NATIONAL TAXPAYER ADVOCATE

2006 ANNUAL REPORT TO CONGRESS

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Internal Revenue Service

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NATIONAL TAXPAYER ADVOCATE

2006 ANNUAL REPORT TO CONGRESS

THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

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The National Taxpayer Advocate gratefully dedicates this report to the remarkable employees of the Taxpayer Advocate Service, who day in and day out serve America's taxpayers.

Through their commitment to helping taxpayers, they manage to do more with less. Our tax system is better as a result of their efforts.

To

Janet Altman Spragens

A fearless champion of the rights of low income taxpayers,

a sage mentor to many in the tax world, and a good friend.

In memoriam.

HONORABLE MEMBERS OF CONGRESS:

I respectfully submit for your review the National Taxpayer Advocate's 2006 Annual Report to Congress. This year's report is in many ways a "Greatest Hits" version of past reports in that many of the Most Serious Problems we identify or the legislative recommendations we make were discussed in previous reports. But there are new wrinkles in all of these subjects, if only because the problems they identify – such as the Alternative Minimum Tax and the Tax Gap – become aggravated with the passage of time, when not addressed early on. In addition, as in past years, we include a second volume that contains two research studies – one on taxpayer needs and preferences for taxpayer service and one on the factors that drive taxpayers into the hands of the Taxpayer Advocate Service (the "Downstream Consequences" study). We believe that both of these studies will lead to a better understanding of the problems taxpayers face in complying with their tax obligations.

Toward a More Expansive Concept of Taxpayer Compliance

Traditional tax policy analysis suggests that the structure of taxation must meet three criteria – equity, efficiency, and administrability. These criteria can apply just as well to tax administration. In order to achieve maximum compliance with the tax laws, tax administration must treat similarly situated persons in a similar fashion; it must not distort taxpayers' economic decisions; and it must be designed such that its processes and requirements do not place an inordinate burden on either taxpayers or the tax administrator.

In the real world, of course, the IRS must grapple with budget constraints, training, hiring and attrition challenges, new tax legislation, archaic computer systems, and unexpected events like hurricanes and floods. The challenge for tax administration is to balance all these competing priorities in a way that maximizes taxpayers' voluntary compliance while addressing truly asocial noncompliance. As a new Congress convenes and IRS and Treasury prepare to respond to Congress' focus on the tax gap, this challenge will be front and center.

Over the last few years, the IRS has adopted the equation "Service + Enforcement = Compliance" to indicate the need for a balanced approach to tax administration. While I understand the importance of providing a succinct policy statement to taxpayers, Congress, and IRS employees, I believe we need to consider a slightly different formulation, and by not doing so, we risk losing the very balance we hope to achieve with the equation.

In reality, there are three types of IRS actions – service, enforcement *and* compliance. We all understand what activities constitute taxpayer service: filing returns, publishing forms and guidance, answering tax law and account questions, conducting outreach and education sessions. We also have a visceral understanding of what constitutes an enforcement action: a levy on a taxpayer's account, a garnishment of wages, a seizure of a principal residence, a criminal investigation. But what about all the activities in

between? Is a "math error" adjustment a taxpayer service or an enforcement action? If the IRS corrects a taxpayer's addition on a return, aren't we really just informing the taxpayer that he or she made an arithmetic or clerical error and that we've "fixed" it?

And what about audits of tax returns? Certainly, some examinations are predecessors to "enforcement" actions, as where a taxpayer is running a cash business, or has participated in an abusive tax scheme, and is intentionally and knowingly underreporting his or her income. Because of the taxpayer's intent to underreport income, the examination turns into an investigation that likely will lead to some sort of enforced collection action. But consider the taxpayer who has simply made an error based on an honest misunderstanding of the law, or even a reasonable interpretation of an unclear statute that just happens to differ from the IRS's interpretation. Surely this taxpayer should not be approached in the same manner as one who has intentionally "gamed" the tax laws.[1]

The IRS is more than a mere enforcement agency – much more. As our Study of Taxpayer Needs, Preferences, and Willingness To Use IRS Services in Volume 2 of this report demonstrates, taxpayers look to the IRS for assistance in many different forms, from direct assistance to assisted self-help to assistance to stakeholders who in turn assist taxpayers. And the IRS's tax gap data show overwhelmingly that the vast majority of U.S. taxpayers comply with their tax obligations in good faith.[2] Most taxpayers sit down every April to file and pay their taxes, voluntarily if not cheerfully. Employers throughout the year withhold and pay over employment taxes, and then report wages and non-employee compensation at year-end. These taxpayers expect – and I believe they have the *right* to expect – that if they make a mistake that results in an audit or a collection notice, their good faith efforts will be recognized and they will not be treated as someone who intentionally and knowingly skirted the law – that is, someone who is the subject of an enforcement action.

Thus, I suggest that the IRS begin to talk to taxpayers, its employees and Congress about the "compliance" activity it undertakes, in addition to its taxpayer service and

[1] Of course, even persons who intentionally attempt to game the tax laws are entitled to certain taxpayer rights and protections. For example, the IRS recently announced a new policy under which its Office of Appeals will send certain unagreed cases back to the examination function for further development. *See* IRS Announcement 2006-100. The rationale for this decision was that the IRS does not develop cases as fully for Appeals consideration as for litigation. This rationale demonstrates a fundamental flaw in the way the IRS handles its cases. If the issues the IRS fails to develop fully before Appeals' consideration are material, then Appeals presumably cannot make proper decisions without more information. If the issues the IRS fails to develop fully before Appeals' consideration are not material, then there is no basis to create a dramatic departure from Appeals' historic role as the final stop before taxpayers may litigate disputes with the IRS in the Tax Court. The IRS justified this deviation on the ground that these taxpayers engaged in "listed" transactions, but by effectively relegating administrative appeals to an intermediate step in the examination process, the IRS both in perception and in reality undermines the right of all taxpayers to an independent administrative appeal.

[2] The voluntary compliance rate for all taxpayers is 83.7 percent. IRS Office of Research, *Tax Gap Map for Tax Year 2001* (Feb. 2006).

enforcement actions.[3] These different categories of IRS action are not mere academic distinctions. They influence how IRS employees view their roles and how these employees interact with taxpayers. Taxpayers, too, respond to different types of IRS actions in different ways. If the IRS treats a taxpayer who has a "compliance" problem in the same way as it treats a taxpayer who has an "enforcement" problem, we are likely to alienate that taxpayer and not achieve the long-term voluntary compliance that should be our goal. Moreover, we have violated one of the central tenets of tax administration – treating similarly situated people alike and, by extension, not treating differently situated people the same.

It is true that my categorization does not lend itself to a neat equation. But neither does human experience nor, most certainly, taxpayer behavior. The categories of taxpayer service, compliance, and enforcement can be analogized to a three-legged stool that is the tax system. Remove any one leg, and the stool becomes wobbly and falls. By viewing IRS as an agency that only undertakes service and enforcement actions, we hobble tax administration, undermine our goal of achieving maximum voluntary compliance, and harm taxpayers.

Toward a More Transparent Tax Administration System

The primary theme of this year's report, however, is transparency and the role it plays in tax administration and tax compliance. According to my well-thumbed 1953 copy of Webster's New Collegiate Dictionary, the word "transparent" means "readily understood" and "clear," "easily detected" or "perfectly evident." Each of these definitions has relevance to tax administration. For example, as discussed in the Most Serious Problem on Transparency of the IRS, IRS public statements about its procedures, positions on tax law, and expectations of taxpayers (collectively, "guidance") must be clear and readily understandable. They should not be hidden from public view, absent compelling law enforcement considerations. Moreover, given the National Taxpayer Advocate's statutory responsibility to ensure that taxpayer rights are protected, her access to such information is paramount. It is disturbing, then, and unprecedented that despite repeated requests to review randomly selected guidance provided by the Office of Chief Counsel to IRS program heads, the National Taxpayer Advocate was denied the ability to review this guidance and determine, on her own, whether taxpayers would benefit from the publication – the making transparent – of that guidance.

But transparency in tax administration is a two-way street. Not only must the IRS be transparent in its guidance to employees, in its official positions, and in its disclosure of how it measures its own performance, but taxpayers also must be willing to engage in transparent (perfectly evident) transactions. In our Most Serious Problem on the tax

[3] This analysis is not unique. The IRS's service center activities used to be organized into processing, accounts, and compliance. See Most Serious Problem, Correspondence Delays, *infra.* More recently, in the course of an audit of the Taxpayer Advocate Service (TAS), the Government Accountability Office (GAO) suggested that TAS align its case "issue codes" into three groups – service, compliance, and enforcement.

gap, we note that a significant determinant of tax compliance is transparency.[4] By saying this, we mean that certain tax administration tools – notably, information reporting – have the virtue of making taxable transactions "transparent" or easily detected.

Transparency and the Annual Report to Congress

The National Taxpayer Advocate's Annual Report to Congress serves to increase the transparency of IRS operations. By design, we identify what we think are 20 of the most serious problems facing taxpayers, describe those problems and the IRS processes or policies that either cause or exacerbate them, and publish the IRS's (unedited) response. Finally, we make our own recommendations for mitigating the problems, including legislative recommendations.

It is notable this year that, in addition to our being thwarted in one instance when attempting to obtain information, the IRS has begun its response to seven of the 21 Most Serious Problems we identify by stating that it "disagrees" with our findings, or otherwise dismisses them.[5] These IRS responses are of concern because in every instance we have carefully described the basis for our identifying these issues as problems, and provided copious, documented sources in support of our positions. The IRS, in most of its responses to our concerns, has made declarative statements without citing any sources that make it possible to verify those statements.

We also note an increased tendency to look for "efficient" approaches to tax administration (from the perspective of IRS resources) and a resistance to undertake analysis from the taxpayer perspective. This approach is most notable in the series of Most Serious Problems addressing IRS collection activities. These seven problems highlight the IRS's short-term perspective on compliance. Rather than intervening early with taxpayers and making personal contact (which the IRS views as resource intensive), the IRS often waits until taxpayers' debts become so large that they warrant the (much more expensive) intervention of IRS field collection personnel. The IRS's solution to early intervention is to relegate many of these taxpayers to the Private Debt Collection Initiative, whereby the government (aka taxpayers) has the "privilege" of paying up to 25 percent of any taxes collected to private collection agencies, even while estimates show that IRS employees could perform the work far more efficiently, with a return on investment of approximately 13:1. We ask, in this report, what business case exists for such an arrangement, and conclude that there is none. As a result, we recommend that Congress repeal

[4] *See* Most Serious Problem, Transparency of the IRS, *infra.*

[5] These Most Serious Problems include *Collection Issues of Low Income Taxpayers; Small Business Outreach; Correspondence Examination; Disaster Response and Recovery; IRS Implementation of Math Error Authority Impairs Taxpayer Rights; Limited English Proficient (LEP) Taxpayers: Language and Cultural Barriers to Tax Compliance;* and *Concerns With the IRS Office of Appeals*, in which the IRS response stated that the issues raised are nearly identical to those in prior reports and "without any level of detail or documentation."

Internal Revenue Code section 6306 and terminate the Private Debt Collection initiative once and for all.[6]

There are numerous other ways in which short-term vision impairs tax administration and affects taxpayers. The existing budget procedures under which the IRS develops its budget and Congress makes IRS funding decisions undercuts the IRS's ability to achieve maximum taxpayer compliance. As we discuss in detail in our Key Legislative Recommendation, *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*, the current procedures treat the IRS as a classic government spending program and pit the IRS dollar-for-dollar against many other federal programs for resources. We point out, however, that the IRS is the Accounts Receivable Department of the federal government, collecting $2.24 trillion a year on a budget of $10.6 billion – a 210:1 return on investment. Studies show that each additional dollar appropriated for the IRS would generate far more than a dollar in additional federal revenue, helping to close the tax gap and reduce the federal deficit. Thus, we suggest a set of guidelines for making IRS funding decisions that recognizes the IRS's unique role as the revenue generator for the federal government and seeks to maximize tax compliance, especially voluntary tax compliance (with due regard for protecting taxpayer rights and minimizing taxpayer burden).

We also highlight several bright spots in tax administration this year. We are pleased to report, as a status update, on the progress made by the IRS on its Questionable Refund Program, which we designated as the second most serious problem facing taxpayers in last year's report.[7] The IRS has made significant strides in addressing our concerns about the program, and even more commendably, has been forthright (transparent) in describing both the improvements and the challenges ahead. These improvements are all the more notable because the program had been defended for so long as one without problems.

Transparency and Taxpayer Service

Another bright spot in tax administration this year is the Taxpayer Assistance Blueprint (TAB). Last year, we identified "Trends in Taxpayer Service" as the most serious problem affecting taxpayers. We recognized that the formation of the Taxpayer Assistance Blueprint (TAB) team was an important first step in the IRS's efforts to develop a long-term strategy to meet taxpayer needs and preferences. Moreover, we committed to participating in and working with the TAB team to develop this strategy.

Over the past year, the TAB has conducted numerous research studies designed to understand taxpayer needs and preferences. We are pleased with the work the TAB is

[6] We also note, in the Private Debt Collection arena, a stunning lack of transparency. The IRS has contractually agreed to let the private collection agencies determine whether their "operational plans" (akin to the Internal Revenue Manual) will be released to the public, resulting in taxpayers not knowing what practices, letters, or scripts the agencies will use. *See* Most Serious Problem, *True Costs and Benefits of Private Debt Collection, infra.*

[7] *See* Status Report, *Major Improvements in the Questionable Refund Program and Some Continuing Concerns, infra; see also* National Taxpayer Advocate 2005 Annual Report to Congress 25-55 (Most Serious Problem: Criminal Investigation Refund Freezes).

doing, and believe the IRS is in a much better place than it was last year in this area. With the publication of the Taxpayer Assistance Blueprint, the IRS will make available its first strategic plan for delivering taxpayer service, one that is based on current research and envisions further studies and refinements. In the following section and in volume 2 of this report, we discuss both our perspective on the TAB and what we have learned about taxpayer needs and preferences. It will be up to Congress and the Administration to ensure that the important work of the Taxpayer Assistance Blueprint is not ignored or short-changed. The IRS and the TAB must be allowed to adequately analyze and understand the available research to develop an accurate picture of taxpayer needs and preferences, and make recommendations for delivering taxpayer service that are based on that research. Without the necessary transparency, taxpayers will not have confidence that the tax administration system is meeting their needs.

Respectfully submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2006

TAXPAYER ASSISTANCE BLUEPRINT:

THE NATIONAL TAXPAYER ADVOCATE'S PERSPECTIVE

In September 2005, the IRS formed the Taxpayer Assistance Blueprint (TAB) team, with employees from several IRS functions, including the Taxpayer Advocate Service (TAS), in response to a congressional directive to develop a five-year plan for taxpayer service.[1] The TAB delivered an initial report to Congress in April 2006,[2] and plans to release its final report in early 2007. The critical portion of the upcoming report is the five-year plan for how the IRS should provide taxpayer service. The following discussion provides a framework for understanding the work of the TAB and the challenges the IRS faces in implementing this strategic plan.

In the 2005 Annual Report to Congress, the National Taxpayer Advocate noted that the first step for developing a plan for taxpayer service is for the IRS to conduct a comprehensive study to determine what services different groups of taxpayers need, and how they prefer to obtain those services.[3] Over the past year, the TAB conducted numerous research studies designed to understand taxpayer needs and preferences. This research forms the basis for the five-year plan for taxpayer service, but for the plan to succeed, the IRS must first understand the definition of a taxpayer "need" and "preference." We believe that defining needs and preferences is a necessary step.[4]

Taxpayer Needs

Last year, the National Taxpayer Advocate recommended that the IRS "[e]ngage in a detailed needs assessment, from the taxpayers' perspective, as part of the IRS' five-year plan for taxpayer service."[5] Needs can be defined as the services taxpayers need to comply with their tax obligations. While all taxpayers require some combination of information and services, in order to comply with their tax obligations, needs will differ from taxpayer to taxpayer according to their specific situations.

[1] H. Rep. No. 109-307, at 209 (2005). The Senate Committee Report provides further detail on the content of the five-year plan, directing the IRS to:

> … undertake a comprehensive review of its current portfolio of taxpayer services and develop a 5-year plan that outlines the services it should provide to improve services for taxpayers. This plan should detail how it [IRS] plans to meet the service needs on a geographic basis (by State and major metropolitan area), including any proposals to realign existing resources to improve taxpayer access to services, and address how the plan will improve taxpayer service based on reliable data on taxpayer service needs. As part of this review, the Committee strongly urges the IRS to use innovative approaches to taxpayer services, such as virtual technology and mobile units. The IRS also should expand efforts to partner with State and local governments and private entities to improve taxpayer services.

S. Rep. No. 109-109, at 133-34 (2005).

[2] IRS, *Taxpayer Assistance Blueprint: Phase I* (April 16, 2006).

[3] National Taxpayer Advocate 2005 Annual Report to Congress 10.

[4] For a detailed discussion of taxpayer needs and preferences, including findings from several of the TAB research studies, see National Taxpayer Advocate 2006 Annual Report To Congress vol II at 1 (Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services).

[5] National Taxpayer Advocate 2005 Annual Report to Congress 24.

When discussing taxpayer needs, two factors must be taken into consideration:

- Is the product or service being delivered in such a way that the taxpayer can understand and use the product or service to comply with his or her tax obligations; and
- Can the taxpayer obtain the needed product or service without experiencing an unreasonable burden?

The IRS must structure service options so the service successfully meets the taxpayer's needs as delivered and allows the taxpayer to comply with his or her tax law obligations. Burden can limit a taxpayer's ability to use certain services, thereby impacting voluntary compliance, and the IRS must remain cognizant of the burden associated with using certain IRS services. If the use of a needed service is too burdensome, the IRS is not successfully meeting taxpayer needs. While needs differ according to taxpayer, all taxpayers have a basic set of needs, and where the IRS is obligated to provide services, taxpayers must be able to use these services conveniently and correctly.

In developing a five-year plan for taxpayer service and weighing various policy and budget considerations, the IRS must decide what obligation it has to provide information and services to taxpayers to meet their needs. There are a number of sources available to meet taxpayer needs, including the IRS, volunteer organizations, and paid practitioners. When deciding how to meet taxpayer needs in the future, the IRS must be sure it is not shifting this responsibility from itself to volunteers and paid practitioners. While volunteer groups and practitioners play an important role in the tax community, where the IRS is the best source for providing information and services to meet taxpayer needs, it should not shift that responsibility to outside groups over which it has little or no control.

Taxpayer Preferences

In addition to understanding taxpayer needs, last year the National Taxpayer Advocate also recommended that the IRS "[d]evelop an understanding of what taxpayers prefer…."[6] Preferences can be defined as the methods or channels through which taxpayers choose to obtain the services they need.

Taxpayer preferences are linked to their ability to use a certain channel. If taxpayers are not willing to use a channel, they will likely not indicate a preference for it. Willingness is driven by a number of issues, many of which are outside of the control of the IRS. Taxpayers' willingness to share personal data over the Internet or the phone, or to deal with an IRS assistor over the phone or in person, can drive the channels they prefer to use to get the service they need. Factors such as age, income, literacy, language skills, and disability also influence preferences.[7] When analyzing taxpayer preferences, the IRS must keep in mind the needs of certain taxpaying populations such as the elderly, low

[6] National Taxpayer Advocate 2005 Annual Report to Congress 24.

[7] *See* Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities, infra; see also* Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Language And Cultural Barriers to Tax Compliance, infra.*

income, low literacy, limited English proficiency (LEP), and disabled. While the general taxpayer population may have certain preferences for obtaining needed services, these preferences may not hold true for all taxpayers. The IRS owes an obligation to provide services in a manner that all taxpayers can access them, including those taxpayers whose needs differ from the general population.

Use as an Indicator of Needs and Preferences

In defining taxpayer needs and preferences and analyzing the related research, it is important to understand that use or nonuse of a service or channel is not an accurate determinant of what taxpayers need or prefer. While use is one indicator that taxpayers need and prefer the service or channel, it does not provide a complete picture, because use is contingent on awareness. If a taxpayer is not aware of a service or channel, he or she will not use it.

Use is also contingent on ability to use. If a taxpayer is aware of a service or channel, but unable to make use of it (*e.g.*, the taxpayer lives too far away, does not have Internet access, or the service or channel is too burdensome), then the taxpayer will not use the service or channel even though it is needed. Further, a taxpayer's current use of a service or channel does not indicate future need. A taxpayer may not currently visit a Taxpayer Assistance Center (TAC) or walk-in site because he or she does not have any outstanding tax issues. However, in the future, that same taxpayer may have a question about a tax account and wish to visit the local TAC to resolve the issue.

In developing the five-year plan for taxpayer service, it is important to know the current usage of IRS services and channels. These usage rates, however, must be considered in context and should not be taken as indicators of taxpayer needs and preferences.

Five-Year Plan for Taxpayer Service

The main outcome of the TAB is the development of a five-year plan for taxpayer service. The TAB conducted a large number of significant research studies which provide the IRS with a wealth of previously unknown information. However, this research will not be useful and the five-year plan will not be successful unless the TAB takes the time to understand what the new data tells us. Additionally, in its report and the five-year plan, the TAB must be sure to present all of the research, even where different studies yield different results. Each research finding tells the IRS something new, and only by examining all of the research can the IRS and Congress truly understand what taxpayers need and develop a plan that best meets those needs.

The work of the TAB is just the first step in improving IRS delivery of taxpayer services. As the delivery of taxpayer services changes, so will taxpayer needs and preferences. Therefore, the IRS must continue to engage in meaningful research to understand these evolving customer needs.

In September 2006, the Department of Treasury Office of Tax Policy issued an aggressive strategy for reducing the tax gap.[8] As part of the strategy, Treasury recognized that taxpayer service plays an important role in compliance. One component of the tax gap strategy is a multi-year commitment to research, including research on the impact of customer service on compliance.[9] The strategy also recommends enhanced taxpayer service as a way to help taxpayers avoid errors.[10] The National Taxpayer Advocate commends this approach. She notes that the research conducted during the TAB focused mainly on taxpayer needs and preferences. The IRS needs to continue the efforts started with the TAB and conduct follow-up research to examine the link between service and compliance. Toward this end, the National Taxpayer Advocate has two commissioned research studies, one exploring the causes of and influences on taxpayer behavior, and one examining the role of return preparers and practitioners in taxpayer compliance (or noncompliance). The National Taxpayer Advocate will publish these studies in 2007.

8 Department of Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap* (Sept. 26, 2006).

9 *Id.* at 12.

10 *Id.* at 14-15.

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NATIONAL TAXPAYER ADVOCATE ANNUAL REPORT TO CONGRESS – VOLUME II

Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services
Downstream Impact Project: Identifying Drivers of TAS Workload

INTRODUCTION: THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

The Internal Revenue Code (IRC) requires the Annual Report to Congress to discuss at least 20 of the most serious problems encountered by taxpayers each year.[1] This year, the National Taxpayer Advocate has identified, analyzed, and provided recommendations for resolving 21 of these problems. The report also includes a status update on an issue discussed in the 2005 Annual Report – the IRS's Questionable Refund Program, operated by the Criminal Investigation (CI) division.[2] While this issue remains an area of concern, the National Taxpayer Advocate believes the IRS has significantly improved the program, and thus we provide a status report on both the work accomplished and the challenges ahead as IRS continues to address the problems we identified.

Consistent with the statutory requirement, we note that this report contains discussions of at least *20 of the most serious problems* encountered by taxpayers – but not necessarily the top 20 most serious problems. That is by design. First, there is no objective way to determine the 20 most serious problems. We use a methodology (described immediately below) that assists us in compiling our list, but it is inherently subjective in many respects. Second, and more significant, simply listing the top 20 problems would require us to repeat large sections of the report from year to year. In a tax system in which nearly 100,000 IRS employees collect more than $2 trillion dollars each year from about 135 million individual income tax filers[3] (not to mention corporate and other taxpayers), there are many glitches that inevitably occur and require attention. By providing flexibility in selecting topics for the report, the statute allows the National Taxpayer Advocate to select topics with an eye toward resolving problems rather than merely listing them.

Methodology of the Most Serious Problem List

TAS considers a number of factors in identifying, evaluating, and ranking the most serious taxpayer problems. The 21 issues discussed in this section of the Annual Report were ranked according to the following criteria:

- Impact on taxpayer rights;
- Number of taxpayers affected;
- Interest to the National Taxpayer Advocate, Congress, and other external stakeholders;
- Barriers these problems present to tax law compliance, including cost, time, and burden;
- The revenue impact of noncompliance; and
- TAS management information data.

1 IRC § 7803(c)(2)(B)(ii)(III).

2 National Taxpayer Advocate 2005 Annual Report to Congress 25-55.

3 IRS, *2005 Data Book*, Tables 1 and 3

Taxpayer Advocate Management Information System (TAMIS) List

The most serious problems reflect not only the mandates of Congress and the Internal Revenue Code, but TAS's integrated approach to advocacy – using individual taxpayer cases as a method of detecting trends and identifying systemic taxpayer problems. TAS tracks individual taxpayer cases on the Taxpayer Advocate Management Information System (TAMIS). The top 25 case issues, which are listed in Appendix 1, reflect TAMIS receipts based on taxpayer contacts from October 1, 2005 through September 30, 2006.

IRS Responses

TAS provides the IRS operating divisions and functional units with the opportunity to comment on and respond to the problems described in each year's report. These responses appear, unedited, under the heading "IRS Comments," followed by the National Taxpayer Advocate's own comments and recommendations.

PROBLEM

TOPIC #1 ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

The most serious problem facing taxpayers today is the complexity of the Internal Revenue Code. In this report, we are choosing to shine our primary spotlight on the poster child for tax-law complexity – the Alternative Minimum Tax for individuals (AMT).

The AMT is a parallel and complex tax structure that is imposed on top of the regular tax structure. While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions, it now affects large groups of middle-class taxpayers with no tax-avoidance motives at all.

Significantly, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed. Today, the AMT is left to punish taxpayers for engaging in such "classic tax-avoidance behavior" as having children or living in a high-tax state. In the first instance, the AMT disallows the personal exemptions that parents are allowed to claim under the regular tax rules to reflect the additional costs they incur in raising children. In the second instance, the AMT disallows the deduction for the payment of state and local income, sales, and property taxes that taxpayers are allowed to claim under the regular tax rules to reduce "double taxation" at the federal and state levels on the same income. This, in essence, is today's AMT.

The AMT is ensnaring an ever-growing number of taxpayers because the amount of income exempt from the AMT (the AMT "exemption amount") is not indexed for inflation. When Congress first enacted a minimum tax in 1969, the exemption amount was $30,000 for all taxpayers. If that amount had been indexed, it would be equal to about $165,000 today.[1] Instead, the exemption amount, after a temporary increase that will expire after 2006, is $45,000 for married taxpayers and $33,750 for most other taxpayers.[2] As a result, it is now projected that in 2010, 32.4 million individual taxpayers – or 34 percent of individual filers who pay income tax – will be subject to the

[1] Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (as of Oct. 31, 2006). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above $200,000 had paid no federal income tax for the 1966 tax year. *See The 1969 Economic Report of the President: Hearings before the Joint Economic Comm.*, 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has increased more than six fold since 1966, so the kinds of taxpayers who caught Congress' attention back then would be making about $1.25 million today. *See* Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (as of Oct. 31, 2006). Yet the AMT today is not primarily affecting taxpayers with incomes over $1.25 million. By 2010, it has been estimated that 82 percent of all taxpayers affected by the AMT will have incomes under $200,000 – and 36 percent will have incomes under $100,000. *See* Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections updated November 2006* (Nov. 1, 2006) (available on the Urban Institute-Brookings Institution Tax Policy Center website at www.taxpolicycenter.org and published in Tax Notes Today, accessible at 2006 TNT 219-50) [hereinafter "Urban Institute/Brookings Institution Tax Policy Center"], table 5.

[2] IRC § 55(d).

