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Transforming the Internal Revenue Service

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EXECUTIVE SUMMARY

The 2022 Inflation Reduction Act (IRA) authorizes \$80 billion in additional funding over 10 years for the Internal Revenue Service (IRS), with the lion's share going to increased enforcement. The Biden administration claims that the funding—enough to double the IRS workforce—will lead to the collection of hundreds of billions of dollars of unpaid taxes.

Even if those higher revenues are realized, they would come at a high cost to the private sector. Although increased enforcement is often characterized as combating tax cheats, more-aggressive IRS enforcement would likely mean strong-armed actions against millions of individuals and

businesses who are either blameless or who have made good-faith efforts to comply with the federal tax code, including middle- and lower-income Americans who are the least able to defend themselves.

Instead of giving more money for enforcement with little or no accountability, policymakers should transform IRS operations and management. Oversight agencies and think tanks have proposed technological and structural reforms to improve IRS administration while reducing the economic losses that federal tax rules impose on individuals and businesses and supporting civil liberties protections for taxpayers.



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INTRODUCTION

Nearly every American interacts directly or indirectly with the IRS. It annually collects almost \$5 trillion in individual income, corporate income, and payroll taxes by processing 261 million returns and forms. In 2021, 80 million taxpayers called or visited the IRS for assistance. The agency also administers complex “spending through the tax code” programs, such as the Earned Income Tax Credit (EITC); the Child Tax Credit (CTC); and the recent but now discontinued pandemic relief checks. In addition, the IRS has vast powers to levy interest and penalties, garnish wages, and seize a taxpayer’s assets to satisfy tax obligations.

The IRS often portrays itself as impoverished and out-gunned. When people ask the IRS why it answers only a small share of phone queries, why it has months-long mail backlogs, and why it aggressively chases taxpayers who make honest mistakes, the IRS blames a lack of money. However, the root causes of IRS dysfunction are poor management, insufficient oversight, and a mindset fixated on enforcement at the expense of service.

MISMANAGEMENT AND ANTIQUATED SYSTEMS

Buried in Paper

The National Taxpayer Advocate is an office of the IRS tasked with looking out for the interests of taxpayers. Recently, the current National Taxpayer Advocate, Erin Collins, told Congress, “Paper is the IRS’s kryptonite, and the agency is still buried in it.”¹ That is true because of the IRS’s antiquated approach to collecting taxes and administering spending through the tax code. The IRS receives 4.7 billion pieces of information each year, primarily through Forms 1042-S (foreign person’s income in the United States); 1098 (mortgage interest); 1099 (miscellaneous income); 5498 (retirement contributions); W-2 (wage income); W-2G (gambling winnings); and K-1 (pass-through income); as well as copies of forms provided to the Social Security Administration.² Most of this information is provided in digital form.

An automated system compares this information with what has been self-reported by each taxpayer, and any

discrepancy generates an automated letter to the taxpayer demanding that any resulting amount owed be paid within 30 or 60 days or, alternatively, the taxpayer must submit an explanation as to why they are innocent.³ The IRS’s goal is to respond to such correspondence within 45 days, but it has recently taken six months or longer.⁴ Failure to resolve the matter results in a fuller audit or a deficiency notice, which, depending on circumstances, the taxpayer can appeal to the IRS Office of Appeals, the independent Tax Court, or a federal judge. Over a million taxpayers receive such a letter each year and most agree to pay. A key objective of the current IRS management is to obtain more data from more sources to feed into this relatively automated process.

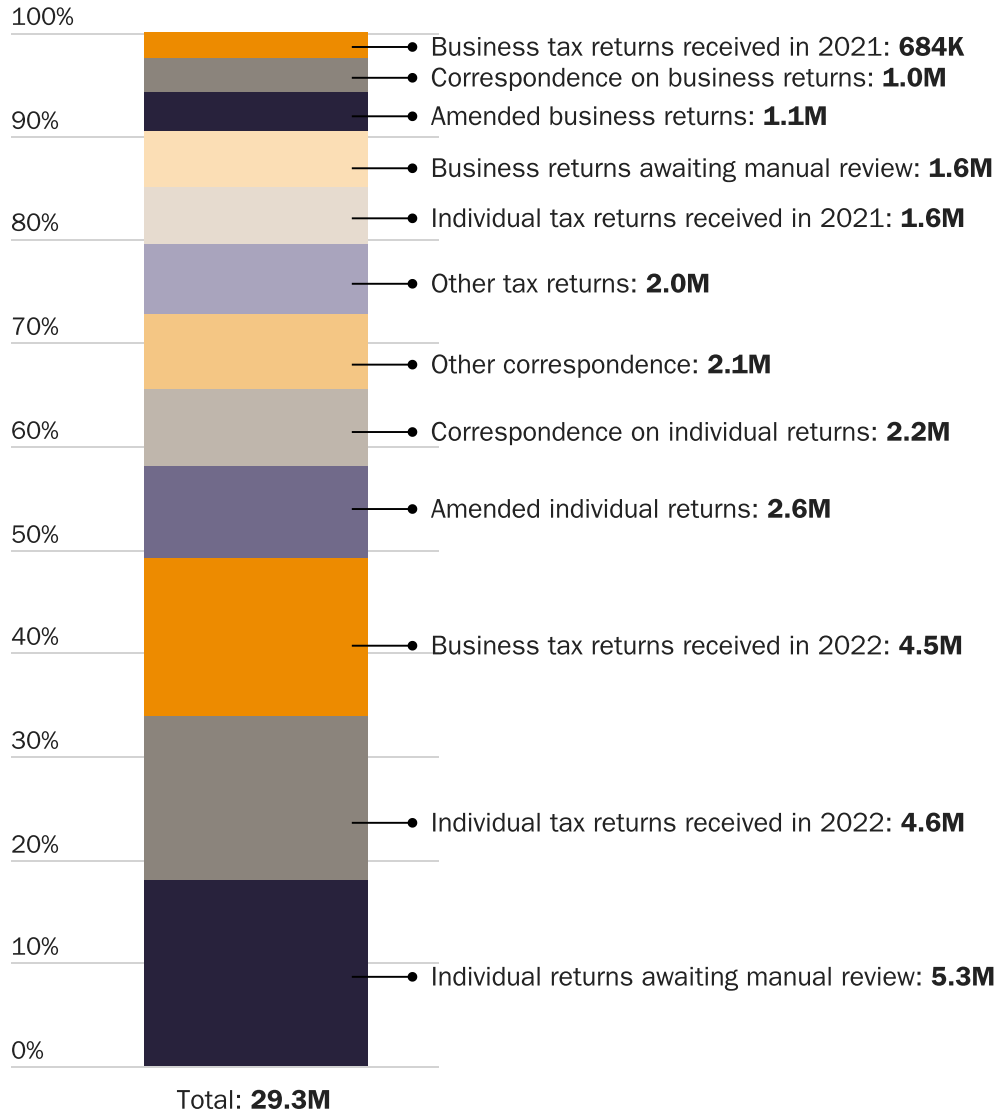
“The root causes of IRS dysfunction are poor management, insufficient oversight, and a mindset fixated on enforcement at the expense of service.”

