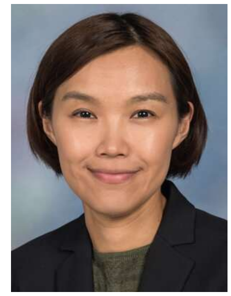
Tax, Social Services And The Need For An IRS Overhaul

By **Joyce Beebe** (June 15, 2022)


Joyce Beebe

Over the past few years and throughout the pandemic, there has been no shortage of complaints and criticism about the performance of the Internal Revenue Service.

The backlog of unprocessed returns has led to delayed refunds, and taxpayers are often unable to have their phone calls answered. The situation does not improve when visiting IRS offices in person — it can take hours of waiting to have simple issues resolved.[1]

In addition, a U.S. Government Accountability Office report released in May shows that although tax audits have declined across income levels over the past decade, audit rates dropped the most for higher-income taxpayers.[2] The report's finding that earned income tax credit claimants have higher-than-average audit rates has infuriated advocates for the refundable tax credit, popular with lower-income working taxpayers with children, and raised equality concerns.

However, there are always two sides to the same coin. Taxpayers' frustration is real; the IRS also has reasons for grievance.

First, there is the staff shortage. Take the audit function as an example. The GAO report indicates the primary reason for the across-the-board audit rate drop is the IRS' lowering head count, and that the trend is expected to continue.

From tax years 2011 to 2020, the IRS lost more than a quarter of its auditors. A higher percentage of the attrition came from revenue agents — 40% — who handled more complex audits, compared to tax examiners — 18% — who worked on less complex issues. In addition, another 15% of current auditors are expected to retire within the next three years.

The patterns of personnel reduction and audit rate decline for high-income taxpayers are related. The tax returns of higher-income taxpayers are typically more complicated and less transparent, and often involve nontraditional income sources, convoluted pass-through ownership structures and well-executed planning.[3]

As such, these returns usually require review by more seasoned staff members, who, as referenced above, have been leaving at a faster pace than less experienced ones. During the same period, the number of returns with taxable income over $200,000 more than doubled, meaning that these audits are being conducted by an ever-smaller pool of experienced agents.

The combination of reduced staff, and the volume and complexity of high-income returns results in substantially greater audit hours per return for higher-income taxpayers. By contrast, audits for lower-income taxpayers are limited in scope, which allows for more automation. Average hours per audit review for lower-income taxpayers have remained stable over the past decade.

Second, the IRS has been asked to do more with less. In recent years, it has been asked to do a lot more with a lot less. Prior to the pandemic, the agency was tasked with implementing the tax elements of several key pieces of legislation, including the Patient

Protection and Affordable Care Act, the Foreign Account Tax Compliance Act, and the Tax Cuts and Jobs Act — each a herculean task by itself.

The pandemic then created a perfect storm for the agency: Amid orders to shelter in place and work remotely, the IRS delivered three rounds of federal economic impact payments — also known as stimulus checks — totaling about 500 million transactions.

The agency has done a superb job with great accuracy. It began issuing direct deposits to taxpayer bank accounts within two weeks of the passage of the Coronavirus Aid, Relief and Economic Security, or CARES, Act,[4] the law that authorized the first stimulus payment, and the amounts were accurate in 99% of payments.[5]

In addition, the unemployment benefit, which has historically been taxable, was retroactively made nontaxable in certain cases by the American Rescue Plan Act.

ARPA was signed into law in March 2021, in the middle of the 2020 tax filing season, after millions of taxpayers had already filed their tax returns. The IRS identified more than 16 million taxpayers who overpaid income taxes as a result of this exception and issued refunds to the vast majority of them.[6]

Furthermore, the IRS was tasked for the first time in its history with delivering advance child tax credit payments, expanded under ARPA, on a monthly basis — all while carrying out its core missions of enforcing tax laws and ensuring taxpayer compliance.[7]

The problems are clear and taxpayer needs certain, and discussions are happening on how to improve IRS operations. So, what are the potential solutions?

The first and probably the most fundamental solution is to simplify the tax codes. Tax professional or not, no one would say the current tax rules are simple and easy to understand. Complexity breeds loopholes, countless hours and billions spent on tax compliance, lower revenue collection and the perception that the system is unfair.

In modern public finance theory, four criteria are often referenced when evaluating whether a tax system is good — efficiency, equity, revenue sufficiency and simplicity.

In practice, equity and revenue sufficiency dominate the discussion; efficiency is occasionally mentioned, but simplicity always takes a backseat. It is thus no surprise that we have ended up with lengthy tax rules that keep getting longer.

The U.S. tax statutes alone — excluding U.S. Department of the Treasury regulations and case law — are well over 1 million words, more than the entire "Harry Potter" series.[8] Few would enjoy reading the Internal Revenue Code as much as the young wizard's adventures.

Although simplified tax codes are desirable, there are no immediately obvious agreements as to how to overhaul the tax code. Ideas such as the flat tax have strong support from efficiency and simplicity perspectives, but have failed to gain traction on equity grounds.

Base-broadening efforts within the income tax mechanism, the gold standard of tax reform, have generally started with solid discussions but often ended up with special considerations that carved out a portion of the tax base. This limits revenue, hampers efficiency and eventually generates complexity.

Instead of simplifying the tax code, a separate approach focuses on reducing taxpayers' compliance burden. For instance, recent research on sending taxpayers prepopulated Form 1040 personal income tax returns yielded promising results, with an average of 40% to 50% of returns being accurate.[9]

Specifically, at the bottom income decile, the study found roughly 60% to 80% of the prepopulated returns were accurate. The accuracy rate dropped as income increased and more taxpayers itemized.

Although these efforts tend to be more successful for simpler returns — generally for taxpayers who are lower income, single, young and have no dependents — and implementation is certainly no easy task, prepopulated returns would definitely free up a sizable portion of the IRS audit workforce.

Even for taxpayers who did not receive completely accurate prepopulated returns, the majority only needed to make one correction. This shows that taxpayers would still benefit from a reduced compliance burden.

Moving beyond simplicity and the compliance burden, some practitioners focus on the different IRS functions. Most of the time, taxpayers see the agency merely as a tax collector.

But more and more, as lawmakers expand the role of tax to fulfill social objectives — as opposed to simply financing public goods and government operations — the wealth of taxpayer data the IRS collects on family characteristics, income and household information makes the agency the ideal candidate to distribute aid.

Observers point out that the scope creep has made the IRS increasingly resemble a social service agency.

As such, some have proposed that the agency be split into two subgroups, with one focusing on revenue services, including the traditional missions of tax law enforcement and collection, and the other focusing on social services, such as distribution of the earned income tax credit, child tax credits or any future stimulus checks.[10]

The reorganization would allow for specialization, clarify taxpayers' understanding of the agency's work and give the IRS an opportunity to ask for a larger budget. However, opponents argue that the overall efficiency and capability of the IRS is the main issue — that simply expanding the head count or budget is not going to solve the underlying problems.

With its increasing tasks and diverse functions, the IRS is in need of change. There is no shortage of well-thought-out ideas for revamping the agency's functions. However, any immediate and practical solutions should start with gradual steps, and visibly improve taxpayer experiences. Tasks such as enhancing customer service quality, reducing wait times, upgrading the agency's IT system, and expanding automation are more likely to be accepted as starting points and be conducive to more fundamental overhauls in the future.

Joyce Beebe, Ph.D., is a fellow at Rice University's Baker Institute for Public Policy.

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