AMT.[3] Among the categories of taxpayers hardest hit, 89 percent of married couples with adjusted gross income (AGI) between $75,000 and $100,000 and with two or more children will owe AMT.[4]

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that the average AMT taxpayer will owe an *additional* $6,782 in tax in 2006.[5] In terms of complexity and time, taxpayers often must complete a 16-line worksheet,[6] read nine pages of instructions,[7] and complete a 55-line form[8] simply to determine whether they are subject to the AMT. Thus, it is hardly surprising that 77 percent of AMT taxpayers hire practitioners to prepare their returns.[9]

Perhaps most disturbingly, it is often very difficult for taxpayers to determine in advance whether they will be hit by the AMT. As a result, many taxpayers are unaware that the AMT applies to them until they receive a notice from the IRS, and some discover they have AMT liabilities that they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in these taxpayers being subject to penalties.

The following two examples illustrate the impact of the AMT on individual taxpayers:

- A mother of five earned $57,000 in 2005. She is seeking a legal separation from her husband and lived apart from him during the final months of the year and thus claimed "married filing separately" filing status. Because she was entitled to claim the children as her dependents and claim the child tax credit, she had no tax liability under the regular tax rules. She therefore did not have any tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of $2,380 due to the AMT. Because of the AMT tax liability, she also owed a penalty for failure to pay estimated tax in the amount of $95.
- A taxpayer filed a joint return claiming two dependent children for 2005. The taxpayer had an adjusted gross income (AGI) of $190,000 and paid state income and property taxes totaling $28,000. The taxpayer had 90 percent of his regular tax liability withheld from his paycheck. When the taxpayer prepared his return, he discovered that he had an additional tax liability of $5,042 due to the AMT.

[3] Urban Institute/Brookings Institution Tax Policy Center, tables 1 & 3. The AMT projections made by the Urban Institute/Brookings Institution Tax Policy Center are the most detailed available. In the past, we have compared its projections with projections made by the Department of the Treasury's Office of Tax Analysis and the Joint Committee on Taxation, and the disparities have been minor.

[4] Urban Institute/Brookings Institution Tax Policy Center, table 3.

[5] Urban Institute/Brookings Institution Tax Policy Center, table 4.

[6] IRS Form 1040, *Individual Income Tax Return,* Instructions at 39 (2006).

[7] IRS Form 6251, *Alternative Minimum Tax - Individuals,* Instructions (2006).

[8] IRS Form 6251, *Alternative Minimum Tax - Individuals,* Instructions (2006).

[9] IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF), Tax Year 2004.

> Because of the additional AMT tax liability, he also owed a penalty for failure to pay estimated tax in the amount of $202.

Thus, while the concept of a minimum tax is not unreasonable, the AMT as currently structured has morphed into something that was never intended: it is hitting taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it is penalizing taxpayers for such non-tax-driven behavior as having children or choosing to live in a state that happens to impose high taxes; it is taking large numbers of taxpayers by surprise – and subjecting them to penalties to boot; it is imposing onerous compliance burdens; it is altering the distribution of the tax burden that exists under the regular tax system; it is changing the tax incentives built into the regular tax system; and it is neutralizing the effects of changes to tax rates imposed under the regular tax system.

RECOMMENDATION

To be viewed as fair, a tax system must be transparent. Yet the complexity of the AMT is such that many if not most taxpayers who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments. Taxpayers subjected to this treatment may wonder whether their government has dealt fairly with them. To say the least, "gotcha" taxation is not good for taxpayers or the tax system.

The National Taxpayer Advocate recommends that Congress repeal the provisions of the Internal Revenue Code that pertain to the Alternative Minimum Tax for individuals.[10]

> The National Taxpayer Advocate previously designated the AMT as the most serious problem facing taxpayers in her 2003 report to Congress,[11] and she recommended in both her 2001 and 2004 reports that the AMT be repealed.[12] She also has recommended repeal of the AMT in several appearances before Congress, including at a hearing of a Senate Finance subcommittee that specifically focused on the AMT.[13] For a comprehensive discussion of the AMT and the National Taxpayer Advocate's concerns, see her testimony and previous reports (available at http://www.irs.gov/advocate).

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[10] As a matter of fairness, the repeal of the AMT would require that Congress address the treatment of unused prior-year minimum tax credits, perhaps simply by retaining § 53 of the Code.

[11] National Taxpayer Advocate 2003 Annual Report to Congress 5-19.

[12] National Taxpayer Advocate 2004 Annual Report to Congress 383-385; National Taxpayer Advocate 2001 Annual Report to Congress 166-177.

[13] *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. On Taxation and IRS Oversight of the Senate Comm. On Finance (2005).*

PROBLEM

TOPIC #2 THE TAX GAP

The federal tax gap is one of the most serious problems facing taxpayers today, and it is one of the top two most serious problems facing tax administration.[1]

It's easy to see why the tax gap is a problem for tax administration. According to the results of the IRS National Research Program study of 2001 tax returns, the government is failing to collect $290 billion of tax revenue that is due each year.[2]

But the tax gap is also a serious problem for the vast majority of compliant taxpayers who pay their taxes willingly and honestly every year. If we divide the estimated $290 billion net tax gap by the roughly 130 million individual income tax returns filed, we can see that each return was effectively assessed a "surtax" of more than $2,200 to subsidize noncompliance by others. That's an extraordinary burden to expect the average taxpayer to bear. Nobody likes to feel like a "tax chump." If we do not manage to close the tax gap, particularly with all the attention the subject has been receiving of late, we run a real risk that our compliant taxpayers will become less compliant over time.

The tax gap data show that the most significant determinant of tax compliance is transparency. Where payments of income are reported to the IRS (*e.g.*, on a Form W-2, Employee's Wage and Earnings Statement, a Form 1099, U.S. Information Return, or a Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.), compliance is generally 95 percent or higher.[3] Where payments of income are not reported to the IRS, compliance plummets to below 50 percent. IRS data indicate that 99 percent of income earned by wage earners is reported on a tax return, yet only about 43 percent of income earned by self-employed persons is reported.[4]

The National Taxpayer Advocate has long advocated three broad strategies to close the tax gap:

- Fundamental tax simplification, with an emphasis on making economic transactions more transparent;
- Expanded third-party information reporting and, in certain situations, tax withholding on non-wage income; and
- Improved IRS compliance initiatives that appropriately balance taxpayer service and enforcement.

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[1] The National Taxpayer Advocate believes that the most serious problem facing both taxpayers and the IRS is the complexity of the Internal Revenue Code. *See* Most Serious Problem, *The Alternative Minimum Tax For Individuals, supra*; National Taxpayer Advocate 2004 Annual Report to Congress 2-7 (designating the complexity of the Internal Revenue Code as the most serious problem facing taxpayers and the IRS alike).

[2] *See* IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006). In fact, the IRS acknowledges the actual tax gap is larger. For example, the study did not even venture a guess as to the amount of illegal source income that goes unreported and on which taxes are not paid.

[3] *See* IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

[4] *Id.*

The National Taxpayer Advocate has discussed the tax gap in considerable detail in her annual reports to Congress[5] and in testimony at congressional hearings on the tax gap over the past 2½ years.[6]

This year, we emphasize three issues that we think warrant particular attention:

- Improving taxpayer service to meet the needs of our nation's taxpayers;
- Ensuring that the IRS's stepped-up enforcement activity proceeds successfully and without violating taxpayer rights; and
- Revising the federal budget process to ensure that decisions about IRS funding are made in a way designed to maximize compliance with the tax laws, especially voluntary compliance, thereby leading to a reduction in the tax gap and an increase in overall federal revenue.

The first two issues flow from the IRS's strategic formula: "Service + Enforcement = Compliance."[7] Although this formula is rather light on specifics, it reflects the indisputable premise that service and enforcement both play an important role in maximizing compliance with our nation's tax laws. The IRS views service as including such activities as publicizing the requirement to file tax returns and pay taxes, publishing tax forms and explanatory guidance, answering taxpayers' tax-law questions and even preparing tax returns, and assisting taxpayers who need other help in complying. The IRS views enforcement as including such activities as verifying compliance on the part of taxpayers, reaching determinations about a taxpayer's correct tax liability if different from what the taxpayer reported, litigating against taxpayers where disputed issues arise, and taking actions to collect unpaid tax.

Where successful, taxpayer service is to be preferred to enforcement for at least two important reasons. First, it is much better for our civic culture when taxpayers report their income and pay their taxes voluntarily. Second, at a more practical level, the IRS

[5] National Taxpayer Advocate 2005 Annual Report to Congress 55-75 (discussing the cash economy) and 381-396 (making legislative proposals to improve compliance in the cash economy); National Taxpayer Advocate 2004 Annual Report to Congress 211-263 (discussing IRS examination strategy, IRS collection strategy, and the application of the Federal Payment Levy Program to noncompliant federal contractors) and 478-489 (making legislative recommendations to combat the tax gap, which includes a chart identifying and commenting on 24 options); National Taxpayer Advocate 2003 Annual Report to Congress 20-25 (discussing noncompliance by self-employed taxpayers) and 256-269 (proposing tax withholding on non-wage workers, a position the National Taxpayer Advocate subsequently modified in her 2005 report cited above in this footnote).

[6] The National Taxpayer Advocate has testified at the following Senate hearings focused on the federal tax gap: Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Sept. 26, 2006); Senate Finance Subcommittee on Taxation and IRS Oversight (Jul. 26, 2006); Senate Budget Committee (February 15, 2006); Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Oct. 26, 2005) (written statement only); Senate Finance Committee (April 14, 2005); Senate Finance Committee (July 21, 2004).

[7] *See* IRS Strategic Plan 2005-2009. In the Preface to this report, the National Taxpayer Advocate discusses an alternative way to view IRS programs based on taxpayer behavior.

lacks the resources to close the tax gap through audits alone. The examination rate is currently less than one percent, and the majority of examinations are limited-scope examinations conducted by mail.[8] Even if we were somehow able to double the examination rate, more than 98 percent of taxpayers would not be examined each year. So we need to focus on maximizing voluntary compliance by simplifying the tax laws and improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.[9]

With regard to taxpayer service, the Senate Appropriations Committee report accompanying the FY 2006 IRS funding bill expressed concern that the IRS was not giving adequate emphasis to taxpayer service, and it directed the IRS, its Oversight Board, and the National Taxpayer Advocate to develop a five-year plan for taxpayer service that includes long-term goals that are strategic and quantitative and that balance enforcement and service.[10] Over the past year, my office has worked very closely with the IRS in developing a taxpayer service strategic plan, and I believe the undertaking has substantially advanced IRS's understanding of taxpayer needs and taxpayer preferences. There is a discussion of this project, known as the Taxpayer Assistance Blueprint, or the "TAB," immediately following the Preface to this report.

With regard to IRS's stepped-up enforcement activity over the past few years, we are beginning to see signs that taxpayer rights are not being protected as well as they have been in recent years, particularly in the collection process. Perhaps this is almost inevitable when enforcement is ramped up quickly and pressure is applied to program managers to show results, but we believe it is important to highlight our concerns and for the IRS to take our concerns seriously to avoid the risk that the enforcement overzealousness which plagued the agency in the mid-1990s will recur. In this section of the Annual Report to Congress, where we list at least 20 of the most serious problems facing taxpayers, fully seven relate to IRS collection practices.

The National Taxpayer Advocate believes strongly that the tax gap cannot and should not be closed by ramping up enforcement activities too quickly or by pressuring IRS examination and collection personnel to hit revenue targets either directly or indirectly through shorter cycle times. Increasing the number of enforcement personnel too quickly would require the IRS to divert experienced personnel from revenue-producing priority work to train new employees. Moreover, new hires generally have lower productivity rates and require significantly closer supervision than experienced employees to ensure they do not take incorrect actions, including actions that impair or violate

8 IRS, *2005 Data Book*, Table 10, at 19. The IRS also proposes adjustments using math-error authority and its automated under-reporter (AUR) and automated substitute for return (ASFR) programs.

9 For research purposes, we believe it is important to study inadvertent errors as well as deliberate misreporting. Knowledge about inadvertent errors can be used to clarify ambiguous laws or administrative guidance to help improve compliance.

10 S. Rep. No. 109-109, at 133-134 (2005).

taxpayer rights. Similarly, revenue targets would inevitably lead to taxpayer rights violations by providing an incentive for enforcement personnel to maximize revenue. That is inconsistent with the IRS's mission, as the government's tax administrator, to achieve the correct tax result in each case.

As a counterpart to the five-year strategic plan the IRS has developed for taxpayer service, the National Taxpayer Advocate recommends that the IRS, in conjunction with the Advocate and the IRS Oversight Board, develop a five-year strategic plan for tax law enforcement that includes long-term goals that are strategic and quantitative in nature (*e.g.*, an increase in the voluntary compliance rate) and that balances enforcement and taxpayer service, including the protection of taxpayer rights. The IRS Strategic Plan 2005-2009, a blueprint the IRS published in 2004, contains some relevant objectives, but a revised plan focused specifically on enforcement, and developed using the results of newer research studies, could help the IRS optimize its allocation of resources to improve compliance.

Finally, with regard to IRS funding, we encourage Congress to re-evaluate the procedures by which IRS funding decisions are made. Under current procedures, the IRS is treated as just another federal spending program, without any clear mechanism for recognizing the revenue that the IRS brings in. Inasmuch as the IRS brings in almost all federal revenue (more than $2 trillion), these procedures are illogical. The appropriate congressional committees should consider creating a separate process to make IRS funding decisions that gives priority consideration to maximizing tax compliance, particularly voluntary compliance. To illustrate the shortcoming with the present procedures, assume that an additional $2 billion spent on the IRS would generate an additional $8 billion in federal revenue. It would seem a "no-brainer" that this expenditure should be made, yet it often cannot be made under the existing rules because Congress sets hard spending caps at the beginning of the budget process, and each dollar spent on the IRS leaves one less dollar available for other programs. In the Key Legislative Recommendations section of this report, we offer a general proposal to improve the budget decision-making process.

In sum, we are pleased that Congress is showing increased interest in closing the federal tax gap. We continue to believe that tax simplification and expanded third-party information reporting are central to that effort. At the IRS level, we believe that a vigorous compliance program that appropriately balances taxpayer service and enforcement with due regard for taxpayer rights can produce better results; and we believe Congress should revise its budget procedures to take into account IRS's unique role as the revenue generator of the federal government when making IRS funding decisions.

PROBLEMS

PROBLEM

TOPIC #3 **TRANSPARENCY OF THE IRS**

RESPONSIBLE OFFICIALS

Kevin M. Brown, Deputy Commissioner, Services and Enforcement
Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division
Richard J. Morgante, Commissioner, Wage and Investment Division
Deborah M. Nolan, Commissioner, Large and Mid-Size Business Division
Steven T. Miller, Commissioner, Tax Exempt and Government Entities
Sarah Hall Ingram, Chief, Appeals
Nancy J. Jardini, Chief, Criminal Investigation
Donald L. Korb, Chief Counsel
Mark J. Mazur, Director, Research, Analysis and Statistics

DEFINITION OF THE PROBLEM

Like all federal agencies, the IRS is required by law to make certain procedures and guidance available to the public (*i.e.*, it is required to be transparent).[1] Although the IRS makes a significant amount of information available to the public, TAS has received complaints that the IRS is not fully complying with this requirement. We have determined that such complaints have merit, and although the IRS has taken steps to improve its transparency in recent years, we believe the IRS's lack of transparency is a serious problem.[2] The IRS's failure to consistently and promptly publish certain procedures and guidance deprives the IRS of valuable feedback that it could use to improve the procedures and guidance. It also deprives taxpayers and their representatives of information that is vitally important in resolving tax problems and disputes.

For example, since November 2004, the specialized group of IRS employees that is supposed to evaluate all offers to compromise tax debts based on "equity and public policy" considerations has been using unpublished guidance to determine whether to accept such offers.[3] As a result, some taxpayers who would be eligible for an offer may not have bothered to apply because they did not know they would qualify. The IRS employees who screened the offers that taxpayers did submit may not have referred them to the specialized group because the employees did not know the taxpayers would qualify either. Since taxpayers did not know what facts the IRS would consider, they most probably did not emphasize (in their offer packages) the facts that the IRS considers most important. Thus, the IRS is more likely to have rejected such offers. Further,

1 *See generally*, 5 U.S.C.A. § 552.

2 Even TAS itself has recognized the need to improve its procedures for complying with these requirements.

3 SB/SE, Collection Policy, *Non-Hardship ETA* (first circulated in October or November 2004); SB/SE, Collection Policy, *Offers In Compromise, Additional Guidance Regarding the Use of "Non-Hardship" Effective Tax Administration OICs* (first circulated in September 2005). As of October 11, 2006, SB/SE's guidance had not been signed, widely distributed beyond the specialized group, or made available to the public.

the IRS has not had the opportunity to receive input from the public that would be helpful in refining its guidance.

ANALYSIS OF THE PROBLEM

Freedom of Information Act (FOIA)

In addition to certain items that the Freedom of Information Act (FOIA) requires the IRS to release upon request or publish in the Federal Register, the law requires the IRS to make available to the public all "administrative staff manuals and instructions to staff that affect a member of the public" unless an exemption applies.[4]

Such exemptions generally protect against disclosure that would harm important interests, such as national security, individual privacy, proprietary business interests, and the functioning of government.[5] For example, certain inter-agency or intra-agency memoranda or letters may be exempt from disclosure to encourage frank discussions between IRS officials. Information used for law enforcement purposes, such as a tolerance level (*i.e.*, a level of noncompliance that the IRS will not pursue), is exempt to prevent taxpayers from using such information to evade detection or abuse the system.[6] But, if disclosure would not harm other important interests, there are good reasons for the IRS to make its instructions to staff available to the public.

Benefits of Transparency

Transparency Promotes Better Decisions

The government often uses disclosure (*i.e.*, transparency) to promote reasonable behavior by taxpayers and practitioners. For example, "reportable transaction" rules require taxpayers to disclose potentially abusive transactions to the IRS.[7] One rationale for these rules is that such transparency may prompt taxpayers to avoid taking unreasonable posi-

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4 *See* 5 U.S.C.A. § 552(a)(2)(C). The IRS is also supposed to make available all: (1) Final opinions made in the adjudication of cases; (2) Statements of policy and interpretations adopted by the IRS; (3) Copies of all records, which have been released under FOIA upon request, that the agency determines have become or are likely to become the subject of subsequent requests; and (4) An index of all such records. *Id.* However, this discussion focuses primarily on "instructions to staff."

5 *See generally*, 5 U.S.C.A. § 552(b). The IRS is not required to disclose: (1) Matters related solely to internal personnel rules and practices; (2) Matters specifically required to be withheld pursuant to a statute other than FOIA; (3) Trade secrets or other confidential commercial or financial information; (4) Inter-agency or intra-agency memoranda or letters that would not be available by law to a private party in litigation; (4) Personnel, medical files, and similar files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy; and (5) Certain records or information compiled for law enforcement purposes. Other exemptions, which rarely apply to the IRS, include: (1) Certain matters specifically authorized by an Executive Order to be kept secret in the interest of national defense or foreign policy; (2) Matters related to certain reports prepared by or for an agency responsible for regulating or supervising financial institutions; and (3) Certain geological or geophysical information. *Id.*

6 *Id.* The IRS generally designates such instructions to staff that are exempt from disclosure as "official use only" (OUO). *See generally*, IRM 11.3.12 (July 25, 2005).

7 *See, e.g.*, Treas. Reg. § 1.6011-4.

tions in the first place.[8] For the same reasons, transparency reduces the likelihood that government decision makers will adopt unreasonable policies.[9]

The law implicitly recognizes that transparency promotes better decisions by policy-makers. Courts generally give more weight and deference to regulations promulgated pursuant to formal "notice and comment" procedures, which require the agency to consider public comments.[10] The courts grant such deference, in part, because transparency resulting from the notice and comment process promotes a healthy dialogue with taxpayers and helps the government to write better regulations.[11]

Transparency Promotes Consistency and Fairness

Transparency also helps to ensure that all IRS employees use the same guidance and procedures, and it assures taxpayers that the IRS is not arbitrarily treating some more favorably than others. Along the same lines, when the IRS compromises a taxpayer's liability, it must make the terms of the compromise available for public inspection.[12] Such transparency may assure taxpayers that the IRS is not arbitrarily or unfairly compromising tax liabilities.

Perhaps most importantly, transparency prevents the inequity that can result if taxpayers who know about undisclosed IRS guidance or processes obtain benefits that similarly situated but uninformed taxpayers are unable to obtain. If only a few practitioners

[8] *See, e.g.*, TD 8876, 65 FR 11,215 (Mar. 2, 2000) (noting that the confidential corporate tax shelter registration provisions were intended "to improve tax compliance by giving the Treasury Department earlier notification of transactions that may not comport with Federal tax law and by discouraging taxpayers from entering into questionable transactions.").

[9] According to the Supreme Court, "the basic purpose of FOIA is to ensure an informed citizenry, vital to the functioning of a democratic society, needed to check against corruption and to hold the governors accountable to the governed." *NLRB v. Robbins Tire & Rubber Co.*, 437 US 214 (1978). A 1996 Report from the House Committee on Government Reform and Oversight further explained: "The Act reflects the view that the full disclosure of information to the public about government wrongdoing and other mistakes will ultimately generate appropriate corrective responses. Such revelations may have a certain degree of preventative effect, prompting a higher degree of probity and conscientiousness in the performance of government operations. Exposures resulting from FOIA disclosures, and the reactions they produce, are critical to maintaining an open and free society." H.R. Rep. No. 104-795 at 7 (1996).

[10] *See, e.g., U.S. v. Mead Corp.*, 533 U.S. 218 (2001). The Administrative Procedure Act requires a notice of proposed rulemaking to be published in the Federal Register. *See* Administrative Procedure Act (APA), 5 U.S.C.A. § 553.

[11] According to the Fourth Circuit Court of Appeals, "[t]he purpose of the notice-and-comment procedure is both 'to allow the agency to benefit from the experience and input of the parties who file comments and to see to it that the agency maintains a flexible and open-minded attitude towards its own rules.' The notice-and-comment procedure encourages public participation in the administrative process and educates the agency, thereby helping to ensure informed agency decisionmaking." (citations omitted). *Chocolate Mfrs. Ass'n of U.S. v. Block*, 755 F.2d 1098 (4th Cir. 1985).

[12] IRC § 6103(k)(1); Statement of Procedural Rules, 26 C.F.R. § 601.702(d)(8).

know about a process, only a few taxpayers will be able to benefit from it.[13] Thus, transparency promotes fair tax administration.[14]

FOIA Challenges Not Unique to the IRS

Despite the benefits of transparency, many agencies have had difficulty implementing the FOIA. Since 1946, when a predecessor of the FOIA was enacted, agencies have narrowly interpreted disclosure laws and have had difficulty complying with them.[15] Although the requirement for agencies to post materials electronically became law (called E-FOIA) in 1996, a study by the General Accounting Office (GAO, now the Government Accountability Office) found that seven out of 25 agencies still had not complied in 2002.[16]

IRS Procedures for Disclosing "Instructions to Staff"

The Internal Revenue Manual (IRM) is supposed to serve as the single official source of IRS "instructions to staff" such as procedures, guidelines, policies, and delegations of authority.[17] The official version of the IRM is available on the Internet in the IRS's "electronic reading room."[18]

Because updating an official IRM can be a lengthy process, many IRS business units send "interim guidance" directives to their staffs with the intent of incorporating these

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[13] According to a report by the Senate Judiciary Committee: "Administrative operations and procedures are public property which the general public, rather than a few specialists or lobbyists, is entitled to know or to have the ready means of knowing with definiteness and assurance." S. Rept. No. 79-752, at 12 (1945). In discussing whether private letter rulings had to be disclosed, the District Court for the District of Columbia stated:

> [a] body of "private law" has in fact been created which is accessible to knowledgeable tax practitioners and those able to afford their services. It is only the general public which has been denied access to the IRS' private rulings. The IRS' argument that publication would cause grave damage to its ruling system, then, is viewed by this Court as a specter having little basis in fact. Those taxpayers most likely to rely upon or challenge the rationale of letter rulings issued to others already have access to many rulings through their own efforts. Publication would simply make available to all what is now available to only a select few, and subject the rulings to public scrutiny as well. Such public availability and scrutiny are the very fundamental policies of the Freedom of Information Act. For, "one fundamental principle is that secret law is an abomination." [Internal citation omitted]. *Tax Analysts and Advocates v. Internal Revenue Service*, 362 F.Supp. 1298 (D.C.D.C. 1973), *modified and remanded* by 505 F.2d 350 (D.C. Cir. 1974).

[14] As noted above, the FOIA requires the IRS to make available to the public only the instructions to staff that "affect a member of the public." Since the determination about which instructions "affect a member of the public" is difficult, reasonable people can disagree about which instructions to staff are required to be available under FOIA. However, it may be beneficial, as described above, to make instructions to staff available to the public even if such materials are not required to be available to the public pursuant to FOIA.

[15] *See, e.g.*, H.R. Rept. No. 104-795 at 7-11 (1996).

[16] General Accounting Office, GAO-02-493, I*nformation Management, Update on Implementation of the 1996 Electronic Freedom of Information Act Amendments* 45-46 (Aug. 2002). The Treasury Department was not one of the agencies identified as noncompliant.

[17] IRM 1.11.2.1 (Oct. 1, 2005).

[18] The IRS's electronic reading room is at http://www.irs.gov/foia/article/0,,id=110353,00.html and IRS instructions to staff are at http://www.irs.gov/foia/content/0,,id=132732,00.html.

into the next IRM revision.[19] In the past, the IRS has been criticized for "managing by memo," *i.e.*, avoiding disclosure by issuing instructions to staff in the form of memoranda or other internal communication that is not timely disclosed rather than by updating the public IRM.[20]

Perhaps in response to such criticism, as of January 2002 all instructions to staff contained in job aids, desk guides, web sites, documents, or any other sources were to be incorporated into the IRM.[21] In October 2004, the IRS instituted procedures to ensure that "instructions to staff" such as "interim guidance" memos were made publicly available on its external website.[22] Pursuant to those procedures, interim guidance issued in November 2004 or later that affects the public, is national in scope, and will be in force for three months or more was supposed to be posted to the Internet in the IRS's "electronic reading room."[23]

Alternatively, the IRS sometimes issues interim guidance by updating an unofficial version of the IRM, which is available only to IRS employees on an internal system called the Servicewide Electronic Research Program (SERP), rather than by issuing memoranda. The IRS Wage and Investment Operating Division (W&I) issues almost all of its interim guidance using SERP.[24] When an IRM author submits an update to the SERP, changes

[19] Although interim guidance is supposed to be incorporated into the IRM and expire within one year, it sometimes remains effective for longer periods or is reissued without being incorporated into the IRM. For example, on February 2, 2006, Collection Policy reissued interim guidance first issued on June 24, 2004. Memorandum for Directors, Collection Area Operations from Cheryl Sherwood, Director, Collection Policy, *Re-Issued Guidance on Preparation of Summons* (Feb. 2, 2006). Although such guidance should have expired on June 24, 2005, in the absence of new published guidance, between June 25, 2005 and February 2, 2006, the public did not know whether IRS employees would continue to follow the expired interim guidance.

[20] *See, e.g.*, Bryan E Gates, *Management By Memorandum, Promulgation by Pub.*, 1999 TNT 99-76 (May 24, 1999); Amy Hamilton, *Rossotti Confirms IRS Is 'Managing By Memorandum*,' 2000 TNT 87-5 (May 3, 2000).

[21] Memorandum from Bob Wenzel, Deputy Commissioner Operations for Division Commissioners, Chiefs, Assistant Commissioners, National Directors, National Taxpayer Advocate, *Issuing and Controlling Interim Procedures* (Aug. 15, 2000); IRM 1.11.2.1 (Oct. 1, 2005).

[22] Memorandum from Susan B. Novotny, Director, Servicewide Policy, Directives and Electronic Research and Beth Tucker, Director, SB/SE Communications and Liaison for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility, *Interim Directives Memorandum and the Freedom of Information Act (FOIA)* (Oct. 27, 2004). *See also*, IRM 1.11.1 (Oct. 1, 2005); IRM 1.11.2 (Oct. 1, 2005); and IRM 11.3 (May 24, 2005).

