Written Testimony
Of
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Subcommittee on Oversight
On the IRS's Implementation of the Affordable Care Act
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Introduction

Mr. Chairman and members of the Committee, thank you for the opportunity to speak to you today on the challenges facing the IRS's implementation of the Affordable Care Act (ACA).

Founded in 1937, the Tax Foundation is the nation's oldest organization dedicated to promoting economically sound tax policy at the federal, state, and local levels of government. We are a non-partisan 501(c)(3) organization.

For 75 years, the Tax Foundation's research has been guided by the immutable principles of economically sound tax policy that were first outlined by Adam Smith – taxes should be neutral to economic decision making, they should be simple, transparent, stable, and they should promote economic growth.

In other words, the ideal tax system should do only one thing – raise a sufficient amount of revenues to fund government activities with the least amount of harm to the economy. By all accounts, the U.S. tax code is far from that ideal. Our current tax system is a Byzantine monstrosity that spans 70,000 pages, costs taxpayers more than $160 billion per year to comply with, and now dictates virtually every aspect of our lives.

Even before the ACA grafted more than 40 new tax provisions to the tax code and effectively paired the IRS with HHS to manage one-sixth of the nation's economy, the relentless growth of credits and deductions over the past 20 years has made the IRS a super-agency, engaged in policies as unrelated as delivering welfare benefits to subsidizing the manufacture of energy efficient refrigerators.

Although the IRS's annual budget may be relatively small, it is essentially controlling vastly more budgetary resources than any Cabinet-level agency. The more than 170 different tax expenditure programs in the tax code have a total budgetary cost exceeding $1 trillion. Some $900 billion of those tax expenditures are targeted to individuals, while another $100 billion are intended to benefit businesses.

These myriad tax provisions were enacted to achieve all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, turn corn into gasoline, buy a home, replace the home's windows, adopt children, put them in daycare, then help them go to college, while saving for your own retirement, and the list goes on.

Managing vast social programs is not a function the IRS is designed to perform, nor is it a function that the IRS performs very well. But the ACA will not only expand the IRS's role in the welfare state, it will force more and more Americans it look to the IRS for their income and benefits.

If the tax code wasn't complicated enough, the ACA will make it unmanageable while increasing the compliance costs of millions of taxpayers. The result will be an increase in fraud, abuse, and erroneous payments.

Oddly, in many of its provisions, the ACA makes the IRS and extension of the Department of Health and Human Services. The bill gives HHS the authority to make the rules while giving the IRS the responsibility for doing the paperwork, policing the system, cutting the checks, and fixing any problems that arise.

While the temptation is to give the IRS more money and resources to meet these tasks, the real solution is to overhaul the tax code and allow the IRS to return to its core mission of collecting tax revenues.

The ACA Gives the IRS Three Big Tasks

The ACA gives the IRS three major roles to play in assuring universal health insurance.[1] First, the IRS is required to collect more than $800 billion in new tax revenue over the next ten years to fund the various components of the legislation. Second, the IRS is tasked with managing very generous refundable tax credits for individuals who cannot afford to purchase private health insurance as well as tax credits for small businesses that cannot afford to provide their employees insurance. Lastly, the ACA puts the IRS in the role of enforcer to extract special taxes – or "penalties" – from individuals who fail to purchase health insurance or from businesses that fail to provide "affordable" insurance.

These are anything but complementary missions. The IRS's own Inspector General fully admits that "the ACA presents a major challenge to the IRS as the ACA represents the largest set of tax law changes in more than 20 years and affects millions of taxpayers."[2]

In order to get a sense of how the IRS will manage these new tasks, it is fair to look at the results of current policies.

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[1] http://www.irs.gov/uac/Affordable-Care-Act-Tax-Provisions

[2] *Affordable Care Act: Planning Efforts for the Tax Provisions of the Patient Protection and Affordable Care Act Appear Adequate; However, the Resource Estimation Process Needs Improvement*, Treasury Inspector General for Tax Administration, June 14, 2012, Reference Number: 2012-43-064, p. 1.

