirement plan contributions and earnings, such as Section 401(k) plans and Individual Retirement Accounts (IRAs), are designed to encourage retirement savings. The deduction for charitable contributions is designed to encourage greater financial support for nonprofit organizations. The deduction for

mortgage interest is designed to encourage home ownership. The elimination of these benefits could have undesirable effects – less health insurance, less retirement savings, smaller charitable contributions, and less home ownership, the report says.

Zero-Based Budget Approach Recommended

Despite the popularity of many tax expenditures, the report urges comprehensive tax simplification. “We believe that taxpayers will support tax reform by wide margins if they better understand the trade-offs involved and can be part of an informed dialogue,” the report says. “If tax reform is enacted on a revenue-neutral basis, the average taxpayer’s bill will not go up, and taxpayers will be much happier to have a simpler and more transparent system. They will understand how much tax they are paying, they will understand how their tax is computed, and many will save time and money because they no longer will have to pay fees to have their returns prepared.”

Ms. Olson makes clear she is not recommending the elimination of all tax expenditures. Rather, the report recommends that Congress aim to simplify the tax code significantly and use a “zero-based budgeting” approach. “The starting point for discussion would be a tax code without any exclusions or reductions in income or tax,” the report says. “A tax break or IRS-administered social program would be added back only if lawmakers decide, on balance, that the public policy benefits of running the provision or program through the tax code outweigh the tax complexity burden the provision creates for taxpayers and the IRS. At the end of the exercise, tax rates can be set at whatever level is required to raise the amount of revenue that Congress determines is appropriate.”

The report highlights several areas of complexity that it recommends Congress address, either as part of comprehensive tax simplification or on a stand-alone basis. They include repealing the Alternative Minimum Tax for individuals, consolidating the family status provisions in the tax code, consolidating at least 12 incentives to save or spend for education, consolidating at least 15 incentives to save for retirement, simplifying worker classification determinations to minimize employee-versus-independent-contract disputes, eliminating or reducing procedural incentives to enact tax provisions that expire and require periodic renewal (sunsets), eliminating or reducing the gradual phase-out of tax benefits as income rises, and streamlining the more than 170 civil penalties contained in the tax code.

Restructuring Family Status Provisions to Reduce Taxpayer Burden and Increase Tax Compliance

The report contains a separate section that proposes to simplify one of the most complex set of provisions in the tax code – the family status-related provisions. These provisions include filing status, personal and dependency exemptions, the child tax credit and additional child tax credit, the earned income tax credit, the child and dependent care credit, and the separated spouse rule under section 7703(b) of the tax code.

“While literally every tax return involves at least two of the Family Status provisions, the IRS is hard-pressed to independently verify the accuracy of the status claimed,” the report says. “Over the years, it has used different government databases and developed ‘rules’ that

assist it in identifying questionable claims of filing status or credits. But these rules fail to account for the fluid nature of household composition.”

To reduce taxpayer burden and increase tax compliance, the report recommends that Congress consolidate the existing family status-related provisions into two categories: (1) a Family Credit and (2) an Earned Income Tax Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Earned Income Tax Credit would provide a work incentive and subsidy for low income individuals.

OTHER KEY ISSUES ADDRESSED

Federal law requires the Annual Report to Congress to identify at least 20 of the “most serious problems” encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems. Overall, this year’s report identifies 20 problems, makes dozens of recommendations for administrative change, makes 10 recommendations for legislative change, and analyzes the 10 tax issues most frequently litigated in the federal courts.

Among the problems addressed are the following:

Taxpayer Bill of Rights. The report credits the IRS with adopting the Taxpayer Bill of Rights and conducting an extensive public outreach campaign to make the public aware of it. However, despite a directive in the Protecting Americans from Tax Hikes Act of 2015 that the Commissioner “ensure that employees of the Internal Revenue Service are familiar with and act in accord with” the Taxpayer Bill of Rights, the report says the IRS has not done enough to educate its employees and incorporate the Taxpayer Bill of Rights into its operations.