[23] Because of difficulty in implementing these procedures, the IRS later revised its procedures to provide that only interim guidance issued on or after June 1, 2005 would be posted. Memorandum from Susan B. Novotny, Director, Servicewide Policy, Directives and Electronic Research, for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility, *Interim Guidance and the Freedom of Information Act (FOIA)* (April 6, 2005).

[24] Chief, Performance Improvement W&I Strategy and Finance, *Response to TAS Information Request* (Jun. 16, 2006).

are reflected on the SERP IRM and available to IRS employees within 48 hours.[25] However, the SERP IRM is not available to the public on the Internet.

Opportunities to Improve IRS Transparency

SERP IRM Not Available to the Public

When the IRS updates the SERP IRM, it does not always concurrently update the official IRM that is available to the public on IRS.gov.[26] For example, as of July 11, 2006, some interim guidance published on the internal SERP IRM as early as February 2004 had not been incorporated into the official IRM available to the public in the electronic reading room on IRS.gov.[27]

As another example, on February 24, 2005, the IRS added section 5.19.7.3.23.3 to the SERP IRM. This new section clarifies the process that the IRS will follow when it determines that it erroneously terminated an agreement to compromise a taxpayer's liability. As of October 25, 2006, the IRM available to the public in the electronic reading room did not include the new section.[28] As a result, taxpayers who do not know about these processes are likely to have more difficulty getting offers reinstated than other taxpayers who have somehow learned about them.[29]

Multiple IRM Versions May Confuse IRS Employees

Some IRS employees may have difficulty figuring out what guidance to follow when various versions of the IRM appear to conflict. Although most IRS employees who regularly use sections of the IRM that appear in SERP know to check the SERP IRM, some others may not. The result may be that some will not follow proper procedures.

[25] IRM 1.11.7.8 (Jun. 1, 2006). Changes to the SERP IRM that are not reflected in the official IRM appear in yellow on the SERP IRM. IRM 1.11.7.9.1 (Jun. 1, 2006).

[26] The official IRM is supposed to be kept up to date and printed for employees on a quarterly or yearly basis. IRM 1.11.7.9 (Jul. 28, 2006). The IRS made 711 updates to the SERP IRM between October 2005 and July 2006. Office of Servicewide Policy, Directives and Electronic Research, *Response to TAS Information Request* (Jul. 11, 2006).

[27] Office of Servicewide Policy, Directives and Electronic Research, *Response to TAS Information Request* (Jul. 11, 2006).

[28] The official IRM section 5.19.7 was shown as having been updated most recently on February 1, 2004. Similarly, on July 21, 2006, the IRS published rewritten IRM sections on SERP describing audit reconsideration procedures (section 4.13), but as of October 12, 2006 the official IRM available on IRS.gov still reflected the procedures adopted on February 1, 2003. On October 25, 2006, TAS noticed that section 4.13 was reflected in the official IRM with an October 1, 2006 revision date.

[29] At least one practitioner sought TAS's assistance in getting a taxpayer's offer reinstated solely because other IRS employees were unaware of the correct procedure for having offers reinstated. Had this section of the SERP IRM been available to the public, she would have been able to assist her client more effectively without TAS's assistance.

To make matters worse, the IRS intranet (the IRS employees-only network) includes an "IRM Online," yet another version of the IRM, in a searchable web-based format.[30] The IRM Online does not include interim guidance posted to SERP unless it is generated using certain software.[31] The IRS estimates that only 25 percent of the interim guidance on SERP is generated using such software.[32] Thus, some of the interim guidance reflected on SERP will be reflected in IRM Online, but most will not. To the extent such inconsistencies confuse IRS employees, causing some to use different procedures than others, similarly situated taxpayers may be treated differently.

IRS Does Not Always Disclose Interim Guidance Memoranda

The IRS's new policy of posting interim guidance to the electronic reading room has been difficult to implement. The IRS estimated that roughly 122 interim guidance memos were issued during calendar year 2004, but as of November 2005 only one had been posted.[33] The IRS later determined to post at least 18 of the memos issued in 2004.[34] A Taxpayer Advocate Service (TAS) comparison of interim guidance memoranda available on the IRS intranet and interim guidance available in the electronic reading room suggests that the IRS is posting much more of its official interim guidance memoranda.[35]

Nonetheless, some IRS business units still have not completed the process of developing standard procedures for posting all required interim guidance memos.[36] TAS identified

[30] Another version of the IRM, which includes PDF files of a hard copy of the IRM, is available on the IRS intranet as part of the Electronic Publishing Catalog. According to the IRS, the IRM published on the Electronic Publishing Catalog is the source document for delivery of two additional IRM applications: SERP and IRM Online. The IRS indicates that *except for the interim procedural updates made to the IRM sections on SERP*, all three of these products originate from the same source documents, only the platform on which they are delivered is different. We refer to these IRM sources as different "versions," however, because if one source of the IRM contains different information than another, as the IRS indicates they do, most people would perceive them to be different versions.

[31] Office of Servicewide Policy, Directives and Electronic Research, *Response to TAS Information Request* (July 11, 2006).

[32] *Id.*

[33] Deputy Director, Office of Servicewide Policy, Directives and Electronic Research (SPDER), *Response to TAS Information Request* (Jul. 11, 2006) (noting that IRS estimated 122 were issued in 2004); Servicewide Policy, Directives and Electronic Research IMD Oversight Council Meeting Minutes (Nov. 16, 2005) (noting that only one had been posted to IRS.gov, but that many were available on the intranet).

[34] Deputy Director, Office of Servicewide Policy, Directives and Electronic Research (SPDER), *Response to TAS Information Request* (Jul. 11, 2006).

[35] The IRS Criminal Investigation (CI) intranet site is available to CI employees only. Information received from CI in response to TAS's information request to CI on June 6, 2006 is not conclusive. As a result, we have not determined if CI has improved its compliance.

[36] For example, the Large and Midsized Business Operating Division is in the process of developing such procedures. LMSB, Director, Performance, Quality and Audit Assistance, *Response to TAS Information Request* (Aug. 14, 2006). TAS is also working to develop and implement such procedures. The Small Business/Self-Employed Operating Division, however, has a very well organized intranet website for interim guidance.

a number of important memos that the IRS did not timely post to the electronic reading room.[37] For example:

Example 1. On March 2, 2006, the Appeals function issued interim guidance to modify procedures described in IRM 4.51.4 by expanding the Fast Track Settlement (FTS) process for use in the Large and Mid-Sized Business Division's (LMSB's) pre-filing Compliance Assurance Process (CAP).[38] Although some of the information in the interim guidance had been made public, some had not.[39]

Example 2. On December 16, 2005, Appeals issued interim guidance to implement the Treasury Inspector General for Tax Administration's (TIGTA's) recommendation to inform taxpayers of their rights and the conditions of the FTS program before they apply for it.[40] While such rights and conditions are already available to the public, the premise of TIGTA's recommendation was that taxpayers were not always aware of them.

Example 3. On October 5, 2005, the Small Business and Self Employed Division's (SB/SE) Examination function issued interim guidance to clarify existing procedures and revised the form letters that the IRS would use in situations where the

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[37] In response to TAS's inquiry, SB/SE identified 16 additional interim guidance memoranda that had not been posted, and has committed to more timely posting such memos in the future. SB/SE Management and Program Analyst, *Response to TAS Information Request* (Sept. 20, 2006). The E-FOIA statute does not directly address when "instructions to staff" must be available to the public except to say that an index of such materials must be published "quarterly or more frequently." *See* 5 USCA § 552(a)(2) (flush). Since Interim Guidance expires within a year, it would be pointless to post it after more than a year. We understand the IRS's policy of not posting Interim Guidance in force for less than three months is based on the notion that, in light of the quarterly indexing requirement and the size of the IRS, it would be unrealistic to require the IRS to post guidance more frequently than every three months. Thus, we use the term "timely" to refer to Interim Guidance that is available to the public within three months.

[38] Memorandum for Director, Field Operations, East, Director, Field Operations, West, Director, Technical Guidance, and Director, Appeals Processing Services, from Diane S. Ryan, Director, Technical Services, *Compliance Assurance Process - Fast Track Settlement* (Mar. 2, 2006). This guidance was not on IRS.gov as of August 4, 2006. Appeals has now posted this guidance. The CAP is a process that taxpayers may use to resolve issues arising in connection with a return before it is filed and FTS is a form of alternative dispute resolution.

[39] *See* Announcement 2005-87, 2005-50 I.R.B. 1144 (noting that FTS may be available in CAP, but providing few details).

[40] Memorandum for Director, Field Operations, East, Director, Field Operations, West, Director, Technical Guidance from: L. P. Mahler, Director, Technical Services, *Interim Guidance: TIGTA Report on the Independence of Appeals - Recommendations Specific to Fast Track Settlement* (Dec. 16, 2005). As of August 14, 2006, this item was not on IRS.gov and neither of the IRM sections that were listed as affected by the guidance had been updated. *See* IRM 4.51.4 (Nov. 15, 2004) and IRM 8.2.1.2.3 (Jun. 20, 2003). Appeals has since posted this guidance.

IRS may need to "bypass" the taxpayer's representative (*i.e.*, communicate with a taxpayer directly rather than through the representative).[41]

Ensuring that interim guidance gets posted to the Internet may not be a top priority for some IRS managers who have limited resources and are often trying to focus on more pressing tax administration issues. In fact, TAS itself recently recognized the need to improve its internal procedures in this regard. However, Congress has determined that FOIA compliance must be a priority for all agencies because transparency is an essential component of good government.

Instructions to Staff Sometimes Remain Unapproved and Undisclosed

Another barrier to transparency is that IRS managers sometimes issue instructions to staff that are not timely signed and approved by these managers or any senior manager or executive. The nondisclosure of such instructions raises the same concerns as the nondisclosure of instructions that are approved. As noted above, since November 2004, the group of offer in compromise (OIC) specialists that is supposed to process all of the offers based on equity and public policy has been using unofficial, unsigned, and unpublished internal guidance to determine whether to accept such offers.[42] The IRS failure to publish such guidance, which it has been using for a long period, has likely resulted in inconsistent treatment of similarly situated taxpayers. Qualified taxpayers who know which facts to emphasize (*e.g.*, because they have come to TAS for assistance) may be able to get their offers accepted, while other similarly situated taxpayers who do not know which facts to emphasize may not get their offers accepted.

To be fair, however, when the IRM is incomplete, frontline employees sometimes need immediate guidance to help them do their jobs before higher level managers have an opportunity to approve official interim guidance that can be incorporated into the IRM. This very problem may have led to inconsistent campus procedures, which we identified in last year's report, as local campus directors established local procedures to fill the void.[43] Thus, as a practical matter, it may be difficult for the IRS to completely eliminate the lag between the time managers provide informal instructions to staff and

[41] Memorandum for Examination Area Directors, from K. Steven Burgess, Director, Examination, *Bypass of Taxpayer Representative* (Oct. 5, 2005). As of October 25, 2006, this item was not on IRS.gov and neither of the IRM sections that were listed as affected by the guidance had been updated. *See* IRM 4.10.3 (Mar. 1, 2003) and IRM 4.11.55 (Jan. 15, 2005). SB/SE released similar interim guidance for using bypass procedures in Collection cases. *See* Memorandum for Directors, Collection Area Operations, from Cheryl Sherwood, Director, Collection Policy, *Interim Guidance - Bypassing of Taxpayer's Representative* (Dec. 23, 2005). As of August 14, 2006, this memo was available on IRS.gov, but was removed when it was incorporated into IRM 5.1.1.7.

[42] SB/SE, Collection Policy, *Non-Hardship ETA* (first circulated in October or November 2004); SB/SE, Collection Policy, *Offers In Compromise, Additional Guidance Regarding the Use of "Non-Hardship" Effective Tax Administration OICs* (first circulated in September 2005).

[43] *See* National Taxpayer Advocate 2004 Annual Report to Congress 132-142 (Most Serious Problem: Inconsistent Campus Procedures); IRM 3.12.251.1.6 (Jan. 1, 2006) (referencing local procedures). In addition, SBSE recently published training materials for instructors, telling them to incorporate local forms and desk guides into their Centralized Offer in Compromise Process Examiner training. SB/SE, *Instructor Guide, Centralized offer in Compromise (COIC), Process Examiner CPE*, Catalog Number 48482G (April 2006).

when such instructions are approved and made available to the public on the Internet. However, the IRS must be particularly diligent in reducing that period with respect to guidance that, if not disclosed, could result in disparate treatment of similarly situated taxpayers.

Along the same lines, the National Taxpayer Advocate is concerned that the IRS Office of Chief Counsel may sometimes render potentially significant legal advice by email, rather than by memo.[44] She is concerned that legal advice rendered by email is less likely to be subject to appropriate internal review and disclosure procedures.

Guidance to "Clarify" the IRM Not Always Incorporated into the IRM

The IRS has many job aids, desk guides, training materials, and similar documents on its intranet that have not been incorporated into the IRM. For example, like many campus functions, the Accounts Management function in the Ogden Campus has a voluminous Desk Reference Guide (DRG), which is filled with clarifying procedures, on its intranet. As each section of the DRG states, "DRGs supplement the IRM by providing the 'how to' not contained in the IRM. They consolidate information contained in multiple chapters/IRMs and provide local procedures when instructed by the IRM." Job aids, desk guides, and training materials exist to help employees make better decisions. Although some information in these materials might be required to be available to the public under E-FOIA, most is probably not required to be available to the public either because it does not directly "affect a member of the public" or because it simply reproduces information already available to the public.[45]

IRS policy, however, requires all instructions to staff that may be contained in job aids, desk guides, web sites, documents, or any other sources to be incorporated into the IRM.[46] If these materials are not incorporated into the IRM, IRS management will find it very difficult to comply with E-FOIA because the agency will not have a central repository of instructions to staff that it can publish and monitor. Further, if the IRM is unclear or confusing, or not reflective of current procedures, and only some IRS employees receive clarifying guidance, the IRS and taxpayers will not reap the benefits of transparency and the purposes of the FOIA will be frustrated.

Disclosure Policy Applicable to Local Procedures Easily Misinterpreted

IRS employees may fail to disclose important procedures based on the impression that they do not need to post "local" procedures, such as campus procedures, to the elec-

[44] *See Tax Analysts v. Internal Revenue Service*, 416 F. Supp.2d 119 (D.D.C. 2006), *appeal pending*, No. 06-5136 (D.C. Cir.). According to the IRM, significant advice should be issued "in writing." IRM Exhibit 33.1.2-1 Q&A #5 (Aug. 11, 2004).

[45] An exhaustive review of all such material is beyond the scope of this report.

[46] Memorandum from Bob Wenzel, Deputy Commissioner Operations for Division Commissioners, Chiefs, Assistant Commissioners, National Directors, National Taxpayer Advocate, *Issuing and Controlling Interim Procedures* (Aug. 15, 2000); IRM 1.11.2.1 (Oct. 1, 2005).

tronic reading room.[47] As noted above, IRS policy only requires interim guidance that is "national in scope" to be posted to the electronic reading room on IRS.gov.[48] This local guidance exception could easily be misinterpreted.

Since current IRS procedures do not clearly require "local" guidance to be posted on the electronic reading room, the IRS may not post its campus procedures unless they are ultimately incorporated into the IRM.[49] Further, if the local guidance exception is misinterpreted as applying to all campus procedures, the IRS is likely to become less and less transparent as it centralizes national functions to "local" campuses.

As an example, consider the discussion of Appeals Campus Centralization in the National Taxpayer Advocate's 2005 Annual Report to Congress.[50] In that report, the National Taxpayer Advocate discussed Appeals campus procedures that were only known to her because of descriptions available in internal IRS documents. In its response to the report, Appeals indicated that it was following different procedures than those described by the National Taxpayer Advocate.

If even the National Taxpayer Advocate, who has access to many internal IRS documents, does not have access to current IRS procedures, the IRS will not receive the benefit of any feedback regarding those procedures from the National Taxpayer Advocate, much less the public.[51] Such secrecy may also harm taxpayers if it makes TAS less effective in helping them to navigate the IRS when normal IRS procedures break down. Moreover, if those procedures are not available to the public, taxpayers represented by practitioners who have recently worked in IRS campus operations may be able to obtain better results for their clients than other practitioners.

[47] IRM 1.11.2.11 (Oct. 1, 2005) (authorizing local procedures that do not contradict or duplicate IRM procedures). *See also* IRM 3.12.251.1.6 (Jan. 1, 2006) (authorizing Campus Submission Processing managers to promulgate local "Desk Procedures," which are not incorporated into the IRM).

[48] Memorandum from Susan B. Novotny, Director, Servicewide Policy, Directives and Electronic Research for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility, *Interim Guidance and the Freedom of Information Act (FOIA)* (April 6, 2005); IRM 1.11.1.9.1 (Oct. 1, 2005).

[49] *Id.*; IRM Exhibit 1.11.2-1 (Oct. 1, 2005). The IRM provides "local procedures may be issued to meet office needs, the needs of a specific group of taxpayers, or the culture of the taxpayer base, as long as they supplement and support prescribed IRM procedures…. Local procedures should be communicated through email, posted on a bulletin board and/or placed on local office websites." IRM 1.11.2.11 (Oct. 2, 2005).

[50] National Taxpayer Advocate 2005 Annual Report to Congress 136-161.

[51] On May 10, 2006, we found a document entitled "Campus Appeals - Field Counsel Fresno 'S' Case Procedures" dated Aug. 12, 2004, on Appeals' intranet site, which we could not locate on IRS.gov. Under current IRS procedures, it may not be clear that this document must be available to the public because it may appear to be local in scope. However, it includes "instructions to staff that affect a member of the public" and that practitioners would find informative. For example, it says that if the taxpayer desires a face-to-face conference with an Appeals Officer, the Fresno Campus Appeals Office will transfer the case to the local Field Appeals Office so that a conference can be held. Moreover, it affects taxpayers nationwide.

The IRS Does Not Post Interim Guidance that Needs to be Redacted

The IRS does not post to its website interim guidance memos that contain any "official use only" (OUO) material because it has no redaction process for interim guidance.[52] According to the IRS, about 14 percent of all IRM sections, representing about 32 percent of the IRM's pages, have been designated as OUO, which is not publicly available.[53] The absence of any redaction process could thus prevent a significant amount of important guidance from being available to the public as contemplated by the E-FOIA.

IRS Does Not Always Publish Changes to Its Published Positions

The IRS does not always publish memoranda that reflect changes to legal opinions that are available to the public.[54] As an example, in late 2004 and early 2005, the Office of Chief Counsel drafted a series of memoranda recommending that the IRS update the IRM to revise the discussion of how the statute of limitations period should be applied to an injured spouse claim for refund. Although the SERP IRM was apparently updated on October 1, 2006 to reflect Counsel's most recent advice, as of November 1, 2006 the IRM available to the public had not been updated.[55] Further, the Counsel memoranda were not released to the public even though they made a publicly available General Counsel Memorandum, GCM 39542 (July 30, 1986), obsolete.[56]

As a result of this particular nondisclosure regarding the period for claiming injured spouse relief, some taxpayers may have wasted the time and expense of making untimely claims for refund. Others may have had their untimely claims processed because IRS employees were not aware of Counsel's revised legal analysis. The IRS's failure to publicize its most current legal analysis may cause both taxpayers and IRS employees to continue to rely on the obsolete legal analysis contained in the publicly available

52 IRM 1.11.1.9.1 (Oct. 1, 2005). Redacted interim guidance memos may be available in the IRS's physical reading room. Unfortunately, the physical reading room has been closed for the last few months due to a June 2006 flood in the IRS headquarters building.

53 Deputy Director, Office of Servicewide Policy, Directives and Electronic Research (SPDER), Response to TAS Information Request (Nov. 14, 2006).

54 IRC § 6110 mirrors FOIA by requiring the IRS to make "written determinations" (*i.e.*, letter rulings, determination letters, technical advice memorandum, and Chief Counsel Advice) available to the public; but, unlike FOIA, section 6110 specifically allows the taxpayer who is the subject of these documents to participate in the redaction process. The IRS routinely makes these written determinations available to the public.

55 IRM 21.4.6.5.9.8 (Oct. 1, 2006). IRM 21.4.6.5.9.8 will not be available to the public electronically because it is part of IRM 21.4.6, which contains sections designated as OUO. However, we understand that IRM 21.4.6.5.9.8 will be available in the physical FOIA reading room at the main IRS building once that building reopens. It is currently closed due to flooding in the basement.

56 These memoranda were not released to the public because advice from the National Office of the Office of Chief Counsel to national program managers is not required to be made available to the public under IRC § 6110. *See generally*, IRC § 6110(i)(1)(A); IRC § 6110(i)(3)(B). However, such advice might be subject to disclosure upon request. *See Tax Analysts v. Internal Revenue Service*, 294 F.3d 71 (D.C. Cir. 2002), *on remand*, No. 1:96-cv-02285-CKK (D.D.C. Aug. 21, 2002). Although the IRS has not adopted any procedure for releasing such memoranda, in late September, 2006 it began to post in its electronic reading room, on a going-forward basis, certain legal advice signed by executives in the National Office of the Office of Chief Counsel and issued to national program managers. For a discussion of such legal advice, *see* Notice CC-2006-013 (May 5, 2006).

GCM that was no longer current.[57] Even though the IRS will eventually update the IRM available to the public (even if only in its physical FOIA reading room), to reflect its revised legal conclusions, the unexplained conflict between the analysis contained in the public GCM and conclusions in the IRM (once it is available to the public) could lead to confusion and litigation. Thus, in order to avoid confusion and inconsistent treatment of similarly situated taxpayers, unless there is a compelling reason for nondisclosure, the IRS should immediately let the public know when it discovers the public legal analysis by its attorneys is incorrect or misleading by releasing the revised analysis to the public. If such disclosure is not required, the IRS should use its authority to voluntarily disclose the revised analysis.

No Formal Procedure for Voluntary Disclosure of Legal Analysis

The IRS has not, however, established a process that allows IRS attorneys to determine, on a case by case basis, whether to make legal analysis available to the public voluntarily. For example, although the author of the memoranda described above, pertaining to the period for claiming injured spouse relief, could have elevated the matter through the Counsel organization and suggested the IRS issue a notice or other public pronouncement, there is no internal process for disclosing the memoranda.[58] While there is a process for the IRS to make discretionary disclosures in response to FOIA requests, on April 8, 2005, the IRS Office of Chief Counsel issued a notice stating that it had determined, under its discretionary authority, not to release any documents pertaining to published guidance, statements of policy, instructions to staff, or written determinations, "except in extraordinary circumstances after receiving an appropriate level of review."[59]

Amount and Significance of Undisclosed Legal Analysis Unknown

The magnitude of any potential tax administration problem posed by undisclosed legal memos depends on the content and number of undisclosed memos at issue. TAS asked the Office of Chief Counsel for a small sample of recent undisclosed memos to national program managers and an estimate of how many exist. The Office of Chief Counsel declined to provide them, citing mainly logistical obstacles to locating the memos.[60] For the same reasons, it declined to estimate the number of undisclosed memos. TAS followed up by proposing a simpler method of gathering a small sample of these memos

[57] Written determinations released pursuant to IRC § 6110 may not be cited as precedent. IRC § 6110(k)(3). Nonetheless, the citations and analysis contained in such documents are often used by lawyers inside and outside the government as a shortcut to reach legal conclusions by applying the same analysis, and as an indication of the views of the government attorneys who wrote and reviewed them.

[58] There are, however, procedures for announcing changes to litigating positions (*see* IRM 36.3.1.10 (Aug. 11, 2004)) and for changes to longstanding advice (*see* IRM 33.2.1.4 (Aug. 11, 2004)). But these procedures do not specifically address how such changes should be made available to the public.

[59] Chief Counsel Notice CC-2005-005 (Apr. 8, 2005); IRM 11.3.13.7.2.5(6)-(10) (Jan. 1, 2006). This notice implemented the IRS's revised discretionary disclosure policy statement to provide that discretionary disclosures should be made only after "full and deliberate consideration." Policy Statement 11-13 (Apr. 23, 2004).

[60] Office of Chief Counsel, *Response to TAS Information Request* (Oct. 30, 2006).

and asked Counsel to propose any reasonable alternative method it would prefer. The Office of Chief Counsel still declined to provide them. Thus, the National Taxpayer Advocate has not been able to determine whether, or to what extent, legal advice on material tax law or procedural issues has been provided out of public view or to form an opinion about whether tax administration would benefit from the disclosure of such advice.

CONCLUSION

Given the size of the IRS and the vast body of legal and procedural guidance that it issues daily, the IRS faces formidable challenges in complying with the disclosure mandates imposed by the FOIA and IRS policies. Indeed, the IRS does make a significant amount of information available to the public, and it has taken steps to improve its transparency in recent years. However, the IRS can and should do better. Transparency in tax administration is essential for purposes of assuring taxpayers that the laws are being administered fairly. Taxpayers and their representatives need to know what standards IRS personnel are applying in order to demonstrate or achieve tax compliance. IRS employees, taxpayers, and practitioners all need to know which procedures and guidance are the most current. For these reasons, the National Taxpayer Advocate believes transparency issues merit further attention.

IRS COMMENTS

The IRS is committed to improving the way it manages instructions to staff. We acknowledge we have experienced growing pains as we have moved towards electronic creation and delivery of the plethora of instructions to staff we produce.

It is the goal of the IRS to use the Internal Revenue Manual (IRM) as the primary source of agency procedures and guidance to ensure fair and consistent application of the nation's tax laws, as well as fair and consistent treatment taxpayers. The IRM ensures the public at large and all IRS employees have one set of procedures. It also ensures that we are transparent in our operations.

Instructions to staff are written for the express purpose of providing consistent policies, procedures, and guidelines to be followed by employees. By using the IRM as a central repository for instructions to staff, a foundation is established for fulfilling legal obligations to preserve and document agency directives, decisions, procedures, etc., required by, for example, the U. S. Code (44 USC § 3101), Code of Federal Regulations (36 CFR § 1222), and the Freedom of Information Act (5 USC § 552). The IRS believes that the use of a centralized repository (the IRM) is evidence of our commitment, which goes beyond statutory obligations. Our response describes the improvements we are actively pursuing to satisfy all of these requirements while at the same time delivering an IRM that for employees is a reliable source of instructions for how to perform their jobs.

All organizations in the IRS, including the Taxpayer Advocate Service, are expected to properly manage the issuance of instructions to staff according to the established policy. This includes (1) using the IRM as the primary source of IRS instructions to staff; (2) converting memorandums, e-mails, and other communications immediately into the appropriate IRM section; (3) establishing a skilled and trained cadre of IRM authors; and (4) devoting the resources to updating the IRM so that it reflects how the IRS really operates.

The IRS agrees that it can do better in making its instructions to staff available to the public. The National Taxpayer Advocate reinforces the value of the IRM by identifying "transparency of IRS operations" as one of the "most serious problems" (MSPs) in her annual report to Congress. This is a timely reminder that the IRM remains the best way to be "transparent" in our operations. It also highlights that IRS employees are not the only ones who look at the IRM. It is widely used by practitioners, taxpayers, state agencies, and even foreign governments to understand how the IRS carries out its tax administration responsibilities.

The National Taxpayer Advocate's report reaffirms the IRS efforts to more strategically manage issuance of instructions to staff. In 1999, to establish a strategic approach and reaffirm the IRM as the primary source of the agency's policies, procedures, guidelines, and delegations, the Office of Servicewide Policy, Directives, and Electronic Research (SPDER) was created to manage and modernize the internal management documents process in IRS. The SPDER office provides oversight of the IRM process, coordinates cross functional decisions regarding IRM activities, and sets guidelines for controlling the issuance of instructions to staff outside of the IRM. The operating divisions are responsible for preparing and issuing instructions to staff, including incorporating into the IRM any policy, procedures, and guidelines issued in the form of memos, desk guides, e-mail, and intranet web sites.