However, much taxpayer information is also received on paper and is processed manually. For the past two years, the IRS has stored much of the paper in dozens of tractor-trailers that have regularly surrounded the IRS’s main processing facility in Ogden, Utah. Unable to keep up with the processing, the IRS has been buried under millions of pieces of unopened mail and unprocessed tax returns (see Figure 1). As of December 2022, it still had nearly eight million unprocessed and suspended individual returns.⁵

In contrast to the automated system for digital information, the IRS must still process 33 million paper tax returns each year. While 91 percent of individual returns are filed digitally, only 69 percent of business returns are filed digitally. One reason for the low rate of business digital filing is that the IRS does not accept digital filing for many of its forms. Form 1040-X, the amended tax return, is always processed on paper, even if a taxpayer submits it digitally. The IRS processes paper submissions at a rate of between 200,000 and 250,000 returns per week, and since many filings are clustered around due dates, a backlog is inevitable.

Figure 1

Composition of the paper backlog, April 2022



Sources: National Taxpayer Advocate, Internal Revenue Service.

Buried in Phone Calls

The backlog extends to the phone, leading the National Taxpayer Advocate to describe the 2021 IRS telephone service as “the worst it has ever been.”⁶ With the IRS tasked with providing pandemic relief checks, phone calls to it during the filing season grew from 39 million in 2019 to 195 million in 2021.⁷ But taxpayers needing answers from the IRS have had no choice but to wait: the IRS answered the phone only about 11 percent of the time, and those lucky people got through after waiting an average of 29 minutes in 2022.⁸ Before the pandemic, in 2016–2017, enQ, a communication services firm that connects tax

professionals with IRS agents, telephoned the IRS ten thousand times as an experiment and determined that the average hold time was 70 minutes. Of these calls, 28 percent received “courtesy disconnects,” which is the IRS’s term for hanging up on someone who has been on hold for 90 to 120 minutes and advising that the person should call another time because of extreme call volume.⁹ Consumer rankings of customer service place the IRS dead last out of 221 private sector and government entities.¹⁰ As the National Taxpayer Advocate commented, “If a private company failed to answer nine out of ten customer calls, customers would go elsewhere.”¹¹

Delays, Delays, and More Delays

The IRS takes over 350 days to resolve cases for the more than 300,000 taxpayers who cannot access their tax refunds because identity thieves have already filed a return using their information. For more ordinary correspondence and disputes, the IRS takes an average of 251 days to respond.¹²

For these problems, the IRS has blamed a lack of funding, COVID-19 restrictions that limited in-person operations, and the current hiring crunch affecting the broader economy. But long after in-person work resumed and the private sector and other government agencies began catching up, the agency still has a months-long backlog of unprocessed tax returns and unopened mail. The IRS's problems with answering the phone, responding to taxpayer inquiries in a timely manner, and adopting modern technology predate the pandemic.

“The Treasury Department’s inspector general estimates that the IRS could save more than \$200 million a year in labor costs by ending the manual processing of mass paper filing.”

COVID-19 would be a useful excuse, but the IRS's woes are caused more by its ineffective use of past funds that were intended to modernize its operations. The IRS continues to demonstrate resistance to modern technology and an unwillingness to accept that most taxpayer errors are not deliberate but are instead honest mistakes from good-faith efforts to follow confusing rules.

IRS personnel manually enter paper returns into the IRS system, resulting in a keypunch error rate between 22 percent and 43 percent.¹³ In 2019, the Office of Management and Budget (OMB) directed that all federal agencies create, retain, and manage all future records in electronic format.¹⁴ In March 2022, the National Taxpayer Advocate ordered the implementation of 2-D barcoding or other scanning technology to make paper returns machine-readable.¹⁵ The IRS has ignored both directives and has yet to set a goal to implement barcoding or optical scan technology on a broad basis.¹⁶ The Treasury Department’s inspector general estimates that the IRS could save more

than \$200 million a year in labor costs by ending the manual processing of mass paper filing.¹⁷

Anecdotes suggest additional costs are imposed by the IRS’s labor-intensive and antiquated focus on paper-return processing. In March 2021, the IRS destroyed 30 million paper-filed information returns, such as Form 1099, because delayed processing took it past the calendar year and the IRS computer system could no longer enter the information.¹⁸ The Treasury inspector general reported that the IRS lost out on \$56 million in bank interest in 2021 by cashing checks long after they were received because of an inability to open mail quickly—or even just opening the mail containing checks quickly. The inspector general reported that equipment enabling that function would cost less than a million dollars.¹⁹ The IRS operations at its Kansas City facility ground to a halt because a vendor stopped servicing printers and copiers, and employees went for months having to do their jobs with little of the needed equipment until the inspector general intervened.²⁰

While most of the private sector and many government agencies have embraced modern tools, such as email, text chat, digital attachment uploads, and online accounts where customers can view documents, access services, and seek customer support, the IRS has done little more than run periodic pilot programs.²¹ When the IRS does launch online tools, they are not very useful. For example, the IRS’s “Where’s My Refund?” webpage has received hundreds of millions of inquiries, but it does not tell taxpayers where their return is in the process, why it is delayed, if it is delayed, or what a taxpayer should do, leading the National Taxpayer Advocate to quip that the “IRS’s ‘Where’s My Refund?’ tool often could not answer that question.”²² Some paid tax preparers have access to an online portal, but correspondence between them and the IRS is not available on the portal because that is maintained on a separate system, and joint filers cannot see certain items such as the Child Tax Credit unless both spouses have accounts. The National Taxpayer Advocate observed that “tens of millions of taxpayers were forced to wait extraordinarily long periods of time for the IRS to process their tax returns, issue their refunds, and address their correspondence.”²³

JUDGE, JURY, AND EXECUTIONER

Many federal agencies are mismanaged and inefficient, but IRS mismanagement is a more serious problem because

it has uniquely broad powers to seize money, impose penalties, disrupt lives, and close down businesses. “The power to tax involves the power to destroy,” as Chief Justice John Marshall once observed, and vast powers to tax are accompanied by the vast potential to destroy.²⁴

The scope and use of these powers might be excusable if the IRS were managed with efficiency, honesty, and integrity. But the IRS is not well-run, as shown by the delays, the frequent errors in calculating tax amounts, the leaks and thefts of private tax return information, and other failures. The solution is not additional funding without constraints but ensuring that the IRS’s extraordinary powers come with extraordinary checks and balances that protect individual rights.

