Ten Crucial Reforms the Next Administration Should Demand of the IRS Commissioner

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Key Takeaways

- The IRS can fundamentally transform itself away from being one of the most hated government entities in America, but only if it is willing to change past practices and take decisive actions in customer service, modernization, and taxpayer rights.
- President-elect Donald Trump and a Republican-controlled Congress must work to ensure that our nation's tax administrator is ready for the work that lies ahead.
- As the new administration and Congress set goals for the IRS, these goals should include progress in ten key areas that will ensure the IRS does not fail taxpayers.

Introduction

Taxpayers need leadership at the Internal Revenue Service (IRS) to help manage the upcoming challenges of the Tax Cut and Jobs Act (TCJA) expiration and our nation's worsening fiscal outlook. President-elect Donald Trump and a Republican-controlled Congress will undoubtedly have these issues at the forefront of their agenda, but they must also work to ensure that our nation's tax administrator is ready for the work that lies ahead.

The IRS has seen a dramatic increase in its budget under the Biden Administration, largely due to the Inflation Reduction Act (IRA). This cash infusion has been associated with progress in some areas, as we detailed in our recent *Grading the IRS* series of reports. But in other areas, the IRS continues to operate business as usual despite the significant funding boost. Indeed, it is likely that the IRS will continue to issue midnight rulings on controversial topics up to and until the end of the year. As the new administration and Congress set goals for the IRS Commissioner—current Commissioner Werfel or his successor—these goals should include progress in ten key areas that will ensure the IRS does not fail taxpayers.

Reforms and Policies to Transform the IRS

1. Produce a regular report to Congress on where tax code administration is overly complex and can be simplified. The tax code is too complex: we calculate that taxpayers spent a collective 7.9 billion hours preparing and filing their taxes last tax season, amounting to $341 billion in opportunity costs of their labor. While we and other outside organizations must use publicly released data from the IRS to inform our research, the IRS possesses technical knowledge that can provide a more detailed picture of tax code complexity.

The IRS Restructuring and Reform Act of 1998 (RRA) directed the IRS to provide Congress with an analysis of tax code complexity and the Joint Committee on Taxation to conduct Tax Complexity Analyses in certain circumstances. Yet, in the decades since the RRA was signed into law, the IRS has rarely issued the statutorily-required annual report, and many important tax laws have foregone a complexity analysis by the Joint Committee of Taxation.

Efforts by Congress to simplify the tax code only increase the importance of clearly understanding where complexity occurs in the tax administration process. Therefore, the IRS Commissioner must commit to producing a study of tax complexity by the statutorily required date of March 1, and annually thereafter.

2. Provide Congress with direct access to IRS technical staff for legislative and rulemaking purposes. While Congress has the responsibility to enact tax laws, it does not always have insight into the administrability of the tax code. To account for this, the RRA law also included language to ensure that Congress has access to front-line technical experts at the IRS during the legislative process. It was understood that, while Congress often consults the IRS or the Department of the Treasury while drafting legislation, the most knowledgeable technical experts from the IRS have rarely been included in these discussions. The National Taxpayer Advocate has also subsequently raised concerns about Congress's access to technical experts at the IRS on several occasions.

The most effective way to achieve the collaborative intent of the law is for Congress to have access to a list of technical staff with whom it can communicate directly instead of working through legislative liaisons as is current practice. The status quo deprives Congress of insight from knowledgeable personnel as to how difficult a provision of the tax code is to implement and enforce. Changing it would have a positive effect on taxpayer compliance—and ultimately taxpayer experience. Compliance costs could also decrease significantly for the IRS itself as well as for taxpayers and private industry. Access to front-line technical experts at the IRS would also be useful for legislators crafting tax-related provisions outside of the tax-writing committees.

Early direct access to technical staff at the IRS could have helped Congress avoid overly cumbersome changes in tax law, such as the recent reduction of the reporting threshold for 1099-K forms and the creation of the Corporate Alternative Minimum Tax (CAMT). Despite these changes occurring in 2021 and 2022 respectively, the IRS has still not fully implemented the law in either case due to the administrative burden.

