

## Cato Institute Policy Analysis No. 222: Why You Can't Trust the IRS

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### Executive Summary

By the end of this year some 40 million Americans will have had an adversarial confrontation with the Internal Revenue Service. In a rising number of such confrontations, the taxpayer is right, and the IRS is wrong. This study finds that despite a doubling of its budget over the past 10 years and a nearly 20 percent increase in enforcement personnel, the IRS is increasingly incapable of administering and enforcing the nation's tax law. The following are some of the reasons the IRS can no longer be trusted.

- The IRS telephone taxpayer assistance program provides about 8.5 million Americans the wrong answers to even the most basic inquiries about the tax laws.
- This year roughly 10 million Americans will receive correction notices from the IRS assessing about \$4 billion. About half of those notices will be erroneous.
- About 40 percent of the revenues the IRS collects through penalty assessments are abated when citizens challenge the penalties. In 1993 taxpayers were over- charged \$5 billion.
- A General Accounting Office audit of the IRS in 1993 found widespread evidence of financial malfeasance and gross negligence. The IRS could not account for 64 percent of its congressional appropriation.

The IRS fails to meet the standards of financial accountability and diligence that it imposes on the citizenry. Since the IRS can no longer adequately police itself, it can no longer be trusted with the authority to police individual American businesses and taxpayers.

### Introduction

The Internal Revenue Service is often portrayed as the nation's most, if not only, efficient government agency. With a 1993 operating budget of \$7.11 billion and total revenue collections of \$1.176 trillion, the IRS collected \$100 of tax for every 63 cents of cost.<sup>[1]</sup> For that reason, Congress has come to regard the IRS as a good deal for taxpayers. Congress has doubled the IRS budget over the past 10 years--making that agency one of the fastest growing nonentitlement programs. It has increased its employment by 20 percent. The IRS wields awesome collection powers. Its powers to investigate and examine taxpayers transcend those of any other law enforcement agency. Virtually all of the constitutional rights regarding search and seizure, due process, and jury trial simply do not apply to the IRS. Its investigative powers are enormous: the IRS has more enforcement agents than the Environmental Protection Agency, the Occupational Safety and Health Administration, and the Drug Enforcement Agency combined. That leads to the question, can the IRS be trusted to do the right thing with regard to tax law enforcement and administration? To answer that question, various aspects of IRS behavior in those general areas are examined.

Unfortunately, this study shows that the trust that Congress has placed in the IRS is dangerously misplaced. A review of the IRS's recent performance presents a picture of an error-prone, negligent, and inefficient agency. The widespread incompetence of the IRS calls into question the agency's ability to enforce and administer our current income tax system.

### **The IRS Environment--The Tax Laws**

Before the shortcomings of the IRS are examined, the hopelessly complicated tax system the IRS administers is discussed.

### **Tax Law Complexity and the IRS**

When the income tax law first took effect in 1913, it had just 170 pages of law and regulation. Since then the tax code has grown to encompass over 17,000 pages of law and regulation. On top of that, hundreds of thousands of pages of court decisions interpret that law. Additional interpretations come in the form of IRS revenue rulings, revenue procedures, opinion letters, information letters, technical advice memoranda, private letter rulings, chief counsel orders and notices, and general counsel memoranda. It is a virtual impossibility for a tax attorney--let alone a typical taxpayer--to keep up with all the changes.

In the 1980s the tax laws were altered more than 100 times. In 1986 Americans were presented with the most sweeping tax law change in 30 years--intended to simplify the tax code. The Tax Reform Act of 1986 brought amendments to more than 2,000 sections of the code and the creation of more than 100 new forms. To teach us about those forms, the IRS produces thousands of pages of instructions, and hundreds of booklets to teach us about the instructions.

The tax change parade continued into the 1990s. Major tax modifications occurred in both 1990 and 1993, with many minor ones in between. The 1994 mid-term congressional elections promise new, sweeping tax law reforms now that Republicans have control of Congress.

Any tax law change, large or small, is no easy matter for the IRS. Consider the burdens the agency faced in 1993 alone; it was expected to

- revise and test more than 6,100 computer software programs;
- revise automated tax information scripts for telephone inquiries;
- train 29,000 service center employees to process returns, compute bills and refunds, and make adjustments;
- train 8,000 taxpayer service employees who answer 40 million taxpayer inquiries;
- design or revise 250 forms and 110 publications;
- print and distribute over 1.3 billion copies of forms and instruction; and
- update taxpayer information and educational materials.<sup>[2]</sup>

It is obvious that the constant revisions of the tax code enacted by Congress impede the IRS's efforts to perform administrative and enforcement duties consistently and correctly.

### **Tax Law Complexity and the Public**

Regardless of its effect on the IRS, there can be little doubt that the constantly changing face of tax law causes much confusion to the public at large. The number of citizens using tax preparers over time is the IRS's bellwether measurement of tax law complexity. The IRS's national opinion surveys conducted in 1987 and 1990 confirm "that the most frequently given reasons for using a preparer are the complicated nature of return preparation, or fear of making mistakes."<sup>[3]</sup>

Each and every year since 1981, the use of paid preparers has risen. As [Figure 1](#) shows, in 1981, 41 percent of taxpayers used a tax professional. In 1986, 46 percent, or 45.22 million citizens, used paid preparers. By 1992, 50 percent, or 57.5 million citizens, sought professional help. That is an 18 percent increase during a period when the tax

laws were supposedly simplified.

Paid preparers are not used only by rich taxpayers. IRS statistics indicate that quite the opposite is true. According to the agency's 1992 financial statement, "in 1989, 1990 and 1991 (the only years for which data is available), slightly more than 80% of the returns filed with paid preparers were for taxpayers with less than \$50,000 of Adjusted Gross Income."<sup>[5]</sup>

1981	41%
1986	46%
1992	50%

[Graph Omitted]  
Source: Daniel J. Pilla, *How to Fire the IRS* (St. Paul: Winning Publications, 1994).

The continual changes in our tax laws create a serious compliance problem. When the tax system consists of 17,000 pages of law and regulation, compliance is no easy matter. Most Americans make every reasonable effort to comply with the law. Often their efforts are defeated by one of two factors. Either they simply do not understand what the law requires, or they cannot afford to pay what they owe.