The IRS’s Extraordinary Powers

The IRS has vast powers to grab personal records, undermining normal Fourth Amendment protections such as a requirement to show probable cause before searches and seizures. The Fourth Amendment to the U.S. Constitution states, “The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.” Generally, federal and state officials, before conducting a search or making an arrest, must have probable cause, meaning “facts and circumstances within their knowledge and of which they had reasonably trustworthy information . . . sufficient to warrant a prudent man in believing that the [suspect] had committed or was committing an offense.”²⁵

Historically, officials who search or seize property outside of those bounds are considered trespassers, and the evidence obtained is inadmissible in court.²⁶ However, federal tax law allows the IRS to summon witnesses or obtain records from any person without showing probable cause or obtaining a court order, and the U.S. Supreme Court held in 1964 that the IRS “need not meet any standard of probable cause to obtain enforcement of [IRS] summons.”²⁷ Challenging an IRS action on Fourth Amendment grounds is therefore very difficult, with courts only concerned that the IRS shows “good faith compliance with summons requirements” as “demonstrated by the affidavit of the IRS agent.”²⁸

In tax matters, unlike other criminal law, the burden of proof is generally on the individual, not the government. An “axiomatic and elementary . . . foundation of the administration of our criminal law” is that a person accused of a crime is presumed innocent until proven guilty beyond a reasonable doubt.²⁹ While criminal defendants have the right to challenge witnesses and evidence against them, they may also present nothing and obtain dismissal of the case if the prosecution fails to meet its burden.³⁰ In tax law, however, the burden of proof rests with “the taxpayer to prove by a preponderance of the evidence that the Commissioner’s determination was erroneous.”³¹ After the federal income tax’s creation, Congress established a Board of Tax Appeals (predecessor to today’s Tax Court), which adopted a rule placing the burden of proof on the taxpayer.³² In 1998, Congress attempted to shift the burden of proof back to the tax authorities but included so many exceptions to the rule that it has proven to be ineffective.³³

“Federal tax law allows the IRS to summon witnesses or obtain records from any person without showing probable cause or obtaining a court order.”

There is no trial by jury in Tax Court. While the Sixth and Seventh Amendments guarantee jury trials for criminal matters, this right is effectively eliminated for tax matters. Taxpayers challenging an IRS assessment can pay the disputed amount in full (tax due, interest, and penalties) and sue for a refund in a U.S. District Court or the U.S. Court of Federal Claims, which is an expensive route to retrieve their disputed money. The main way to challenge an IRS assessment *before* payment is to file a petition in Tax Court, but because Tax Court is an administrative tribunal (in legal parlance, an “Article I court”) rather than an “Article III court” that exercises judicial power, it is not required to use jury trials.³⁴

The Fifth Amendment also does not apply to tax matters. The IRS Form 1040 requires taxpayers to sign “[u]nder penalty of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.” This requirement “operates to invalidate the Fifth

Amendment protection against self-incrimination . . . disclosing information sought in tax returns constitutes a waiver of Fifth Amendment protections [and the] IRS can and does release that information to federal, state, and local agencies for both tax and nontax law enforcement purposes.”³⁵ In 1927 the U.S. Supreme Court upheld the requirement to fill out and file tax returns against a Fifth Amendment challenge, with Justice Oliver Wendell Holmes pithily stating that a taxpayer “could not on that account refuse to make any return at all” or “draw a conjurer’s circle around the whole matter by his own declaration that to write any word upon the government blank would bring him into danger of the law.”³⁶ Failing to file a tax return is penalized at the rate of 5 percent of the unpaid tax per month, up to 25 percent of the unpaid tax, in addition to tax owed, interest, and other penalties.³⁷

IRS Rulemaking Is Vast and Opaque

The IRS does not follow normal due process, as other government agencies usually must. Most agencies wishing to adopt a regulation must first publish a proposed rule in the *Federal Register*, accept comments from interested parties and the general public, and then issue a legally binding final rule that responds to those comments. This “notice and comment” or “notice of proposed rulemaking” (NPRM) procedure is established by the Administrative Procedure Act (APA) of 1946 as part of a congressional judgment that “fairness and informed administrative decisionmaking require that agency decisions be made only after affording interested persons notice and an opportunity to comment.”³⁸ An agency that does not follow this APA procedure risks a court striking down the regulation as “arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with the law.”³⁹

The IRS and the Treasury Department do not follow APA procedures for most of the hundreds of official changes they make annually to how they enforce the tax code, “having claimed for several decades that their rules and regulations are exempt from those requirements.”⁴⁰ They characterize APA directives as merely interpretive, not legally binding, and therefore they are not subject to the APA. But even when the Treasury Department has initiated a formal notice-and-comment rulemaking process, it often skips steps. In more than 36 percent of cases, it made the proposed rule legally binding before accepting any comments, and in nearly 5 percent of cases, it skipped

accepting comments and simply adopted the final rule.⁴¹ If the IRS analyzes the compliance or economic costs of its subregulatory guidance, it does not release its analysis publicly.⁴²

“In more than 36 percent of cases, the Treasury Department made the proposed rule legally binding before accepting any comments, and in nearly 5 percent of cases, it skipped accepting comments and simply adopted the final rule.”

Treasury and IRS guidance take many forms:

- Treasury Regulations/Treasury Decisions (TDs), (17 of these were issued in 2021)
- Revenue Rulings (IRS official interpretation applying the law to a set of facts; 24 were issued in 2021)
- Revenue Procedures (statements of internal practice and procedure; 54 were issued in 2021)
- Private Letter Rulings (PLRs), (an official ruling obtained from the IRS giving its position on a set of facts; 786 were issued in 2021)
- Technical Advice Memorandums (TAMs), (explanations requested by IRS personnel; 3 were issued in 2021)
- IRS Notices (public pronouncements that may contain substantive guidance; 66 were issued in 2021)
- IRS Announcements (19 were issued in 2021)
- various other documents, such as field service advice memoranda, general counsel memoranda, Chief Counsel notices, information letters, service center advice, and litigation guidance memoranda.

The bland names of these documents often understate their importance. For instance, Revenue Procedure 2019-48 sets the annual business travel per diem amounts; Revenue Ruling 2019-13 establishes taxability rules for distributions by dissolving S corporations; TAM 2019-03017 answers whether the value of meals and snacks provided by employers to employees is taxable; and Notice 22-03 sets the standard mileage deduction rate. None went through APA notice-and-comment procedures.