The Growth in Nonpayers and the IRS's Role in the Welfare State

One of the most troubling development in recent years is that the expanded use of the tax code to deliver social policy has knocked millions of taxpayers off the tax rolls and turned the IRS into an extension of the welfare state – a role it has not managed well.

Today, a record number of Americans – 56 million, or 41 percent of all filers – now pay no income taxes after taking advantage of the generous credits and deductions in the tax code. At least half of these filers look to the IRS as a source of income thanks to the more than $100 billion in refundable tax credits paid out to people who have no income tax liability. As a result of removing millions of people off the tax rolls, we have dramatically reduced the number of people with "skin in the game" while increasing the amount of redistribution through the tax code.

In 2010, the budgetary cost of both the non-refundable and refundable tax credits totaled $224 billion. After adjusting for inflation, this is ten-times their cost in 1990. To put today's costs in perspective, if tax credits were combined into a single program, they would now be the fourth-largest domestic program behind Social Security, Medicare, and Medicaid. "The two largest refundable credits, the EITC and the ACTC, receive a much larger appropriation than the IRS's own budget." [3]

The ACA's generous tax credits and cost-sharing payments – with an average value of $4,000[4] – will no doubt increase the number of nonpayers while increasing the IRS's role as deliverer of social benefits. The cost of the Health Insurance Premium Tax Credit and exchange subsidies is now expected to total more than $800 billion during the ten years after it goes into effect in 2014.

The IRS is Ill-Equipped to Manage Social Programs

The IRS has a dismal record in managing the plethora of tax credit programs it is already responsible for, so we should expect the ACA to led to billions of dollars in fraud, abuse, and erroneous payments. For example, Treasury's IG for Tax Administration has testified here that "the unintended consequences of [refundable] credits is that they are often the targets of unscrupulous individuals who file erroneous claims for these credits."[5] The fact that the value of the Premium Tax Credits could approach $14,000 for a family of four, by some estimates[6], all but guarantees that the IRS will have to combat considerable fraud and abuse.

[3] "Improper Payments in the Administration of Refundable Tax Credits," Testimony of the Honorable J. Russell George, Treasury Inspector General for Tax Administration, Hearing Before the Committee on Ways and Means Subcommittee on Oversight, U.S. House of Representatives, May 25, 2011, p. 2.

[4] Stephen Ohlemacher, "Can the IRS Manage to Police Both Taxes and Health Care Law?", Associated Press, July 19, 2012. http://www.usatoday.com/money/industries/health/story/2012-07-09/IRS-to-tackle-health-care-and-taxes/56108848/1

[5] Ibid.

[6] Stephanie Rennane and Eugene Steurle, Health Reform: A Two-Subsidy System, Tax Policy Center S10-0001, Table 3, (2010). http://www.taxpolicycenter.org/numbers/Content/PDF/S10-0001.pdf

IG reports are replete with examples of how the IRS has failed to control fraud and erroneous payments in virtually all of the tax credit programs under its jurisdiction. Some recent examples include:

> **Earned Income Tax Credit**: The largest tax credit program leads to the most abuse. The IRS reports that "23 to 28 percent of EITC payments are issued improperly each year," which translates into "$11 to $13 billion in improper EITC payments."[7] Remarkably, reports the IG, "the IRS does not require individuals to provide any supporting documentation to verify eligibility for claiming the EITC."[8] The EITC has the second highest amount of improper payments after Medicaid.[9]
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> **The Additional Child Tax Credit**: The IG reports a substantial increase in the number of filers who are not authorized to work in the U.S., but use an Individual Taxpayer Identification Number (ITIN) to improperly claim the credit. In 2010, the IRS paid $4.2 billion in refundable child credits to individuals who were not authorized to work in the United States.[10]
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> **Plug-in Electric and Alternative Motor Vehicle Credit**: The IG "identified 12,920 individuals who electronically filed their tax returns and erroneously claimed $33 million in Plug-in and Alternative Motor Vehicle Credits" because "IRS processes did not ensure the plug-in electric and alternative motor vehicles met the requirements for vehicle year, placed-in-service date, and make and model."[11]
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> **Residential Energy Credits**: The IG reported that because the IRS did not require any third-party documentation for the expenses related to home energy efficiency improvements, 362 prisoners or under-age tax filers erroneously claimed the Residential Energy Credits on their tax returns.[12]
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> **Hope Credit**: The IG found that, "Some taxpayers are claiming the Hope Credit for more years than allowed by law." [13] The limit is two years but some were found to claim the credit for three and even four years. In one investigation, the IG found that "the amounts of credits inappropriately claimed averaged close to $1,400 and totaled just over $232 million."[14]