In 1992 then IRS commissioner Shirley Peterson testified to Congress about administrative changes regarding the IRS's "tax amnesty" programs.<sup>[6]</sup> She told Congress,

The [tax] law is now so complex that it affects taxpayers' ability to comply--and often affects their willingness to comply, as well. . . . A good part of what we call non-compliance with the tax laws is caused by taxpayers' lack of understanding of what is required in the first place. Once you acknowledge that reality, it makes good business sense to increase our efforts to help taxpayers comply rather than relying solely on after-the-fact enforcement.<sup>[7]</sup>

Peterson went on to say,

Many taxpayers fail to comply because they are unaware of the requirements of the law or because they cannot easily understand what they are supposed to do.<sup>[8]</sup>

### **Tax Law Complexity and Tax Professionals**

The tax laws are now so complex that even professional tax preparers are often ignorant of all the nuances of the code. Each year since 1987, Money magazine has surveyed private-sector tax preparers. Money constructs a hypothetical family financial profile based on the demographics of its readers. The facts are presented to 50 different tax professionals in the private sector. The instructions are simple: compute the tax liability of the sample family on the basis of your understanding of the tax laws and the facts given.

In each of the surveys from 1987 to 1991, 50 different preparers came up with 50 different answers. What is worse, none calculated the correct answer. The results of the 1992 study were the same: 48 different preparers came up with 48 different answers. Again, none came up with the right answer.

Even more troubling was the spread of tax liability shown in the results for 1992. On the high side, the tax for the sample family was fixed at \$46,564. On the low end, the tax was said to be \$16,219. With a target tax of \$26,619, both seem worlds away from the correct result.<sup>[9]</sup> Money's analysis of the results provides some insight into the problems created by our complex law.

While there were no perfect scores, a dozen returns were exemplary. Because of the tax code's ambiguity, the target tax of \$26,619 was not the only acceptable answer.<sup>[10]</sup>

That statement, perhaps more than anything else, indicates the nature of the problem. We now have a law that is so confusing that two people of reasonable intelligence can read the same provision and come away with completely different understandings of what it means.

### **Tax Law Complexity and Congress**

There is substantial evidence that Congress itself does not understand the tax laws it writes. In 1993 Money discovered that about 60 percent of the members of the House Ways and Means and Senate Finance Committees--the two tax-writing committees--do not prepare their own tax returns.<sup>[11]</sup>

Clay Shaw, a Florida representative, is both a CPA and an attorney. He is quoted as describing the U.S. tax code as a "rat's nest." Former chairman of the Finance Committee Daniel Patrick Moynihan was reported to use a professional, as was former Ways and Means chairman Dan Rostenkowski. Even former treasury secretary Lloyd Bentsen, long-time chairman of the Finance Committee, uses a tax professional. The reason, he said, is because his return "is a complicated one."<sup>[12]</sup>

Unlike the taxpaying public, however, Congress does not have to go it alone. While the public pays \$30 billion per year to employ return preparation professionals, Congress receives the service at taxpayers' expense. Those who prepare their own returns have the expert lawyers employed by the tax-writing committees at their service.

Moreover, the IRS funds and staffs two offices in Washington during tax preparation time for members of Congress and their staffs, at a cost to taxpayers of \$100,000 annually. Each year IRS specialists provide advice to about "4,000 of the 20,000 people who work on Capitol Hill."<sup>[13]</sup>

### **The IRS and Tax Administration**

To what extent is the IRS itself able to fully understand and correctly administer the tax laws? Answering that question involves examining four major areas of IRS interaction with the public: taxpayer assistance programs; adjustments and correspondence; penalty assessments; and tax examinations, commonly called audits.

#### **Toll-Free Taxpayer Assistance**

During the 1993 filing season, the IRS "assisted" approximately 77 million citizens. The agency provides assistance in the form of toll-free telephone "assisters" and IRS personnel in offices receiving walk-in customers. That element of tax administration is "an important indicator" of how well the IRS performs in a given filing season.<sup>[14]</sup> The IRS correctly asserts that "providing accurate and timely telephone assistance reduces errors on tax returns and promotes taxpayer confidence in the IRS."<sup>[15]</sup>

Two factors can be used to gauge the proficiency of the IRS telephone assistance program. The first is the agency's "accuracy" in answering questions. The second is the "accessibility" of assisters to the public. The IRS does an annual survey, known as the Integrated Test Call Survey System (ITCSS), of its assistance program. The purpose of the ITCSS is to ascertain the level at which the IRS performs in both categories. The General Accounting Office monitors the test program to verify the IRS's findings.

The ITCSS consists of a series of tax law and return preparation questions covering areas about which individuals regularly make inquiries to the IRS. The "centerpiece of ITCSS is a 62-question test covering seven major individual tax law categories about which taxpayers ask questions."<sup>[16]</sup>

In 1989 the IRS answered just 62.8 percent of taxpayer questions correctly.<sup>[17]</sup> Since approximately 65 million inquiries were made to the "assister" program that year, 24.18 million taxpayers were given incorrect or incomplete

information.

Admittedly, the IRS and the GAO have made accuracy in the assistance program a priority, and the level of accuracy has risen over the years. By 1993 the ITCSS reported IRS accuracy in response to some 77 million inquiries at 89 percent. But even with that improvement, 8.5 million people are getting incorrect or incomplete information from the IRS.

Moreover, the progress must be tempered for two reasons. First, little has been said about a phenomenon that has been occurring since 1989. As the IRS claims to be more accurate in the answers it provides, a smaller percentage of citizens has access to the program. In 1989 the IRS responded to 65 million inquiries. That represents 58 percent of 112 million total attempts to ask questions. In 1993 the IRS responded to 77 million inquiries. But that represents just 24 percent of 320 million total attempts to get information. The GAO reported in November 1993 that the problem is getting worse.