Much of this guidance is included in the Internal Revenue Bulletin (IRB). Although the IRS claims that subregulatory “guidance” is interpretive, most observers treat IRBs as legally binding quasi-legislative activity that most practitioners ignore at their peril. For example, the Government Accountability Office (GAO) noted in 2016 that the IRS itself tells its employees that IRB materials are “authoritative” and “a good source of general information,” leading the GAO to conclude that “taxpayers can use IRB guidance to support a position knowing that IRS is bound by IRB guidance because IRS employees must follow it.”⁴³

“The IRS attempted to dismiss the lawsuit by arguing that the federal Anti-Injunction Act, a Civil War–era law protecting the federal government from judges suddenly halting tax collection, precludes *any* lawsuit against the IRS that might halt tax collection.”

The IRS’s refusal to follow the APA was a key issue in its recent unanimous loss in the U.S. Supreme Court in *CIC Services, LLC v. IRS*.⁴⁴ In that case, the IRS had issued a Notice punishing all tax advisers who file returns involving certain insurance transactions by ordering them to comply with extensive and expensive reporting and recordkeeping requirements. One company sued the IRS over the requirements, arguing that the IRS issued the Notice without complying with APA notice-and-comment procedures. The IRS attempted to dismiss the lawsuit by arguing that the federal Anti-Injunction Act, a Civil War–era law protecting the federal government from judges suddenly halting tax collection, precludes *any* lawsuit against the IRS that might halt tax collection (except for a suit for refund after the taxpayer has paid). The Supreme Court rejected this broad IRS reading of the Anti-Injunction Act in a 9–0 decision, noting that it is “too attenuated a chain of connection” to conclude that challenging the IRS’s notice would imperil tax collection.

In 2022, the Supreme Court removed a separate IRS obstacle halting taxpayer lawsuits in another 9–0 decision in the case of *Boechler v. Commissioner*.⁴⁵ This case rejected the IRS

position that taxpayers waive all their claims if they are one day late in filing their appeal to the Tax Court. In that case, the IRS’s attempt to keep taxpayers from reaching the Tax Court was self-serving and especially dangerous, as the Tax Court is the only neutral body that a taxpayer can reach for a decision before having to pay a disputed tax. Otherwise, a taxpayer must persuade the IRS’s Office of Appeals—which is not functionally independent from enforcement functions and is often pressured by leadership in specific cases—or undertake expensive, time-consuming litigation in federal court.

It is no accident that the IRS set up a situation where it claimed its one-sided and burdensome regulation was both exempt from the APA process and unable to be challenged because of the Anti-Injunction Act, or that the IRS can take months to respond to taxpayers, but taxpayers automatically lose if they take even one extra day to respond. The *CIC Services* and *Boechler* decisions chip away at defenses that the IRS has often used to insulate its subregulatory “guidance” from legal challenge. But there still has not been a congressional or judicial declaration that the IRS must follow the APA. Until that happens, the IRS enjoys, as six federal judges observed in 2011, “a world in which no challenge to its actions is ever outside the closed loop of its taxing authority.”⁴⁶

THE BIDEN ADMINISTRATION’S \$80 BILLION “SOLUTION”

In April 2021, the Biden administration announced its plan for fixing the IRS’s woes: a lot more money. The White House proposed giving the IRS an extra \$80 billion over 10 years to add 87,000 more personnel—a significant boost considering that its budget is about \$13 billion per year and currently employs 78,000 personnel.⁴⁷ Congress adopted the \$80 billion proposal as part of the Inflation Reduction Act (IRA) of August 2022. In early 2023, House Republicans voted to rescind most of the funding, which will set up an ongoing battle over the IRS budget.

New Enforcement Efforts Threaten All Taxpayers

The extra \$80 billion included \$46 billion for enforcement, \$25 billion in operations support, \$5 billion for systems modernization, and just \$3 billion for taxpayer

services. Administration officials claimed that the IRS expansion would generate a windfall of \$700 billion in extra tax revenue.⁴⁸ But that figure was later revised down by the Congressional Budget Office (CBO) to just \$207 billion.⁴⁹ The money to be gained by squeezing taxpayers became a significant “pay-for” in the IRA to supposedly reduce the overall cost.

After a delay, in April 2023 the IRS produced a strategic plan on how it would spend the \$80 billion. While generally discussing improving taxpayer service, IRS Commissioner Daniel Werfel said the focus would be “exclusively on increasing our capacity to assess compliance of high-income and high-wealth individuals, complex partnerships, and large corporations” by using enforcement activities such as expanded audits and new information reporting requirements that Werfel’s predecessor described as “intrusive to taxpayers.”⁵⁰ These initiatives include capturing enormous amounts of data to be fed into IRS computers to look for perceived inconsistencies, and then sending out a flurry of automated letters to taxpayers demanding they explain the perceived inconsistencies or else pay more taxes to make a threatened audit go away.

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The few specific elements of this IRS vision that are public have prompted backlashes. In 2021, the Treasury Department proposed that Congress amend the federal tax code to require financial institutions to report annual inflow and outflow transaction data to the IRS for all personal and business accounts with at least \$600 in annual activity.⁵¹ The Treasury claimed that the proposal was “about making sure the top 1 percent can’t evade \$160 billion per year in taxes,” but the low threshold level was guaranteed to ensnare virtually every business and individual in the country.⁵² The median American small business has an inflow and outflow of \$755 *a day*, and the median personal checking

account balance is \$3,400 at any one time.⁵³ Banks and credit unions immediately opposed the proposal because of implementation burdens; privacy advocates opposed it because of data security issues; and taxpayer advocates opposed it because they predicted that the IRS would gain a mountain of data having little bearing on what people put on their tax returns. A group of state treasurers sent a letter to Washington leaders saying, “There is zero quantitative or qualitative evidence that this proposed measure will aid in collecting taxes from tax evaders.”⁵⁴

After this outcry, the Treasury grudgingly raised its proposed threshold from \$600 to \$10,000.⁵⁵ It reported that the raised threshold would almost halve projected revenue collection from \$470 billion to \$260 billion over 10 years. This admission by the Treasury undermined the credibility of its original claim about targeting high-income individuals, since nearly half the revenue apparently came from those with between \$600 and \$10,000 in annual bank account activity.⁵⁶ Senators then announced that they would not include the proposal in any pending legislation.

Other recent actions by the IRS indicate the type of enforcement actions it is considering. Taxpayers who sell or resell a few goods online each year will receive a 1099-K form for the first time in 2024, likely misleading many of them into thinking that they owe additional income tax. Reselling something at a loss is not taxable income, but if the information is provided to the IRS, the taxpayer bears the burden of proving that they did not make money on the sale. Online platforms such as eBay, Etsy, and even Ticketmaster will now generate Form 1099-K information returns for anyone who resells something online for just \$600 in annual revenue. This is a change from the previous level of 200 transactions and more than \$20,000 in revenue after the inclusion of a Treasury proposal in the American Rescue Plan Act of 2021. The proposal is expected to raise just \$7.7 billion over a decade, at a cost many times that in compliance burdens on small internet sellers or even individuals who sell a concert or sporting event ticket or two.⁵⁷ The vast majority of these taxpayers have no tax liability from the sales but will have to explain that to the IRS when they get a letter in 2023 claiming that they do.

