

**THE ROLE OF THE INTERNAL REVENUE SERVICE IN  
THE ADMINISTRATION OF SOCIAL WELFARE POLICY**

**Background Paper and Bibliography**

**for the**

**Tax Policy and Simplification Committee**

**January 24, 2014**

**by**

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# Table of Contents

<b>I. THE PROGRAM AND SPEAKERS .....</b>	<b>1</b>
<b>II. THE ROLE OF THE ABA TAX SECTION.....</b>	<b>2</b>
A. THE MISSION OF THE TAX SECTION .....	2
B. EXAMPLES OF RECENT WHITE PAPERS.....	2
<b>III. BACKGROUND .....</b>	<b>2</b>
A. HISTORY .....	2
B. THEORY .....	2
C. ILLUSTRATIVE PROVISIONS.....	3
D. POSSIBLE APPROACHES.....	7
<b>IV. ADDITIONAL BIBLIOGRAPHY.....</b>	<b>8</b>
A. U.S. DEPARTMENT OF THE TREASURY .....	8
B. JOINT COMMITTEE ON TAXATION.....	8
C. NATIONAL TAXPAYER ADVOCATE .....	9
D. U.S. GOVERNMENT ACCOUNTABILITY OFFICE.....	9
E. OTHER TAX REFORM REPORTS.....	9
F. ACADEMIC WORK.....	10

# THE ROLE OF THE INTERNAL REVENUE SERVICE IN THE ADMINISTRATION OF SOCIAL WELFARE POLICY

(Background Paper for the Committee on Tax Policy and Simplification Committee, January 24, 2014)

by Eric A. San Juan<sup>1</sup> & Jonathan Barry Forman<sup>2</sup>

## I. THE PROGRAM AND SPEAKERS

Friday, January 24, 2014

9:00 AM – 10:30 AM

Tax Policy and Simplification

Chair: Professor Jonathan B. Forman, University of Oklahoma, Norman, OK

9:00 AM                    **The Role of the Internal Revenue Service in the Administration of Social Welfare Policy**

MODERATOR:            Kenneth W. Gideon, Skadden Arps Slate Meagher & Flom LLP & Affiliates, Washington, DC,  
<http://www.skadden.com/professionals/kenneth-w-gideon>

PANELISTS:            Eileen J. O'Connor, Pillsbury Winthrop Shaw & Pittman LLP, Washington, DC, <http://www.pillsburylaw.com/eileen-oconnor?view=9>

Roger Royse, Royse Law Firm PC, Palo Alto, CA,  
<http://rroyselaw.com/people/roger-royse/>

Nina E. Olson, National Taxpayer Advocate, Washington, DC (invited),  
<http://www.taxpayeradvocate.irs.gov/Media-Resources/National-Taxpayer-Advocate-Bio>

Professor Susannah Camic Tahk, University of Wisconsin, Madison, WI,  
<http://law.wisc.edu/profiles/stahk@wisc.edu>

Professor Michelle L. Drumbl, Washington and Lee University, Lexington, VA, <http://law.wlu.edu/faculty/profiledetail.asp?id=162>

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<sup>2</sup> Alfred P. Murrah Professor of Law, University of Oklahoma; B.A. 1973, Northwestern University; M.A. (Psychology) 1975, University of Iowa; J.D. 1978, University of Michigan; M.A. (Economics) 1983, George Washington University.

## II. THE ROLE OF THE ABA TAX SECTION

### A. THE MISSION OF THE TAX SECTION

As the national representative of the legal profession, the mission of the ABA Section of Taxation is to serve our members and the public through education and leadership and to achieve an equitable, efficient, and workable tax system.

[http://www.americanbar.org/groups/taxation/about\\_us.html](http://www.americanbar.org/groups/taxation/about_us.html)

### B. EXAMPLES OF RECENT WHITE PAPERS

1. [Statement of Policy Regarding Reform of Federal Wealth Transfer Tax](#)
2. [Statement of Policy Regarding U.S. International Taxation](#)
3. [Joint Statement on Tax Issues in Health Care Reform](#)
4. [Statement of Policy Favoring Reform of Federal Civil Tax Penalties](#)
5. [Statement of Policy Favoring Tax Simplicity, Stability, and Transparency](#)

## III. BACKGROUND

### A. HISTORY

“While tax expenditures had been born with the income tax, the last quarter-century witnessed a proliferation of social tax benefits. Previously, Assistant Secretary Surrey had announced the advent of negative taxes, and the Excise Tax Reduction Act of 1965 had made a fuel tax credit refundable, when the purchaser may have been a farmer fueling a tractor. After the 1975 enactment of the EITC, a latter-day parade of refundable credits, in response to both good and bad economic conditions, brought in the additional child tax credit, trade adjustment health credit, first-time homebuyer credit, Making Work Pay credit, American Opportunity Tax Credit, PPACA individual credit, and adoption credit.”<sup>3</sup>

### B. THEORY

Social welfare policy is embedded in the Internal Revenue Code through tax expenditures, or government spending structured through the revenue system.<sup>4</sup>

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<sup>3</sup> NATIONAL TAXPAYER ADVOCATE, 2011 ANNUAL REPORT TO CONGRESS vol. 2, § 1, at 1, 43-44 (2011) (Research Study: From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913 – 2011), [http://www.irs.gov/pub/irs-utl/irs\\_tas\\_arc\\_2011\\_vol\\_2.pdf](http://www.irs.gov/pub/irs-utl/irs_tas_arc_2011_vol_2.pdf).