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[7] Ibid., p. 3.
[8] Ibid., p. 4.
[9] http://www.treasury.gov/tigta/semiannual/semiannual_sept2010.pdf. p.23.
[10] J. Russell George, Inspector General, Memorandum for Secretary Geithner, "Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2012," p. 12.
[11] "Energy Tax Policy and Tax Reform," Testimony of the Honorable J. Russell George, Treasury Inspector General for Tax Administration, Hearing Before the Committee on Ways and Means Subcommittees on Select Revenue Measures and Oversight, U.S. House of Representatives, September 22, 2011, p. 4.
[12] Ibid., p. 5.
[13] "Improvements and Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions," Treasury Inspector General for Tax Administration, September 30, 2009, Reference Number: 2009-30-141, p. 2.
[14] Ibid.

Despite the IG's recent report suggesting that the IRS's plans to implement the ACA appear "adequate," the vast number of problems the IRS is already having administering its current portfolio of tax programs should give us great concern over its ability to skillfully manage the ACA.

The IRS Has Stumbled Early in Administering the ACA

The IRS stumbled out of the gate in implementing some of the earliest – and, perhaps simplest – provisions of the ACA: the Small Business Health Care Tax Credit; the Indoor Tanning Excise Tax; and, the Expansion of the Adoption Credit.

The initial results from the Small Business Health Care Tax Credit do not bode well for lawmakers' broader goal of incentivizing businesses to provide affordable health insurance for their employees.[15] Despite the IRS's $1 million expense to mail 4.4 million postcards to potentially eligible small business owners, only 309,000 had claimed the credit as of October 2011. These taxpayers claimed $416 million in credits, a fraction of the $2 billion cost the Congressional Budget Office had estimated for that year.[16]

When the IRS surveyed business owners to find out why they did not take advantage of the program, many responded that the benefit was not worth the effort. This is not surprising considering that "there are multiple steps to calculate the Credit, and seven worksheets must be completed in association with claiming the credit."[17] If this small provision is any indication of the added compliance burden that the ACA will place on businesses, it is fair to say that the total compliance costs for the entire act will be staggering.

The IRS's experience with implementing the Tanning Excise Tax – the most joked about tax in the bill – should also give us pause. As the IG has reported, the number of businesses who first paid the tax was much lower than expected, in part because there were no good figures on how many businesses actually provide tanning services. The Indoor Tanning Association estimated that there were roughly 25,000 such businesses, but the actual number who filed excise tax returns last year averaged around 10,300.[18]

Lastly, the ACA increased the value of the Adoption Credit to $13,170 from $12,150 and made it refundable. [19] As it has with the other tax credit programs, the IRS has struggled to prevent erroneous payments. In the first quarter of 2011, the IG identified 736 taxpayers who had received more than $4 million in improper Adoption Credits.

While these may seem like trivial issues, there are provisions within the ACA that likely will cause the IRS similar problems. For example, it is fair to wonder if small biotech firms will find the administrative cost of claiming the tax credits available through the Qualified Discovery

[15] TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (September 2011).
[16] Ibid. p. 6.
[17] Ibid. p. 2.
[18] TIGTA Semiannual Report to Congress, April 1, 2011 – September 30, 2011, p. 29.
[19] IRS Management Challenges Memorandum, p. 9.

Project Program worth the effort. On the other hand, if the IRS could not determine how many tanning businesses were required to charge the Tanning Excise Tax, how can it successfully implement the Medical Device Excise Tax? This will require the IRS to coordinate its efforts with the FDA, which has classified some 1,700 generic classes of medical devices.