Taxation of cryptocurrency transactions will change after Congress included several provisions in the Infrastructure Investment and Jobs Act that passed in November 2021.

The bill requires that all digital asset transactions worth more than \$10,000 be reported to the IRS, which is problematic in a deliberately decentralized financial system, but also imposes this reporting requirement on noncustodial actors such as vendors, blockchain validators, and protocol developers. Several members of Congress have proposed amendments to roll back these changes.⁵⁸

An early version of what became the IRA law included a repeal of the requirement that IRS supervisors approve the imposition of all taxpayer penalties. The approval requirement was added in 1998 after instances of IRS agents going rogue and imposing unsubstantiated penalties on taxpayers.⁵⁹ Requiring supervisor approval seems like a minor hurdle, but the IRS routinely neglects this step and sees penalties thrown out in litigation. The Joint Committee on Taxation estimated that this change would have raised \$1.4 billion over 10 years in extra penalty collections, showing that IRS agents' failure to get supervisory approval is hardly a small problem. After an outcry, Congress dropped the proposal from the final version of the IRA.

Secretary of the Treasury Janet Yellen directed the IRS to submit a detailed plan for spending the \$80 billion by February 2023, but it missed the deadline.⁶⁰ The plan will be subject to close scrutiny, especially since the Republicans took control of the House of Representatives in the 2022 midterm elections. A former IRS commissioner, John Koskinen, reacted to the \$80 billion idea: "I'm not sure you'd be able to efficiently use that much money."

The IRS Should Be Increasing Productivity

The IRS and its defenders blame a lack of funding for the agency's lack of productivity. On Tax Day 2022, a Treasury Department statement acknowledged the enormous processing backlog and stated that it "is the byproduct of chronic underfunding that has starved the IRS of the tools it needs to serve the American people."⁶¹ The IRS took the *Washington Post* on a tour of its Austin office, showing off a 1970s machine to open mail, computers running Windows XP, and "Tingle tables" used to manually sort incoming mail.⁶² ProPublica has released reports claiming that "the IRS was gutted" and forced to be "understaffed, hamstrung and operating with archaic equipment."⁶³

It is true that the IRS has archaic equipment, but it is not clear that funding is the problem. Since 1992, IRS funding levels have ranged between about \$12 billion and \$15 billion in constant 2021 dollars (see Figure 2).⁶⁴ The IRS's 2021 funding level of \$13.7 billion is about the same as the 30-year average funding level of \$13.5 billion in constant dollars. The IRS should be doing more with fewer people as better technology becomes available, as the private sector does continuously.

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While the IRS headcount has declined the past 25 years, efficiency gains in technology and communications have enabled the private sector to produce more output with fewer people. Labor productivity, which is output per hour of employed persons, grew 74 percent from 1992 to 2022.⁶⁵ Thus, the private sector has found ways to improve worker productivity about 1.9 percent per year, on average, over the past three decades. Professional service firms—perhaps the closest private-sector analog to compare IRS employee productivity—have seen large productivity gains.

Federal agencies, including the IRS, should be similarly increasing their productivity. But the IRS has been reluctant to deploy technology for better and more personalized service and has stuck with labor-intensive and duplicative tax processing practices, which are the causes of its continued inefficiency relative to the private sector.