IRS data indicate that taxpayers who call IRS have a good chance of getting a correct answer to their tax law questions; but their chances of getting through to ask those questions are poor. People who called during the 1993 filing season, for example, had a 1 in 4 chance of getting through--even worse than the 1 in 3 chance we reported in 1992. [\[18\]](#)

Second, while the IRS boasts of giving the right answer 89 percent of the time, that probably overstates the real level of accuracy. It is critical to note that the ITCSS is an IRS function monitored by the GAO. The IRS, not the GAO, develops the questions. The IRS, not the GAO, conducts the test calls. The IRS, not the GAO, determines what is considered a correct answer to a given question. The test consists of what the IRS identified as 62 of the most commonly asked questions in just seven major individual tax law categories. Moreover, the survey involves only basic, relatively simple areas of law affecting a large number of people, as opposed to obscure areas of law that are not handled on a regular basis. The fact that front-line assisters still cannot achieve total accuracy in straightforward areas of the tax code is an extremely negative reflection on the agency as a whole and suggests a poor track record on complicated tax questions.

While the accuracy level is rising, the IRS is providing fewer representatives to do the job. That is one reason the accessibility rate has dropped so. That is an outrageous development in light of the fact that more and more people are in need of assistance each year. The GAO described the situation as a "continuing erosion of the telephone service." [\[19\]](#) Countless millions of questions are going unanswered. Taxpayers are forced to founder through the preparation process with no information at all.

The bad situation of those who are given incorrect information is often later exacerbated by the IRS. We all know the IRS charges penalties and interest when a citizen makes a mistake on his tax return. Each year millions of individual penalties are assessed, leading to billions in additional revenue. However, citizens are misled by the IRS about their right to cancel penalties and interest attributable to IRS error.

In 1988 Congress passed and President Ronald Reagan signed into law the Taxpayers' Bill of Rights Act. [\[20\]](#) One of the most hotly debated provisions of the bill was a measure to require cancellation of interest assessments when it is shown that the interest is attributable to either IRS error or IRS delay. That measure was in direct response to the high level of incorrect information passed out by the IRS at the time.

After much debate, Congress added Internal Revenue Code section 6404(e) to the law. It states, in part, that the agency shall cancel any interest assessment when it is shown that such interest is due "in whole or in part to any error or delay by an officer or employee of the Internal Revenue Service." [\[21\]](#) Unfortunately, the agency fails to tell the truth about that right. Indeed, the IRS deliberately misleads millions with respect to that and other taxpayer rights.

### **Computer-Generated Notices**

As the world turns faster and faster toward computer automation, the IRS does the same. Since 1984 the agency has embarked on a massive computer upgrade program known as Tax Systems Modernization (TSM). The idea behind

TSM is to transform what was a largely manual system into one that is entirely automated. The price tag for that aggressive undertaking is expected to be more than \$21 billion.<sup>[22]</sup>

At the heart of TSM is the computer notice program. Using computer upgrades acquired since TSM began in earnest in 1984, the IRS greatly expanded its program of contacting taxpayers with computer notices. The idea of expanding the use of such notices was first expressed in a 1984 IRS strategic plan.<sup>[23]</sup>

One of the many goals set forth in the plan was to "seek additional ways to create and maintain a sense of presence" in the lives of all Americans.<sup>[24]</sup> And one way to do that was "to expand our computer-generated contact program."<sup>[25]</sup> In other words, the IRS intended to embark on a mail-order program of tax administration.

And mail notices it did. The notices encompass a wide range of programs allegedly designed to "correct" improper or incomplete tax returns. The correction programs focus on nonfilers, underreporters, math errors, and general return preparation mistakes. Computer notices generally explain that the IRS reviewed the tax return in question, found an error, and corrected it. Usually, additional tax is owed as a result of the correction. The notice includes a demand for payment of the tax, with interest and penalty.

In 1984 the IRS mailed 420,000 "service center correction notices."<sup>[26]</sup> By 1986 the number had grown to 769,000, an increase of more than 83 percent in just two years.<sup>[27]</sup>

My career as a tax consultant has brought me face-to-face with countless citizens across the nation confronted with computer notices. After talking with hundreds of them, and given my knowledge of the 1984 strategic plan, I concluded that the IRS was deliberately sending bogus bills to the public. The error rate in the notices I personally examined seemed much too high to be inadvertent.

In November 1986 I made the claim on national radio that the IRS was indeed mailing to the public bills that it either knew or should have known were incorrect. In 1988 the GAO released a study revealing huge error rates in the program. The results of the analysis are shocking. Among other things, the GAO reported,

Our review of correspondence and related cases at three service centers indicated that the IRS' letters, the adjustments discussed in the letters, and/or the action taken by the IRS in response to the taxpayers' inquiries was often incorrect, unresponsive, incomplete or unclear. Such notices sometimes resulted in the assessment of incorrect tax and penalties. Equally serious, however, are the potential for confusion and frustration on the part of taxpayers and the extra time and expense IRS and taxpayers incur in processing of additional correspondence needed to resolve the issue.<sup>[28]</sup>

More specifically, the GAO found that 48 percent--virtually one-half--of all IRS correspondence and actions regarding account adjustments were either "incorrect, unresponsive, unclear or incomplete."<sup>[29]</sup> Further, in 68 percent of the cases studied, the IRS failed to comply with its own "procedures designed to foster good taxpayer relations."<sup>[30]</sup> Even worse, the GAO found that the vast majority of taxpayers have a very difficult time correcting inappropriate notices. The report described a poll of 406 members of the Tax Division of the American Institute of Certified Public Accountants. The poll showed that

1. 75 percent of the respondents felt that IRS was least efficient in handling inquiries,
2. 83 percent of the respondents noticed unusual delays by IRS in answering clients' correspondence, and
3. 75 percent said they had unusual difficulties getting IRS to correct problems.<sup>[31]</sup>

The respondents to that poll were trained professionals. Imagine the frustration and puzzlement of average citizens trying to resolve their problems with erroneous IRS notices.