3. Create a detailed punch list and implementation plan for technology modernization. The Inflation Reduction Act (IRA) granted the IRS an influx of $80 billion, largely earmarked for enforcement. But technology remains a key shortcoming of the IRS and making measurable progress on modernization outcomes should be a main focus. As summarized by the National Taxpayer Advocate: "When I look back eight years from now on how the IRS spent its Inflation Reduction Act funding, the changes I consider 'transformational' will primarily involve the deployment of new technology and innovative thinking."

Unfortunately, while the IRS has reported spending one-third of its IRA modernization funding already, it has not yet completed a modernization plan. The Government Accountability Office (GAO) has reported that the IRS released an "enterprise roadmap" to implement the initiatives that it outlined in its Strategic Operating Plan. Despite being the most important element of its transformation work, the IRS covered all areas of IRA funding in the roadmap except technology modernization. Furthermore, the IRS previously told GAO that the technology section of the enterprise roadmap would be completed at the end of November 2023, yet GAO's recommendation to complete the roadmap remains open.

Another recommendation that remains open is for the IRS to complete a modernization plan that includes milestones, a description of work, and legacy system replacement. Without a plan, the IRS risks severely mismanaging the investment that it received from taxpayers. While the Strategic Operating Plan that it released outlining fiscal year goals is a first step toward developing a plan, the IRS did not meet any of the modernization goals that it outlined for itself one year after the plan's release. It is very likely that the IRS is using the same methods and personnel for this modernization drive that failed to achieve past technology modernization efforts.

The IRS must significantly enhance reporting on its IRA-funded technological modernization to watchdogs like GAO, Congress, and the public. This includes providing a detailed explanation of how it will meet objectives in the Strategic Operating Plan, with return on investment (ROI), timelines, and punch lists.

4. Make the IRS Independent Office of Appeals truly independent. The Independent Office of Appeals is an organization within the IRS that helps taxpayers resolve tax controversies

without litigation in a manner that is impartial to the government or the taxpayer. It is one of the few guardrails within the IRS to ensure that its responsibility to enforce the tax code is appropriately balanced with taxpayer rights. In fact, the right to appeal in an independent forum is one of the essential liberties enshrined in the official Taxpayer Bill of Rights.

Current IRS practice undermines the Office's independence. Most troubling is the presence of IRS Chief Counsel attorneys in the Office's hearings with taxpayers, even over the taxpayer's objections, which can provide an unfair advantage to the IRS in disputes. Since these attorneys provide counsel to the IRS, taxpayers may view their presence as beneficial to the IRS in developing a case against the taxpayer for trial. The National Taxpayer Advocate recommends requiring taxpayer consent to include Chief Counsel attorneys or seeking advice from external experts to avoid this sense of unfairness. Failure to uphold the independence of the Independent Office of Appeals is a direct infringement of a critical taxpayer right and must be remedied.

5. Permit the National Taxpayer Advocate to hire her own attorney rather than use IRS lawyers. The National Taxpayer Advocate has an important role in protecting taxpayer rights within the IRS's internal structure. The Advocate has access to IRS data and personnel that provides a deep understanding of the issues affecting taxpayers and transparently releases this information to Congress and the public.

But the National Taxpayer Advocate is overly dependent on IRS leadership in one crucial area: the use of legal counsel. IRS Chief Counsel attorneys cannot reasonably be expected to side with the Advocate over IRS leadership where there is disagreement. A provision allowing the Advocate to hire independent legal counsel was nearly included in the RRA, but was ultimately omitted from the final version of the bill that became law. This exclusion has left uncertainty as to the National Taxpayer Advocate's ability to hire independent counsel, leading the IRS to deny the Advocate's request to hire counsel, even in instances of staff shortages within the IRS.

While awaiting clarification from Congress in statute, the IRS must grant future requests from the National Taxpayer Advocate to independently hire counsel.

6. Allow Congress to decide the future of the Direct File program. The Inflation Reduction Act of 2022 granted the IRS $15 million to study the cost and feasibility of providing a free IRS-run electronic tax filing option. Immediately upon submitting its mandated report to Congress, the IRS proceeded to launch a Direct File pilot program. Later, it was revealed that the IRS had been working to develop the pilot program while conducting the study, despite telling members of Congress that it had not yet made a determination about whether to move forward with the program.