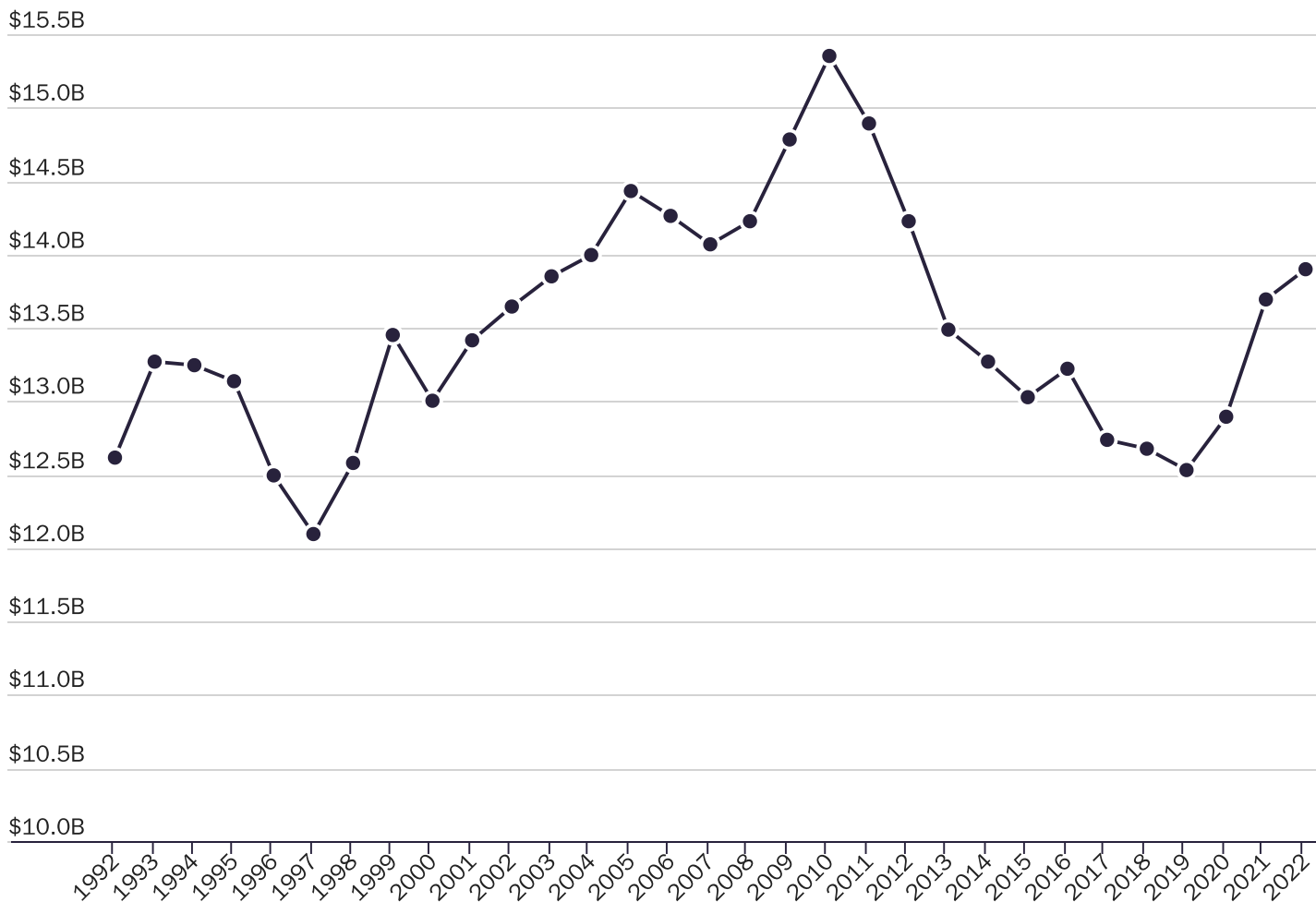
The Tax Gap Is Modest and Not Growing

Supporters of increased IRS enforcement spending point to the federal tax gap of taxes that are legally owed but not paid. But all tax systems have such gaps, and the U.S. federal income tax gap is modest and not growing. Tax cheating is a problem, but there is not a growing crisis as many pundits claim.

The IRS released its latest estimates of the tax gap in 2022.⁶⁶ The IRS found that the annual gross tax gap for

Figure 2

IRS budget in constant 2021 U.S. dollars



Sources: Internal Revenue Service; Bureau of Labor Statistics.

2014–2016 was \$496 billion. After late payments and enforcement actions, the net tax gap was \$428 billion. That figure represented 2.7 percent of GDP, the same as estimates for other recent years, and down from 3.3 percent in 2001 and 3.4 percent in 2006.⁶⁷ The IRS estimates that the gap in 2017–2019 dipped to 2.6 percent of GDP.

International studies show that the United States has a fairly low tax gap compared to other countries.⁶⁸ In a 2018 study, Polish economists Konrad Raczkowski and Bogdan Mróz estimated tax gaps for 35 countries, including 28 EU countries and the United States. They put the U.S. gap at 3.8 percent of GDP and the EU gap at 7.7 percent of GDP.⁶⁹ In a 2015 study, Raczkowski estimated that the tax gap for 28 EU countries was 10.7 percent of GDP.⁷⁰ In a 2019 study, political economist Richard Murphy estimated that the tax gap for 28 EU countries was equivalent to 5.6 percent

of GDP.⁷¹ The latest IRS study puts the U.S. federal tax gap at 2.7 percent, but with an estimated state-local tax gap added, the U.S. total tax gap would be about 4.2 percent of GDP (see Table 1).⁷²

Policymakers often point to the richest individuals as the main tax gap problem, but that is not what the IRS data show. Two of the largest drivers of the U.S. tax gap are pass-through businesses and self-employed freelance and “gig” economy workers. There would be a substantial cost in heavy-handed enforcement actions against such taxpayers. As Cato’s Chris Edwards writes: “If the IRS were to squeeze more money out of small businesses, for example, some businesses would reduce hiring and investment or even close their doors. Those responses would reduce revenues raised. Tax cheating is unethical, but higher taxes would damage the private economy whether they stem

Table 1

Tax gap as a percentage of GDP

Study	United States	Europe
IRS (2022) + estimated state/local	4.2%	
Raczkowski and Mróz (2018)	3.8%	7.7%
Raczkowzki (2015)		10.7%
Murphy (2019)		5.6%

Sources: *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014–2016* (Washington: Internal Revenue Service, August 2022); Konrad Raczkowski and Bogdan Mróz, “Tax Gap in the Global Economy,” *Journal of Money Laundering Control* 21, no. 4 (December 2018): 545–54; Konrad Raczkowski, “Measuring the Tax Gap in the European Economy,” *Journal of Economics and Management* 21, no. 3 (October 2015): 58–72; and Richard Murphy, “The European Tax Gap: A Report for the Socialists and Democrats Group in the European Parliament,” January 23, 2019.

from law changes or IRS crackdowns.”⁷³ Consequently, the best way to reduce the U.S. tax gap is not through expansive new audits or harsher enforcement on small businesses and gig economy workers but by reducing tax and regulatory burdens that create the shadow economy in the first place. Greater tax burdens from enforcement may even *grow* the size of the shadow economy.

In the past, the IRS has acknowledged that small businesses, especially cash-based businesses, are the source of much of the tax gap.⁷⁴ Notwithstanding public IRS statements that the \$80 billion in added enforcement will focus on billionaires and millionaires, tax officials privately acknowledge that any effective tax gap enforcement regime would necessarily target the gig economy and cash-based businesses.⁷⁵ Policymakers should remember that the IRS is often wrong, and more enforcement means targeting more people who prove to be innocent.⁷⁶

Auditing Those Who Won’t Fight Back

Supporters of expanded IRS funding argue that the agency’s audit rates have been dropping, particularly of high-income individuals, and that added funding will reverse this trend. However, the IRS directs funding toward auditing low-income and middle-income people because that is where they can recover money. Of the 386,752 audits the IRS conducted in 2019, 196,717 (50.8 percent) were on tax returns with less than \$25,000 in income, and a further 162,308 (41.9 percent) were on tax returns with income between \$25,000 and \$200,000.⁷⁷ The IRS will likely continue to audit low- and middle-income people.

In fairness, 93.8 percent of all tax returns have an income under \$200,000, so it is not statistically surprising that they

represent 92.7 percent of all audits. Audit rates are higher for those with incomes of one million dollars or more; 7,395 of those 639,361 returns, or 1.2 percent, were audited in 2019. But although the IRS says it wants to audit more high-income individuals but cannot because of a lack of resources, it has found the resources to continue to audit hundreds of thousands of low-income and middle-income individuals.

If the IRS’s auditing resources are as slim as claimed, why is it not exclusively focused on high-income individuals and businesses likely to generate the most revenue? Because, as IRS statistics bear out, targeting auditing resources toward low-income and middle-class individuals is more lucrative. For example, in 2021, the IRS generated \$3,130 per audit hour on returns that claim the Earned Income Tax Credit (EITC), which is almost double the \$1,590 per audit hour from returns of \$1 million to \$5 million, although less than returns with incomes higher than \$5 million.⁷⁸ The Congressional Research Service (CRS) estimated that the IRS takes 1.6 hours to complete an audit of a low-income EITC recipient, while it takes 10.8 hours for an average non-EITC audit.⁷⁹ If pressed to maximize its return on investment, the IRS will *increase* audits of low-income people and cheaper correspondence audits instead of pursuing audits of higher-income people that take longer to complete.