The IRS as an Extension of HHS

In key areas, the ACA gives HHS responsibility to determine eligibility and set the program's rules but gives the IRS the responsibility of verifying eligibility based on tax returns and staggering amounts of data from employers and insurance companies. Then, the IRS is also responsible for delivering benefits and fixing any problems that arise. At best, this is a recipe for bureaucratic turf battles. At worst, it is a quagmire for both the IRS and taxpayers.

The Premium Assistance Credit is a case in point. The credit amount is determined by the Secretary of HHS, but it is up to the IRS to verify household income based on tax return data for past years. Recipients can either chose to have Treasury make direct payments to the insurance plan in which they are enrolled or they can chose to pay the premiums themselves and apply to the IRS for the credit at the end of the tax year.

However, if HHS and the exchanges miscalculate someone's credit amount, it is up to the IRS to fix the overpayment or underpayment on a taxpayer's 1040. The overpayment will be treated as a tax while an underpayment will be treated as a reduction in tax. Either way, taxpayers will be caught between any communications disputes between the IRS and HHS.

Imagine if the Food Stamp system were run in the same fashion, where the eligibility for Food Stamps was determined by USDA but the IRS was responsible for verifying the incomes of recipients and either giving "food" tax credits directly to taxpayers or sending checks to grocery stores on their behalf. Does anyone think that this would make for an efficient and user-friendly system?

Compliance Costs will Skyrocket Under ACA

The ACA is a full employment act for the tax preparation industry and will add billions of dollars in compliance costs to people who cannot afford health insurance. As it stands, complying with the current tax code costs taxpayers an estimate $163 billion each year according to the National Taxpayer Advocate.

About 80 percent of all taxpayers use professional tax return preparers and commercial software to complete and file their tax returns, and that figure is surely to rise as the result of the ACA. While some may think that this will make compliance easier, the burden of these costs fall disproportionately on small businesses[20] and the poor. For example, about 73 percent of those

[20] http://www.sba.gov/sites/default/files/files/rs382.pdf

claiming the EITC pay a professional preparer to complete their tax return.[21] No doubt, this number will rise for taxpayers attempting to claim the Health Insurance Premium Tax Credit. The irony is that many taxpayers will have to ask themselves how much they can afford to pay a professional tax preparer in order to claim a tax credit that is intended to pay for health insurance they currently cannot afford.

Furthermore, it may be impossible to calculate the added compliance burden on businesses who must calculate the costs of the innumerable scenarios facing them: pay for health insurance for employees, absorb the employer-mandate penalties, or do nothing.

The experience with the Hope Credit suggests that much of these new compliance costs will go to waste. The IG reported that educational institutions spent millions of dollars and staff hours to provide taxpayers and the IRS with copies of Tuition Statements (Form 1098-T). However, the IRS did not use this Form in its compliance programs, or accept the Form as documentation to support claims for education credits.[22]

Conclusion

Mr. Chairman, it is hard to believe that anything could make the tax code look simple and understandable, but the Affordable Care Act does just that.

Ironically, while most everyone agrees that the tax code is badly in need of simplification and that the IRS is already overburdened, the Affordable Care Act has saddled the agency with duties that are beyond its core competency and has set it up for failure.

While we can never anticipate every unintended consequence of legislation, it is fairly easy to predict that the ACA will lead to more Americans taken off the tax rolls and made more reliant on the IRS for much of their income. And, it will produce more fraud, abuse, and improper payments from programs that should not be delivered through the tax code in the first place.

The solution is not to give the IRS more money, resources or staff. The solution is to reform the tax code, eliminate the most burdensome and distortionary tax preferences, and return the IRS to its core mission of simply collecting the necessary amount of tax revenues to fund the government.

Thank you very much. I would welcome any questions you may have.

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[21] National Taxpayer Advocate, Report to Congress: Fiscal 2010 Objectives, June 30, 2009, p. xxii. http://www.irs.gov/pub/irs-utl/fy2010_objectivesreport.pdf

[22] Ibid., p. 1.