The GAO acknowledged such frustration as a significant problem. It attributed the failure of the IRS to provide responsive answers and decisive action to the increased workload of its service centers. Yet that increased workload is largely self-imposed. After all, if the IRS does not adequately respond to initial inquiries and requests concerning



account action, it can expect to receive second, third, and even fourth letters from disgruntled taxpayers seeking action. As the GAO noted, "Taxpayers are understandably persistent about having adjustments made to their accounts."<sup>[32]</sup> The GAO pointed out,

In addition to the unnecessary cost associated with processing repeat correspondence and incorrect adjustments, inappropriate letters can frustrate taxpayers, as indicated by the tone of some taxpayer correspondence we reviewed. For example, one taxpayer wrote: "I have either written, or telephoned on this issue in the past to try and resolve this problem, but all I get is the run around."<sup>[33]</sup>

In 1990 the GAO revisited the question of IRS proficiency in handling adjustments and correspondence. The GAO asked a simple question: what has been done to correct the problem identified in the 1988 report? The answer was equally simple: not much. The GAO did acknowledge a "new program" to handle adjustments and correspondence as part of TSM. The program is known as the Automated Inventory Control System. However, the GAO noted,

It does not appear likely that any significant improvement will occur as a result of the modernization program until after 1992 when IRS' Automated Inventory Control System is expected to be in operation.<sup>[34]</sup>

What has been done since 1992 to fix that most serious problem? While some improvements have been made, the GAO continues to acknowledge that "problems still exist."<sup>[35]</sup> Those problems, the GAO observed, "increase IRS's costs, frustrate taxpayers, and ultimately hinder compliance with IRS laws."<sup>[36]</sup>

In sum, a serious problem with IRS correspondence was detected in 1988. By 1990 nothing had been done to correct it, though clearly it was costing American taxpayers billions each year. And today the GAO says the problem persists.

Despite the clear and manifest defects of the program, the number of correction notices has exploded. Former commissioner Peterson, in her 1991 Annual Report, revealed just how widespread the correction notices are. She stated,

We send close to 100 million letters or notices to taxpayers annually, with service center account adjustments alone generating 10 million letters.<sup>[37]</sup>

That is an increase of 1300 percent in just four years.

Why does the IRS continue to expand a program so flawed and abusive? One answer is that it is a large revenue generator. In 1993 the Information Returns Program by itself was responsible for \$3.702 billion in additional tax, penalty, and interest assessments.<sup>[38]</sup> It does not seem to bother Congress or the IRS that about half the notices are wrong.

The adjustments and correspondence program inaugurated in 1984 has led to tens of millions of notices over the years. Countless citizens are randomly burdened with notices that are flat wrong about half the time. Yet the IRS does little to correct the problem. Despite repeated promises to "upgrade" and "modernize," the agency seems content to let stand a problem that leads to the collection of billions in unwarranted revenue each year.

### **Penalty Assessments**

Tax penalties have increased in both number and amount. From 1954 to the present, the number of different penalties has grown from about 15 to 140. They cover record keeping, tax return preparation, information return preparation and filing, estimated tax payments, employment tax deposits, tax computation, employee withholding statements, asset valuation, cash transaction reports, Social Security numbers, and on and on.

With the growth of the number of penalties has come concomitant growth of the number of penalty assessments. During the 1960s, for example, penalty assessments were so insignificant that the IRS did not even show them as a separate entry in its annual report. By the 1980s, however, penalty assessments were looked upon by the IRS as a

source of revenue. Rather than using penalty provisions to punish and deter wrongful conduct, the IRS used them as a back-door method of collecting more money.

In 1992, with the adoption of its "amnesty programs," the IRS agreed to stop using penalties in that fashion.<sup>[39]</sup> Despite that promise, penalty assessments are steadily on the rise. For example, in 1980, on the threshold of the decade that brought over 100 changes to the tax laws, the IRS assessed 19.59 million penalties. Total revenue from penalties was \$1.55 billion.<sup>[40]</sup> The next several years of tax "simplification" culminated in the Tax Reform Act of 1986. The first year in which that law was in effect was 1987. Exactly how much the tax laws were simplified may be surmised from the 1987 penalty data.

In 1987 the IRS assessed a total of 26.97 million penalties, worth a total of \$9.99 billion.<sup>[41]</sup> So while tax law compliance was "simplified," the number of penalties grew by 37 percent and penalty revenue exploded by more than 640 percent.

By 1991 the number of assessments had grown yet again. It went from 26.97 million in 1987 to 32.70 million in 1991, a jump of 21.5 percent.<sup>[42]</sup> Bear in mind that in 1992 the IRS promised to stop using penalty assessments as a means of collecting revenue. Rather, it would use penalties only for the intended purpose of "encouraging voluntary compliance."<sup>[43]</sup>

Despite the IRS's promise, by 1993 total assessments had increased to 32.97 million (see [Figure 2](#)), slightly more than in 1991.<sup>[44]</sup> It seems that the IRS remains intent on using penalties as a means of raising revenue, contrary to their legislative purpose, and contrary to its own promise.

The growth in penalty assessments (59 percent from 1980 to 1993) is a serious problem for taxpayers because the error rate is very high. For starters, the IRS makes the majority of penalty assessments through the adjustments and correspondence process. The error rate for correspondence is 48 percent. There is nothing to indicate that the rate is any less when the correspondence involves penalty assessments.

Other evidence also speaks to the penalty error rate. For example, each year the IRS penalizes more than 1.5 million businesses for violation of the payroll tax deposit rules.<sup>[45]</sup> The rules are complex, cumbersome, and subject to regular change. Despite the great number of assessments, the IRS admits that it abates more than "60 percent of the penalty amounts when taxpayers request abatement and provide sufficient justification."<sup>[46]</sup>

<b>Figure 2</b>	
<b>Number of Penalties Assessed by the IRS</b>	
<b>(millions)</b>	
1980	19.6
1987	27
1991	32.7
1993	32.97

[Graph Omitted]  
Internal Revenue Service, 1993 Annual Report (advance draft), Table 15.

The IRS's own data indicate how error prone the agency is in assessing taxpayer penalties. The data in [Table 1](#) indicate that about 40 percent of penalty revenue has been canceled through the abatement process over the last five years. In 1993 the IRS mistakenly overcharged taxpayers more than \$5 billion in penalties.

The IRS takes a "shotgun" approach to penalty assessments. Without any investigation of the facts of particular cases, it simply imposes penalties. It is then up to the taxpayers to seek cancellation, provided they are able to obtain



sufficient information to guide them through the process.

The number of penalty abatements would be much higher except for the fact that IRS taxpayer assistance personnel often provide false or misleading information on the abatement process. Countless citizens phone each day seeking help with penalties. They are told a host of tales, including, "penalties cannot be canceled," "penalties are automatic," "one must pay the penalty before he can challenge it." Such incorrect statements, because of their intimidating effects, dissuade most people from challenging a penalty in the first place. Abatement rates might be significantly higher if the IRS were honest about the process.