The IRS Can’t Do Your Taxes for You

The IRA designates \$15 million for the IRS to study the feasibility of developing a direct e-file tax return system to replace current free file options provided by private vendors. This government-run portal will have its challenges, with practitioners (including a former IRS commissioner) saying that a system focused on the simplest types of returns

may be the only one practicable.⁸⁰ Complex eligibility rules for refundable credits, family information not available in third-party documents, and business and self-employment deductions are complicating factors in expanding e-file beyond the simplest types of returns.

Far less practicable would be to have the IRS directly prepare tax returns for all Americans, as is occasionally proposed in Congress.⁸¹ The tax code's complexity comes from ambiguous provisions that are susceptible to multiple interpretations, eligibility and phase-out rules that create uncertainty, and confusing definitions of income, all of which generate millions of tax disputes a year.⁸² While countries with simpler tax laws, like Estonia, can produce prepopulated tax returns, the American tax system would require significant simplification before this could be a realistic option. Pre-prepared tax returns also would create a major conflict of interest since having the IRS prepare tax returns would make it harder (and more intimidating) for taxpayers to challenge IRS positions. The IRS's continuing backlog challenges and privacy failures also demonstrate that it is not capable of undertaking such an effort without catastrophic negative consequences.

A NEW VISION FOR THE IRS

Instead of the current policy direction of providing the IRS a blank check, removing the leash on it, and directing it to collect as much revenue as possible, lawmakers should consider a 10-part plan for reforming the IRS.

1. Codify Taxpayer Rights

The National Taxpayer Advocate developed a list of 10 rights for taxpayers: the right to be informed; the right to quality service; the right to pay no more than the correct amount of tax; the right to challenge the IRS position and be heard; the right to appeal an IRS decision in an independent forum; the right to finality; the right to privacy; the right to confidentiality; the right to retain representation; and the right to a fair and just tax system.⁸³ Congress added those rights to federal law in 2015 with modified language that deleted any ability for taxpayers to invoke the rights in disputes.⁸⁴ Without this, the list of rights has become a mere suggestion for IRS employees that they can safely ignore. Congress should recodify these rights and strengthen the language from aspirational to enforceable.

2. Digitize Tax Filing and Processing

Grocery stores have used barcodes for 40 years, state tax agencies have used them on tax returns for 20 years, and nearly every restaurant rolled out QR code menus during the pandemic. However, thousands of IRS data-entry employees still take months to manually enter tax returns into a database with an error rate that would be unacceptable in any private enterprise.

“Pre-prepared tax returns also would create a major conflict of interest since having the IRS prepare tax returns would make it harder (and more intimidating) for taxpayers to challenge IRS positions.”

The IRS commissioner, Treasury secretary, and lawmakers should set a 2023 filing season goal to have all IRS forms available for digital filing. For those who still file by paper, all tax returns should have barcodes when they are printed or else be compatible with optical scan technology when they are processed. The IRS should utilize existing technology, not wait for future technologies to be invented. The IRS now has the financial resources to cover purchase costs needed to digitize tax filing and processing, and this change would likely save the agency more than \$1 billion in labor costs over the next decade.⁸⁵

Additionally, temporary COVID-19 changes that allowed taxpayers to make electronic submissions should be made permanent. This should include a congressional modernization of the “mailbox rule,” which treats mailed payments as being submitted on the postmark date, but electronic payments as being submitted only when the payment clears (which can sometimes be two or three days later).

3. Adopt Communications Triaging and Other Tools

When the IRS demands answers from taxpayers, the agency insists on communicating only by mail (that it does not open) or phone (that it does not answer). Almost alone among the private or public sector, the IRS resists using

electronic mail to communicate.⁸⁶ With email still a “new technology” that seemingly frightens the IRS, there is little hope for more innovative tools such as automated online chat services, artificial intelligence (AI) help desks, or Siri-style services that anticipate needs before they arise.

“When the IRS demands answers from taxpayers, the agency insists on communicating only by mail (that it does not open) or phone (that it does not answer). Almost alone among the private or public sector, the IRS resists using electronic mail to communicate.”

The IRS management can start small by using the tried-and-true technique of communications triage. All inquiries to the IRS should not be treated alike, but rather sorted into common questions (which can be serviced by online FAQs and virtual assistance); clarifications of confusing matters (email where IRS personnel can provide clarification questions pointing to the correct answer); and in-depth or urgent resolutions of individual matters (phone or in-office visits, where conversations or extended back-and-forth are needed to resolve issues). Treating all communications alike makes taxpayers sort through Technical Advice Memorandums and Notices, spend 30 minutes on hold on the phone only to receive “a maelstrom of confusion” when they get through, and wait by the mailbox for months for a letter in response.⁸⁷ With support from existing technology, the IRS can be more dynamic in its customer service and resolve easy questions so it can focus its human resources on harder ones.

4. Implement Online Accounts

Most financial institutions, online sellers, utilities, and government agencies offer users a single centralized online account from which to view documents, access services, and seek customer support. The IRS has created online tools to perform specific functions, such as checking on the status of a refund, but taxpayers still do not have access to a single account with all their tax filing information.

A fully integrated online account would benefit both taxpayers and the IRS. With such an account, taxpayers would have an easier time filing their taxes and resolving disputes with the IRS because it could easily view their past returns and other filed forms.

5. Establish an IRS Board of Directors

The IRS commissioner formally reports to, and is appointed by, the president via the Treasury secretary, but this relationship has been at arm’s length since Richard Nixon and some of his predecessors notoriously used the IRS against perceived enemies.⁸⁸ The reforms to insulate the president’s direct control of the IRS are laudable but have created a situation where the commissioner effectively reports to no one. Congress approves the IRS budget and conducts periodic oversight hearings where the commissioner testifies, but these do not substitute for the regular and ongoing review and approval of the IRS’s short-term activities and long-term goals.

A board of directors can solve this supervision gap, create accountability, and focus on long-term objectives. Such an entity could insist on setting a customer service vision, with the commissioner regularly reporting on timelines and metrics to achieve it. The board could provide a voice for the agency’s taxpayer constituencies and balance the enforcement focus of the IRS’s current management.

6. Revise the IRS Legal Strategy to Prioritize Clarity for Taxpayers

The IRS should be reflecting on its current legal strategy after successive 9–0 losses in the U.S. Supreme Court in *CIC Services* and *Boechler*, as well as a string of losses in Tax Court in cases where the IRS is using audit, litigation, and listed transaction obligations to deter taxpayers from taking deductions that the IRS disfavors. Letters from the IRS to taxpayers and its subregulatory guidance are frequently written in confusing legalese. Often the IRS will not answer direct questions about its position and then litigates when taxpayers choose wrong— IRS whistleblowers say that is deliberate policy.⁸⁹ In both *CIC Services* and *Boechler*, the IRS invoked technicalities in court rather than seeking judicial clarity of the questions on their merits.