Beginning in 2000, the IRS has communicated the requirements for managing procedures and guidance. Executives in the major business units have been reminded of the importance of the IRM as the official source of instructions to staff. Training and outreach has been conducted for authors and managers, and memoranda and instructions have been issued to ensure interim guidance is included in the IRM. Footnotes in the National Taxpayer Advocate's report, in fact, identify many of the internal communications that have been issued on this subject.

Since 2004, a concerted effort has been made to increase Servicewide awareness of the FOIA requirements of making available to the public any administrative staff manuals and instructions to staff that affect a member of the public. The following are actions the IRS has taken:

- **May 2004 –** Initiated a task force with Governmental Liaison and Disclosure (GLD) and the Business Operating Divisions on actions to meet FOIA requirements.

- **October 27, 2004 –** Issued a joint memorandum with SB/SE Communication and Liaison for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility on the requirement to make interim directive memoranda available to the public as required under the FOIA.
- **April 6, 2005 –** Issued a memorandum for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility providing guidance and procedures on electronic public availability of instructions to staff including interim guidance meeting the FOIA requirements.
- **October 1, 2005 –** Revised IRM 1.11.1, Internal Management Documents to include procedures on FOIA requirements for making instructions to staff including interim guidance available electronically to the public.
- **March 2005 to present –** Conducted training, outreach and presentations to the Business Operating Divisions and Functions on the FOIA requirements.

As of November 2006, most of the business units have developed and implemented internal standard procedures for posting interim guidance memoranda, conducted training and workshops on the FOIA and the requirements for electronic availability. The IRS has made progress on the transparency of interim guidance since the 2005 process was established. As of November 2006, 41 interim guidance memoranda were posted on IRS.gov.

Each business unit has indicated it has either posted identified interim guidance memoranda in the electronic reading room or are in the process of doing so. SPDER will ensure the identified guidance is appropriately disclosed or incorporated into an IRM and that training and outreach will be conducted. Beginning FY 2007, we will monitor the interim guidance issued by each business unit to ensure it gets posted to IRS.gov. SPDER will be working with each business unit to provide greater attention to the importance of transparency, including conformance with the FOIA law, and to ensure the IRM is the central official repository of procedures of the IRS.

The IRS has demonstrated that progress is underway to improve the way we manage instructions to staff and to restore the IRM as our primary source of these instructions. We are also taking steps to address other inconsistencies in our processes that we have recognized as barriers.

- The disclosure policy applicable to local procedures can be easily misinterpreted. We intend to issue a clarification to the exception of local procedure. Although the issuance of local procedures is minimal and discouraged, clarification will be obtained early in fiscal year 2007 to ensure local procedures are appropriately transparent.

- A new process for posting redacted interim guidance issued by the business units has been established. A memorandum will be issued in December 2006, and incorporated into the applicable IRMs clarifying this process. Training and outreach will be conducted to support this newly established process in fiscal year 2007. Once completed, redacted guidance will be posted to the electronic reading room on IRS.gov.
- We eliminated multiple unofficial IRM sources by establishing the IRS corporate publishing repository version as the official IRM. From that official source file in the Media and Publications repository, the IRS now distributes the IRM through two internal delivery methods and one external delivery method: (1) IRM sections in PDF; (2) a web based product known as "IRM Online" that includes interactive links to IRM sections and IRS forms; and (3) an HTML version for IRS.gov.
- SERP is a customized tool for the accounts management assistors. The IRM on SERP begins from the IRS corporate repository. SERP updates and Submission Processing Hot Topics are issued solely to quickly disseminate evolving guidance to employees who are frontline assistors to taxpayers or processing tax returns. These "interim" instructions are to be incorporated into the IRM within a year of issuance, which generally is the next filing season update. An analysis for FOIA applicability of SERP IRM updates and Submission Processing Hot Topics is being conducted and a methodology for public access is being considered. SPDER will begin monitoring SERP IRMs and Submission Processing Hot Topics over one year old and providing appropriate non-compliance reports to management.
- SPDER has initiated long-term process improvements to eliminate the lag between the time instructions to staff are provided and when such instructions are officially available to the public on the internet. This includes: (1) IRM process redesign project to address this technological gap of officially publishing procedures as soon as procedures are approved, (2) creation of an electronic clearance process to address the issue of length of time of paper clearance, and (3) establishing an improved web-based IRM for use by employees.

In conclusion, it is the goal of the IRS to use the Internal Revenue Manual (IRM) as the primary source of agency instructions to staff and to reduce reliance on other internal dissemination methods. We have made great progress since the 2000 reorganization and will continue to do so. Through the IRM, the IRS will continue to ensure the timely issuance, and public availability, of instructions to staff.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS, and especially SPDER, for the steps it has taken to improve disclosure of instructions to staff and to address the concerns identified in the report. She agrees that the IRS has made significant progress since 2000. Most of the actions the IRS is taking to address the National Taxpayer Advocate's concerns, however, are being taken by SPDER, rather than by other IRS business units, which are in a better position than SPDER to identify their unpublished instructions to staff that affect the public. Mere memoranda alone will not make guidance public; what is required is the personal commitment of each IRS executive. As a start, the National Taxpayer Advocate recommends that each head of office have a specific annual performance commitment and goal to achieve greater transparency with respect to instructions to staff.

Like other IRS business units, the Taxpayer Advocate Service (TAS) has, in the past, not given enough attention to transparency issues. However, TAS recently developed detailed internal procedures for promptly issuing instructions to staff in the form of interim guidance memoranda and then promptly posting those memoranda to the electronic reading room on IRS.gov. If there is any doubt about whether instructions should be issued in the form of an interim guidance memo or another communication vehicle, TAS will generally issue an interim guidance memo. If there is any doubt as to whether an interim guidance memo should be posted, TAS will generally post it. Because of the uncertainty caused by the local guidance exception, TAS will not use that exception, *i.e.*, it will post even local guidance if it may affect the public. TAS has also recently reviewed existing unpublished interim guidance and has posted (or is in the process of posting) those items identified as possibly affecting the public.

The National Taxpayer Advocate invites other IRS business units to follow her lead to ensure not only that they are complying with the law, but also that all employees are using the same procedures and all taxpayers face a level playing field in their dealings with the IRS. Such transparency may also enable them to receive constructive feedback from practitioners and other interested parties in a timely fashion when they adopt new procedures.

The National Taxpayer Advocate is concerned that some IRS business units may view transparency as SPDER's responsibility rather than their own. For example, as of this writing, although SB/SE has received and had the opportunity to comment on this report, it has still failed to post its guidance to the group of employees charged with evaluating all offers in compromise based on effective tax administration, which was first provided as instructions to employees in 2004.[61] In fact, the National Taxpayer Advocate has learned that SB/SE also recently declined to release this guidance in

[61] On December 11, 2006, after these comments were completed, the National Taxpayer Advocate received a signed memo containing the guidance. Memorandum For Directors, Collection Area Offices, From Director, Collection, *Guidance Regarding "Non-hardship" Effective Tax Administration Offers in Compromise* (Nov. 30, 2006). We commend the IRS for finally issuing this memo, which was posted on IRS.gov in late December.

response to a specific FOIA request from a practitioner. One consequence of SB/SE's failure to make these instructions to staff available to the public is that Appeals and Compliance employees now appear to be applying different versions of the guidance. Although Compliance has recently updated its version of the guidance in response to concerns raised by the National Taxpayer Advocate, Appeals appears to be using an older and more restrictive version of the guidance. As a result, the Appeals process is useless for many taxpayers because Appeals is applying a different and stricter standard than Compliance. When advocating for taxpayers whose offers should be accepted under Compliance's revised guidance, TAS has to try to get the cases reconsidered by Compliance rather than by Appeals. Since Compliance employees do not normally reach a different conclusion in a given case without direction from above, each case has to be elevated to a very high level to be resolved and taxpayers who do not come to TAS are at a distinct disadvantage. Such efforts, which are necessary, in part, because SB/SE has neglected to make its guidance available to the public, are a significant waste of resources.

In addition, the IRS response does not address what IRS business units plan to do to ensure instructions to staff that are being used by IRS employees do not remain unapproved for extended periods of time. Nor does it address how the IRS plans to ensure that its voluminous job aids, desk guides, and similar information are incorporated into the IRM as required by IRS policy.

Further, the IRS's comments do not provide any additional explanation for the Office of Chief Counsel's lack of transparency with respect to potentially significant e-mail, as well as technical advice memos to national program managers that may be inconsistent with advice that is publicly available. Nor has the Office of Chief Counsel agreed to make any additional changes to its policies or procedures as a result of the issues raised in the report.

As noted in the report, the IRS takes the position that it is not legally required to disclose certain legal advice from a national office component of the Office of Chief Counsel to other IRS employees in the national office, including national program managers. It is easy to imagine that undisclosed legal memos from Chief Counsel attorneys in the national office to national program managers frequently involve issues of significant importance that affect many taxpayers. As discussed above, for example, the IRS recently changed its policy for computing the period of time within which a taxpayer must file an injured spouse claim and allocation. While the policy itself has been incorporated into the IRM, the basis for computing the time period is not explained in the IRM and the Office of Chief Counsel has refused to disclose a legal memorandum that explains the basis for the change in policy and the way the time period should be computed. Further, the undisclosed memo's analysis and conclusion contradict the analysis and conclusions contained in a public GCM that the IRS has not publicly obsoleted or revoked. Thus, taxpayers who seek injured spouse relief – and practitioners who might represent such taxpayers -- lack important information that would assist them.

More fundamentally, the National Taxpayer Advocate is deeply concerned about the refusal of the Chief Counsel to allow her staff to review samples of recent legal advice to national program managers that has not been released to the public. As a consequence of real and perceived enforcement abuses in the 1990s, Congress created the position of National Taxpayer Advocate in its current form and directed the National Taxpayer Advocate to report directly to the tax-writing committees each year on problems encountered by taxpayers. At the time, there were serious discussions about whether to place the Advocate's position inside or outside the IRS, and among the chief perceived benefits of placing the Advocate within the IRS was to enable to the Advocate to have access to internal IRS information.

Since the Office of the Taxpayer Advocate "stood up" in 2000, this is the first instance of which we are aware in which an IRS function has flatly refused to provide information requested by the Advocate to prepare her annual report to Congress. The effect of this refusal is to thwart congressional intent in seeking a taxpayer perspective on potential problems within the IRS. Without the ability to review the documents in question, the Office of the Taxpayer Advocate cannot fulfill its statutory mission of determining whether the Office of Chief Counsel's policies have harmed taxpayers.[62] As a consequence, Congress is being left in the dark, and taxpayers are being harmed.

[62] The Office of Chief Counsel justified its refusal to provide TAS with access to these documents on the ground that there is pending litigation with Tax Analysts, the publisher of Tax Notes Today, over whether some of the documents are required to be disclosed under FOIA. We find this justification unpersuasive for two reasons. First, the Tax Analysts lawsuit was instituted in 1996, so Counsel's justification effectively means that TAS would never have been entitled to determine whether Counsel's policy of keeping this guidance secret is harming taxpayers. Second, TAS offered in advance both (1) to avoid describing any memo in detail and (2) to avoid articulating any conclusion about whether it believed any document we reviewed was subject to disclosure under FOIA. We agreed to describe solely the nature of the documents and to discuss solely whether we believe the documents should be available to taxpayers as a normative matter and without regard to FOIA. On November 3, 2006, we made our final request as follows:

> TAS is asking to review a representative sample of memoranda or other written legal advice or guidance issued by the National Office of the Office of Chief Counsel to IRS national program managers or industry directors over the past year or so that has not already been released to the public. This request is made without regard to whether the guidance is the subject of litigation, and we would make clear that any conclusions we draw reflect solely a taxpayer advocacy perspective and not a judgment about whether the guidance is subject to disclosure under existing law. TAS believes a request by the Chief Counsel or his designee to the Associate Chief Counsels for recent memoranda would produce a sufficient sample very quickly. If the specific method we are suggesting is not feasible, we are open to any other reasonable way to arrive at the same result. In our report to Congress, we would describe any documents we review only in general terms, if at all, and we would make clear that our observations relate to what we believe is desirable from a taxpayer advocacy perspective and do not constitute an opinion about whether documents are subject to release under FOIA (which should address Counsel's concern about possible effects of our report on the pending litigation with Tax Analysts).

On November 9, 2006, the Office of Chief Counsel provided the following response:

> As we have discussed, the FOIA lawsuit with Tax Analysts over the applicability of the FOIA to written legal advice or guidance issued by the National Office of the Office of Chief Counsel to IRS national program managers or industry directors remains pending before Judge Kollar-Kotelly of the United States District Court for the District of Columbia. Inasmuch as that matter has not been resolved, it would be inappropriate for our office to provide to you the documents you have requested.

RECOMMENDATIONS

1. The Office of Chief Counsel should establish a process to allow for prompt disclosure of legal advice or analysis that is not otherwise required to be made available to the public if it is inconsistent with IRS legal analysis that is available to the public.
2. The Deputy Commissioner for Services and Enforcement should issue a memo directing all IRS business units to take steps to eliminate informal procedures and guidance that are being used but are not formally approved or available to the public. Any such instructions to staff that affect the public must be disclosed under FOIA whether or not they are formally signed and approved.
3. The Commissioner of the IRS should establish a time table with specific and realistic goals for when each business unit will have incorporated all training materials, desk guides, job aids and other documents that contain instructions to staff into the publicly available IRM in accordance with IRS policy. Each business unit should be required to report on its progress in achieving these goals as part of its business performance review.
4. SPDER should work with Modernization & Information Technology Services (MITS) and other IRS business units to establish automated or manual procedures to ensure that updates to the SERP IRM are promptly reflected on the IRM that is posted to IRS.gov, IRM-Online, and the IRM found in the Electronic Publishing Catalog.
5. In coordination with the Office of Chief Counsel, SPDER should either eliminate the "local guidance" exception to the requirement to post "instructions to staff" or clarify that it does not apply to any procedures that "affect a member of the public," especially local instructions that may affect taxpayers nationwide.
6. SPDER should work with MITS and other IRS business units to post portions of the IRM and interim guidance that contain Official Use Only information to the electronic reading room in a redacted form.
7. SPDER should also work with MITS and other IRS business units to reduce the period between the time when guidance is issued and when it is made electronically available to the public.
8. Each IRS head of office should have a specific annual performance commitment and goal to achieve greater transparency with respect to instructions to staff.

According to the IRS comments (above), SPDER has already begun to implement recommendations 4-7. We applaud these efforts and renew our commitment to ensure TAS guidance is quickly available to the public.[63]

[63] For a description of TAS's interim guidance procedures, see http://www.irs.gov/foia/content/0,,id=160715,00.html.

IRS COLLECTIONS AND LEVIES: DID YOU KNOW?

- **In FY 2006, the IRS reported more delinquent tax dollars as "currently not collectible" than it actually collected on active balance due accounts (TDAs), installment agreement accounts, and offers in compromise (OIC) combined.[1]**
- **In FY 2006, the IRS reported over $16 billion delinquent tax dollars as "not collectible," over 85 times as many as it accepted via offers in compromise.[2]**
- **IRS studies and external experts in collection confirm that collection cases 24 months past due generally yield less than 15 cents on the dollar and after three years are practically uncollectible.[3]**
- **As of September 2006, approximately 65 percent of the IRS's open collection accounts involved tax years over three years old.[4]**
- **Of cases in which the IRS issued a final collection notice in FY 2006, approximately 87 percent of individual tax delinquencies totaled less than $10,000. Of those involving business taxes, 76.2 percent amounted to less than $3,000.[5]**
- **From FY 2000 through FY 2006, the IRS has annually collected less than two percent of the revenue dollars in the "currently not collectible" inventory.[6]**
- **As of September 2006, over 779,000 delinquent taxpayer accounts were assigned to the "collection queue" awaiting active assignment to IRS personnel.[7] The Small Business / Self Employed division's Collection function resolved only 11,399 accounts through accepted offers in compromise (OICs).[8]**
- **A recent IRS study indicates that over 40 percent of tax modules associated with rejected and withdrawn offers are ultimately reported as not collectible.**

[1] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006); IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006); IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006) In FY06, approximately $16.2 billion in balance due accounts were reported as CNC; approximately $7.2 billion was collected on open balance due accounts and $7.4 billion was collected though installment agreements, i.e. formal agreements between taxpayers and the IRS to pay delinquent taxes through regularly scheduled periodic payments, usually monthly.

[2] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006); IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2006).

[3] IRS/Booz-Allen & Hamilton, *SBSE Collections Quick Hits Approach and Preliminary Findings 30* (Mar. 27, 2001).

[4] IRS, *Collection Activity Report, Taxpayer Delinquency Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[5] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

[6] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (FY-2001 - 2005).

[7] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Apr. 2, 2006).

[8] IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2006).

Of those, 27 percent involving individual taxpayers were in CNC status while the IRS considered the OIC.[9]

- **During FY 2004 and 2005, in cases where the IRS denied taxpayers' requests for installment agreements, 31 percent were later reported as not collectible. Of those, 52 percent were in CNC status at the time the taxpayers requested the agreements.[10]**
- **The number of OICs accepted by the IRS Collection operation (excluding those accepted by the Appeals function) declined by over 69 percent from FY 2001 to FY 2006.[11]**
- **A recent IRS study of the OIC program indicates approximately 80 percent of the taxpayers who had their offers accepted remained in compliance with their filing and paying requirements during the five-year post-OIC monitoring period.[12]**
- **Another study by the Treasury Inspector General for Tax Administration (TIGTA) confirmed this high degree of compliance during the post-OIC monitoring period, and also found these taxpayers remained in compliance after the monitoring period had concluded.[13]**
- **In fiscal year (FY) 2006, the IRS served 3.74 million notices of levy upon third parties, an increase of over 36 percent from FY 2005. The number of notices of levy served on third parties rose by 1,603 percent from FY 2000 to FY 2006. The IRS processed 93 percent of the levies it issued in FY 2006 through the Automated Collection System (ACS).[14]**
- **Approximately 84 percent of the levies the IRS issues as part of the automated Federal Payment Levy Program (FPLP) involve taxpayers who are elderly and/or disabled.[15]**

9 IRS, *Analysis of Various Aspects of the OIC Program 9-10* (Sept. 2004).

10 IRS, *Accounts Receivable Inventory Report* (FY 2004 and FY 2005).

11 IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108*. (FY 2001 – FY 2006).

12 IRS, *Analysis of Various Aspects of the OIC Program 6* (Sept. 2004).

13 Treasury Inspector General for Tax Administration, Ref. No. 2006-30-100, *The Offer in Compromise Program Is Beneficial but Needs to Be Used more Efficiently in the Collection of Taxes 7* (Jul. 17, 2006).

14 IRS, Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report (Oct. 2, 2006); IRS, Collection Account Report, Field Collection Levies- NO-5000-23-240 (Oct. 2, 2006); IRS, Statistics of Income (SOI), Tax Stats 2005; Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, Trends in Compliance Activities Through Fiscal Year 2005 (Mar. 2006). FY 2005 data showed 2,743,577 levies were served while FY 2006 showed 3,742,276.

15 IRS, Wage & Investment Operating Division, *FPLP Monthly Counts CUM* (May 2006).

- **TAS cases involving the IRS's FPLP levies on Social Security benefits increased by 143 percent from FY 2005 to FY 2006.**[16]
- **Levy-related cases in TAS have risen by 64 percent from FY 2005 to FY 2006. Almost 65 percent of the taxpayers whose levy cases were closed by TAS in FY 2006 have received relief from their hardship, with almost 56 percent being given full relief (*i.e.*, release or removal from the FPLP process).**[17]

[16] Taxpayer Advocate Service, *Taxpayer Advocate Service, Business Performance Review* (Sept. 30, 2006). For FY 2005, there were 1,707 FPLP/Social Security-benefit related cases in TAS and 4,147 for FY 2006.

[17] Taxpayer Advocate Service, Business Performance Management System (as of Sept. 30, 2006). For FY 2005, there were 11,477 levy-related cases in TAS and 18,800 such cases in FY 2006. Taxpayer Advocate Service, Business Performance Management System (Sept. 30, 2006). These percentages are based on case closures meeting the provisions of IRC § 7811. Specifically, there were 15,818 closures and of these, 10,272 received some type of relief (8,823 were granted full relief and 1,449 partial).

PROBLEM

TOPIC #4 TRUE COSTS AND BENEFITS OF PRIVATE DEBT COLLECTION

RESPONSIBLE OFFICIAL

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

In September of 2006, the IRS began assigning taxpayer accounts to private collectors as part of its Private Debt Collection (PDC) initiative.[1] Although the IRS originally planned to assign 40,000 accounts in this first phase (known within the IRS as Release 1.1), fewer cases have been assigned due to a number of complications.[2] In the next phase of the initiative (Release 1.2), the IRS plans to assign approximately 446,000 cases to private collectors over a two and one half year period.[3]

The results of the private collector work on these accounts have been mixed. For example, the IRS assigned approximately $65 million of inventory (11,500 delinquent accounts) to private collectors with approximately $1 million collected for the first month.[4] On the other hand, only half of that revenue collected in the first month was commissionable.[5] In other words, the IRS's initial contact of these taxpayers, and not any action on the private collector's part, generated the account resolution.[6] Approximately eight percent of the dollars placed to date have been collected.[7] By design, the first cases assigned to private collectors were the least complicated of the inventory eligible for assignment, and therefore the most likely to result in payment

[1] Three private collectors are being used in this first phase of the initiative: CBE Group Inc. of Waterloo, Iowa; Linebarger Goggan Blair & Sampson of Austin, Texas; and Pioneer Credit Recovery, Inc. of Arcade, N.Y. Internal Revenue Service News Release, IR-2006-42 (March 9, 2006).

[2] The National Taxpayer Advocate understands that these complications include the unforeseen extent of IRS employee involvement in the manual administration of these cases.

[3] These cases will be comprised of 93,000 cases in part of FY 2007 (Jan. through Sept. 30), 138,000 in FY 2008, and 215,000 in FY 2009. Internal Revenue Service, Filing & Payment Compliance (Nov. 30, 2006).

[4] IRS, *Filing and Payment Compliance Briefing Document* 8 (Nov. 1, 2006).

[5] *Id.*

[6] The IRS points out that after the first month the ratio of commissionable to non-commissionable income increased. By the end of October commissionable revenue was approximately $4.7 million while non-commissionable income was approximately $884,000. Internal Revenue Service, Filing & Payment Compliance (Nov. 30, 2006). Our point here is that minimal effort by the IRS prior to assignment of the case generated a substantial response from taxpayers. The first 11 days after the assignment of the contract is an important point for comparison. Pursuant to the contracts with the collectors, a payment is non-commissionable if it is received within 11 days of the assignment of the account to the private collector. (*see* Section 4.1 of contracts with collectors: TIRN-0-06-K00181; TIRN-0-06-K00179; and TIRN-0-06-K00182). After the account is assigned, the private collectors initiate their calling campaigns of taxpayers – thus, it is expected that over time the ratio of commissionable to non-commissionable collections will increase.

[7] As of November 1, 2006, approximately $73 million had been placed and approximately $5.5 million has been collected. IRS, *Filing and Payment Compliance Briefing Document* 8-9 (Nov. 1, 2006).

after an initial contact.[8] Yet IRS collection units with less promising inventory experience better collection results than eight percent.[9]

We have previously expressed our serious concerns about the private debt collection initiative as details of the plan evolved. In the 2005 Annual Report to Congress, we stated our concern about the IRS's plan to allow private collectors to train themselves on tax law topics and IRS procedures.[10] As we learned more details of the initiative, it has become clear that much of the rationale underlying the initiative has eroded.

In this report, we look at the central tenets underpinning the IRS's use of private debt collection and ask, in light of what we know now, whether the costs of the initiative outweigh the projected benefits. We are also concerned about the initiative's impact on vital components of our tax administration system, such as customer service, consistent treatment of similarly situated taxpayers, and emphasis on long-term tax compliance. To compound these problems, the IRS advised us that public disclosure of the operational plans and calling scripts of the private contractors is not permitted unless the private collectors consent, thereby making the IRS less transparent and rendering this initiative less accountable. Our conclusion is that this initiative is fatally flawed, risking much for a small return on investment.

ANALYSIS OF THE PROBLEM

The relatively short history of private collectors in the business of federal tax collection has been tumultuous. The Debt Collection Act of 1982 broadly authorized federal agencies to use private collection agencies but specifically prohibited collection of federal taxes by private collectors.[11] Under a limited initiative authorized by Congress in 1995, the IRS was able to experiment with a limited private debt collection initiative in 1996.[12] In 1997, the IRS discontinued the initiative, primarily because the revenue collected was less than the IRS's direct costs plus the "opportunity costs" that resulted from directing collection resources towards support and monitoring of the private collectors.[13]

8 Government Accountability Office, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 (Sept. 29 2006).

9 For example, the Offer in Compromise Program in the Small Business/Self-Employed Division collected 17 percent of taxes compromised in FY 2006. Collection Activity Report, *Report of Offer in Compromise Activity*, No-5000-108 (Oct. 2, 2006).

10 National Taxpayer Advocate 2005 Annual Report to Congress 76-93.

11 The Debt Collection Act of 1982, Pub. L. No. 97-365, 96 Stat. 1749. For discussion of history of private collection agencies in Federal Government, see Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005); codified at 31 U.S.C.A. 3718(f).

12 Treasury, Postal Service, and General Government Appropriations Act of 1996, Pub. L. No. 104-52, 109 Stat. 468, 473-474 (1995); *see* Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

13 General Accounting Office, GAO/GGD-97-129R, *IRS: Issues Affecting IRS's Private Debt Collection Pilot* 5 (Jul. 18, 1997).

Notwithstanding its 1997 experience, in 2002 the IRS renewed its efforts to utilize private contractors to address the growing inventory of debts that the IRS was unable to handle.[14] In 1998, the Federal Activities Inventory Reform (FAIR) Act was enacted to encourage competitive sourcing, a process whereby federal agencies identify commercial functions being performed by the agencies, develop a business case to determine if the private sector can efficiently compete with the agencies, and if so, determine the most efficient organization to perform the function. However, the law specially precludes the contracting out of inherently governmental functions.[15] The IRS and the Office of Management and Budget (OMB) have long considered the collection of taxes to be an inherently governmental function,[16] and have never certified the type of work being performed by the private collectors as commercial.[17]

In 2003, the IRS's backlog of receivables of approximately $120 billion again caused the IRS to consider private debt collection as a solution.[18] To address the buildup of potentially collectible inventory, the IRS favored and the Department of Treasury proposed that Congress allow the IRS to employ private debt collectors to help collect the aging receivables in exchange for commissions based on the amount collected.[19] The American Jobs Creation Act of 2004 gave the IRS authority to again use private collection agencies to collect delinquent federal tax debts.[20] It was believed that this legislation would cure the defects of the 1996 initiative by permitting private collectors to work for commissions while at the same time allowing them to perform only such functions that were commercial in nature, rather than inherently governmental.[21]

[14] General Accounting Office, *IRS is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources*, GAO-04-492, 4 (May 2004).

[15] Federal Activities Inventory Reform Act (FAIR) of 1998, Pub. L. No. 105-270, 112 Stat. 2362; now codified at 31 U.S.C.A. § 501, *see* Note § 5 (2)(b), providing that a function is "inherently governmental" under the statute if it is "so intimately related to the public interest as to require performance by Federal Government employees." *Id.* Examples of inherently governmental functions include actions: (1) "to bind the United States to take or not take some action;" (2) "to determine, protect and advance United States. . . interests;" and (3) "to significantly affect the … property of private persons." *Id.*

[16] In OMB Circular A-76 (which sets forth the standards under which federal work is subject to competitive sourcing), as it existed in 1999, the collection of taxes was specifically listed as an inherently governmental function. In 2003, OMB Circular A-76 was revised to remove all specific examples of inherently governmental functions; *see also* General Accounting Office, *IRS: Issues Affecting IRS's Private Debt Collection Pilot* (Jul. 18, 1997), indicating that the IRS and the Department of Treasury have long considered the collection of taxes to be an inherently governmental function.

[17] IRS Federal Activities Inventory Reform Act certifications, available at http://www.treas.gov/offices/management/dcfo/procurement/fair/inventories/index.html.