**Table 1**

**Penalty Abatement**

Tax Year	Gross Revenue	Net Revenue	Percentage Abated
1989	\$11.799	\$7.107	39.8%
1990	11.848	6.079	48.7%
1991	10.820	6.520	39.75
1992	12.505	8.875	29.0%
1993	13.128	7.969	39.0%

Note: All data from IRS Annual Reports for years stated; dollars are in billions.

### Audit Results

The term "audit" makes one think of a grueling exploration by the IRS of all one's books, records, papers, and documents. The face-to-face audit process is nothing more or less than the procedure by which the IRS ascertains the correctness of one's income tax return. In practice, however, the IRS has turned the tax audit into a revenue enhancement tool. Under the guise of determining the correctness of the return, the agency assesses billions in unwarranted taxes and penalties each year. That is done with the apparent encouragement of Congress, which continues to increase the IRS enforcement budget.

In each of the last three years, additional tax and penalties assessed as a result of face-to-face audits averaged about \$26.5 billion.<sup>[47]</sup> That is in addition to the revenue collected through the computerized notice process.

One way to measure audit accuracy is to review the results achieved by those who appeal audit decisions. In 1993 the IRS audited the individual income tax returns of 1.06 million people. Of those, 84 percent were found to owe more money.<sup>[48]</sup> The average individual face-to-face tax audit led to the assessment of \$4,780 in additional tax and penalties, not including interest.<sup>[49]</sup> However, just 5 percent of those found to owe more money appealed.<sup>[50]</sup> The 5 percent number is significant in this way: the GAO has proven that the IRS's computer notices are wrong 48 percent of the time. Still, 95 percent of the public is persuaded that IRS audit results are correct or not worth fighting. That testifies to the degree to which the IRS has the public convinced that it cannot win when challenging an audit.

The appeals statistics, however, tell a much different story and indicate just how inaccurate the audits are. Of the cases received by the Appeals Division in 1993, nearly 97 percent were settled by agreement. That is to say, while the taxpayer was unable to reach a satisfactory settlement with the tax auditor, he could with an appeals officer 97 percent of the time. Why such a tremendous settlement rate at the appeals level? The answer is found in the rules governing practice before the Appeals Office. Consider the language of Rule I:

(1) Rule I. An exaction by the U.S. Government which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the U.S. Constitution. Accordingly, an Appeals representative in his conclusion of fact or applications of the law, shall hew to the law and the recognized standards of legal construction. It shall be his or her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the

Government, and without favoritism or discrimination as between taxpayers.<sup>[51]</sup>

Appeals officers are under a strict admonition to determine the correct tax liability. They are to settle cases on the basis of recognized law and the facts of the case. Incredibly, no similar guidelines exist for tax auditors.<sup>[52]</sup> That situation and years of practice lead to the conclusion that tax examiners put forth opinions designed to collect more money. On the other hand, appeals officers put forth opinions based on the law and the facts. However, most citizens are intimidated by the audit process and are ignorant of their rights. Consequently, they often end up facing assessments of tax and penalties they do not owe.

The second level to which a taxpayer may appeal is the U.S. Tax Court. Tax court cases are a direct result of one's inability to settle with the Appeals Office. As [Table 2](#) shows, in recent years taxpayers have won all or part of their claims in tax court about 50 percent of the time.<sup>[53]</sup> That indicates an error rate at the appeals level of 50 percent.

**Table 2**

**Tax Court Success Rate**

Tax Year	Number of Cases	Taxpayer Success (%)
1992	1,431	49.8%
1991	Data not available	Data not available
1990	1,270	50%
1989	1,268	51.3%

Data from IRS Annual Reports for year stated; "split decisions," where some issues were decided for the taxpayer and some for the IRS, are included.

### **The Public's Perception of IRS Performance**

A major priority of the IRS is to win and maintain the confidence of the public. The tax system would be impossible to administer if the public lost confidence in the IRS's efficiency, fairness, and integrity. Yet that is exactly what is happening. The pattern of decline has been steady over the past several years.

One significant measure of the public's confidence in the IRS is the estimated "tax gap" figure. The tax gap is defined as the amount of taxes due from legal activities, compared with what is paid. According to the GAO, total tax gap figures have been on the rise since 1987.<sup>[54]</sup> In 1987 the tax gap was estimated at \$71 billion. By 1992 it had risen to \$94 billion. Today it is estimated at well over \$100 billion.

Publicly, the IRS claims the tax gap exists because of tax "cheaters." A rising tax gap is indicative, says the agency, of falling "voluntary compliance." Voluntary compliance is defined as reporting and paying the correct amount of tax without the IRS's taking enforcement action.

However, the reality seems to be quite different. It is reasonable to conclude from the evidence that the rising tax gap (or the falling level of voluntary compliance) is at least in part a result of improper IRS actions and increasing citizen distrust of the tax system. For example, a citizen who is abused or victimized in an audit may retaliate by underreporting his income in a subsequent tax year.

The results of the IRS's Customer Satisfaction Survey give some insight into the public's confidence in the agency ([Table 3](#)). The IRS regularly conducts surveys of the U.S. adult population to determine satisfaction with IRS actions. The respondents are asked to rate the IRS on a scale of 1 to 10 (10 being the best) in various areas. The summer 1993 survey shows a dramatic drop in the public's perception of IRS quality.

The public's overall assessment of the IRS is shown by a composite average of all areas. That assessment dropped<sup>[55]</sup>

from 6.42 in 1992 to just 5.88 in 1993. It is inconceivable that a private-sector enterprise, large or small, could stay in business if its customers felt they were wronged, cheated, or otherwise inadequately served 41.2 percent of the time.

**Table 3**

**Customer Satisfaction Survey**

Key Changes in Perception	Summer 1993	Summer 1992	Change 1992-93
Does IRS maintain highest standards of integrity?	6.10	6.53	(0.43)
Does IRS keep tax return information confidential?	7.45	7.85	(0.38)
Do IRS employees respond to people's requests?	6.55	6.95	(0.40)
Does IRS accurately answer tax questions?	6.55	6.91	(0.36)
Are IRS employees courteous?	6.46	6.77	(0.31)

Source: General Accounting Office, "Examination of the IRS's Fiscal Year 1993 Financial Statements," p. 61.