<sup>4</sup> See Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton University Press, 1997); NATIONAL TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS (2010), vol. 2, § 6, at 101 (Research Study: Evaluate the Administration of Tax Expenditures), [http://www.irs.gov/pub/irs-utl/vol\\_2\\_tasresearchandrelatedstudies2010arc.pdf](http://www.irs.gov/pub/irs-utl/vol_2_tasresearchandrelatedstudies2010arc.pdf).

C. ILLUSTRATIVE PROVISIONS

1. Primarily for Individuals

a. Earned income tax credit

“First, proponents argue, the EITC and other tax-based transfers can enhance administrative efficiency by reducing bureaucratic cost and complexity. \* \* \* \* \* The EITC presents two intrinsic problems of compliance and enforcement: the unusual problem of incentives for income overstatement, and the disproportionate cost of collecting erroneous overpayments from EITC recipients.” Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARVARD LAW REVIEW 533, 564-65, 586 (1995); see also Anne L. Alstott, *Why the Earned Income Tax Credit Doesn’t Make Work Pay*, 73 LAW & SOCIAL PROBLEMS 285 (2010).

The earned income tax credit is one of the ten government programs with the highest reported amount of improper payments. See Governmental Accountability Office, *Improper Payments: Remaining Challenges and Strategies for Governmentwide Reduction Efforts* (GAO-12-573T, March 28, 2012). The Improper Payments Information Act of 2002, Pub. L. No. 107-300, 116 Stat. 2350 (2002), governs payments over \$10 million “derived from Federal funds.” OMB Circ. A-123, Appdx. C, M-11-16, Pt. I at 5 (Apr. 14, 2011), imposes a threshold of 2.5 percent of program outlays.

b. Other benefits for qualifying children

The largest Federal child-care program is a tax provision, the credit for child and dependent care expenses.<sup>5</sup> Historically, the courts had held that child-care was akin to personal, living, and family expenses that were neither deductible nor creditable.<sup>6</sup> In the Internal Revenue Code of 1954, Congress legislatively overturned this result by enacting the child-care credit.<sup>7</sup>

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<sup>5</sup> I.R.C. § 21.

<sup>6</sup> See *Smith v. Comm’r of Int. Rev.*, 40 B.T.A. 1038 (1939).

<sup>7</sup> See generally Mary Louise Fellows, *Rocking the Code: A Case Study of Employment-Related Child-Care Expenditures*, 10 YALE J. L. & FEMINISM 307 (1998).

### c. Education benefits

The plethora of tax credits, deductions, and exclusions that offer incentives to spend, borrow, and save for education has been the subject of numerous simplification proposals.<sup>8</sup> Nevertheless, recent legislation has increased the complexity of education provisions for both taxpayers and the Internal Revenue Service (IRS), notably by increasing, making refundable, and re-naming the Hope Scholarship credit as the American Opportunity Tax Credit.<sup>9</sup> In overseeing the implementation of this legislation, the Treasury Inspector General for Tax Administration (TIGTA) published a 2011 audit report concerning apparently erroneously-claimed education credits.<sup>10</sup> According to the report, 2.1 million individuals received education credits that were potentially erroneous either because they did not attend an eligible educational institution, they attended less than half time or were graduate students, they were dependents on another taxpayer's return, or they were incarcerated.<sup>11</sup> This audit highlights the challenges to the IRS in administering education policy where the tax collector is not well-positioned to gather accurate information due to various issues, such as differences between the taxable and academic years.

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<sup>8</sup> See Senate Finance Committee, *Families, Education & Opportunities* (Senate Finance Committee Staff Tax Reform Option Paper, April 18, 2013), <http://www.finance.senate.gov/issue/?id=211fefcd-aac7-47af-92e4-a2a25c3db2cf>; NATIONAL TAXPAYER ADVOCATE, 2004 ANNUAL REPORT TO CONGRESS 203 (2004), <http://www.irs.gov/Advocate/National-Taxpayer-Advocate's-2004-Annual-Report-to-Congress>; Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) Of The Federal Tax System*, *JCS-3-01, Volume 1*, *JCS-3-01, Volume 2* & *JCS-3-01, Volume 3* (2001); ABA Section of Taxation, the AICPA Tax Division, and the Tax Executives Institute, *Tax Simplification Recommendations* (2001), <http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2001/0102simpl.authcheckdam.pdf>.

