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That's One Way to Catch Up

Outside the Internal Revenue Service building in Washington, D.C. (Jonathan Ernst/Reuters)

By **DANIEL J. PILLA**
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The IRS's decision to destroy 30 million information returns reveals the inadequacy of our income-based tax system.

As the Internal Revenue Service struggled to dig out of the backlog of millions of unprocessed tax documents and incoming correspondence last year, it stumbled on a potential solution to the problem. Why not just destroy the returns that can't be processed? As crazy as that sounds, it's exactly what the agency did.

The Treasury inspector general for tax administration (TIGTA) recently reported that in March 2021, IRS management elected to destroy an estimated 30 million paper-filed information returns simply because it could not process them in time.

Information returns are Forms W-2 and 1099 (of which there are dozens of varieties). Such returns report payments by third parties to individual taxpayers and businesses, which are then used to carry out the computerized process of confirming income amounts reported on tax returns.

For example, IRS computers compare the income reported for a given taxpayer as reflected in, say, a W-2, with the reported income on the taxpayer's income-tax return (Form 1040). If the W-2 shows that more income was received than was reported on the return, the computers kick out a notice advising the taxpayer that he underreported his wage income. The notice computes the new tax liability and demands payment of the alleged additional tax owed.

These notices flow from two programs: (1) the Automated Underreported Program and (2) the Automated Substitute for Return Program. The latter issues notices to individuals with reported income who have not filed a tax return. According to IRS data, approximately 1.6 million notices were mailed under both programs for tax year 2020.

As the TIGTA's report makes eminently clear, these returns are overwhelming the IRS. In tax year 2020, the agency received more than 3.4 *billion* of them. When combined with the various families of tax-return documents that citizens and businesses file, the IRS receives about ten documents for every man, woman, and child alive in America today. That doesn't even address the millions of additional letters and statements mailed to the agency annually.

And yet as far as the IRS is concerned, it's not enough. Every year the agency presses Congress for more information-reporting requirements that would add to its already-insurmountable mountain of data. The latest example of this is the Biden administration's failed proposal to require bank reporting on all accounts with net transactions of $600 per year or more. Even after congressional Democrats increased the threshold to $10,000 per year, the law still would have caused an explosion in the number of information returns collected by the government.

The only solution offered by the IRS and Congress has been to mandate the e-filing of tax documents. The Taxpayer First Act, for example, contained three specific provisions mandating that businesses e-file certain tax returns. Since that law's enactment in July 2019, about 81 percent of individual income-tax returns and about 35 percent of business-tax returns are now e-filed.

Yet either way, the trillions of bytes of data — regardless of how they flow to the agency — must still be processed, assimilated, and put to effective use in tax-law enforcement. The more data that flow to the agency, the less likely the IRS is to be able to use that data, as evidenced by its destroying 30 million documents.

It is clear that the brain trust in Washington has devised arguably the most *inefficient* way possible to administer a tax system. But how could it be anything else? Our tax system is based on income. To fully ascertain the correct amount of income tax owed, and to enforce the assessment and collection of that tax, the taxing authority must know everything there is to know about a person: where and how he earns his money, where he spends it, the details of his lifestyle, etc., etc. That is to say, the taxing authority must be omniscient.

In my view, one of the ten principles of sound tax policy is that the tax system must be *efficient*. Paying taxes to support the necessary and legitimate functions of government is our responsibility as citizens. But being forced to annually undertake the mind-numbing task of reporting to the government every aspect of one's private affairs, and all the interactions had with others, is intolerable in a free society.

It is well past time that we seriously and honestly discuss the need to abolish the income tax and adopt a tax system that does not make every individual in America a spy for the government in the name of tax collection. A tax system that is simple, fair, and efficient cannot have income as its base. The best model in its place, which would meet all ten principles of a sound tax system, is a retail-sales tax. A national retail-sales tax assessed on all consumption goods and services could raise the needed revenue without the massive expenses associated with income-tax compliance, enforcement, and administration. Even better, such a system would spare citizens from the all-out assault on liberty that is inherent in an income-tax system.