**The IRS and Domestic Surveillance**

Late last year Americans were alarmed to learn that 368 IRS agents were illegally scouring through the returns of thousands of citizens--typically neighbors, friends, and celebrities. An indication of the level of IRS concern about such blatant invasions of taxpayers' privacy is provided by the fact that only five of the offending agents were eventually fired. In 1993 the GAO discovered that there are very few protections against such abuses of financial privacy. The GAO reported, Though heavily dependent on automated systems to process and safeguard taxpayer data, IRS did not adequately control access authority to this information. Further, controls did not provide reasonable assurance that only approved versions of computer programs were implemented. Such weaknesses increase the risk of unintentional errors and fraud and may compromise the confidentiality of taxpayer information. For example, IRS internal reviews found that some employees had used their access to monitor their own fraudulent returns, to issue fraudulent refunds, and to inappropriately browse taxpayer accounts.<sup>[56]</sup>

One thing seems clear. As the IRS is handed more computer power, and more access to information, and as citizens are required to submit more data to the agency, it seems reasonable to assume that snooping occurs on a fairly broad scale. And whether the illegal snooping is broad in scope or not, clearly it has a negative impact on the public's perception of the agency. As Sen. William Roth (R-Del.) observed during the course of the August 1993 hearings on the topic,

When tens of thousands of IRS employees are at liberty to access confidential information of millions of taxpayers and this public trust is abused, taxpayers begin to lose confidence in the tax system. Creating fraudulent tax refunds, browsing through tax records of friends, relatives, neighbors and celebrities and violating the privacy of taxpayers raises fundamental questions about the security of our tax system.<sup>[57]</sup>

Unfortunately, IRS snooping into the private affairs of U.S. citizens is not new. Twenty years ago Sen. Frank Church of Idaho chaired a Senate Select Committee to Study Governmental Operations with Respect to Intelligence Activities. The focus of the 1975 committee report was the illegal intelligence activities of the IRS. The committee hearings revealed, among other things, that the IRS

- routinely engaged in undercover surveillance of public meetings, such as sporting events and the like;

- regularly used undercover operatives to supply IRS contacts with statements made by citizens under investigation; and
- would take license plate numbers of the most expensive-looking automobiles present at public gatherings to develop lists of people to audit.

Some of the more bizarre revelations included the fact that the Federal Bureau of Investigation and even the Central Intelligence Agency regularly asked for and were given the tax returns of any person or organization they wished. The hearings revealed that the IRS had developed "hit lists" of some 8,000 people and 3,000 organizations that would be targeted for audit, though they were not suspected of owing taxes. It was revealed that the IRS had created a specialized--and highly secret--staff whose job was to conduct surveillance and intelligence-gathering activities against various political groups for political reasons, not for reasons of tax law enforcement. The title given that group by the IRS was the Special Service Staff, or SSS.

At the conclusion of the hearings, Senator Church made this statement to then IRS commissioner Donald C. Alexander regarding IRS treatment of confidential tax return information:

This committee is concerned about what is becoming obvious in the course of these hearings, and this is the spreading of "Big Brother" government methods, and what your testimony shows is that, at least as of now, every taxpayer in this country is on notice that when his tax return is filed in the IRS, it means any agency of Government that can claim an official interest can get into that tax return for its own purposes. What better form is there to intimidate people, harass people, force them to comply with whatever it is some other agency may have in mind, than to have his tax return and information it may contain. [\[58\]](#)

Throughout his testimony, Commissioner Alexander assured the concerned senators that the IRS would fix the problem. The SSS, for example, was dismantled under Alexander. He assured former senator Walter Mondale that he was very much in favor of the idea that confidentiality laws "should be tightened up." [\[59\]](#)

The promises former commissioner Alexander made 20 years ago closely resemble those of current commissioner Margaret Richardson. In her testimony to a Senate committee on August 4, 1993, she gave the following assurance to Congress regarding the security of confidential taxpayer information: "As a result of our internal reviews, we have taken steps to put greater management emphasis to ensure the safeguards of the privacy and security of taxpayer information." [\[60\]](#)

While her assurances about taxpayer privacy are certainly impressive, the facts indicate something entirely different. On December 20, 1994, fewer than 18 months after her glowing statement to Congress regarding taxpayer privacy, the IRS, under Commissioner Richardson, announced a plan to install a system that would link its computers with every public and private database in the nation. The purpose of the system is to provide the IRS with "on-line access" to data, including

commercial sources, state and local agencies, construction contract information, license information from state and local agencies, Currency and Banking Reports (CBRS), data regarding assets and financial transactions from state and local agencies, and information on significant financial transactions from reviews of periodicals and newspapers and other media sources. [\[61\]](#)

The notice goes on to describe exactly who would be the target of the proposed IRS invasion of every database in the nation. The proposal identifies the people covered under the aggressive electronic surveillance system as

any individual who has business and/or financial activities. These may be grouped by industry, occupation, or financial transactions included in commercial databases, or in information provided by state and local licensing agencies. [\[62\]](#)

The IRS's information-gathering plans could not be broader. Very simply, the agency intends to use electronic methods to spy on the daily activities of every individual in the nation. Under the guise of tax law enforcement, the IRS plans to create an electronic dossier on every citizen. Under the best of circumstances, that is a chilling

proposition. Given the IRS's record on truthfulness, accuracy, and reliability in its activities, the idea of its conducting electronic surveillance of every citizen is exceedingly dangerous.

The idea that the IRS would provide any measure of confidentiality with respect to the information it gathers is laughable. If one enjoyed his right to privacy with regard to his financial affairs, the IRS would be precluded from gathering the data in the first place.

In defense of the IRS, the problem of lack of taxpayer confidentiality simply cannot be addressed or solved adequately under the current tax law structure. The income tax structure by its very nature is invasive, burdensome, and necessarily dependent on information gathering. The concepts of financial privacy, or taxpayer confidentiality, and income tax law enforcement are--by their nature--mutually exclusive. As we move further into an information age, the potential for privacy abuses is heightened.

The very idea of taxpayer confidentiality, in the true sense of the word, has long been foreign to IRS administrators. Consider this exchange between former senator Robert Morgan and former IRS commissioner Alexander. The dialogue occurred during the 1975 Senate hearings on intelligence activities within the IRS.