The IRS went beyond its authorization to produce a report on the feasibility of Direct File by initiating a pilot program, and is now seeking to expand its scope even further. Not only did the IRS make this unilateral decision beyond its statutory authority, it did so with troubling evidence about the program's costs. The Treasury Inspector General for Tax Administration (TIGTA) found that the IRS could not provide any evidence to support its legally-mandated cost estimate for a Direct File program, and the Government Accountability Office (GAO) later found that the IRS still had not properly estimated the program's costs even after the pilot ended. Unfortunately, several key transformation projects languished as vital resources were devoted to the Direct File program.

The decision as to whether to continue Direct File should come from Congress. The IRS must pause Direct File and provide Congress with the information necessary to make a decision about the program's future. This includes a full cost analysis of the pilot program and potential costs of continuing the program in an expanded form. The IRS must also be transparent about the benefits of the program by providing Congress with all of the feedback received by taxpayers and program partners during and after the pilot program, including negative feedback.

7. Halt the aggressive litigation strategy against conservation easements and micro-captive insurance providers. Congress legislates the taxation of conservation easements and micro-captive insurance, as with all other legal entities for individuals and businesses, leaving the IRS to administer the law. Yet IRS legal positions tend to punish taxpayers who take lawful tax positions in both of these situations, assuming that all such taxpayers are suspect.

The IRS is litigating essentially 100 percent of cases relating to conservation easement deductions, focusing on esoteric deed language (and denying its shifting regulatory posture) rather than valuation disputes. The IRS has lost a string of these cases in Tax Court (notably, *Hewitt v. Commissioner*, and *Green Valley Investors, LLC v. Commissioner*), and its aggressive litigation strategy is inappropriate and overbroad. Yet, instead of changing course, the IRS has responded to these losses by adding 200 lawyers to litigate the same unproductive strategy in more cases. In another case, the IRS has allegedly hired an appraisal expert to give a zero valuation, but that same expert was used by the plaintiffs, creating a clear conflict of interest and tainting the evidence that the IRS was seeking to introduce. Although the IRS recently issued a final rulemaking for certain easements, court dockets remain crowded with past cases and new settlement offers that the government issued earlier this year have been met with caution in the legal community. Policy preferences aside, Congress has placed conservation easement deductions in the tax code; therefore the IRS's strategy to litigate 100% of partnerships who take the deduction is an abuse of power.

Small businesses that take advantage of micro-captive insurance products are subject to a similarly harsh litigation strategy, with the IRS tending to view most uses of micro-captive insurance as tax evasion. In 1986, Congress included line 831(b) in the U.S. Internal Revenue Code, allowing small businesses to self-insure against unforeseen risks which are traditionally not covered by mainstream insurers. Originally signed into law by President Ronald Reagan, these insurance opportunities were expanded by another act of Congress in 2015. However, the language of 831(b) is confusing for taxpayers, and has been interpreted by the IRS in ways that are contrary to congressional intent. The IRS's interpretation ultimately results in indiscriminate litigation, foregoing fair and equal treatment of taxpayers under the law.

These IRS abuses amount to a serious violation of taxpayer rights and cost taxpayers significant resources defending against unjust audits and fees. Furthermore, they diminish the purpose of the law by discouraging taxpayers from using legal tax strategies. The IRS must immediately halt its 100% litigation strategy against conservation easements and micro-captive insurance.

8. Rescind the proposed supervisory signature regulation and follow the "no signature, no penalty" intent of current law. As directed by law since 1998, an IRS supervisor must approve any penalty prior to it being levied on a taxpayer. Frequently, however, the IRS

fails to do so. There have even been instances of IRS employees backdating signatures from supervisors.

Instead of condemning the actions of these employees, under Commissioner Werfel's leadership, the IRS has proposed regulations to circumvent the "no supervisory signature, no penalty" law. Under these proposed regulations, the IRS would define "supervisor" to mean a wide swath of IRS employees, limit the law's protection to only some taxpayers, and allow for supervisor approval to occur long after the taxpayer has received the penalty notice, even as late as when the taxpayer is already contesting deficiency in Tax Court.