[18] This $120 billion dollar inventory was growing at approximately four percent per year. General Accounting Office, GAO-04-492, *Tax Debt Collection, IRS is Addressing Critical Factors for Contracting Out but Will Need to Study the Best Use of Resources* 1 (May 2004).

[19] General Accounting Office, GAO-04-492, *Tax Debt Collection, IRS is Addressing Critical Factors for Contracting Out but Will Need to Study the Best Use of Resources* 1 (May 2004).

[20] The American Jobs Creation Act of 2004, Pub. L. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004); now codified in IRC § 6306.

[21] Government Accountability Office, *IRS Needs to Complete Steps to Help Ensure Contracting Out Achieves Desired Results and Best use of Federal Resources*, GAO-06-1065 (2006); *see also* Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

The government's rationale for its current use of private debt collectors to collect federal taxes stood upon three pillars:

- Use of private collectors is cost efficient and effective;[22]
- Private collectors will work the easy cases, thereby ensuring that they will not engage in "inherently governmental" activities and that the IRS will be able to focus on more complex work;[23] and
- Other federal agencies have successfully used private collection agencies.[24]

Cost Efficiency of IRS Private Debt Collection Initiative

"The purpose of this program is to provide value to the American taxpayer."[25]

"If additional IRS allocations would yield greater returns than PCA use, then there is no justification for a PCA program."[26]

"If it [IRS] hires federal employees, they'll spend far less than if they go out with these private collection firms. In addition to the issues of privacy, et cetera – which are horrifying to my constituents - Republican and Democrat alike – you're spending more money than you have to collect these taxes."[27]

Pursuant to the FAIR Act, federal law requires that the government follow prescribed processes for determining whether activities performed by the government can or should be subject to outsourcing.[28] These processes are set forth in Office of Management and Budget (OMB) Circular A-76. Each year, agencies of the federal government must file a report with the OMB identifying the work that is commercial and that which is

[22] Mary Dalrymple, Associated Press, *IRS Warns Taxpayers Not to Fall for Thieves Posing as IRS Debt Collectors*, USA Today (Aug. 23, 2006) (available at: http://www.usatoday.com/money/perfi/taxes/2006-08-23-irs-collection_x.htm?csp=34), quoting an IRS spokesman who said, "The purpose of this program is to provide value to the American taxpayer." (*See* discussion *infra* regarding the Federal Activities Inventory Act and OMB Circular A-76 which govern competitive sourcing in the Federal Government and the emphasis on cost efficiency).

[23] Testimony of Mark W. Everson, Commissioner of Internal Revenue, Private Debt Collection: Hearing Before the Subcomm. on Oversight, House Comm. on Ways and Means, 108th Cong., 1st Sess. (May 13, 2003).

[24] *Id.*

[25] Mary Dalrymple, Associated Press, *IRS Warns Taxpayers Not to Fall for Thieves Posing as IRS Debt Collectors*, USA Today (Aug. 23, 2006) (available at: http://www.usatoday.com/money/perfi/taxes/2006-08-23-irs-collection_x.htm?csp=34), quoting an IRS official.

[26] Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

[27] Comments of United States Congressman Steve Rothman (D-NJ) during testimony of Internal Revenue Service Commissioner, Mark W. Everson, House Committee on Appropriations: Subcommittee on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, FY 2007 Appropriations for the Internal Revenue Service (March 29, 2006).

[28] Federal Activities Inventory Reform Act of 1998, Pub. L. No. 105-270, 112 Stat. 2362; now codified at 31 U.S.C.A. § 501, *see* Note § 5.

inherently governmental.[29] If the function is determined to be inherently governmental, the function cannot be privatized. If the function is "commercial," the government must undertake a cost-based analysis to determine whether the function should be subject to competitive sourcing, *i.e.*, whether the function can be performed more efficiently by the private sector.[30] If the agency cannot establish the business case for outsourcing the function, then the function will not be outsourced.[31]

The American Jobs Creation Act of 2004 (AJCA) enabled the PDC initiative to circumvent the Circular A-76 process. There was no designation of collection functions as commercial, nor any rigorous cost analysis in support of a PDC business case. The IRS now acknowledges that the PDC initiative, which pays private collectors up to 25 percent of amounts collected, cannot collect the money as efficiently as the IRS's own collection function.[32] Thus, the IRS admits that a central tenet for outsourcing any functions of the federal government, *i.e.*, cost efficiency, does not exist.

On the revenue side, the IRS's initial goal for Release 1.1 is that the private agencies will collect six percent of the dollars assigned.[33] On the expense side, in addition to commission expenses, private collectors will also receive administrative fees for certain unresolved cases, such as those where the taxpayer has died or filed for bankruptcy and cases where the taxpayer enters into an installment agreement for longer than five years.[34] There are also substantial expenses for each phase of the initiative, such as systems acquisition costs and consulting fees. For example, the IRS has projected that the initial phases of the initiative (Release 1.1 and Release 1.2) will cost $61 million and may bring in revenues of between $56 million and $92 million.[35]

Thus, the business case for using private collectors over IRS employees appears to be weak. In fact, the IRS acknowledges the accuracy of a 2002 study that concluded that if Congress budgeted an additional $296 million to hire new collection staff, the IRS

[29] The Federal Activities Inventory Reform Act of 1998, Pub. L. No. 105-270; Office of Management and Budget Circular A-76; *see also* IRS Office of Competitive Sourcing, IRS Circular A-76 Primer, available at: http//www.irs.gov.ustreas.gov/pub/cmpsrc/learn_more/irs_a76-primer.pdf.

[30] Mohab Tarek Khattab, *Revised Circular A-76: Embracing Flawed Methodologies*, 34 Pub. Cont. L. J. 469 (2005); *see also* Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

[31] IRS Office of Competitive Sourcing, IRS A-76 Primer, (Feb. 2005), available at: http:www.irs.gov/pub/cmpsrc/learn_more/irs_a76_primer.pdf.

[32] Testimony of Commissioner of Internal Revenue, Mark W. Everson, House Committee on Appropriations: Subcommittee on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, FY 2007 Appropriations for the Internal Revenue Service (March 29, 2006).

[33] IRS, *Filing and Payment Compliance Briefing Document* 3 (July 31, 2006).

[34] IRS Request for Quotations, Request No. TIRNO-05-Q-00187, at I-20 and I-34 (¶ J.4.4.12).

[35] Government Accountability Office, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 Appendix III (Sept. 29 2006).

could collect an additional $9.5 billion annually.[36] Implementation of the ideas set forth in the 2002 study contrasts favorably to the IRS's own estimate of what the private collectors will bring in over a ten year period: $1.4 billion, less the $330 million in commissions and other costs.[37] In other words, the IRS is implementing a plan that returns $4 for every dollar invested over a plan that returns $32 per dollar invested.[38]

Although the IRS points out that it did not receive the $296 million in funding described in the 2002 study,[39] we do not believe that private debt collection is the only other option available for the IRS to reduce its inventory backlog. Improving its own efficiency and its approach to contacting taxpayers should be a starting point. It is apparent that the private collectors can collect delinquent accounts with considerably less than $296 million. We have learned that the three private collection agencies are using only 75 employees in the aggregate to make calls on accounts. It is difficult to fathom how 75 employees can achieve what the IRS cannot with its thousands of collection employees and its collection budget of nearly $2 billion.[40] Moreover, the IRS is allocating at least 65 of its own employees to monitor the program; thus, the IRS is using almost as much in human resources to monitor these companies as it takes the companies to do the work.[41]

Debate over How to Measure Performance Highlights Fundamental Problem with IRS Collection Policy

We do not believe the IRS has made an adequate business case for this initiative. In response to the requirements of the AJCA, which direct the IRS to issue a biennial report to Congress on a number of factors, including a complete cost-benefit analysis

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36 Testimony of Treasury Secretary John Snow, in an exchange with Senator Robert C. Byrd, Senate Committee on Appropriations: Subcommittee on Transportation, Treasury and General Government, Hearing on FY 2004 Appropriations for the Treasury Department, May 20, 2003; for referenced study see 2002 Report of IRS Commissioner Charles O. Rossotti to IRS Oversight Board, *Assessment of the IRS and the Tax System* (Sept. 2002).

37 David Cay Johnston, *IRS Enlists Help in Collecting Delinquent Taxes*, New York Times (Aug. 20, 2006).

38 Testimony of United States Treasury Secretary, John Snow, in an exchange with Senator Robert C. Byrd, Senate Committee on Appropriations: Subcommittee on Transportation, Treasury and General Government, Hearing on FY 2004 Appropriations for the Treasury Department, May 20, 2003.

39 Testimony of Commissioner of Internal Revenue, Mark W. Everson, House Committee on Appropriations: Subcommittee on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, FY 2007 Appropriations for the Internal Revenue Service (March 29, 2006).

40 IRS Fiscal Year Budget in Brief, available at: http://www.irs.gov/pub/irs-utl/bib-irs.pdf. The IRS's budget for tax law enforcement in fiscal year 2006 was approximately $4.7 billion dollars and its proposed enforcement budget for fiscal year 2007 is approximately $4.8 billion dollars. IRS Budget in Brief FY 2007, available at: http://www.irs.gov./pub/irs-news/fy07budgetinbrief.pdf.

41 This figure includes Referral Unit employees (approximately 33), Oversight Unit employees (approximately 15), and 17 other staff members. Government Accountability Office, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 49 (Sept. 29 2006).

of the initiative,[42] the IRS is planning to develop a cost-benefit comparison between private collectors and the IRS. However, the IRS plan drew criticism from the GAO for a number of reasons, including that the initial design omitted the most significant cost of the initiative, *i.e.*, commissions paid to the private collectors, as a separately stated expense item.[43] We have additional concerns about the IRS's planned PDC cost effectiveness study. The IRS intends to conduct a test using IRS employees for purposes of making a performance comparison. However, these IRS employees will be working different (and, in some instances, more complex) types of cases than private collectors handle.[44] Consequently, we wonder how a decision-maker can assess which approach – the IRS or the private collection agency (PCA) – is most efficient at collecting the type of inventory IRS is assigning to PCAs.

The IRS's rationale for not undertaking an "apples to apples" comparison between the IRS and private collectors is that "IRS [employees] would not work PDC inventory even if they had additional resources and are better than PCAs at working those cases."[45] This IRS response essentially ignores the importance of tax compliance and taxpayer rights for those taxpayers who populate the PDC inventory. The IRS, in essence, is saying that there is a population of taxpayers whose liabilities are too trivial for the IRS to bother with, and therefore those cases should either be left to PCAs or, absent PCAs,

[42] The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(e), 118 Stat. 1418 (2004), providing in pertinent part:
(e) BIENNIAL REPORT.–The Secretary of the Treasury shall biennially submit (beginning in 2005) to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report with respect to qualified tax collection contracts under section 6306 of the Internal Revenue Code of 1986 (as added by this section) which includes–
(1) a complete cost benefit analysis,
(2) the impact of such contracts on collection enforcement staff levels in the Internal Revenue Service,
(3) the impact of such contracts on the total number and amount of unpaid assessments, and on the number and amount of assessments collected by Internal Revenue Service personnel after initial contact by a contractor,
(4) the amounts collected and the collection costs incurred (directly and indirectly) by the Internal Revenue Service,
(5) an evaluation of contractor performance,
(6) a disclosure safeguard report in a form similar to that required under section 6103(p)(5) of such Code, and
(7) a measurement plan which includes a comparison of the best practices used by the private collectors with the Internal Revenue Service's own collection techniques and mechanisms to identify and capture information on successful collection techniques used by the contractors which could be adopted by the Internal Revenue Service.

[43] In the IRS's response to the GAO report, the Commissioner of Internal Revenue agreed to GAO's recommendation to separately state the commissions as a cost of the initiative. Government Accountability Office, GAO-06-1065 49, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources* (Sept. 29 2006).

[44] The IRS will be working the "next best cases," a phrase which has yet to be defined in any meaningful way. For example, it is clear that IRS employees in the study will be working some business taxpayer cases. IRS, *Filing and Payment Compliance* (Nov. 14, 2006). It is generally understood within the IRS and the tax profession that business tax cases are more complex and can be less productive than individual taxpayer cases.

[45] IRS, *Filing and Payment Compliance* (Nov. 14, 2006).

should be left unworked until the amounts due become worthwhile to collect, after the accrual of penalties and interest over the years.[46]

If the IRS is correct in saying there is a pool of cases that will result in revenue if only someone contacted the taxpayer – and this is the fundamental premise of the Private Debt Collection initiative – then it stands to reason that we should not only determine whether the IRS itself can do this work efficiently (as compared to PCAs) but also determine whether this work is a productive use of the IRS's own resources. Such a "proof of concept" may well demonstrate that early intervention by lower-graded IRS employees with limited collection authority (and who are authorized to make outbound calls and conduct thorough address searches, just as the PCAs are doing) will both collect past due accounts and provide a training ground and recruitment source for higher graded IRS collection positions.[47]

Private Collectors will Work only the Easy Cases

"The cases the IRS would refer to PCAs are those where the taxpayer would likely pay the outstanding tax liability if contacted by telephone."[48]

A central tenet of the PDC initiative is that the IRS has a significant number of accounts in which taxpayers could be induced into paying what they owe by a simple phone call.[49] It is not clear whether there are any really easy tax collection cases; however, if the cases that the IRS identified for private collection are this easy, we wonder about the wisdom of working so diligently to identify the most productive cases only to hand them off to private collectors.

A more serious problem for our tax administration system, however, is that the assigned inventory turned out to be far more complex than the IRS ever expected. In the first batch of inventory identified for possible assignment to private collectors, for example,

[46] In other sections of this report, we address the importance of contacting taxpayers early in the collection process, particularly for low income taxpayers, so that compliance problems can be reversed and the taxpayer is put on a path towards tax compliance. *See* Most Serious Problems, *Early Intervention in Collection Cases* and *Collection Issues of Low Income Taxpayers, infra.*

[47] If this "proof of concept" test takes the form of a direct comparison between IRS workers and private collectors working the same types of cases, to avoid the appearance of a conflict of interest, the test design and final analysis should be reviewed by a third party. The IRS has available employees to perform such a test. For example, we have identified a unit of IRS employees whose positions are being eliminated due to an IRS restructuring. These employees can be trained in a similar environment to private collectors and can use the IRS's outbound call systems to contact taxpayers with delinquent accounts. Only a direct comparison between IRS employees and private collectors working the same types of cases will demonstrate whether the benefits of using private debt collectors truly outweigh the costs.

[48] *See* Testimony of Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

[49] *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals, 99 (February 2003), stating:

> Many taxpayers with outstanding tax liabilities would make payment if contacted by telephone and, if necessary, offered the ability to make payment of the full amount in installments. If PCAs could perform these tasks for this group of taxpayers, without affecting any taxpayer protection, the IRS would be able to focus its resource on more complex cases and issues.

there was a high incidence of shelved delinquent tax return investigations.[50] Under the IRS's traditional collection practices as well as the PDC required procedures, taxpayers cannot obtain installment agreements if they are not compliant for other tax years, *i.e.*, they have not paid taxes or filed returns.[51] While the IRS plans to include this more complicated type of case in Release 1.2 when its systems can communicate the existence of the delinquent return to the private collector assigned to the account, it did not anticipate that such cases would be among the "simple" Release 1.1 inventory. In two different statistical samplings of the Release 1.1 inventory, the IRS learned that in over 30 percent of the cases there were unresolved delinquent tax return investigations in the taxpayers' filing histories.[52] The finding suggests that over 30 percent of the taxpayers will not be eligible for the collection arrangement that the private collectors are authorized to offer. The initial impact of this determination was that the IRS had to remove 15,500 cases from the initial 42,800 to be assigned to the collectors.[53] The IRS is using other inventory, including older cases, to make up for the deficit.

The IRS also had to substitute older inventory when it identified two other unexpected case characteristics. In July of 2006, the IRS needed to eliminate another 10,000 cases from the potential inventory because payments on those accounts, which were thought to be voluntary, turned out to be involuntary levy payments.[54] Additionally, the IRS learned that its systems could not transfer updated account information identifying taxpayers as being represented by tax professionals. When the taxpayer files Form 2848 (Power of Attorney) with the IRS, the IRS and private collectors under this initiative must contact the taxpayer only through the authorized representative. Consequently, it removed from inventory 5,500 accounts that were intended for assignment to private collectors.[55] Thus, as of this date, taxpayers who can afford representation are exempt from this initiative.

Inventory Problems Lead to Expansion of Case Criteria

The shortage of the promised "easy" inventory is driving the IRS to assign inventory with the types of complexities that were never intended to be worked by private collectors. As described above, the IRS plans to assign accounts known to have delinquent tax return investigations in the account history in Release 1.2. Regardless of whether its systems can communicate this type of information to private collectors, utilizing private collectors to

[50] A shelved delinquent tax return investigation is an investigation of a taxpayer's failure to file a tax return for one or more years that has been closed as unresolved.

[51] *See* IRM 5.14.1 (July 2005) and IRS, Private *Collection Agency Policies and Procedures Guide*, 31 (Sept. 2006).

[52] IRS, Partial Production Log (March 16, 2006).

[53] IRS, *Filing & Payment Compliance Advisory Council Presentation* 9 (Jul. 31, 2006).

[54] The initial criteria for assignable inventory in Release 1.1 limited inventory to cases where the taxpayer indicated the amount is due on a tax return and cases where the tax has been assessed and the taxpayer has made three or more *voluntary* payments on the tax. Testimony of the Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

[55] IRS, *Filing & Payment Compliance Advisory Council Presentation* 9 (Jul. 31, 2006).

interact with taxpayers about their obligation to file tax returns raises multiple problems, including the lack of training of private collection employees as to which taxpayers are required to file tax returns.[56] Depending on the taxpayers' circumstances, they may be under no legal obligation to file tax returns.[57] Private collectors have not been trained to determine when filing is required and when it is not. In fact, since such a determination requires the exercise of judgment and discretion, the authority to make a determination of a filing requirement *cannot* be delegated to a non-governmental employee.

Federal Payment Levy Program Cases

The pressure to find steady inventory for private collectors is evident in the IRS's position with respect to accounts that have been assigned to private collectors but which are then subject to the IRS's Federal Payment Levy Program (FPLP).[58] The IRS agrees that it would be inappropriate to assign cases with active FPLP levies to the private collectors. In fact, the Commissioner testified that such cases would be inappropriate for private collector assignment:

> The IRS would not refer to [Private Collection Agencies] PCA cases for which there is any indication that enforcement action would be required to collect the tax liabilities.[59]

However, if the IRS assigns to a private collector a case that is later subject to an FPLP levy, the IRS is unwilling to recall the case. While the IRS acknowledges that cases with active FPLP levies are the wrong type of cases for assignment to private collectors, the

[56] IRC § 6306 (b)(1) sets forth the functions that Congress expected private collectors to be performing:
"(A) to locate and contact any taxpayer specified by the Secretary,
(B) to request full payment from such taxpayer of an amount of Federal tax specified by the Secretary and, if such request cannot be met by the taxpayer, to offer the taxpayer an installment agreement providing for full payment of such amount during a period not to exceed 5 years; and
(C) to obtain financial information specified by the Secretary to such taxpayer…"

[57] *See* IRS Publications 501 (*Exemptions, Standard Deduction and Filing Information*) and 17 (*Your Federal Income Tax for Individuals*).

[58] IRC § 6331(h)(2)(A) authorizes the IRS to issue continuous levies on federal disbursements, including certain components of Social Security income such as payments under Old Age, Survivors and Disability Insurance (OASDI) of the Social Security Act (42 U.S.C.A. § 1302 *et seq*.). The IRS's other automated levy programs include the State Income Tax Levy Program and the Alaska Permanent Dividend Fund Levy Program.

[59] Testimony of Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

IRS's position is that taxpayers under an FPLP levy of their Social Security income will benefit from the interaction with private collectors.[60]

By allowing private collectors to pursue installment agreements on these accounts, the IRS will needlessly be paying commissions for accounts on which the IRS is already receiving payments. More importantly, we do not believe it is appropriate for private collectors to pursue taxpayers who are already subject to FPLP levies, most of whom are elderly taxpayers and receiving Social Security payments.[61]

Other Federal Agencies Use Private Collectors

> *"Mr. Chairman, I appreciate Mrs. Capito's amendment and the seriousness of this issue. When we talk about private collection of debts, we should understand that the Federal Government is already using private debt collectors in other areas. One significant example is student loans. I have certainly visited facilities where private companies are handling the confidential information involved. They are handling it with responsibility. They are handling it in compliance with all legal standards, and they are doing a very good job for the Government, not only getting revenue that we would lose otherwise if we did not collect on the debts but collecting on debts that the Federal Government was having difficulty being able to collect upon."*[62]

> *"Over 40 states have used private collection agencies successfully as part of their tax collection efforts, and other federal agencies have used private collection agencies for a number of years to collect a significant amount of delinquent federal nontax debt."*[63]

To compare the collection of delinquent student loans and other federal debts to the collection of delinquent federal taxes is to fail to recognize:

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[60] In February of 2006, the National Taxpayer Advocate issued a Proposed Taxpayer Advocate Directive (Proposed Taxpayer Advocate Directive 2006-1-P) ordering the IRS to alter certain aspects of the PDC initiative's design. The National Taxpayer Advocate issues a Taxpayer Advocate Directive to order administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers. IRM 1.2.2.11.3 The IRS responded to the Proposed Taxpayer Advocate Directive and addressed the Taxpayer Advocate Service's position with respect to FPLP levies, as follows:

> Allowing PCAs to work with taxpayers with FPLP [Federal Payment Levy Program], SITLP [State Income Tax Levy Program] and Alaska Fund levies will be beneficial to taxpayers. In these cases, PCAs will assist taxpayers in resolving the situation, which will result in a levy release if an installment agreement is obtained.

Memorandum from the Commissioner of the Small Business/Self-Employed Division to the National Taxpayer Advocate Regarding Proposed Taxpayer Directive 2006-1 (March 28, 2006).

[61] Over the last four years, 84 percent of FPLP levies have been against Social Security benefits. IRS, Wage & Investment Division Information Request, September 28, 2005. *See* Most Serious Problem, *Levies, infra.*

[62] Statement of Representative Ernest J. Istook, Jr. in debate before the United States House of Representatives, between Representative Shelley Moore Capito, Representative Christopher Van Hollen and Representative Istook, regarding amendment to H.R. 5025 to prohibit use of private collectors by the IRS (September 4, 2004).

[63] Testimony of the Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

- The extensive resources the IRS receives for its collection function;
- That other federal agencies must go through a competitive sourcing process which requires cost efficiency and protections for affected employees, all of which this initiative bypassed; and
- The importance of tax collections and long-term tax compliance to our government on the one hand and the small return on investment from this initiative on the other.

Other components of the federal government may utilize private debt collectors efficiently; however, there are important differences between those agencies and the IRS. One such difference is that, in contrast to those other agencies, the IRS has a large collection infrastructure with thousands of trained employees and an annual budget of nearly two billion dollars.[64] The IRS has 14 Automated Collection System (ACS) sites that interact with millions of taxpayers annually, in contrast to the private collectors who operate out of single locations with 75 employees in the aggregate. The IRS continues to spend significant resources on the same technology used by private collectors, such as predictive dialer systems.[65] Predictive dialers are automated systems that contact taxpayers and hand off the taxpayer to a live telephone assister when the phone is answered. Effective use of these systems is central to the success of collection agencies in the private sector; yet, the IRS elects not use its predictive dialers to any real extent.[66] Given the IRS's collection infrastructure, it is unclear why the IRS needs private collectors to reach its own inventory.[67]

Another important difference between the IRS and other federal agencies is that when other agencies outsource their collection work through the competitive sourcing process, the agencies must certify the functions as "commercial," must compile a business case using rigorous cost analysis demonstrating that the private sector can do the work more efficiently, and must then determine the most efficient organization to perform the function.[68] Reductions in force are a typical result of competitive sourcing when

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64 IRS Fiscal Year Budget in Brief, available at: http://www.irs.gov/pub/irs-utl/bib-irs.pdf. The IRS's total budget for tax law enforcement in fiscal year 2006 was approximately $4.7 billion dollars and its proposed enforcement budget for FY 2007 is approximately $4.8 billion dollars. IRS Budget in Brief FY 2007, available at: http://www.irs.gov./pub/irs-news/fy07budgetinbrief.pdf. For fiscal year 2006, the Small Business/Self-Employed Division allocated approximately 11,270 full time equivalents (FTEs) towards collection efforts. IRS Small Business/Self-Employed Division, FY 2006–FY 2007 Plan. The IRS Wage & Investment Division allocated approximately 3,332 FTEs to collection. Wage & Investment Division, *FY 2006 Plan.*

65 In 2004, the IRS acquired an additional "predictive dialer" system used to automatically contact taxpayers. National Taxpayer Advocate 2004 Annual Report to Congress 234.

66 In FY 2004, Automated Collection System use of predictive dialers constituted less than five percent of direct time. ACS Management Reports, Oct. 1, 2003, through Sept. 20, 2004. For discussion of IRS use of predictive dialers, see National Taxpayer Advocate 2004 Annual Report to Congress 234.

67 For an analysis of how much more impact the IRS could achieve through improved collection strategy and practices, *see* Most Serious Problems, *Collection Alternatives* and *Early Intervention in Collection Cases*, *infra.*

68 IRS Office of Competitive Sourcing, *IRS Circular A-76 Primer*, available at http//www.irs.gov.ustreas.gov/pub/cmpsrc/learn_more/irs_a76-primer.pdf.

the private agency prevails.[69] Consequently, employees have rights throughout the competitive sourcing process. Employees can appeal the classification of activities as "commercial" as well as the competitiveness determination, first internally and then to the Government Accountability Office.[70]

The most important difference between the IRS and other federal agencies relates to the importance of taxes and tax compliance to the operation of the federal government.[71] Unlike the collection of delinquent student loans or other areas where the government contracts out its collection function, the Constitution of the United States confers the power to collect taxes upon Congress.[72] This power reflects the importance of taxes to the operation of the federal government. Taxpayers annually pay over two trillion dollars to the IRS, without any IRS follow-up or enforcement action.[73] These taxes are paid in part because taxpayers desire to avoid the IRS's collection authority. This authority – and its deterrent effect – are diluted where the IRS uses civilian collection agencies that are also calling about past-due credit card accounts and medical bills.

Using private collectors also exposes taxpayers to new risks. With the private debt collection initiative, the IRS has compromised its identity as the nation's tax collector, opening up a new avenue for scam artists to impersonate private collectors. Indeed, the IRS kicked off this initiative with a warning about the need for taxpayers to protect themselves.[74] Instances of fraud and misuse of taxpayer information are inevitable, as is a degraded image of the IRS.

HIDDEN COSTS OF PRIVATE DEBT COLLECTION – COSTS TO OUR TAX ADMINISTRATION SYSTEM

In the analysis above, we described costs of the initiative in terms of direct financial expenditures. However, we are also concerned that the initiative will exact a cost on vital components of our tax administration system, including: customer service, the transparency of IRS tax collection operations, consistent treatment for similarly situated taxpayers, and tax compliance.

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[69] Jacques S. Gansler and William Lucyshyn, *Competitive Sourcing: What Happens to Federal Employees?* 16 (October 2004), available a http://irs.ustreas.gov/pub./cmpsrc/an_p_gas_lucy.pdf.

[70] Office of Management and Budget Circular A-76 (2003); *see also* Jacques S. Gansler and William Lucyshyn, *Competitive Outsourcing: What Happens to Federal Employees?* 16 (October 2004), available at http://irs.ustreas.gov/pub./cmpsrc/an_p_gas_lucy.pdf.

[71] As Supreme Court Justice Owen Roberts noted in 1935 as a means of explaining the importance of collecting tax revenues above other interests: "But taxes are the lifeblood of government, and their prompt and certain availability an imperious need." *Bull v. U.S.*, 295 U.S. 247, 259, 55 S.Ct. 695 (1935).