Senator Morgan: We were talking about intelligence gathering in this committee's work. And it seems to me that you [the IRS] have probably more confidential information on individuals and their finances than any other agency in government. Do you agree with that?

Commissioner Alexander: Well, I surely hope so. If another agency has more than we have, they have no business having it.<sup>[63]</sup>

The problems of taxpayer confidentiality cannot possibly be solved when high-ranking IRS administrators "hope" to have more confidential information on individuals and their finances than does any other government agency.

### **The IRS and Congress**

Each year the IRS appears before Congress with requests for more money, more equipment, and more manpower, and each year Congress grants at least part of those requests. Between 1986 (the year of tax "simplification") and 1993, the IRS's annual operating budget increased by 84 percent, from \$3.84 billion to \$7.07 billion, and the number of IRS employees rose from 95,880 to 113,300, an increase of 18 percent.<sup>[64]</sup> In its 1995 budget request, the IRS asked for the money to hire an additional 5,078 employees.<sup>[65]</sup> In addition, between 1986 and 1993 the IRS spent about \$1.3 billion on TSM, and it expects to spend over \$21 billion before the project is completed in 2008.

The IRS says that the new employees will produce "\$9.2 billion in revenues in the next five years and that overhaul of TSM will generate substantial "taxpayer and IRS benefits."<sup>[66]</sup> However, the GAO has found that IRS estimates of revenues have been consistently erroneous--by as much as 60 percent. The GAO explained:

Policy makers have generally thought that annual revenue impact of IRS' enforcement programs was about \$50 billion. . . . In fact, however, IRS does not know how much revenue its enforcement programs actually generate. In recent years, IRS and the Department of Treasury's Office of Tax Analysis explored enforcement revenue. The results for fiscal year 1989 showed revenues of \$30 billion. With such a wide variation, Congress and the administration can have little confidence as to the overall revenue impact of IRS' enforcement programs.<sup>[67]</sup>

Even if one gives the IRS the benefit of the doubt and assumes that the agency is not deliberately misleading Congress, the agency's unreliable projections and estimates are just the tip of the iceberg. The ironic truth is that the IRS has systemic problems with its accounting and recordkeeping systems.

### **The Breakdown of the IRS**

On August 4, 1993, the General Accounting Office released its findings in the first audit of the IRS ever.<sup>[68]</sup> That the

IRS was audited just once in its 80-year history is amazing, and the findings of the audit are an indication of the impending breakdown of our income tax system.

The GAO found widespread evidence of financial malfeasance and nonfeasance and, perhaps, outright fraud. Just for starters, the GAO could not even ascertain the correctness of the agency's financial statements because "critical supporting information for billions of dollars was either not available or was unreliable."<sup>[69]</sup>

The specific problems discovered by the GAO include the following:

- *The IRS significantly overstated its accounts receivable.* The GAO found the IRS guilty of consistently overstating its accounts receivable ledger to Congress. Instead of the \$105 billion in receivables alleged by the IRS, the GAO found the number to be closer to \$65 billion. The IRS is using tax gap data, among other things, to win appropriations from Congress. The data are, however, unreliable.
- *Important revenue information was unavailable or unreliable.* GAO auditors were able to ascertain how much money was collected, but they could not "audit the components of revenue because IRS systems could not provide the detailed transactions supporting the revenue balance, which is a serious limitation."<sup>[70]</sup> As a result, the GAO could not determine the specific amounts of excise and Social Security taxes collected. Further, the GAO was unable to distribute excise tax collections to the various trust funds, or the general revenue fund, to which they are assigned by law.
- *The IRS failed to "control access authority given to computer support personnel or adequately monitor employee access to this information."*<sup>[71]</sup> As a result, it seems that any IRS employee who wishes it has unfettered computer access to sensitive data on the tax returns and information of any citizen. Some employees "used their access to monitor their own fraudulent returns, to issue fraudulent refunds, and to inappropriately browse taxpayer accounts."<sup>[72]</sup>
- *There was inadequate management of operating funds.* That is the most far-reaching aspect of the IRS's financial reporting failures. Of the \$6.7 billion spent on the entire agency during fiscal year 1992, the GAO was unable to audit 64 percent, or \$4.3 billion. The IRS could not account for 64 percent of its total congressional appropriation.

The list of the IRS's failures, oversights, errors, omissions, and misstatements goes on and on.

Although the IRS continues to demand them, it is clear that new computers cannot help the agency. The typical government approach of throwing money at a problem will not solve this one. The problem is not lack of money. The IRS has received all the money it has ever required from Congress. Its budget has roughly doubled in the past 10 years.

While the government is quick to hold private enterprise liable for its errors, oversights, and occasional fraudulent conduct, it seems unwilling to hold its agencies to the same standards. As the GAO pointed out, "IRS's lack of fundamental recordkeeping is inconsistent with recordkeeping requirements placed on taxpayers."<sup>[73]</sup> Unfortunately, the IRS is unwilling or unable to meet the same high standards of financial accountability it requires the average citizen to meet.

## Conclusion

A tax system with 17,000 pages of law and regulation few citizens understand is not suitable for a free society. Similarly, a federal agency that cannot adequately maintain its own accounting ledgers is poorly suited to police those of individual and business taxpayers.

The tax system of a free society must necessarily release the American people from the burdens of compliance and the hassle of dealing with an error-prone enforcement agency. The potential for enforcement abuse is too great to allow a government agency to continue to wield the power of the IRS, particularly given its dismal track record of accountability.

An increasingly viable alternative is to eliminate the income tax system and the agency that administers it. We are currently presented with an opportunity to radically overhaul our tax system. Such an opportunity has not existed for



80 years. The present tide of public opinion is against the IRS and the income tax. So is the chairman of the Ways and Means Committee.

The IRS can no longer be trusted. The income tax is no longer sustainable. Americans should abolish it in favor of a national sales tax.<sup>[74]</sup>

### Notes

[1] Internal Revenue Service, "Chief Financial Officer's Annual Report, Fiscal Year 1993."

[2] General Accounting Office, "Examination of IRS's Fiscal Year 1993 Financial Statements," GAO/AIMD-94-120, June 1994, p. 53.

[3] Ibid., p. 56.

[4] Ibid., Figure 13, p. 56.

[5] General Accounting Office, "Examination of IRS's Fiscal Year 1992 Financial Statements," GAO/AIMD-93-2, June 1993, p. 34.