The primary goal of the IRS’s legal strategy should be clarity for taxpayers, with enforcement prioritized only where that clarity exists. The IRS commissioner and chief counsel should not initiate enforcement in any situation where the law or interpretive guidance is disputable. Where the agency has failed to give clarity to taxpayers on what they should do in a particular situation, taxpayers suffer when the IRS provides that clarity only through after-the-fact enforcement actions rather than through statutory changes or regulatory announcements. The IRS should also agree to proceed to merit determinations rather than use legal technicality arguments to avoid them.

7. Enhance Taxpayer Appeal Rights

For decades, the legal industry has extensively used mechanisms such as mediation, arbitration, or neutral fact-finding followed by negotiation for resolving disputes short of litigation. These tools are cheaper and provide quicker resolutions. Unfortunately, the IRS resists these innovations and prefers to go immediately from audit to litigation with no involvement from neutral third parties. The IRS commissioner should reverse this policy, and Congress can also modify statutes governing the IRS dispute process to incorporate alternative dispute resolution.⁹⁰

“Congress could also consider narrowing the Anti-Injunction Act to limit only preliminary or temporary injunctions instead of the current broad ban on suing the IRS in federal court. This change would allow more taxpayers to have their day in court without first paying the disputed tax.”

Congress could also consider narrowing the Anti-Injunction Act to limit only preliminary or temporary injunctions instead of the current broad ban on suing the IRS in federal court.⁹¹ This change would allow more taxpayers to have their day in court without first paying the disputed tax. Similarly, the

jurisdiction of the Tax Court, which uses neutral judges and faster and easier procedures than federal court, should be expanded to take the place of the IRS’s biased appeals office. Currently, taxpayers who pay the disputed tax or do not respond to a math-error notice or a deficiency notice within a short timeframe lose their right to go to Tax Court. All filing deadlines for taxpayers should be waivable by the court under common equitable doctrines.

8. Increase the Independence of the National Taxpayer Advocate

In 1998, Congress established that the National Taxpayer Advocate would be appointed by the Secretary of the Treasury, establishing that the advocate could be an effective watchdog while embedded within the IRS. But IRS leaders have increasingly resented the existence of the advocate and sometimes resist or revoke the advocate’s orders and interfere with personnel decisions in the advocate’s office. The current advocate has proposed a series of statutory changes to increase her independence, including reversing the IRS’s policy of not allowing the advocate to hire lawyers or file amicus briefs; ending the IRS practice of conducting personnel reviews of the advocate’s staff; granting the advocate access to IRS memos and documents; allowing the advocate to continue operations during government shutdowns (as the IRS is allowed to do); and requiring the IRS to respond to the advocate’s comments on proposed regulations or guidance.⁹² The National Taxpayer Advocate is often the first to sound the alarm on problematic IRS practices, and these changes would strengthen the advocate’s ability to do so.

9. Reform Penalty and Interest Provisions

Taxpayers should not pay an economic cost for waiting months for their tax refunds to be processed. They should be compensated for the delay. The IRS does pay interest on delayed tax refunds, but the set rates lag market interest rates. In 2022, the IRS raised the interest rate paid on refunds from 3 percent to 6 percent, which still runs below the 7 to 9 percent inflation rate.⁹³

Self-employed individuals who make estimated tax payments generally receive no interest if they overwithhold,

leading to the oft-stated warning by financial advisers not to make “an interest-free loan to the government” in the form of excessive estimated tax payments. This leaves taxpayers susceptible to penalties if they estimate incorrectly, while also likely depriving the federal government of more spread-out revenue.

Requiring the IRS to pay realistic interest on all refunds better accounts for inflation and ensures that taxpayers do not lose value on their refunds by being forced to wait. It would also create a greater incentive for the IRS and Congress to ensure on-time processing and payment.

10. Dramatically Simplify Federal Tax Laws

Tax complexity imposes a large cost on Americans by distorting individual decisionmaking and discouraging business investment. Fair administration and easy compliance can reduce some of these costs, but policymakers should go further and pursue fundamental tax reform to dramatically reduce the burden of tax code compliance and the adverse economic effects of taxation.

The federal income tax does not merely collect revenue to fund government services but is also used to micromanage the activities of individuals and businesses on a vast scale. Tax complexity continues to grow because each administration and Congress proposes new targeted tax breaks to manipulate the economy, and many become law. President Biden’s tax proposals in 2021 included a vast array of new and expanded tax breaks, including for low-income housing, new markets, electricity produced from renewable resources, solar facilities, alternative fuels, electric transmission property, carbon sequestration, nuclear power production, aviation fuel, clean hydrogen, nonbusiness energy property, residential energy efficiency property, energy-efficient commercial buildings, energy-efficient homes, conservation, wildfire mitigation, plug-in electric vehicles, commercial electric vehicles, fuel cell vehicles, alternative fuel refueling property, electric bicycles, advanced energy projects, insulation installation, manufacturing investment, advanced manufacturing production, environmental justice, clean electricity production, clean electricity investment, clean electricity

investment for low-income communities, clean fuel production, public university research infrastructure, and compensation for local journalists.⁹⁴

Instead of complicating the tax code with an ever increasing number of tax breaks, lawmakers should reverse course and push for a major simplification. They should aim for a neutral tax, a flatter tax rate structure, and a reduction in penalties on saving and investment. A flat tax, for instance, could reduce U.S. tax compliance costs by over 90 percent.⁹⁵ Other countries have undertaken dramatic reforms to simplify their tax codes and reduce tax rates, and so there is no reason why the United States cannot make major reforms.⁹⁶

CONCLUSION

A powerful but dysfunctional IRS is very costly to taxpayers and is not the best way to improve tax compliance. Many policymakers say they want to close the tax gap but overlook the important role that an efficient, disciplined, and accountable tax collection agency could play in achieving that goal.

Instead of funneling more enforcement money to an unaccountable entity, policymakers should transform the IRS. This study provides 10 reform suggestions, including the creation of a board of directors to provide more active oversight. Lawmakers and IRS leaders should also consider reform ideas offered by the Treasury Department’s Inspector General, the National Taxpayer Advocate, the Government Accountability Office, and the National Taxpayers Union.

The IRS should rethink its culture of enforcement-before-service and guilty-until-proven-innocent attitude, which views all taxpayers as cheats who deserve maximum pressure for every perceived transgression. The IRS’s aggressive culture has led to its view that its rulings need not go through the normal procedures followed by other agencies, and to a legal strategy that has resulted in consecutive 9–0 rebukes by the U.S. Supreme Court.

The most important reform steps need to be taken by Congress. It should pursue major tax reforms to reduce the tax code’s vast compliance costs and reduce the need for a large IRS. Short of such reforms, policymakers should push for technology and structural changes to the IRS to cut costs for them and taxpayers alike.

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