[72] U.S.C.A. Const. Art. I, § 8, providing:

> The Congress shall have the Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for a common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

[73] Statistics of Income, *IRS Data Book*, 2004-2005, available at: http://www.irs.gov/taxstats/article/0,,id=102174,00.html.

[74] IRS News Release, Simple Steps Can Prevent Scams as Private Debt Collection Begins (Aug. 23, 2006).

Customer Service

> *"Our working equation at the IRS is service plus enforcement equals compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes."*[75]

We could not agree more that customer service is a vitally important part of achieving greater rates of tax compliance. We have also cautioned that changing or reducing services may affect taxpayers' willingness or ability to comply with the tax law.[76] The IRS has made strides in the provision of its customer service.[77] However, by using private debt collectors, the IRS has separated taxpayers from its world class customer service.

Contrast in Customer Service Approach

The IRS's vast resources dwarf the capacity of private collectors to duplicate the IRS's level of customer service. The operational plans of the three contractors emphasize the importance of collection results rather than customer service and do not address the complex needs of U.S. taxpayers. The IRS's Multilingual Initiative (MLI) provides one example of the type of quality service that private collectors will not and cannot duplicate.

Executive Order 13166 requires all federal agencies to establish a plan to ensure that persons with limited English proficiency have meaningful access to government related products and services.[78] The IRS created a Multilingual Initiative (MLI) Strategy Office to implement the order through the services provided by the IRS.[79] For taxpayers with

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[75] *Internal Revenue Service FY 2006 Budget Request, Hearing Before the Subcomm. on Transportation, Treasury, Judiciary, Housing and Urban Development, and Related Agencies, Senate Comm. on Appropriations*, 109th Cong. 1st Sess. (Apr. 7, 2005) (Statement of Mark W. Everson, Commissioner of Internal Revenue).

[76] *See* National Taxpayer Advocate 2005 Annual Report to Congress 2 (discussing trends in taxpayer service).

[77] The IRS recently described improvements to its customer services, including:
- Employment of advanced call routing technology;
- Developed interactive job aids for IRS employees;
- Improved information systems;
- Strengthened managerial and executive involvement in service delivery;
- Expanded service to alternative locations (such as post offices, federal and state offices, libraries, and community organizations) during filing season; and
- Providing return preparation services using volunteers and Taxpayer Assistance Center personnel.

See National Taxpayer Advocate 2005 Annual Report to Congress 18, where the IRS responded to Most Serious Problem, *Trends in Taxpayer Service*.

[78] Exec. Order 13166; 65 Fed. Reg. 50,121 (Aug. 11, 2000). The IRS has interpreted the Executive Order to require:
- The availability of transcription services so that any IRS letter to a taxpayer who speaks a regularly encountered language can have the letter translated into that language;
- Oral language assistance will be provided for regularly encountered languages; and
- Educational and outreach documents will be translated for regularly encountered languages. IRM 22.31.1.6.1 (April 2006).

[79] IRS, *Multilingual Initiative Customer Base Report FY 2006* 12 (Feb. 2006).

limited English proficiency, the MLI will improve all other services provided by the IRS, by opening access and lines of communication which were heretofore unavailable.[80]

In contrast, the three private collection agencies have taken next to no steps to address taxpayers with limited English proficiency. One of the collectors had a telephone number for Spanish speaking individuals on its contact letters; however, when representatives from TAS dialed the number, there was only an English speaking voice that first transferred the call to another line, after which the call was automatically terminated. After TAS drew the IRS's attention to the problem, the IRS ensured that this particular problem was corrected, but we believe the example to be symptomatic of the problems with this initiative. The other two collectors have not taken any meaningful action to provide services for taxpayers with limited English proficiency.

"Proprietary Information" and the Lack of PCA Transparency of Operations

> *"The Treasury Department and the IRS determined early on that no proposal to engage PCAs would ever be feasible unless and until those developing the proposal could assure themselves and others that taxpayer rights would not be weakened in any way."*[81]

Elsewhere in this report, we have detailed the obligation of the IRS to disclose most policies and procedures and the effect that a lack of transparency can have on taxpayer rights.[82] Likewise, we noted that the Internal Revenue Manual (IRM) is supposed to serve as the single, official source of IRS "instructions to staff" such as procedures, guidelines, policies, and delegations of authority.[83] Generally, the IRS adheres to its disclosure obligations, although we have provided some serious examples in this report where it has not. While the IRS substantially complies with its disclosure obligations, it has failed to ensure that the operations of its private collectors are equally transparent to the public and to decision makers.

Some aspects of the plans reflect dramatic departures from IRS practice and impact taxpayer rights. We would like to discuss some of the specifics in this report, but the IRS has advised us that much of the information in the PCA operational plans and calling scripts is designated as "proprietary information," and generally cannot be released without the consent of the PCAs. The operational plans and calling scripts describe such things as belated Fair Debt Collection Practices Act (FDCPA) warnings and psychological techniques used to coax debtors into paying.

[80] For an extensive discussion of problems facing taxpayers who speak English as a second language (if at all), see this report for the Most Serious Problem, *Multilingual and Cultural Barriers, infra*. While we have suggestions for improving the IRS's services to these taxpayers, there is simply no comparison between private collectors and the IRS as to the sophisticated array of services and outreach that the IRS provides.

[81] Testimony of the Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

[82] *See* Most Serious Problem, *Transparency of the IRS*, *supra see generally,* 5 U.S.C.A. § 552.

[83] IRM 1.11.2.1 (Oct. 1, 2005).

Throughout the development of the PDC initiative, there was general agreement that all restrictions that apply to IRS collection employees would also apply to PCA employees and that, to achieve this objective, the rules would provide for a "level playing field" for IRS employees and PCA employees. Significantly, the IRS publishes the procedures its collection personnel must follow in the Internal Revenue Manual, yet it now turns out that private collection agencies are employing proprietary collection techniques that are not published, that cannot be revealed without the private contractors' consent, and that even the National Taxpayer Advocate, the Government Accountability Office, and the Treasury Inspector General for Tax Administration presumably cannot report on publicly. This lack of transparency is a serious problem for taxpayers and a serious flaw of this initiative.

Inconsistent Treatment of Taxpayers

> *"A taxpayer contacted by the PCA would enjoy the same rights and protections as a taxpayer contacted by an IRS employee."* [84]

As a result of the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS reorganized from its geographic structure into operating divisions designed to serve different types of taxpayers, *i.e.*, the Wage & Investment Division, Small Business/Self-Employed Division, Large & Mid-Sized Business Division, and Tax Exempt/Government Entities Division.[85] One goal of this reorganization was to ensure consistency in service so that similarly situated taxpayers received the same treatment.[86] Lack of consistency results in poor customer service and can also lead to impairment or violations of taxpayers' rights.

At this stage of the PDC initiative, there are three private collectors, all with their own operational plans, form collection letters, and collection scripts to use when they get taxpayers on the telephone. In Release 1.2, there will be up to 12 collectors with 12 operational plans and dozens of different ways to communicate the same issue to taxpayers.[87] A review of those plans and letters demonstrates how different these agencies' approaches to collection are from that of the IRS, and from each other. Some examples of inconsistencies are demonstrated below.

[84] Testimony of Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

[85] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 1001(a)(2) and (3), 112 Stat. 685.

[86] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, Part Two, Title I.A.1, IRS Mission and Restructuring (§§ 1001 and 1002), 17.

[87] Internal Revenue Service News Release, IR-2006-131 (August 23, 2006), indicating up to 10 private collectors; but *see* Government Accountability Office, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 Appendix 1 (Sept. 29, 2006), indicating up to 12 private collectors.

Obtaining Financial Information:

Under IRS procedures, no financial statements are required as a condition of entering into an installment agreement if the liability is under $25,000, provided the taxpayer indicates an inability to pay and the taxpayer otherwise qualifies for an installment agreement.[88] IRS collection information statements are lengthy financial statements that require detailed information of income, expenses, assets, and liabilities. In the initial drafts of the operating plans, each of the private collectors planned to obtain financial information on each account where the taxpayer indicated that he or she could not fully satisfy the liability. The IRS has negotiated with the collectors on the issue; however, the plans still do not provide clear guidelines about when and when not to obtain financial information.

Collection Scripts

The IRS requires its telephone representatives to seek full payment, but they cannot employ trickery or any device to manipulate taxpayers. For example, training given to IRS Automated Collection Service (ACS) collection representatives includes an emphasis on fairness, accuracy, and taxpayer rights.[89] In contrast, we are concerned that the private collectors are using trickery, device, and belated Fair Debt Collection Practices Act warnings to take advantage of taxpayers.[90] At the IRS's request, we have removed specific references to the scripts of the private collectors.[91]

Tax Compliance

The IRS's outreach and enforcement efforts are designed to be compliance based. For example, the IRS requires its collectors to conduct interest-based interviews when attempting to resolve past accounts in order to structure the resolution in the taxpayer's and the IRS's long-term interest. Therefore, to avoid future noncompliance, current withholding amounts should be adjusted before allocating amounts towards installment agreements.[92] The IRS is requiring the collectors to inquire about the adequacy

[88] Under IRS procedures, no financial statements are required as a condition of entering into an installment agreement if the assessed liability does not exceed $25,000 and this balance will be fully paid within 60 months (or fully paid prior to the collection limitations period, whichever comes first), provided the taxpayer otherwise qualifies for an installment agreement. IRM 5.14.5.2.(10).

[89] ACS Basic Modules A-1 (Training Course 6602-102) is an eight week training course in a classroom setting for employees to the ACS function, which emphasizes listening to taxpayers. Materials include a 326 page training document containing seven modules. Training Publication 6602-102, Module B: Understanding the Rights of Taxpayers also teaches seven modules including the Taxpayer Bill of Rights, the IRS Restructuring and Reform Act of 1998, and IRC § 6103.

[90] 15 U.S.C.A. § 1692e (11), requiring creditors to warn debtors that the communication is an attempt to collect a debt and that any information obtained will be used for that purpose.

[91] *See* discussion, *supra,* of IRS's insistence that operational plan information is "proprietary information" and cannot be disclosed.

[92] IRM 5.14.1.5(3).

of withholding to meet the current year's obligation but is not providing any training or guidance on the purpose or procedure for doing this.[93]

At the heart of the IRS's compliance based approach to tax administration is an appreciation that the $2 trillion paid by taxpayers annually, without enforcement, is fostered by a consistent, fair, and long-term approach to tax administration. In contrast to the trillions of dollars paid voluntarily each year, the IRS predicts that the private debt collection initiative will collect $1.4 billion, less costs, over ten years. Thus, with the private debt collection initiative, we have risked much for a small return on investment.

CONCLUSION

A decision by the federal government to outsource one of its core functions to the private sector should not be undertaken lightly. By taking this step, the government is substituting private-sector employees with a narrow objective, *i.e.*, to maximize profits, for civil-service employees who are trained to think and act for the public good. It is true that there are many functions performed by the government that are commercial in nature and that can be privatized in an appropriate and cost-efficient manner. On the other hand, there are other functions that are so inherently governmental that the involvement of public employees is required throughout the process to further and protect the long-term interests of the government, its employees, and more importantly, its citizens.

To balance these complex interests, the government employs the OMB Circular A-76 procedures, which follow a defined process of identifying commercial activities, conducting a rigorous cost analysis to determine whether outsourcing makes the most business sense, and then finding the most efficient organization to perform the function. This process, while not without problems, provides protections for employees who can make challenges at critical steps along the path towards privatization. The private debt collection provisions in the AJCA and the manner in which the initiative was implemented did not allow for the development of a true cost-benefit comparison for the use of private collectors as compared with IRS collectors at the front-end of the process. The IRS has never certified the types of functions being performed by private collectors as commercial, and the IRS acknowledges that its employees can perform those functions more efficiently than private collectors. Accordingly, it does not appear to us that the PDC initiative would have been implemented if it were subject to the competitive sourcing rules under Circular A-76.

We must also be mindful of the hidden costs of using private collectors, notably potential erosion of customer service, lack of transparency of private collection operations, potential failure to provide consistent treatment for all taxpayers, and potential erosion of tax compliance. We do not believe that these principles should be compromised for the revenue gain, if any, this program may produce. For the reasons described, the

[93] IRS, *Private Collection Agency Policies and Procedures Guide* 28.

National Taxpayer Advocate believes the PDC concept is fatally flawed and should be terminated. Moreover, regardless of whether the PDC initiative continues, the National Taxpayer Advocate believes the IRS should conduct a "proof of concept" test to determine the potential revenue benefits of using lower-graded IRS employees with limited collection authorities to locate and contact taxpayers with "potentially collectible" accounts.

IRS COMMENTS

We view the Taxpayer Advocate Service (TAS) and the National Taxpayer Advocate as our partners in the PDC initiative and appreciate their hard work in helping reach our shared goal of providing taxpayers with a high level of service. Since the start of the project, we have worked with TAS at each stage, listening and responding to their suggestions, and making appropriate adjustments. The National Taxpayer Advocate is one of the many stakeholders, both within and outside the IRS, whose input we have actively sought for this project on issues such as IRS and PCA policies, procedures, letters, publications, scripts, and training. We shared PCA procedures, operational and training plans, letters, and other documents with trusted stakeholders, including Congressional staffs, the National Taxpayer Advocate, the Government Accountability Office and the Treasury Inspector General for Tax Administration. For example, the PCA Policy and Procedures Guide contains all the IRS-required procedures to be followed by the PCAs; 90 percent of TAS's suggestions resulted in changes to this document, and a majority of suggestions received from all stakeholders were fully adopted.

This initiative strives to make certain that PCA employees adhere to the same guidelines and restrictions as IRS employees. Where possible, the documents governing this effort have been made available to all necessary parties. That includes certain PCA documents that are proprietary and not immediately subject to public release under procurement regulations. As soon as we learned the National Taxpayer Advocate wanted to publish the PCA scripts, we took steps to have all three firms approve their release. Additionally, we have begun the process of releasing other appropriate information.

Cost Benefit Analysis

The PDC project has started off well, due in no small part to the involvement of a full spectrum of stakeholders. In the 10 weeks from the project's inception through November 16th, the IRS placed nearly $90 million in outstanding accounts, and collected $8.43 million. This yield exceeds the conservative target of 6 percent set for this initial year and is on target for achieving the business case assumption of 10 to 15 percent annually, depending on case type. This assumption is comparable to the Automated Collection System (ACS) collection rate for the IRS during FY 2006, which was 14 percent.

The proportion of commissionable to non-commissionable payments received in the first month is an anomaly and that rate has risen steadily. While commissionable

revenue in September was 46 percent, the cumulative percentage through November is 85 percent. The total compensation is significantly below the 25 percent legislative cap. Commissions paid to the PCAs from the project's inception through November 16th amounted to $1.55 million, calculated on $7.15 million in commissionable payments. The effective rate of commissions paid is 21.68 percent of commissionable payments, and 18.38 percent of all payments received in the PDC program.

During FY 2007, gross revenue received as a result of the project is expected to range from $33.8 million to $62.3 million, with costs ranging from $23 million to $29.3 million. Going forward, we expect improved margins as investments in automation allow us to expand the number of case assignments with little additional IRS support. We expect to recoup all PDC sunk investment costs during FY 2008 providing for growth in the return on investment (ROI) as the program continues. The new system for managing PCA caseload was developed as a foundation for all future PCA casework. The costs of this program should be viewed in that context.

As noted by the National Taxpayer Advocate, we are in the process of conducting the first portion of a cost effectiveness study. Our original design for this study compared PCA and IRS effectiveness in working the same type of inventory. After consultation with the GAO, we changed the design to better respond to the following recommendation in the May 2004 GAO report:

> *"...the IRS Commissioner should ensure that a study is completed that compares the use of PCAs to a collection strategy that officials determine to be the most effective and efficient overall way of achieving collection goals."*

In response to GAO's recent report, we again adjusted our methodology to include commissions paid to PCAs as a separately stated expense item. Our revised plan will compare PCA results on working PDC inventory with IRS results at working the next best case available. We will also define the full cost benefit of PDC and its ROI. It is important to note that PDC cost comparisons to IRS costs should be made cautiously, using similar types of collection cases worked by phone or letter, not through field contact.

The comparison data, which will be provided to Congress in 2007 as part of the biennial report required under the American Jobs Creation Act of 2004, will be used to assure that we are applying our resources in the most effective manner. The National Taxpayer Advocate recommended a straight IRS cost to PCA cost comparison of like inventory. However, if PDC resources were diverted to hire additional IRS collectors, they likely would not work PDC inventory, as implied by the National Taxpayer Advocate's study design, since IRS has other priorities that will need to be weighed. On November 14, 2006, we briefed the National Taxpayer Advocate on the study and we proposed that we work with the National Taxpayer Advocate to further refine our study to address cost-to-cost comparison questions raised by the National Taxpayer Advocate.

PROBLEMS

Service to Taxpayers

Service levels to taxpayers assigned to PCAs will meet or exceed the standards set for IRS customer service and quality. PCA quality, measured the same way as IRS quality, has ranged from 97 to 100 percent across various quality dimensions. This compares favorably with the ACS average range of 89.5 to 99.5 percent along the same dimensions for FY 2006. Of the nearly 19,000 cases assigned to PCAs, only 108 taxpayers have requested that their accounts be handled by the IRS. At any time, taxpayers may avail themselves of IRS services, including the assistance of TAS. There have been 31 reported contractual complaints, all of which have been reviewed in depth. The majority of these complaints deal with taxpayer questions about identity authentication procedures intended to protect taxpayer privacy. There have been no instances of fraud or misuse of taxpayer information.

IRS staff use several methodologies to review and monitor PCA activity with taxpayers. Live calls and cases are reviewed as well as continuous discussions on relevant procedures, as contained in and required by the PCA Policy and Procedures Guide and as outlined in evolving operational plans submitted by each contractor. Under procurement regulations, their operational plans are proprietary and can be made public when permitted by the PCAs. We have begun the process of releasing to the public pertinent portions of the PCA documents.

Each of the private collection agencies is working with the IRS continuously to update and improve their procedures. The successful initialization of the new IRS support groups for this effort ensure that taxpayers may always avail themselves of direct IRS service if they so choose. Furthermore, the taxpayer can contact the IRS to resolve the liability or provide information to determine the collectibility of their unpaid tax liability at any point during the collection process.

The overall success of this project is predicated on placing the *right cases* with PCAs at the *right time* from the *right universe* of inventory. We stage PDC cases in a way that allows us to ensure quality case work, the protection of taxpayer rights, and the delivery of the appropriate level of training to the PCAs. Inventory perfection is an ongoing and evolutionary process. Decisions to bring forward or push back the placement of various types of inventory reflect our efforts to identify the best possible universe of cases for assignment to PCAs during the initial build-up of this program. At times, we have slowed the pace of assignment to ensure proper program delivery at the lowest possible risk; there has never been a shortage of inventory or any pressure to deliver an arbitrary number of assignments. There is no contractual guarantee to the PCA firms of any volume of placements, dollar value of cases, or age of receivables. Future inventory decisions will be based on analysis of PCA performance on cases placed at this time.

As an example of this process, we have always considered placing Tax Delinquent Investigations (TDIs), as clearly stated in the February 2003 Request for Quotations (RFQ), but had reserved them for later placement because the timing was not right in the

initiative's initial phase. To prepare for TDI placement, we plan on testing assignment of Tax Delinquent Accounts (TDAs) with associated TDIs to PCAs during the third quarter of FY 2007. The test will help determine which of these cases are appropriate inventory, and it will include additional training of PCA employees on how to ask taxpayers to file their returns. PCA procedures currently include similar instructions for requesting outstanding returns on the inventory already assigned to PCAs, since returns may be due while the case is being handled by a PCA. We agree with the National Taxpayer Advocate that a determination of a filing requirement is inherently governmental. Under PDC procedures, this decision is made by IRS employees supporting the PCAs.

Our position on the Federal Payment Levy Program (FPLP) cases in PCA inventories is consistent with how these cases are treated within the IRS and not the result of inventory placement decisions. Involuntary levy cases such as those in the FPLP are removed from potential PCA inventory as part of the normal inventory selection process. After assignment, if a FPLP match occurs on a PCA case, the taxpayer has immediate access to work with someone to resolve the delinquency. If the taxpayer wishes to resolve the account using installment payments, the FPLP levy would be prevented or released and the contractor would monitor the agreement. Taxpayers who are unable to pay their balance due will be recalled from the PCA and placed in currently not collectible status when those requirements are met, and the FPLP levy would be prevented or released. Since the PCAs have the ability to resolve the account, there is no need to automatically recall accounts subject to an FPLP levy from the PCA inventory. If the facts of the case warrant a recall from the PCA, then the account will be recalled. Under no circumstance will commissions be paid on levy payments, as outlined in the Task Orders issued to the three firms.

All PCAs have taken actions to provide service for non-English speaking taxpayers. These experienced firms all service non-English speaking customers as part of their normal business. Two PCAs have bilingual staff to handle non-English calls. The third PCA is in the process of making arrangements to provide increased assistance to non-English speaking taxpayers. At all three PCAs, when the language spoken by the taxpayer prevents the PCA employee from assisting the taxpayer, IRS Referral Unit employees provide the necessary assistance. This allows us to provide the same level of service to all taxpayers.

The PCA procedures for collecting financial information directly align with IRS procedures and ensure protection of taxpayer rights. The PCA Policy and Procedures Guide, which the PCAs are contractually required to follow, prohibits the PCAs from obtaining financial information from a taxpayer unless directed to do so by the Guide. As an example, Section 11 of the PCA Policies and Procedures Guide states: "Under no circumstances will a PCA secure financial information from a taxpayer unless specifically directed to do so by the procedures contained in the guide." The instructions provided to the PCAs in the Policy and Procedures Guide on securing financial information do not differ from the procedures used by the IRS when collecting balance due accounts. No PCA is permitted to supersede IRS procedures; they are precluded from doing so by

task order. The PCA Policy and Procedure Guide emphasizes the appropriate time to collect financial information and we verified the PCAs' understanding of this requirement in face-to-face meetings. PCA operational plans are evolving documents, and the IRS is continually working with the PCAs to perfect these documents and to ensure they conform to IRS procedures. We have begun the process of releasing portions of these plans for public review.

Consistent Taxpayer Treatment

All taxpayer delinquencies are taken seriously by the IRS, regardless of their size, and none is considered "trivial." We notify all taxpayers immediately if we discover they are delinquent, explain the consequences of non-compliance, and offer assistance to help them meet their tax obligations. We customize further treatment based on case characteristics to ensure taxpayers receive the appropriate level of service and to make best use of limited IRS resources. The PDC initiative is a way to provide a higher level of personal assistance to taxpayers within IRS' appropriated resource levels.

All taxpayers with representation whose cases meet the criteria for assignment to PCAs are included in available inventory. No determination of taxpayer ability to afford representation is being used to select inventory. PCA cases with taxpayer representation are currently being worked by PCAs. However, cases where a Power of Attorney (POA) is already on file are being reserved for later assignment in Release 1.2. We expect to assign them in January 2007 when all disclosure systemic concerns will have been resolved to ensure, for example, that updated information is provided to the PCAs when a taxpayer ceases to use a POA and/or obtains a new POA.

We have completed comprehensive procedural and legal reviews on talking scripts used by the PCAs. All taxpayer rights and protections are in force throughout all PCA scripts. The National Taxpayer Advocate expressed concern about a PCA script regarding the pacing of collector dialogues with taxpayers. The PCA assistor was offering the taxpayer an opportunity to engage in conversation and not being asked to enter into a full payment schedule prematurely. We have begun the process of releasing the scripts for public review. We also have a rigorous process in place to ensure PCA employees working on this program are fully trained in critical topics such as taxpayer rights, privacy, disclosure, and TAS-related procedures. PCA employees working on this program are also required to execute the same certifications of training required by IRS employees on critical topics.

Compliance Impact

While the determination of the full cost benefit and cost effectiveness of the project will be known when the studies in progress are completed, the compliance benefit of the project continues to lie firmly on the leverage PCAs provide. For the one-time cost of setting up the project, we are experiencing the benefits of the efforts of PCA employees and the thousands of contacts made on outstanding accounts. PCA assistors working

on the IRS contract work exclusively on IRS cases. During FY 2007, we project that the IRS will spend 31 FTEs in direct support of PCA activities, delivered by a headcount of 65 IRS employees who work on this program as needed. The total leverage provided by using PCAs allows currently unassigned cases to be worked with more personal interaction than would be achievable otherwise, given the IRS's appropriated level of resources. The IRS already uses its resources to make as many outcalls as possible on priority collection inventory. In FY 2006, the IRS attempted more than 1.3 million predictive dialer calls on Automated Collection System cases.

We also know that collection programs such as PDC have compliance benefits that range far beyond revenue collected. As Commissioner Everson testified in March 2006 on IRS's FY2007 Budget regarding the indirect effect of increased enforcement activities in deterring non-compliant behavior, "[e]conometric estimates of the indirect effects indicate that they may be 10 times the size of the direct effects, or larger." The impact of merely informing taxpayers that they have been selected for this project is evident in the success of both the IRS and PCA initial taxpayer contact letter in generating payments, equal to approximately half of all payments in the first month. When a taxpayer is selected for PDC, he or she has already received multiple balance due and reminder notices from the IRS requesting payment. During the contractually specified non-commissionable period after PCA assignment, many taxpayers responded to the one letter that does not request payment, but informs them of the PCA assignment. Taxpayers are also informed of their right to opt-out of the program in the initial contact letter. The initial taxpayer reaction experienced is clearly the result of PDC activity and substantiates the anticipated compliance benefit of the PDC initiative.

Part of the reason the IRS sought legislative approval to use PCAs was the successful experience of other federal agencies. Section 6306(a) of the Internal Revenue Code exempts the IRS PDC initiative from coverage under the FAIR Act or OMB Circular A-76 by providing: "Nothing in any provision of law shall be construed to prevent the [IRS] from entering into a qualified tax collection contract" with a PCA. Moreover, IRS is not outsourcing but contracting for assistance in delivering a small portion of the overall collection function. No reductions in force were made due to this initiative.

Since 1982, PCAs have been used to assist the government in collecting debt. In FY 2005, the federal government referred $13.7 billion to PCAs, resulting in collections of $693.5 million. The Departments of Education, Health and Human Services, and Treasury all use PCAs to collect outstanding debt. More specifically, the Department of the Treasury's Financial Management Services (FMS) currently has 25 FTEs committed to support five PCAs who have roughly 400 employees. The FMS contracted agencies to handle cases after they have been through the FMS debt collection process, similar to previous IRS activity on PCA cases. During FY 2006, FMS placed nearly 300,000 cases valued at $3.5B with the five PCAs and collected approximately $71M. The PDC commission fees of 21 to 24 percent are within the norm of what other federal agencies are paying for collecting similar federal debt.

PROBLEMS

Conclusion

Given the backlog of IRS receivables and our limited collection resources, the PDC initiative allows the IRS to ensure that more delinquent taxpayers are personally assisted with meeting their obligations. Oversight of this initiative is a role that we take very seriously, and we will continue to make program decisions to protect the privacy and security of taxpayers while collecting outstanding government debt.

TAXPAYER ADVOCATE SERVICE COMMENTS

By the IRS's calculation, the initiative to date has cost approximately $56 million in direct costs, with additional planned expenditures of at least $23 million in FY 2007, $21 million in FY 2008 and another $32 million in 2009.[94] These figures do not include a projection of the opportunity cost of the initiative to date or a projected opportunity cost through FY 2009, which the IRS has not yet calculated; nor does the IRS include the downstream (hidden) costs of the initiative.[95] As part of the 1996 PDC initiative, however, the IRS estimated a $17 million opportunity cost based on direct expenditures of approximately $3 million.[96] In other words, the 1996 initiative incurred over $5 in opportunity cost for every dollar of direct costs spent on the initiative. The 1996 initiative, which was terminated as a failure, collected $3 million in revenue in its only year in existence; thus, the 1996 initiative paid for its direct costs after only one year. In comparison, the IRS does not project that the current initiative will break even until sometime in FY 2008, and this projection does not consider the opportunity costs of the initiative. Even if the current initiative has less of an opportunity cost, for example $3 per dollar invested (resulting in $168 million of opportunity costs on expenditures to date and $396 million through 2009), the opportunity costs are significant.[97] Thus, when the IRS indicates above that the initiative has started off

[94] The Filing & Payment Compliance unit provided information for this report indicating that $38.18 million was expended in FY 2004 and FY 2005 and $15.83 million was expended in 2006, plus an additional $1.9 million (from IRS information provided above) in commissions is added. IRS, *Filing and Payment Compliance Briefing Document* 10 (Dec. 5, 2006).