[6] Those programs allow citizens to reduce or eliminate tax debts they cannot pay. See Daniel J. Pilla, *How to Get Tax Amnesty* (St. Paul: Winning Publications, 1992).

[7] Shirley Peterson, Testimony to House Government Operations Committee, June 3, 1992, p. 2.

[8] Ibid., p. 3.

[9] The model return was prepared and the target figure was determined for Money by a team of tax experts.

[10] Money, March 1992, p. 90.

[11] Money, April 1993, p. 96.

[12] Ibid., p. 97.

[13] Ibid., p. 99.

[14] General Accounting Office, "Examination of IRS's Fiscal Year 1993 Financial Statements," p. 52.

[15] Ibid.

[16] General Accounting Office, "Monitoring the Accuracy and Administration of IRS's 1989 Test Call Survey," GAO/GGD-90-37, January 1990, p. 3.

[17] Ibid., pp. 6-7.

[18] General Accounting Office, "Collecting Delinquent Taxes and Communicating with Taxpayers," GAO/T-GGD-94-50, November 9, 1993, p. 6.

[19] Ibid.

[20] Public Law 100-647, November 10, 1988.

[21] 26 U.S.C. section 6404 (e)(1)(A).

[22] Bender's Federal Tax Week, no. 10, March 11, 1993, p. 119.

- [23] Internal Revenue Service, "Internal Revenue Service Strategic Plan," IRS document 6941, May 1984.
- [24] Ibid., p. 57.
- [25] Ibid., p. 61.
- [26] Internal Revenue Service, "Highlights," 1984 Annual Report, Table 7.
- [27] Internal Revenue Service, "Highlights," 1987 Annual Report, Table 7.
- [28] General Accounting Office, "IRS's Service Centers Need to Improve Handling of Taxpayer Correspondence," GAO/GGD-88-101, July 1988, p. 14.
- [29] Ibid., Table 2.1, p. 14.
- [30] Ibid.
- [31] Ibid., p. 9.
- [32] Ibid., p. 23.
- [33] Ibid., p. 23.
- [34] General Accounting Office, "IRS Efforts to Improve Taxpayer Correspondence," GAO/IMTEC-90-26, March 1990, p. 1.
- [35] General Accounting Office, "Collecting Delinquent Taxes and Communicating with Taxpayers," GAO/T-GGD-94-50, November 9, 1993, p. 7.
- [36] Ibid.
- [37] Internal Revenue Service, "Highlights," 1991 Annual Report, p. 7.
- [38] Internal Revenue Service, 1993 Annual Report (advance draft), Table 18.
- [39] Internal Revenue Service, policy Statement P-1-18, May 19, 1992.
- [40] Internal Revenue Service, "Highlights," 1980 Annual Report, Table 14.
- [41] Internal Revenue Service, "Highlights," 1987 Annual Report, Table 14.
- [42] Internal Revenue Service, 1991 Annual Report, Table 14.
- [43] IRS Policy Statement P-1-18.
- [44] Internal Revenue Service, 1993 Annual Report (advance draft), Table 15.
- [45] Internal Revenue Service, 1992 Annual Report, p. 9.
- [46] Ibid.
- [47] Data from Internal Revenue Service, Annual Reports, Table 14, for the years stated.
- [48] Internal Revenue Service, 1993 Annual Report (advance draft), Table 11.
- [49] Ibid., Tables 13 and 14.

[50] Ibid., Table 31.

[51] Internal Revenue Regulation, section 601.106 (f)(1), "Appeals Conference and Practice Requirements." Emphasis added.

[52] Compare Internal Revenue Regulation, section 601.104 (a)(1)-(a)(4), "Examination of Returns and Claims for Refund."

[53] Internal Revenue Service, 1993 Annual Report (advance draft), Table 31.

[54] General Accounting Office, "Examination of IRS's Fiscal Year 1993 Financial Statements," p. 54.

[55] Ibid., Figure 16, p. 61.

[56] Charles Bowsher, comptroller general of the United States, Testimony, in "First Financial Audits of IRS and Customs Revealed Serious Problems," GAO/T-AIMD-93-4, August 3, 1993, p. 14.

[57] U.S. Senate Committee on Governmental Affairs, Auditing the Auditors: Waste and Abuse at IRS and Customs: Hearing before the Senate Committee on Governmental Affairs, 103rd. Cong., 1st sess., August 4, 1993, p. 13.

[58] U.S. Senate Select Committee to Study Governmental Operations with Respect to Intelligence Activities, Report of Select Committee on Governmental Operations with Respect to Intelligence Activities, Internal Revenue Service, 94th Cong., 1st sess., October 2, 1975, p. 36.

[59] Ibid., p. 33.

[60] U.S. Senate Committee on Governmental Affairs, p. 31.

[61] Internal Revenue Service, "Notice of Proposed Amendment to Privacy Act System of Records," Federal Register 59, no. 243 (December 20, 1994).

[62] Ibid.

[63] Report of Select Committee on Governmental Operations with Respect to Intelligence Activities, pp. 25-26.

[64] Internal Revenue Service, 1993 Annual Report (advance draft), Table 27.

[65] General Accounting Office, "Analysis of IRS' Budget Request for Fiscal Year 1995," GAO/GGD-94-129, April 1994.

[66] Ibid., p. 8; and General Accounting Office, "Examination of IRS' Fiscal Year 1993 Financial Statements," p. 65.

[67] General Accounting Office, "IRS Needs More Reliable Information on Enforcement Revenues," GAO/GGD-90-95, June 1990, p. 4. Emphasis added.

[68] General Accounting Office, "Examination of IRS's Fiscal Year 1992 Financial Statements."

[69] General Accounting Office, "First Financial Audits of IRS and Customs Revealed Serious Problems," p. 7.

[70] Ibid., p. 10.

[71] Ibid., p. 13.

[72] Ibid., p. 4.

[73] General Accounting Office, "Examination of IRS' Fiscal Year 1993 Financial Statements," p. 29.

[74] See Laurence Kotlikoff, "[The Economic Impact of Replacing Federal Income Taxes with a National Sales Tax](#)," Cato Institute Policy Analysis no. 193, April 15, 1993; and Daniel J. Pilla, *How to Fire the IRS* (St. Paul: Winning Publications, 1994).