Fraud Detection and Refund Delays. The report credits the IRS with improving its detection of refund fraud and identity theft on submitted tax returns but expresses concern that the agency’s fraud detection filters have a high degree of inaccuracy and thereby cause significant headaches and refund delays for hundreds of thousands of taxpayers who file accurate returns. During 2016, many of the filters and business rules the IRS used to detect bogus claims had false positive rates in excess of 50 percent, meaning that more than half the returns flagged were legitimate. One process had a false positive rate of about 91 percent.

Private Debt Collection. The report describes the IRS’s implementation of the private debt collection program mandated by Congress. It expresses concern that the IRS Office of Chief Counsel has provided questionable legal advice that may constitute “a results-oriented end-run around the statute.” Specifically, section 6306 of the tax code authorizes the IRS to enter into qualified tax collection contracts in which private collection agencies may “request full payment” from a taxpayer or, if the taxpayer cannot make full payment, “offer the taxpayer an installment agreement providing for full payment . . . during a period not to exceed five years.” Notwithstanding that this authority only authorizes private collection agencies to collect “full” payments during a period “not to exceed five years,” the

Office of Chief Counsel has opined that private collection agencies may make repeated calls to taxpayers to request partial payments and may effectively offer installment agreements that exceed five years by obtaining “IRS approval of a taxpayer’s request.”

TAS RESEARCH STUDIES AND LITERATURE REVIEWS

Volume 2 of the report contains five new research studies, including a study examining the effect of IRS service delivery choices on different demographic groups; a study of the subsequent filing behavior of taxpayers who claimed the Earned Income Tax Credit, apparently in error, and were then sent an educational letter from the National Taxpayer Advocate; and the importance of IRS financial analysis when placing taxpayers into installment agreements to minimize the likelihood of defaults and future noncompliance.

For the first time, the National Taxpayer Advocate’s report also contains a third volume that presents literature reviews on seven tax administration topics that reflect information gathered from related fields, such as psychology, organizational theory, network theory, and marketing. The literature reviews present information on taxpayer service in other countries, incorporation of taxpayer rights in tax administration, behavioral science lessons for tax compliance, geographic considerations for tax administration, customer considerations for online accounts, options for alternative dispute resolution, and reductions of “false positive” determinations in fraud detection.

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Please visit www.TaxpayerAdvocate.irs.gov/2016AnnualReport for more information.

Related Items:

- [Complete Report: 2016 Annual Report to Congress](#)
- Executive Summary:
https://taxpayeradvocate.irs.gov/Media/Default/Documents/2016-ARC/ARC16_ExecSummary.pdf

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About the International Conference on Taxpayer Rights

The National Taxpayer Advocate has organized and will convene the second International Conference on Taxpayer Rights in Vienna, Austria, on March 13-14, 2017. The conference will be hosted by the Institute for Austrian and International Tax Law at WU (Vienna University of Economics and Business) and sponsored by Tax Analysts. Registration is now open on the [Taxpayer Rights Conference](#) website. The conference will bring together government officials, scholars, and practitioners from around the world to explore how global taxpayer rights serve as the foundation for effective tax administration. The inaugural International Conference on Taxpayer Rights, organized by the National

Taxpayer Advocate in 2015, attracted more than 170 attendees from 22 countries. “The first conference was a great success and an important step toward developing an understanding of best practices,” Ms. Olson said. “I’m delighted there has been strong interest in institutionalizing international conferences on taxpayer rights to share ideas and build on our success.”

About the Taxpayer Advocate Service

The Taxpayer Advocate Service (TAS) is an *independent* organization within the Internal Revenue Service (IRS) that helps taxpayers and protects taxpayer rights. Your local advocate’s number is in your local directory and at <https://www.taxpayeradvocate.irs.gov/contact-us>. You can also call TAS toll-free at 1-877-777-4778. TAS can help if you need assistance resolving an IRS problem, if your problem is causing financial difficulty, or if you believe an IRS system or procedure isn’t working as it should. And our service is free. For more information about TAS and your rights under the Taxpayer Bill of Rights, go to www. taxpayerAdvocate.irs.gov. You can get updates on tax topics at facebook.com/YourVoiceAtIRS, Twitter.com/YourVoiceatIRS, and YouTube.com/TASNTA.