[95] We note that the IRS has not conducted any studies to determine if PCAs incur more or less downstream costs – such as TAS involvement in cases – than IRS employees doing the same work.

[96] General Accounting Office, GAO/GGD-97-129R, *IRS: Issues Affecting IRS's Private Debt Collection Pilot*, 5 (Jul. 18, 1997).

[97] The opportunity cost reflects the loss of revenue from diverting funds from the best or next best investment opportunity. Because of the return on investment for enforcement dollars in general is high, we believe the PDC initiative has a high opportunity cost. As the Government Accountability Office recently noted in testimony on the tax gap:

> As part of an effort to make the best use of its enforcement resources, IRS has developed rough measures of return on investment in terms of tax revenue that it assesses from uncovering noncompliance. Generally, IRS cites an average return on investment for enforcement of 4:1, that is, IRS estimates that it collects $4 in revenue for every $1 of funding. Where IRS has developed return on investment estimates for specific programs, it finds substantial variation depending on the type of enforcement action. For instance, the ratio of estimated tax revenue gains to additional spending for pursuing known individual tax debts through phone calls is 13:1 versus a ratio of 32:1 for matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns.

Testimony of Michael Brostek, Director, Government Accountability Office, before the Senate Finance Committee, Tax Gap (July 26, 2006).

well, we feel compelled to ask: *In comparison to what?* At best, the initiative will break even in two years on its direct costs, which is a long time to wait for a zero return on investment of taxpayer dollars.

The stated reason for the PDC initiative was that the IRS did not have the resources to work its inventory backlog of potentially collectible cases. The initiative was presented as a cost efficient way to address the types of cases that could be resolved with a phone call, as evidenced by the success of other federal agencies. Over the last year, we have learned that: the IRS is more efficient at collecting these accounts than private collectors, the backlog of inventory was more complex than originally believed, and the IRS plans to increase the complexity of assigned cases with the next phase of the initiative, Release 1.2.

The analogy of the IRS collection effort with other federal agencies is a poor one, as the IRS has within it a vast collection agency funded at nearly $2 billion dollars annually and a mission unlike any other federal agency, in essence, to function as the government's Accounts Receivable department, collecting today's delinquent tax dollars and ensuring tomorrow's tax compliance. In this report, we have juxtaposed two different processes for contracting out federal work: the Circular A-76 process and the process used in the PDC initiative. The Circular A-76 process addresses many important questions before proceeding with contracting out, including such threshold questions as whether the function is commercial or inherently governmental and whether the private sector can perform the work more efficiently. The language cited by the IRS from the FAIR Act does not bar the IRS from conducting a study to determine whether PCAs are cost effective. The National Taxpayer Advocate does not understand the IRS's resistance to testing its assumptions of cost-effectiveness *before* implementation, given that taxpayer privacy and taxpayer dollars are at risk.

The IRS indicates that its Collection function has not actually suffered a reduction in force as a result of the PDC initiative, and thus, it should not be held to the standards of the government's competitive sourcing process. This may be true, so far; however, we are aware of reductions in force that are occurring throughout the IRS of low-graded employees, capable of being trained to interact with taxpayers. Thus, we have asked the IRS to compare the performance of private collectors with IRS personnel on the same types of cases so that decision-makers can decide who should be making these calls. To date, the IRS has declined, indicating that even with additional resources it will not work these low priority cases. In light of the fact that part of the initiative was for the IRS to learn best collection practices from private industry,[98] this may be the one salvageable lesson learned from this PDC experiment: no case is too insignificant

[98] The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(e), 118 Stat. 1418 (2004), providing in pertinent part:

(7) a measurement plan which includes a comparison of the best practices used by the private collectors with the Internal Revenue Service's own collection techniques and mechanisms to identify and capture information on successful collection techniques used by the contractors which could be adopted by the Internal Revenue Service.

so as not to warrant the expense of a phone call. The problem, of course, is that the IRS wants the private industry to make the calls.

We should not allow the private industry to make these calls. The costs to our tax administration system are too high. These costs, *i.e.*, the cost to customer service, consistency, transparency, and tax compliance, will never show up on the IRS's projected financial statements. The talented IRS professionals working on this initiative may be able to extract some concessions towards customer service; however, the concessions appear to fall far short of the mark. For example, the IRS gives credit for two of the three contractors for having bilingual staff (though we are not sure how many staff members are bilingual, in what languages they are bilingual, and whether their employment is happenstance or by design); however, the IRS would not honor TAS's request to address multilingual services to taxpayers as part of the operational plans so that the contractors could be held accountable.

Lack of Transparency

The issues surrounding the initiative's lack of transparency have continued to evolve even as we complete this report. The lack of transparency of the operational aspects of the private contractors is another significant cost to our tax administration system. In an initial draft of this report, we cited sections of a collection script used by one of the contractors which used psychological tricks during the conversation to get the taxpayers to commit to a payment, which is then followed by a belated Fair Debt Collection Practices Act warning at the end of the conversation. The IRS informed us that private collection agencies had designated the "collection scripts" and operational plans as proprietary and that we could not cite specific portions of the scripts. Following Federal Acquisition Regulations, the IRS requested the agencies to release the information to the public. To date, one agency has agreed to disclosing portions of its operational plan, one gave a qualified response about releasing portions of its plan, and the third contractor refused.

Thus, this initiative has placed into the hands of private collectors the power to determine the extent to which the public will know about their collection practices, as they go about doing the government's work. This is a very significant cost to our tax administration system, which, like the other hidden costs described above, will only increase as the IRS begins dramatically expanding this initiative with its Release 1.2, beginning in January of 2007.

RECOMMENDATIONS

Congress should repeal the private debt collection authority granted to the IRS through the American Jobs Creation Act for the reasons set out above.[99] The initiative risks too much for too little.

[99] Since this recommendation is in essence a legislative recommendation, we have also included the proposal as a Key Legislative Recommendation, *Repeal Private Debt Collection Provisions, infra.*

If Congress does not terminate the initiative, the IRS should be required as part of its biennial reporting process[100] to take steps that will assist decision makers in determining who should be working these cases, *i.e.*, the IRS or the private sector, rather than simply assuming that private collectors should be working these cases since they are "unproductive" for the IRS. To answer this question, the IRS should compare the performance of its own employees with private collectors on the same types of cases. The IRS should also utilize the cost analysis procedures used by its Office of Competitive Sourcing to see how such determinations are made by professionals trained in that area.

If Congress does not terminate the initiative, the IRS should revise its second Request for Quotations (RFQ) process to incorporate some of the important lessons learned in the first RFQ. For example:

- The IRS should mandate public disclosure of operational plans, scripts and training materials of contractors as a condition of competing in the process.
- The IRS should require that the contractors contain operational plans for dealing with taxpayers who speak English as a second language.
- The IRS should require that Fair Debt Collection Practice Act warnings be given at the beginning of each contact and prohibit the use of trickery or device.
- The IRS should hence forth provide direct training on issues relating to taxpayer rights, the Office of Appeals, levies and other topics essential to the collection process, as well as training as to who has an obligation to file tax returns.

[100] The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(e), 118 Stat. 1418 (2004).

PROBLEM

TOPIC #5 EARLY INTERVENTION IN IRS COLLECTION CASES

RESPONSIBLE OFFICIALS

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division
Richard J. Morgante, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The lack of early, meaningful interventions by the IRS on delinquent tax accounts contributes to long-term financial problems for many taxpayers and costs the government billions of dollars in lost revenue.

ANALYSIS OF PROBLEM

Background

The IRS Collection function, which is responsible for collecting delinquent unpaid tax assessments and pursuing tax returns that have not been timely filed, is an essential component of our voluntary compliance tax system. In addition to collecting billions of delinquent tax dollars for the U.S. Treasury, a fair and effective tax collection operation is necessary to ensure every citizen pays a fair share of his or her government's expenses. For millions of American taxpayers, the Collection operation is the face and voice of the IRS.

In the 2004 Annual Report to Congress, the National Taxpayer Advocate identified several essential elements for a collection strategy that would balance the goals of tax collection, taxpayer service, and tax compliance. These elements included the need for prompt human contact with delinquent taxpayers, understanding the reasons for their noncompliance, and identifying the appropriate collection treatment for each taxpayer based on his or her individual characteristics and needs.[1] Over the last several years, the IRS has stressed that tax enforcement plus taxpayer service equates to tax compliance.[2] The National Taxpayer Advocate has consistently emphasized that while enforcement and taxpayer service are critical components of the voluntary compliance tax system, they are not mutually exclusive. In fact, to maximize the effectiveness of its collection program, the IRS must recognize the role of taxpayer service within the context of enforcement and broaden its understanding of all that falls under the tax enforcement umbrella.[3]

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[1] National Taxpayer Advocate 2004 Annual Report to Congress 226-245.

[2] IRS, *Strategic Plan 2005-2009* 3 (Jun. 2004).

[3] Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies (Apr. 27, 2006); Nina E. Olson, National Taxpayer Advocate, Keynote Address, American Bar Association Tax Section (May 5, 2006); Statement of Nina E. Olson, National Taxpayer Advocate, before the United State Senate Committee on Finance on The Tax Gap (Jul. 26, 2006).

While federal tax liens, levies, and seizures are certainly IRS collection tools, so are collection notices, personal contacts by collection personnel, installment agreements, and offers in compromise. For those taxpayers who do not resolve their tax delinquency problems through responses to collection notices, we believe a timely personal contact from an IRS collection employee is a vital action for bringing about compliance. Timely, personal interventions on collection accounts are powerful motivations for taxpayers to resolve tax problems. They are excellent opportunities to ensure that delinquent taxpayers understand the serious financial consequences that can develop if tax debts are not resolved timely. These interventions also represent the appropriate point in the collecting process to identify and resolve issues that have caused the taxpayers to become delinquent, thereby preventing future noncompliance, and to explore meaningful payment options.

IRS case assignment practices do not promote early intervention in collection cases.

IRS methods for establishing the priority of collection cases have traditionally placed primary emphasis on the aggregate dollar amounts of the delinquencies.[4] For example, a taxpayer owing $100,000 will typically receive higher priority than one owing $10,000, while the latter taxpayer will generally be considered a much higher priority than one owing $1,000. While the type of tax at issue may affect the priority of a case – for example, a case involving employment taxes may receive more priority consideration than one involving income taxes -- generally the age of the account does not receive appropriate weight in determining its priority, which in turn plays a critical role in deciding which cases receive personal contacts from IRS collection personnel. As a result, many collection accounts do not receive adequate attention because the taxpayer does not owe "enough" delinquent taxes, at least not yet.

Aggregate dollar amounts of tax delinquencies do not accurately reflect the nature of most IRS collection cases.

Most IRS collection cases originate as relatively small balances due on recent tax periods. In fiscal year 2006, for example, of the collection cases in which the IRS issued a final collection notice,[5] 87.2 percent of individual (Individual Master File or IMF) and 91.5 percent of business (Business Master File or BMF) cases involved delinquencies of less than $10,000.[6] Additionally, 62.9 percent of IMF cases and 76.2 percent of the

[4] IRS, SBSE, *Risk Based Collection* (Mar. 2006), available at http://sbse.web.irs.gov/ACS/Risk_Based/Risk_Based_Collection.htm.

[5] When a tax return is filed and a taxpayer does not fully pay all assessed amounts due, a series of notices are mailed to the taxpayer. The first is a settlement notice advising of a balance due. For individual accounts, when a balance remains on the account up to three additional collection notices will be sent at five-week intervals. Business taxpayers will receive the first notice and in five weeks, the final collection notice. The final collection notice advises taxpayers of the Intent to Levy and is the last notice required before a federal tax lien may be filed. *See* IRM § 5.19.1-3.

[6] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

BMF cases involved less than $3,000.[7] The IRS's emphasis on considering aggregate dollar amounts of collection cases, *i.e.*, the cumulative total of several delinquent tax periods, as a prime factor in establishing case assignment priorities contributes to a lack of meaningful personal contacts with these taxpayers until the delinquency problems "grow" into a pre-defined priority status.

Because of this approach, IRS collection cases often are not given priority consideration, *i.e.*, personal contacts from employees working in the Automated Collection System (ACS) or revenue officers in the field, until the taxpayers accumulate debts on multiple tax periods, a condition commonly known as the "pyramiding of liabilities." The IRS's routine methods for prioritizing and assigning collection accounts in this manner appear to have essentially "institutionalized" the pyramiding of liabilities. At the conclusion of FY 2006, taxpayers with delinquencies whose accounts were assigned to ACS for collection had an average of 1.9 delinquent tax periods, taxpayers whose accounts were waiting in the so-called collection "queue"[8] to be assigned to field personnel had an average of 3.1 delinquent tax periods, and taxpayers whose accounts were assigned to a revenue officer in the collection field operation had an average of 4.2 delinquent tax periods.[9] In the collection field program, 58.2 percent of the BMF taxpayer cases involved three or more delinquent tax periods and 69.3 percent of the IMF cases involved two or more delinquent periods.[10] These conditions not only reflect a problem with pyramiding liabilities, which seems to be built into collection case assignments, but also indicate a considerable passage of time between the origination of the initial debt and the point at which the IRS determines the case requires personal, priority treatment.

Timely, meaningful contacts are critically important in collecting accounts receivable.
It is understood in the business community that accounts receivable become much more difficult to collect the longer they remain delinquent. According to a study by Dun & Bradstreet, the probability of collecting a payment 90 days past due declines by 12 percent for each additional 30-day period.[11] A survey of members of the Commercial Collection Agency Section of the Commercial Law League of America, completed in June 2001, indicates that generally, if an account is 90 days delinquent, only 73 percent of the debt will be collected; at six months only 50 percent will be collected; at 12 months the figure falls to 25 percent; and at 24 months, only 10.5 percent will be collected.[12] In fact, the IRS has also recognized and validated this "collectibility curve" in

[7] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

[8] The IRS collection queue is an inventory of cases awaiting assignment to the Collection Field operation. While these cases are considered to be "open" collection accounts, they remain inactive until assigned to a revenue officer. A case assigned to the collection queue will ultimately be reported as currently not collectible (CNC) if not actually assigned to a revenue officer within a prescribed period of time.

[9] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[10] *Id.*

[11] David Shor and Martin Shor, *How to Collect Debts and Still Keep Your Customers* at 51 (1999).

[12] *Collection Trends* at www.proconsrv.com/colltrends.htm.

a number of studies.[13] These studies acknowledge that on tax debts that are 24 months past due, the IRS typically collects approximately 13 cents on the dollar, and these debts become practically uncollectible after three years.

IRS collection program measures do not accurately reflect the true age of delinquent accounts.

IRS measures designed to track the age of collection accounts generally are not based on the due date of the tax return, but instead track the length of time the account has been assigned to a particular status in the collecting process, *i.e.*, ACS, offer in compromise (OIC), or the Collection Field function (CFf). These measures appear to be designed more to measure the program efficiency of the operation to which the accounts are assigned than to accurately reflect the ages of the delinquent accounts themselves. For example, as of September 2006, IRS reports reflect 18.1 percent of open balance due collection accounts had been assigned to the current collection function for 16 months or longer.[14] However, 65.4 percent of these accounts involved tax periods in 2002 or prior tax years.[15] Consequently, although the IRS acknowledges the "collectibility curve" and the impact of time on the ultimate collectibility of accounts receivable, there is a noteworthy absence of program measures that reflect the age of collection cases from the taxpayer's perspective, *i.e.*, the due date of the tax return.

For example, assume a taxpayer filed a balance due delinquent income tax return for the 1995 tax year in early 2002. Further, assume the case spent several months working its way through the routine collection notice process, a year in ACS, and two years in the collection queue before being assigned to a revenue officer in the collection field operation in early 2006. At the point the account is assigned to a field collection status, traditional IRS measures of "overaged" accounts do not recognize it as an aged account receivable, even though from the taxpayer's perspective the balance has been due for almost ten years. Although the collection potential of this account is likely to be negligible, IRS cycle time measures will indicate the account is not aged.

The accumulation of interest and penalties significantly exacerbates the taxpayer's delinquency problem.

Interest accrues on delinquent tax accounts at a rate of eight percent annually, *compounded daily*,[16] and applies to penalties and interest as well as the outstanding tax

[13] IRS/Booz-Allen & Hamilton, *SB/SE Collections Quick Hits Approach and Preliminary Findings* 30 (Mar. 27, 2001); IRS, *Automated Collection System Operating Model Team, Collectibility Curve* (Aug. 5, 2002).

[14] IRS, *Collection Activity Report, Taxpayer Delinquency Account Cumulative Report, NO-5000-2* (Oct. 2, 2006). The Collection function uses the term "balance due" to describe open collection accounts. In this report, the term is used to describe IRS collection accounts that remained delinquent after issuance of the routine IRS collection notices. In the past, these accounts were called Taxpayer Delinquency Accounts (TDAs).

[15] IRS, *Collection Activity Report, Taxpayer Delinquency Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[16] IRC §§ 6601 and 6621(a)(2). Rev. Rul. 2006-49, 2006 WL 2590501. Interest generally accrues on delinquent tax accounts at the federal short-term rate plus three percentage points.

balance itself. Failure to pay penalties accrue at 0.5 percent per month up to 25 percent of the delinquent balance.[17] When balance due accounts are not addressed and resolved timely, it is not uncommon for penalties and interest to equal or exceed the original delinquencies. Such additional liabilities can make it very difficult for taxpayers to pay both their delinquent taxes and their current liabilities.

Unlike other financial institutions, the IRS does not clearly communicate to taxpayers the true cost of owing money to the government. While the Truth in Lending Act[18] requires lending institutions to inform borrowers of the annual percentage rate (APR) representing the *total* finance charges associated with a loan, no such requirement exists for outstanding federal tax debts. We do not suggest that penalties and interest on tax debt are synonymous with finance charges on consumer loans. However, taxpayers are often stunned by the cumulative impact of penalties and interest (P&I) on their balances due. Taxpayers might be more motivated to seek alternative financing sources if they knew the true cost of "borrowing" from the IRS.

Delayed contacts and insufficient use of alternative payment options result in thousands of IRS collection cases remaining unresolved for prolonged periods of time.

Delayed interventions by IRS collection personnel and insufficient use of reasonable payment options result in many collection cases ultimately being reported as currently not collectible (CNC), or remaining inactive in the collection queue. In either situation, the taxpayers' problems remain unresolved while penalties and interest accrue. For these taxpayers, "no news" is not necessarily "good news." Frequently, the taxpayer must also contend with the impact of the federal tax lien.[19] Aside from the economic burden, lingering financial problems often carry a psychological burden, including a sense of shame, humiliation, and a loss of independence and control over a very important aspect of one's life.[20]

The IRS reports a substantial number of collection cases as CNC each year. In FY 2006, the IRS reported over 750,000 taxpayer accounts as currently not collectible, including more than 1.7 million tax periods and approximately $16.2 billion in revenue.[21] *More delinquent tax dollars were reported as CNC than were actually collected on open taxpayer*

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17 IRC § 6651(a)(2).

18 Truth in Lending Act, 15 U.S.C.A. 1601 et. seq. (West. 2006).

19 IRM 5.16.1.1(4) (Sept.19, 2005), which specifies that "Liens should be filed when the unpaid balance of assessments exceeds the amount in LEM 5.16.1.1(4)."

20 John Bachman, Ph.D, *The Psychology of Debt*, Credit & Collections World (April 2001), available at http://www.creditcollectionsworld.com/04papr01.htm.

21 IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006).

delinquent accounts (TDAs), installment agreement accounts, and offers in compromise combined.[22] Of those accounts reported as CNC, approximately 63.2 percent involved situations in which the IRS decided not to actively pursue collection due to their relative low priority.[23] While technically the IRS may continue to collect delinquent revenue in CNC accounts, historically it has not succeeded in doing so, and data indicates that the IRS actually collects less than two percent of the revenue dollars reported as not collectible.[24] IRS data for FY 2006 reflects over $53 billion of delinquent revenue in the cumulative inventory of accounts reported as CNC.[25] This situation is not one that has recently developed. From fiscal years 2001 through 2006, the IRS averaged $14.6 billion per year in revenue dollars reported as CNC and annually collected less than two percent of the CNC dollar inventory.[26]

As of September 2006, over 779,000 taxpayer cases with balance due accounts resided in the IRS collection queue, and 27.1 percent of the related delinquent tax modules were assigned to the queue for 16 months or longer.[27] Over $27 billion in delinquent tax revenue was associated with these accounts.[28] While theoretically these accounts are inactive and awaiting assignment to the collection field operation, they often remain unassigned and ultimately are systemically reported as CNC once they have been in the queue for a predetermined time.[29] Collection accounts closed in this manner are commonly referred to as "surveyed" or "shelved." According to a report by the Treasury Inspector General for Tax Administration (TIGTA), from FY 2001 through FY 2004 the IRS "shelved" 1.8 million balance due tax modules involving 934,000 taxpayers and

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[22] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006); IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006); IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006); IRS, *Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2005). In FY 2006, approximately $16.2 billion in balance due accounts were reported as CNC; approximately $7.2 billion was collected on balance due accounts that remained open after the routine collection notice process, *i.e.*, Taxpayer Delinquent Accounts (TDAs) and $7.4 billion was collected though installment agreements, *i.e.*, formal agreements between taxpayers and the IRS to pay delinquent taxes through regularly scheduled periodic payments, usually monthly. Approximately $284 million was accepted in offers in compromise.

[23] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006). Of the accounts reported as CNC in FY 2006, 40.1 percent were closed as "surveyed," meaning the IRS decided to curtail further collection activity due to the perceived relative low priority of the collection accounts. Another 23.1 percent were closed as "toleranced," meaning the IRS did not pursue collection activity beyond the collection notice stream. Again, these decisions are based on the relative low priority of the collection accounts.

[24] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006).

[25] *Id.*

[26] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (FY-2001 - 2005).

[27] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[28] *Id.*

[29] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-030, *High Risk Work Is Selected From the Unassigned Delinquent Account Inventory, but Some Unassigned Accounts Need Management's Attention* 4 (Feb. 2006).

balances due of $7.8 billion." [30] The report indicates that the IRS will probably never personally contact a significant number of these taxpayers to resolve their collection-related issues, unless or until their accounts grow into a high priority status.[31]

The IRS often cites limited resources to justify collection inventory delivery practices, yet while current, self-reported accounts are ignored, collection resources are directed to other, less productive cases.

We have already discussed the critical impact of elapsed time on the collectibility of accounts receivable. In light of this very real consideration, it would be natural to expect the IRS to place top priority on addressing current, self-reported delinquent accounts as expeditiously as possible. There is little question that the assessments in these cases are valid, and recognized business practices as well as IRS data indicate that early, timely intervention will recover a high percentage of delinquent revenue. The IRS usually cites a lack of available collection resources as a barrier to providing personal attention to many of these cases.[32] However, we have identified a number of situations where the IRS routinely employs collection resources and achieves questionable results.

We recognize and appreciate the need for the IRS to also pursue compliance cases where the taxpayers have not voluntarily reported their tax liabilities. However, IRS data indicate that the manner in which these "compliance-oriented investigations" are generated and processed often leads to unproductive investigations and wasted collection resources. For example, in addition to recovering delinquent revenue on assessed taxes, the Collection operation also pursues and secures delinquent tax returns. The primary instrument for this purpose is the Delinquent Return (Del Ret) investigation. In FY 2006, the IRS issued approximately 2.4 million Del Ret investigations.[33]

IRS data indicates that during FY 2006, only 38.4 percent of the Delinquency Return modules closed in the field and 42.4 percent in ACS were resolved by actually obtaining delinquent returns.[34] On the other hand, a substantial number of Delinquent Return modules were closed because the taxpayers were determined not to be liable for the returns in question (49.7 percent in the field and 43.5 percent in ACS).[35] The identification and pursuit of delinquent tax returns is an important component of a tax system based on voluntary compliance. However, the methods used to generate delinquent return investigations should be based on reliable indicators that the identified returns

[30] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-030, *High Risk Work Is Selected From the Unassigned Delinquent Account Inventory, but Some Unassigned Accounts Need Management's Attention* 2 (Feb. 2006).

[31] *Id.*

[32] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* (Mar. 2006).

[33] IRS, *Collection Activity Report, Taxpayer Delinquency Investigation Cumulative Report, NO-5000-4* (Oct. 2, 2006).

[34] *Id.*

[35] *Id.*

are legally required and delinquent. Otherwise, the IRS will continue to waste resources that it could apply to servicing the inventory of current, self-identified balance due accounts.

Another means of securing delinquent income tax returns is the Substitute for Return (SFR) program, which uses income reported by third parties, usually via Forms 1099, U.S. Information Return, and W-2, Employee's Wage and Earnings Statement, to establish potential income tax liabilities for taxpayers who have not voluntarily filed returns for the years in question. In theory, the SFR program, particularly the automated version of the program (ASFR), is an efficient method of addressing non-filing. In practice, this compliance program appears to generate a great deal of unproductive work for the IRS. In FY 2006, only about 21.4 percent of SFR dollars assessed were "resolved" during the collection notice process through the collection of revenue dollars. *The IRS abated approximately 3.7 times more SFR tax dollars than were collected on these accounts.*[36]

Another collection tool is the Trust Fund Recovery Penalty (TFRP), which the IRS uses to collect the trust fund portion of employment tax delinquencies in situations involving business entities, usually corporations, which are delinquent in their employment tax obligations. In situations where the corporation cannot pay the employment tax debt, the corporate officers or other responsible parties may be held personally liable for the trust fund portion of the debt.

TFRP investigations, in a manner similar to business-related seizures, represent failure conditions for the IRS. That is, the IRS can generally avoid TFRP situations through early interventions with businesses at the first indication of an employment tax problem. However, the IRS typically makes TFRP assessments long after the underlying employment tax problems have materialized. Although the TFRP provides something of a "safety net" for the IRS in situations where corporate employment tax liabilities are not addressed timely, it does not appear to be an *effective net*. The overall collection results of TFRP investigations underscore the importance of early intervention in employment tax cases. Of the TFRP balance due assessments reported as dispositions in FY 2006, only 18.9 percent were full paid, with another 16.7 percent approved for installment agreements. However, 28.5 percent of these assessments were reported as not collectible *and the IRS abated or reported as CNC over six times as many TFRP assessed dollars as it ultimately collected*.[37] These results should not surprise collection managers. They closely reflect the impact of time and the "collectibility curve."

The "downstream" costs related to delayed collection contacts are significant.

As previously mentioned, there are firm indications in IRS data that delayed meaningful contacts on delinquent collection cases actually contribute to wasted resources by focusing them on inventories that are inflated by multiple delinquent tax periods per taxpayer

[36] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

[37] *Id.*

entity. Routine "assembly line" processing of cases and increased emphasis on automated, "bulk-processing" collection treatments in lieu of personal contacts with taxpayers do not appear to be effective in fully resolving tax delinquency problems, and may actually increase the overall costs involved.

For example, since FY 2000 TAS has observed a marked increase in the volume of levies the IRS has issued, with the vast majority originating from accounts assigned to ACS.[38] We have also noted a corresponding increase in levy-related taxpayer problems referred to TAS.[39] IRS management has confirmed that many of these levies are now issued "systemically," *i.e.*, as cases are assigned to ACS at the conclusion of the collection notice process, the system will generate levies on identified sources before attempting any personal contact with the taxpayers.