<sup>9</sup> See I.R.C. § 25A, as amended by the American Recovery & Reinvestment Act of 2009, Pub. L. No. 111-5 (2009).

<sup>10</sup> See Treasury Inspector General for Tax Administration (TIGTA), No. 2011-41-083, Recovery Act: Billions of Dollars in Education Credits Appear to Be Erroneous (2011), <http://www.treasury.gov/tigta/auditreports/2011reports/201141083fr.pdf>.

<sup>11</sup> *Id.* at 3 (relating to Tax Year 2009 through May 28, 2010).

#### d. Housing credits & deductions

A major justification for the home mortgage interest deduction has been a “desire to encourage homeownership.”<sup>12</sup> However, economic research has shown that the deduction “does little if anything to encourage homeownership. Instead, it serves mainly to raise the price of housing and land and to encourage people who do buy homes to borrow more and to buy larger homes than they otherwise would.”<sup>13</sup> In 2005, a bipartisan commission recommended substantial modification of the home mortgage interest deduction because it “encourages overinvestment in housing.”<sup>14</sup> Nevertheless, the IRS can process the home mortgage interest deduction like any other monetary adjustment to gross income, verifiable by a third party, as matter of administrative efficiency.<sup>15</sup>

#### e. Retirement preferences

Recently, commentators have suggested a need to implement administrative reforms especially in one area of the Tax-Exempt/Government Entities (TE/GE) operating division of the IRS.<sup>16</sup> Meanwhile, the Employee Plans (EP) subdivision outweighs the other TE/GE functions

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<sup>12</sup> Congressional Research Service, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Print 110-667, 110th Cong., 2nd Sess., Committee on the Budget 330-32 (December 2008), [http://www.budget.senate.gov/democratic/index.cfm/files/serve?File\\_id=d481f456-b175-4c2d-9b07-0045317e585d](http://www.budget.senate.gov/democratic/index.cfm/files/serve?File_id=d481f456-b175-4c2d-9b07-0045317e585d) (noting that interest historically had been deductible regardless of personal or business purpose).

<sup>13</sup> William G. Gale, Jonathan Gruber & Seth Stephens-Davidowitz, *Encouraging Homeownership Through the Tax Code*, 115 TAX NOTES 1171 (June 18, 2007).

<sup>14</sup> *Simple Fair and Pro Growth: Proposals to Fix America's Tax System*, Report of the President's Advisory Panel on Federal Tax Reform 59 (2005), <http://www.treasury.gov/resource-center/tax-policy/Documents/Simple-Fair-and-Pro-Growth-Proposals-to-Fix-Americas-Tax-System-11-2005.pdf>; see also *THE NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM, THE MOMENT OF TRUTH* 30-31 (2010), [http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12\\_1\\_2010.pdf](http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf) (recommending restriction of the mortgage interest deduction to main homes, rejecting secondary residences).

<sup>15</sup> See generally NATIONAL TAXPAYER ADVOCATE, 2010 ANNUAL REPORT TO CONGRESS vol. 2, § 6, at 101 (2010) (Research Study: Evaluate the Administration of Tax Expenditures), [http://www.irs.gov/pub/irs-utl/vol\\_2\\_tasresearchandrelatedstudies2010arc.pdf](http://www.irs.gov/pub/irs-utl/vol_2_tasresearchandrelatedstudies2010arc.pdf).

<sup>16</sup> See Treas. Inspector Gen. for Tax Admin. *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review*, No. 2013-10-053 (May 14, 2013); Lily Kahng, *The IRS Tea Party Controversy and Administrative Discretion*, 99 CORNELL L. REV. ONLINE 41 (2013).

by a couple of measures. In 2011, pension plans contained \$6.35 trillion in assets.<sup>17</sup> In FY 2012, TE/GE performed almost seven times the number of guidance and other regulatory activities for EP than Exempt Organizations, with the Tax-Exempt Bond function coming in a distant third with a twelfth as much work.<sup>18</sup> In a voluntary pension system, the IRS may assume a somewhat passive role, but that only underscores the adverse implications of low participation rates for coverage and adequacy of savings.<sup>19</sup>

## 2. *Primarily for Businesses*

### a. Energy & environmental incentives

According to the Solar Energy Industries Association, the

solar Investment Tax Credit (ITC) is one of the most important federal policy mechanisms to support the deployment of solar energy in the United States. \* \* \* \* Tax policies related to renewable energy play a vital role in creating new high-wage American jobs, spurring economic growth, ensuring U.S. global competitiveness, lowering energy bills for consumers & businesses, and reducing pollution.<sup>20</sup>

Economists concur that the “current growth of solar energy is mainly driven by policy supports.”<sup>21</sup> As a practical matter, I.R.C. § 48(a)(3)(D)(i) effectively outsources certain regulatory standards to the Energy Department.

