When Counting on IRS Enforcement Revenues, Don’t Forget to Count on IRS Overreach

Democrats are supersizing the Internal Revenue Service (IRS) and increasing enforcement efforts in the hopes of generating billions in new tax revenues. The plan is to hire thousands of new agents and increase the number of audits to close the tax gap: an estimate derived using tax data from 2011-2013 of the amount people pay in taxes versus what they actually owe.

There are people who willfully avoid filing taxes or engage in fraud. Under current law, the IRS, with oversight from the Treasury Inspector General for Tax Administration (TIGTA), pursues individuals and businesses that break the law. For example, last May, a former IRS employee pled guilty to filing false tax returns for herself and others that defrauded the Treasury of $170,000.\(^1\)

Estimates of the tax gap range from under $400 billion to over $1 trillion. As National Taxpayers Union Foundation (NTUF) has noted, proponents of enforcement are promising more in receipts than they are likely to achieve.\(^2\) While tax cheats are the focus of the proposal, there are lots of cases where taxpayers and the IRS disagree over the nature of financial transactions and how they should be

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Key Facts:

- Democrats plan to significantly boost the IRS’s enforcement budget to target “tax cheats.” But past and recent examples of aggressive audit positions by the IRS shows that innocent taxpayers often get ensnared in the process.

- Due to the complexity of the tax code, many filers get mired in audits, investigations, and legal cases over the proper interpretation of financial arrangements under the law. These cases can last years.

- Protecting taxpayer rights to due process and privacy must be central to legislative proposals regarding the IRS.
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treated under tax law. Due to the complexity of the tax code and respective business or accounting arrangements of certain taxpayers, many filers get mired in audits, investigations, and legal cases over the proper interpretation of financial arrangements under the law.

These cases can be drawn out for years. This June, a reporter for Law360 interviewed a recently retired tax lawyer whose former firm had finally resolved a pharmaceutical company's tax dispute dating as far back as tax year 2009. The lawyer noted that the length of this case is common for complex tax disputes.

Among the worst examples of the protracted dispute resolution process has to be the case of Exxon. The IRS challenged a $27.4 million debt deduction Exxon claimed in 1960 after the communist regime in Cuba seized a refinery it owned. The company paid the amount under protest in 1979 and sued for a refund. The trial did not occur until 1984. Exxon finally won the case and was issued a refund in 1991 -- thirty-one years after the IRS initiated the tax dispute.

Challenging the IRS can take a lot of time and resources, but the agency is by no means always successful in securing judgments against those it accuses of fraud. Below is a list of recent news articles where the IRS had taken an overaggressive position against taxpayers and ultimately lost in court.

U.S. Supreme Court Rules Unanimously Against IRS in CIC Services Case
In May, the U.S. Supreme Court unanimously ruled that the IRS cannot block a challenge to one of its regulations by invoking the federal Anti-Injunction Act. This case stems back to an IRS notice in 2016 that any taxpayer engaging in certain micro-captive transactions (or their tax advisor) must comply with extensive (and expensive) reporting and record-keeping requirements. Noncompliance can result in fines of up to $100,000 and imprisonment up to one year.

IRS Overvalued Michael Jackson Estate by $370M, Tax Court Rules
Earlier this year, the Tax Court ruled that the Jackson estate was about $111 million—less than a fourth of the $481 million the IRS determined. The case dates back to 2013.

Taxpayer Awarded Costs After Court Finds IRS's Positions on Basis and Method of Accounting Issues Were Not Substantially Justified
A taxpayer was entitled to roughly $15,000 in litigation costs after the Tax Court ruled that the IRS's challenges to his partnership basis and accounting method were not adequately founded.

NY Couple Doesn't Owe Penalty on Easement, Tax Court Says
The IRS disputed the value of a $770,310 conservation easement claimed by a taxpayer in 2004. They then sought to assess a 40 percent gross valuation-misstatement penalty for the amounts carried forward to 2005 and 2006. The Tax Court determined the correct total of the easement and ruled that because the taxpayer's original claim was only 15 percent higher than the value the Court determined, the penalties do not apply.

Additional examples can be found in a review by Edward A. Morse of the Creighton University School of Law, who published Important Developments in Federal Income Taxation (2020). Among the 138 rulings

reviewed, the report includes eleven cases where the IRS did not follow the proper procedure in receiving supervisory approval before assessing penalties on a taxpayer. Requiring this approval is an important protection to prevent IRS agents from aggressively using penalties to force taxpayers into settlements.

Since last year, social distance restrictions have bogged down the IRS’s ability to process returns and forms, but there are other long-standing administrative, transparency, and privacy concerns.

**Leak of Taxpayer Records Highlights IRS Security Problems**

The recent publication of confidential taxpayer information highlights data security problems that TIGTA has warned about for decades.

**IRS Improperly Redacted Forfeiture Records, Court Says**

The IRS improperly redacted information in response to a request by a nonprofit libertarian law firm for records on the agency’s asset forfeiture program. This is an ongoing Freedom of Information Act request dating back to 2018.

**Review of the Independent Office of Appeals Collection Due Process Program**

The IRS made processing errors in 20 percent of collections due process hearing cases audited by the TIGTA. In some cases, the IRS incorrectly extended the time period, allowing the IRS additional time to collect delinquent taxes. In other cases, the IRS incorrectly decreased the time to collect delinquent taxes. An effective process is necessary to ensure that statutory requirements are met, and taxpayers’ rights are protected.

These recent cases and reports should give pause to lawmakers considering vast amounts of new IRS funding without structural reforms to fix flaws in the agency. For decades, the National Taxpayers Union has informed Congress of IRS maladministration, including numerous examples of taxpayer “horror stories,” and led the coalition of civil liberties organizations that helped enact the first Taxpayer Bill of Rights in 1988. Throwing good money after bad is likely to exacerbate these problems significantly.

The next decade brought to light continuing tax enforcement abuses. After gut-wrenching congressional hearings, President Clinton said the IRS “seemed to be an unaccountable, downright tone-deaf agency.” Soon after this, the IRS Restructuring and Reform Act of 1998 became law and strengthened due process rights of taxpayers.

Nonetheless, problems and scandals have persisted at the IRS, including the destruction of evidence by deleting Lois Lerner’s emails and wiping the hard drive of another IRS official, hindering congressional investigations.

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NTU and NTUF continue to work tirelessly on reforms to not only lower taxes across the board, but also to make it easier to comply with the complicated tax system. These reforms include improving the structure and administration of the IRS, and bolstering taxpayer rights. For example, NTU President Pete Sepp testified to Congress about protecting taxpayers in disputes with the IRS. NTUF recently established the Taxpayer Defense Center to defend taxpayers from administrative abuses.

Because of the ongoing problems illustrated above, proposals to rake in revenues from enforcement are counting their chickens before the eggs hatch. Protecting taxpayer rights to due process and privacy must be central to legislative proposals regarding the IRS.

About the Author

Demian Brady is the Vice President of Research for National Taxpayers Union Foundation, where he runs the organization’s Taxpayers’ Budget Office.