The status of this proposed rule remains uncertain. The rulemaking docket for the rule lists a date of final action of July 2024, but in an email response to an inquiry on August 16, 2024, a representative of the IRS Office of Chief Counsel wrote, "We continue to work towards finalizing these regulations." Follow up inquiries have received no response. This proposed rule is a clear violation of taxpayer rights and must be rescinded immediately.

9. Rescind unworkable cryptocurrency regulations, including one slated to take effect in 2025. In July 2024, the IRS issued its final regulations on taxation of digital assets. As we have submitted in numerous comments, the IRS's digital asset taxation scheme and the accompanying Form 1099-DA are unworkable. The IRS's framework is the same as that of the traditional, paper-based stock market system, which misses the evolving nature of digital assets. For instance, while some digital assets are used as stock and investment assets, other digital assets are treated as cash. Attempting to apply traditional, paper-based stock market rules to a constantly developing digital asset-based market is unworkable. For instance, the exchange of assets is no longer connected to paper, rather, it is now an instantaneous, transnational occurrence that is not slowed down by traditional financial institutions or processing requirements. Another example is that digital assets are not offered to the market in the same manner traditional stocks are and digital assets have yet to universally adopt an initial public coin offering method.

In short, the IRS's digital asset regulation is premature for the digital asset industry. As written, the IRS's digital asset regulation threatens a booming digital asset economy. Instead, focus should be placed on enabling America to emerge as the leader in digital assets, with the IRS taxation mechanism workable for all crypto types and not at odds with other federal regulatory efforts.

10. Publish a dashboard of regular metrics and data to inform decision-making. The IRS cannot be held accountable without an appropriate understanding of how it operates. Metrics and data collection must be improved, especially regarding taxpayer service and the tax gap, two areas which received increased investment through the IRA.

One favored yet fundamentally flawed metric used by the IRS to measure taxpayer service is its Line of Service (LOS) metric. While this seemingly indicates how many taxpayer calls are answered by the IRS, calculation of the metric is highly technical and excludes millions of calls to alternative phone lines at the IRS. This metric also does not account for taxpayer satisfaction with the service received if their call is answered.

Other taxpayer service metrics reported by the IRS are simply too unclear to provide an understanding of the Service's success, despite being published as achievements. For example, the IRS recently reported increases in both Taxpayer Assistance Center (TAC) contacts and uses of its "Where's My Refund?" online tool. Cumulative and high-level

data on TAC contacts does not describe how satisfied taxpayers are with their experience at TACs, what issues taxpayers present the most at TACs, which communities experienced increases in TAC contacts, and why more taxpayers are seeking this assistance. High-level metrics on the use of the "Where's My Refund Tool?" fail to account for paradata including how long taxpayers spend on the page and peak times of use during the tax season.

The IRS's efforts to close the tax gap must also be reported more transparently, especially given the sheer amount of resources devoted to tax enforcement by the IRA. As a first step, the IRS should provide in-depth data on its confidence in its measurement of the tax gap, which is an incredibly complex figure to calculate. Thus far, its new efforts to close the tax gap have included niche initiatives and easy wins, like focusing on corporate jet usage and collecting known taxes owed by high-income earners. The IRS must develop and disclose metrics that will be used to close the tax gap, which will be critical for determining the rate-of-return of increased enforcement funding.

Unfortunately, these are only some examples of an ongoing lack of detailed and transparent metrics from the IRS. Taxpayer trust is vital to our voluntary tax system. It is time for the IRS to provide the public with the necessary information in dashboard form to determine whether its new initiatives are successful, rather than relying on editorialized IRS reports that fail to paint the full picture.

Conclusion

The IRS can fundamentally transform itself away from being one of the most hated government entities in America, but only if it is willing to change past practices and take decisive actions in customer service, modernization, and taxpayer rights. The incoming Trump Administration, its Treasury Secretary, and its choice for IRS Commissioner will be in charge of whether the IRS succeeds or fails. These ten recommended action items are essential for success.

NATIONAL TAXPAYERS UNION FOUNDATION

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