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<sup>17</sup> U.S. Department of Labor, Employee Benefits Security Admin., PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2011 FORM 5500 REPORTS (June 2013), <http://www.dol.gov/ebsa/publications/form5500dataresearch.html>.

<sup>18</sup> See INTERNAL REVENUE SERVICE, 2012 DATA BOOK, 53 tbl. 22 (2012), <http://www.irs.gov/pub/irs-soi/12databk.pdf>.

<sup>19</sup> See generally George A. (Sandy) Mackenzie & Jonathan B. Forman, *Reforming the Second Tier of the U.S. Pension System: Tabula Rasa or Step by Step?* 46 JOHN MARSHALL L. REV. 631 (2013).

<sup>20</sup> Solar Energy Industries Association, Solar Investment Tax Credit (ITC), <http://www.seia.org/policy/finance-tax/solar-investment-tax-credit> (accessed January 15, 2014) (relating to I.R.C. §§ 25D & 48).

<sup>21</sup> Govinda R. Timilsina, Lado Kurdgelashvilib & Patrick A. Narbel, *Solar energy: Markets, economics and policies*, 16 RENEWABLE & SUSTAINABLE ENERGY REV. 449, 465 (2012).



## b. Non-profit exemptions

Due to the broad range of “charitable” purposes, the IRS may be the arbiter in the first instance of enterprises as disparate as a religious publisher that becomes profitable<sup>22</sup> and electronic medical record services.<sup>23</sup> In recent years, states have enacted statutes for the organization of social enterprises that have purposes that are charitable and “low profit.”<sup>24</sup> While the nature of these enterprises may not fall within its institutional expertise, the IRS is thrust by § 501(c)(3) into determining whether the government should subsidize emerging sectors of the economy. In 2009, charities held \$2.7 trillion in assets.<sup>25</sup>

### D. POSSIBLE APPROACHES

1. *Keep social welfare provisions out of the Tax Code or, at least, get rid of provisions requiring institutional expertise beyond that of the tax collector.*<sup>26</sup>
2. *Assuming that Congress has enacted social welfare policy into the Internal Revenue Code, make concomitant modifications to the IRS mission & skill-set.*<sup>27</sup>

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<sup>22</sup> See *Presbyterian & Reformed Publishing Co. v. Comm’r*, 743 F.2d 148 (3<sup>rd</sup> Cir. 1984).

<sup>23</sup> See Internal Revenue Service Memorandum, *Hospitals Providing Financial Assistance to Staff Physicians Involving Electronic Health Records* (May 11, 2007), <http://www.irs.gov/pub/irs-tege/ehrdirective.pdf>. The American Recovery & Reinvestment Act of 2009, Pub. L. No. 111-5, Tit. VIII, H. Conf. Rept. 111-16, 111<sup>th</sup> Cong. 1<sup>st</sup> Sess. 461, with respect to the Social Security Admin. (SSA) states: “As the largest repository of electronic medical images in the world, SSA has a vital interest in exploring how health information technology can be integrated into the disability process through the widespread adoption of electronic medical records.” Relieving burdens of government may be a charitable purpose. See Treas. Reg. § 1.501(c)(3)-1(d)(2).

<sup>24</sup> See, e.g., Vt. Stat. Ann. § 3001(23) (2008).

<sup>25</sup> Paul Arnsberger, *Nonprofit Charitable Organizations, 2009*, 32(2) STATISTICS OF INCOME BULLETIN 169 (Fall 2012), <http://www.irs.gov/PUP/taxstats/productsandpubs/12eofallbulteorg.pdf>.

<sup>26</sup> See NATIONAL TAXPAYER ADVOCATE, 2009 ANNUAL REPORT TO CONGRESS vol. 2, 75 (2009) (Research Study: Running Social Programs Through the Tax System), <http://www.irs.gov/Advocate/Reports-to-Congress>. Compare Jonathan Barry Forman, *Let’s Keep (and Expand Upon) the Earned Income Credit*, 56 TAX NOTES 233-34 (1992) and Andrew D. Cuccia & Gregory A. Carnes, *Simplifying the Personal Income Tax*, 55 TAX NOTES 1817 (1992).

<sup>27</sup> See NATIONAL TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS 15 (2010) (Most Serious Problems: The IRS Mission Statement Does Not Reflect the Agency’s Increasing Responsibilities for Administering Social Benefits Programs), [http://www.irs.gov/pub/irs-utl/2010arcmsp2\\_irsmission.pdf](http://www.irs.gov/pub/irs-utl/2010arcmsp2_irsmission.pdf).

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