While on the surface this practice may appear to be cost efficient, prior IRS studies have concluded that the IRS costs associated with servicing responses to "bad" levies (the taxpayer is no longer employed by the levy source or no longer maintains an account with the identified source) are considerable, not to mention the burden these levies place on the third parties who are required to respond.[40] In addition, several IRS studies have concluded that taxpayers respond to "call me" letters from ACS at a rate comparable to those subjected to levy action.[41]

Levies are powerful collection tools, not "calling cards." Private sector collection operations must secure court orders to effect garnishments of this nature. Levies should not be confused with legitimate attempts to establish personal contact with delinquent taxpayers. Systemic levies bypass the personal communication process completely, move immediately to enforcement, and produce dubious results.[42] Ironically, although the IRS does not emphasize the use of telephonic outcalls as a primary method of establishing contact with delinquent taxpayers, it has recently contracted with several private debt collection (PDC) agencies, who will take precisely that approach to collect delinquent taxes.[43]

We have already discussed the high percentage of abated tax assessments in the ASFR and TFRP programs. Overall, in FY 2006 the IRS abated $7.1 billion on balance due collection cases.[44] Of this amount, $3.9 billion was abated in the Collection Field

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[38] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* 4 (Mar. 2006).

[39] Taxpayer Advocate Service, *Business Performance Review* 49 (Mar. 16, 2006).

[40] IRS, *Automated Collection System Redesign Project*, 9 (Jun. 1998).

[41] *Id.*

[42] *See* Most Serious Problem, *Levies, infra.*

[43] IRS, *Private Debt Collection Talk Points*, available at http://sbse.web.irs.gov/collection/programs/pdc/docs/PDC_talkpoints.doc. *See also,* Most Serious Problem, *True Cost and Benefits of Private Debt Collection, supra.*

[44] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

operation and over $1.6 billion was abated in ACS.[45] Abatements often involve time-consuming, manually generated case actions. Would it not be more practical to apply these resources to early intervention efforts designed to resolve the thousands of collection cases that currently are overlooked each year?

The IRS has already demonstrated the effectiveness of early intervention, yet has not embraced the lessons learned.

The IRS's treatment of employment tax delinquencies is a particularly noteworthy example of how the right treatments applied by the right personnel at the right time can profoundly affect taxpayer service, revenue collection, and compliance. Employment taxes, as reported quarterly on Form 941, Employer's Quarterly Federal Tax Return, are withheld in trust by employers for their employees and paid over to the IRS via federal tax deposits. Because employment tax liabilities accrue rapidly, it is imperative that the IRS react to early indicators that a business is delinquent. Otherwise, employment tax debts can pyramid very quickly, often to a point where the accumulated debt is very difficult for the business to resolve. Employment tax delinquencies tend to start with small quarterly balances. Of the cases in which a final collection notice was issued in FY 2006, 71.1 percent of the business (BMF) employment tax cases involved delinquencies of less than $3,000.[46] Based on dollar amount alone, these early indicators of employment tax problems may not appear to warrant priority attention. However, a focus on dollar amounts alone does not fully capture the impact of delayed contacts in these cases.

In 2001, an IRS collection reengineering team, with assistance from external consultants, studied the processing of employment tax cases. The team confirmed that collectibility on employment tax cases diminishes with age.[47] The team also confirmed that due to limitations built into the ACS system, routine processing of these accounts through assignment to ACS did not fully resolve the majority of the accounts, which led to further aging and pyramiding of liabilities.[48] The study concluded that delayed IRS intervention in employment tax delinquencies creates situations where taxpayers are less likely to resolve tax problems without going out of business or filing bankruptcy.[49]

The team recommended that employment tax delinquencies be handled on a "last due, first worked" basis with highest priority based on the age and type of case rather than the dollar amount.[50] In fact, the team recommended that recently assessed employment tax cases with relatively low delinquent balances due be given the highest priority for

45 IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

46 IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

47 IRS/Booz-Allen & Hamilton, *SB/SE Collections Quick Hits Approach and Preliminary Finding*s 4. (Mar. 27, 2001).

48 *Id.* at 24.

49 *Id.* at 19-21.

50 *Id.* at 5.

expedited assignment to the Collection Field operation.[51] The team projected that such early intervention on trust fund cases would significantly improve revenue collected and protect against further lost revenue by preventing the pyramiding of additional liabilities.[52] Taxpayer service would improve by providing more time and opportunities to resolve tax problems. Further, the team concluded that early intervention would also improve IRS employee satisfaction by allowing revenue officers to intervene in settings that are less confrontational because taxpayers would have a greater capacity to resolve their problems without escalated enforcement.[53] The IRS accepted the team's recommendations in 2001 and implemented them in FY 2002.

The positive results from this effort were almost immediate. By the close of FY 2005, revenue collected by the Collection Field operation had risen by 42.2 percent, contributing significantly to an overall increase in collections of 44.8 percent in IRS balance due cases.[54] Focus group interviews with Collection Field personnel confirmed that "accelerating contact on cases with more current liabilities and less owed has put the Service and the taxpayer in a much better position to reach an amicable resolution. It was also felt that the accelerated contact decreased the likelihood of future liabilities, fostered taxpayer compliance and prevented businesses from failing."[55] Indeed, the impact on compliance was evidenced by more than anecdotal accounts from field personnel. After implementing the new inventory delivery methods, the IRS witnessed a significant decline in the receipt of new employment tax balance due cases from FY 2003 to FY 2005.[56]

A new collection strategy, based on recognizing specific taxpayer needs and characteristics, had been developed and implemented and was generating very positive results. This new approach could have served as the model for similar improvements for other segments of the IRS collection inventory, including those involving individual master file (IMF) cases. Unfortunately, it appears that the IRS has not applied these lessons to other collection cases.

Even more disturbing, in FY 2005 the IRS resumed its practice of assigning more employment tax cases to ACS. It is our understanding that the driving factor behind this change was the perception that small dollar delinquencies are not priority assignments, and should not be assigned to the Collection Field operation until ACS has had an opportunity to resolve them. As a result of the reengineering inventory delivery

[51] IRS/Booz-Allen & Hamilton, *SB/SE Collections Quick Hits Approach and Preliminary Findings* 4 (Mar. 27, 2001).

[52] *Id.* at 21.

[53] *Id.* at 8-12.

[54] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (2001 – 2005).

[55] IRS, *Collection Reengineering Phase I, Joint Implementation Monitoring Committee* (Final Report) 15 (Aug. 2002).

[56] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (2003 – 2005) The IRS reported 1,107,046 balance due module receipts involving employment tax delinquencies (Forms 941) in FY 2003 and 958,179 receipts in FY 2005 – a reduction of 148,867 modules (14 percent).

changes, by FY 2004 only 26.6 percent of the new balance due cases involving trust fund taxes (Form 941) were assigned to ACS. Through September 2006, 36.7 percent of these cases have been assigned to ACS.[57] The inventory delivery impact of the 2001 reengineering recommendations is almost completely reversed. Further, IRS data indicate that the issuance of Failure to Deposit (FTD) alerts, another tool for early identification of employment tax delinquencies, also has been curtailed significantly.[58] Interestingly, IRS data for 2006 indicate that BMF case receipts are again increasing while BMF revenue collections have significantly declined.[59]

Meaningful early interventions in IRS collection cases represent a key element of the "social contract" that serves as a prerequisite for a voluntary tax system.

Tax enforcement and taxpayer service are not mutually exclusive. The concept of voluntary compliance that serves as the foundation of our nation's tax system has at its core an understanding that compliance with the tax laws is based on more than a simple business relationship between each taxpayer and the U.S. government. In a typical business relationship, each party has the clear option to terminate the transaction and take its business elsewhere. If a collection issue becomes too difficult to resolve, a business entity can refuse to provide further goods or services to the customer. In turn, an unsatisfied customer may turn to a competitor who may offer more realistic and convenient payment options.

The taxpayer and the government have no such options. Taxpayers who are delinquent in tax filing and payment obligations are not cut off from receiving federal services and protections. Taxpayers who fall behind in their tax obligations and cannot reach mutually agreeable payment arrangements with the IRS do not have the option of "taking their business elsewhere" and escaping their tax obligations. Within this context, an important outcome of any IRS effort to collect delinquent taxes is the need to bring the delinquent taxpayer back into the ranks of those who voluntarily comply. On the other hand, compliant taxpayers also have an interest in their government consistently addressing problems with noncompliance in a fair and equitable manner.

In their book "How to Collect Debts and Still Keep Your Customers," David and Martin Shor write:

> If the debt collection effort is handled properly, both parties to that process should also remain friends. Remember, your obligation should be to collect the most

[57] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[58] IRS, *Collection Activity Report, Collection Workload Indicators, NO-5000-23* (Sept. 6, 2006). Through August 2006, only 0.4 percent of staff hours devoted to IRS collection operations were spent on FTD Alerts. This is a 68 percent reduction from the number of staff hours used to work FTD Alerts in FY 2003. IRM 5.7.1.1 (Apr. 1, 2005). The FTD Alert process identifies, at an early stage (*i.e.* before the return is due), taxpayers who have fallen behind in their deposits.

[59] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (FY 2005 and FY 2006).

> money as fast as you can, net of expenses, while maintaining the goodwill of the debtor. Keep in mind that most people are honest and intend to pay. On average, 80 percent of the people who owe you money will pay on time; 18 percent intend to pay as promised, but are unable to do so for one reason or another; and 2 percent are "credit criminals" who never intended to pay. Forget the "credit criminals" – you aren't going to collect your money from them anyway. And, you certainly don't have to worry about the 80 percent who are going to pay as agreed. So, almost all of your collection effort will be directed at the 18 percent who have good intentions, but who are unable to pay on time.[60]

The authors' numbers in this passage closely parallel the voluntary compliance rate figures published by the IRS. Most American taxpayers voluntarily file and pay their taxes on time – approximately 83.7 percent, according to the most recent IRS analysis.[61] We do not suggest that the IRS would or should ever "forget the credit criminals" who intentionally engage in fraudulent tax avoidance schemes.[62] Tax debts are very different from other debts, in that taxes are the revenue stream for government. However, the observation that most delinquent accounts represent people with basically good intentions who are struggling to meet their financial obligations in a timely manner is also pertinent to IRS collection accounts. In our routine casework, TAS's experience with taxpayers attempting to resolve problems indicates that most tax collection cases do not involve individuals who set out to deliberately defraud the government. The need to "maintain the goodwill of the debtor" is even more important within the context of good government and tax administration. The concept of voluntary compliance is based on this goodwill.

However, an emphasis on maintaining the goodwill of the debtor does not routinely surface in an objective review of the IRS's traditional policies and procedures designed to collect delinquent taxes, as published in the Internal Revenue Manual. Nor is this concern evident in the IRS's previously described collection inventory delivery system. The traditional IRS "enforcement model" seems to be based on the assumption that collection cases routinely involve taxpayers who are attempting to intentionally avoid their tax obligations.[63] This bias is clearly evident in procedures established for determining the availability of collection payment alternatives, which appear to be designed to ensure

[60] David Shor and Martin Shor, *How to Collect Debts and Still Keep Your Customers* 42 (1999).

[61] Government Accountability Office, GAO-06-453T, *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions* 6 (Feb. 15, 2006).

[62] The IRS does not have a reliable system of tracking taxpayers who have a history of abusive filing behavior or chronic tax delinquency problems. The IRS uses an "R code" to systemically identify taxpayers who have accumulated repeat delinquencies within a specified period of time. However, the IRS applies this systemic coding to any taxpayer with more than one delinquent tax period. Because a single incident can lead to delinquencies in multiple periods, the "R code" does not accurately reflect taxpayers with multiple, distinct episodes of delinquent filing and paying behavior. As a result, this indicator provides limited useful information to assist IRS management in the early identification of high risk collection accounts.

[63] IRS, *Automated Substitute for Return (ASFR) Program, An Analysis from the Customer's Perspective*, (Nov. 1998); *Automated Collection System (ACS) Redesign Project* (Jun. 1998).

that delinquent taxpayers aren't "getting away" with noncompliance.[64] If such options are to be considered, they must represent the taxpayer's *maximum* ability to pay, even though this approach more often than not will result in the denial or failure of such payment options to actually resolve the delinquency problems.[65] In essence, taxpayers who do not resolve their delinquency problems during the routine collection notice process are perceived as potential "credit criminals" and are set up to fail.

The National Taxpayer Advocate believes that the underlying social contract between the federal government and American taxpayers requires that the collection process should routinely set the stage for taxpayers to succeed in resolving their debts. A new model should assume that the majority of taxpayers would sincerely like to resolve their problems and move forward with their lives. Prior IRS studies have supported this assumption,[66] and we have yet to see a study that indicates the majority of IRS collection cases involve "credit criminals." The new model should assume that fear and uncertainty about the IRS may impede many taxpayers' inclination to contact the IRS or respond to routine collection notices. The media attention focused on the IRS's renewed emphasis on tax enforcement in recent years may not lead many of these taxpayers to conclude that the IRS is an agency that will listen to their problems and look for "win-win" solutions. Consequently, recognition of the social contract requires that the IRS more effectively identify those taxpayers who will not likely resolve their own problems through the notice process, and initiate meaningful, personal contacts to address and resolve tax problems when they are most likely to be successful.

We again emphasize that an efficient and effective tax collection operation should be characterized by prompt human contact with delinquent taxpayers, an understanding of the reasons for their noncompliance, and identification of the appropriate collection treatment for each taxpayer based on his or her individual characteristics and needs. This type of taxpayer service within the context of IRS enforcement actions is absolutely essential to maximize the recovery of unpaid revenue while also maintaining the goodwill of the taxpaying public and effectively promote voluntary compliance.

IRS COMMENTS

We agree that the IRS Collection function is an essential component of the tax system and that we must balance the goals of tax collection, taxpayer service, and tax compliance. We also agree that early intervention in collection cases is critical and that personal contact is an important tool for helping taxpayers return to compliance. In striving to contact the greatest number of taxpayers as early as possible in the collection process, we consider the entire Collection system, including our notice process and our campus operations. We have designed our treatments to direct as many taxpayers

[64] *See* Most Serious Problem, *IRS Collection Payment Alternatives*, *infra.*

[65] *Id.*

[66] IRS, *Automated Substitute for Return (ASFR) Program, An Analysis from the Customer's Perspective*, (Nov. 1998); IRS, *Automated Collection System (ACS) Redesign Project* (June 1998).

as possible to the least invasive and least burdensome option possible. We believe that a balance between prompt attention and appropriate treatment streams will ultimately secure payment of as much of the delinquent tax as possible.

Case Selection and Assignment

It is axiomatic that the IRS will never have sufficient resources to work every balance due case. Therefore, there must be a process to select and prioritize cases. The three major components of our selection process are business rules, compliance risk codes, and modeling. Business rules are used to identify areas of special emphasis or policy decisions. The practice of prioritizing or scoring cases by compliance risk began in 1999 and was substantially modified in 2001. The reengineering effort placed additional emphasis on the type of tax and dollar values to stress earlier intervention, especially for employment tax liabilities. The third component of our case assignment uses computer modeling to determine the cases with the highest potential yield. Contrary to the National Taxpayer Advocate report's conclusion, age and tax type are the primary determinates of priority, not the amount of the liability. For example, a new employment tax liability is generally more likely to be selected for assignment than an older income tax liability regardless of the amount owed.

While we contend that our current process strikes an appropriate balance among these factors, we acknowledge that further refinement of this process based on improved technology and better data is a desirable goal. We are currently engaged in an IRS-wide effort to revisit these rules so as to better route cases to the appropriate IRS function. Known as the Corporate Approach to Collection Inventory (CACI), the project expects to match cases to the appropriate treatment stream by supplementing the aforementioned rules with information on the source of assessment (*i.e.*, self-reported or compliance assessments) and the various functions' historical success in resolving different types of cases. Ultimately, we hope this project will result in routing cases in a manner that achieves a better match between case characteristics and employee skill set.

Even the CACI project is somewhat limited in its potential effect because it continues to focus on the characteristics of the tax liabilities. The next, more sophisticated level of analysis is to make case selection decisions based on the characteristics of the taxpayer. The long-term effort to achieve this next level has already begun in the form of Consolidated Decision Analytics (CDA). This will use internal and external data on taxpayer characteristics to better match taxpayers to the treatment stream that will most likely result in meaningful contact and timely resolution of the case.

Currently Not Collectible (CNC)

The statement that *"[m]ore delinquent tax dollars were reported as CNC than were actually collected on open balance due accounts and installment agreement accounts combined"* is misleading because it fails to recognize significant parts of the collection process. This comparison does not include delinquent notice accounts where the IRS is actively pursuing collection through the notice stream. In FY 2006, the IRS collected $8.9 billion on balance

due notice status accounts.[67] The comparison also fails to include dollars collected with returns secured as part of non-filer cases. In FY 2006, an additional $3.9 billion was collected with secured returns.[68]

It is important to note that reporting a case "currently" not collectible does not represent an irreversible decision to write off that case. Cases shelved due to resource constraints can be reactivated as resources permit, and a case placed in CNC status due to hardship may be reactivated if there are systemic indications that the taxpayer's financial condition has improved. In FY 2006, the IRS collected over $400 million on cases in CNC status. That said, we are actively studying CNC rates to see if either case selection processes or the manner in which we work cases can be improved. In spite of a changing mix of work in the field, CNCs as a percentage of dispositions have remained relatively constant–even as CNC rates have declined markedly in ACS. A recent study revealed that over 35 percent of field CNC closures were defunct corporations. This points to a need for better case creation and selection so that scarce field resources are used in a productive manner. We intend to delve deeper into this issue and to continue to refine our business practices accordingly.

Collection Program Measures – Age of Accounts

We acknowledge that, because the reports cited are tactical in nature, they reflect the age of the account within each function, not the total age of the account since date of assessment. Since not all accounts flow through all parts of the process, these reports are specifically designed to reflect the efficiency of each discrete process and are not considered IRS-wide indicators. Potentially Collectible Inventory (PCI) is a corporate-level indicator that tracks the subset of the Unpaid Assessment Inventory that is either actively being worked in Automated Collection, Field, or Notice, or backlogged in the queue. Analysis of active PCI shows that corporate inventory is declining in overall age. The proportion of the inventory that is less than two years old has increased from 43 percent at the close of FY05 to 51 percent at the close of FY06.

Balancing Inventory and Self-Reported Accounts Versus Compliance Assessments

The IRS is focused on reducing the tax gap. An analysis of the most recent tax gap data shows that of the $310.6 billion total tax gap only $31.7 billion, or roughly 10 percent, is attributable to underpayments. We therefore attempt to engage taxpayers who have not filed or who have underreported. We acknowledge that compliance assessments are more difficult to collect and often result in adjustments, but these adjustments represent successfully determining the tax owed from taxpayers who previously failed to file. In

[67] Source: Sept. FY06 CAR 5000-2/242 BDN Report: ALL: National: IMF line 3.1 column G plus IRAF line 3.1 column R plus BMF line 3.1 column N.

[68] Source: Sept. FY06 5000-139 C139 Report, ALL, National, Summary page.

FY 2006 we secured 897,288 returns through our ASFR program. Also in FY 2006, a total of $3.8 billion was collected through active compliance assessments.[69]

Downstream Costs of Delayed Contacts

Regarding concerns about the downstream costs of delayed contact, a large number of the references cited in the footnotes are aged reengineering studies that were published between 1998 and 2001. Subsequently, we made changes in technology and procedures that were not referenced in the National Taxpayer Advocate's report. Examples include increased use of locator sources, modeling for case selection, and the increased use of technology in call routing and predictive dialing for processing ACS accounts. Notably, approximately 90 percent of so called "bad" levies are now resolved through an automated process with no direct employee intervention. We agree that the apparent effectiveness of the "call me" letter in gaining a response warrants considering broader use of this tool when new contact information becomes available.

All of our processes are designed to reduce personal burden by directing taxpayers to the right treatment at the fastest possible time. While a programming error in FY06 artificially inflated the number of business accounts assigned to ACS, we continue to examine our business rules and are committed to ongoing improvement in our ability to intervene early in collection cases.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is pleased that the IRS acknowledges that early intervention is a critical component of an effective collection program, and also recognizes that personal contact in collection cases is an important tool for helping these taxpayers return to compliance. We are also encouraged by the IRS's current efforts to improve its performance in these areas, most notably the Corporate Approach to Collection Inventory (CACI) project. We acknowledge the IRS's candor in recognizing that much more work is needed to develop and implement a collection "treatment stream" that better ensures meaningful contacts and timely resolutions of IRS collection cases. However, the IRS appears not to recognize the severity of the problems created by the delayed interventions that characterize the current collection inventory delivery system. The IRS contends that it is "axiomatic that the IRS will never have sufficient resources to work every balance due case," and implies that only "refinements" are needed to improve its collection inventory delivery system. We respectfully disagree.

The IRS reports that because it has insufficient resources to work every delinquent tax account, it has developed a process to prioritize collection cases, which is based on "business rules," an assessment of "compliance risk," and a projection of "revenue yield." We believe the time has arrived when the "limited resource" issue must be

[69] The IRS did not provide reference sources to substantiate that "$3.8 billion was collected through compliance assessments." Our review of the IRS Collection Activity Reports does not confirm the accuracy of this statistic.

considered in relation to the IRS's inventory delivery system, along with its policies and procedures for handling the collection workload.[70] In other words, we believe the inability to provide timely and effective taxpayer service on IRS collection cases has as much to do with the *manner in which the IRS chooses to process the workload* as it does the size of the workload itself. We are concerned that the taxpayer service concerns raised in this report are hardly acknowledged in the IRS comments. While the IRS does acknowledge the significant impact of the aging of accounts receivable, the IRS continues to track the aging of collection accounts with measures that are not taxpayer-centric. When the "business rules" factored into the current inventory prioritization model result in a situation where taxpayer service issues and concerns cannot be handled as a priority, it is time to change the model.

The IRS comments note that in FY 2006, $8.9 billion was collected on balance due notice status accounts, and an additional $3.9 billion was collected with secured returns. (It should be noted that of the $3.9 billion secured with delinquent returns, over $3 billion – 78 percent – was collected through the routine collection notice stream.[71]) We agree with these observations. Many taxpayers successfully address and resolve their tax debts through the routine collection notice process. However, *some do not*. Collections secured via the routine notice process do not require a significant amount of IRS resources. We again emphasize that of the *post-notice* collection cases closed in FY 2006, more delinquent tax dollars were reported as currently not collectible than were collected on post-notice TDA accounts, installment agreement accounts, *and* offers in compromise *combined*. The IRS's observation that over $400 million collected during FY 2006 on cases in CNC status is hardly a noteworthy accomplishment, in light of the $53 billion in delinquent revenue that was reported in the inventory of CNC cases as of September 2006.[72] When an inventory prioritization model based on revenue "yield" produces these types of results, it is time to change the model.

The IRS claims that "compliance assessments" are important in its efforts to reduce the tax gap, and therefore the investments of collection resources needed to produce them are appropriate. The IRS reports it secured 897,288 returns through the ASFR program in FY 2006. However, as we have already disclosed in this report, only 21.4 percent of the SFR assessments resolved during the collection notice process in FY 2006 were actually collected revenue dollars.[73] The IRS either abated the rest of these assessments or reported them as not collectible. Further, of the delinquent returns secured during FY 2006 through the SFR program, the IRS actually collected only 2.5 percent of the net

[70] National Taxpayer Advocate 2004 Annual Report to Congress 244. In the 2004 Annual Report, the National Taxpayer Advocate stated "the problem of scarce resources does not mean that the IRS should not address the strategic and structural flaws in its collection strategy. In fact, resource limitations may make the need to address those flaws more acute."

[71] IRS, *Collection Activity Report, National Delinquent Return Activity Report, NO-5000-139* (Sept. 29, 2006).

[72] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006).

[73] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (October 2, 2005).

assessments.[74] We have already noted that the vast majority of revenue dollars collected during FY 2006 with delinquent tax returns was secured through the collection notice process. It should also be noted that of the delinquent returns secured outside of the routine notice process, only 5.3 percent of the assessed dollars were actually collected.[75] When an inventory prioritization model based on "compliance risk" produces these types of results, it is time to change the model.

The IRS states in its comments that "All of our processes are designed to reduce personal burden by directing taxpayers to the right treatment at the fastest possible time." Based on the issues identified in this report, we continue to believe the IRS's lack of timely and meaningful contacts with delinquent taxpayers leads to unsatisfactory revenue collections and taxpayer service. Delayed interventions in IRS collection cases set the taxpayers up to fail in their efforts to resolve their debts. These failures are clearly evident in the IRS's collection program results.

RECOMMENDATIONS

We believe the IRS will need to significantly overhaul current practices in this area to improve the benefits generated by its collection programs, and develop taxpayer-centric as well as IRS-centered measures, thereby ensuring the proper of treatment of taxpayers and protecting the public interest. Moreover, Congress needs to provide the IRS collection function with funding for the proper tools, systems, and research that Collection needs to accomplish its job in an effective manner.

1. The IRS needs to revise the methods used to prioritize and assign collection cases to fully recognize the impact of elapsed time on collectibility and taxpayer service. In particular, top priority should be placed on initiating personal contacts on *current* accounts, *i.e.*, tax delinquencies on recently due tax periods involving taxpayers who have not resolved their tax delinquencies through the collection notice process.
2. The IRS needs to tailor the delivery of collection inventory to recognize the differing needs and characteristics of different types of taxpayer cases. The IRS should conduct additional studies to identify opportunities to expedite personal contacts on collection cases, where it is evident such actions are needed for mutually successful resolutions. Are there common characteristics for taxpayers who do not self-correct during the collection notice process? Does it make sense to repeat the collection notice cycle for taxpayers who have had prior delinquencies assigned to ACS or the Collection Field operation? The IRS needs to ask and answer such questions to ensure that collection resources are used in the most efficient and effective manner.

[74] IRS, *Collection Activity Report, National Delinquent Return Activity Report, NO-5000-139* (Sept. 29, 2006).

[75] *Id.*

3. The IRS should expand the practice in employment tax cases of making prompt, face-to-face contact as early in the collection delinquency cycle as possible. This contact will ensure the maximum collection of revenue, prevent future delinquencies, and engage business taxpayers at a point when they have the best opportunity to resolve their tax problems while salvaging their businesses.
4. The IRS needs to more actively incorporate the reality of the "collectibility curve" into the consideration of reasonable collection alternatives, particularly installment agreements (IA) and offers in compromise (OIC), in the resolution of collection cases. IRS data indicate that most tax collection cases age because the lack of meaningful, early IRS interventions allow them to age. While this unfortunate condition continues in collection cases involving tax delinquencies in excess of 24 months, the IRS should establish liberal and flexible IA and OIC acceptance policies.[76] The IRS not only needs to recognize that any recovery of revenue on these accounts "beats the odds" recognized by most business authorities in the area of collection, but must also acknowledge that reasonable payment arrangements are the best opportunity to bring these taxpayers back into the ranks of those who comply with the tax laws.
5. The IRS needs to revise or develop collection program measures that accurately reflect the true age of its accounts receivable. These measures should reflect the age of collection accounts from the taxpayer's perspective, *i.e.*, the due date of the tax return.
6. The IRS needs to develop a more realistic measure of collection "yield" that accurately reflects the recovery of potentially lost revenue. This measure should provide the net revenue collected on accounts that were not resolved through the routine collection notice process, *i.e.*, Taxpayer Delinquent Accounts (TDAs). A measure that reflects TDA dollars collected (including offsets) minus revenue dollars reported as not collectible (CNC) and revenue dollars abated would provide a more accurate assessment of the effectiveness of the IRS collection program, as well as promote case dispositions that provide resolution and closure to taxpayers seeking to resolve their tax debts.
7. The IRS should improve its communications with delinquent taxpayers regarding the accruals of penalties and interest on collection cases. Better communication regarding this issue, delivered early in the IRS collection notice process, may not only reduce the element of surprise for the typical taxpayer regarding the rapid accumulation of penalties and interest on IRS collection

[76] Congress has already made this observation. The conference committee report for the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) states,

> the Committee believes that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the Committee believes that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.

accounts, but might also encourage many taxpayers to more vigorously pursue other financing alternatives, with substantially more favorable finance charges.[77]

8. The National Taxpayer Advocate acknowledges and supports the IRS's efforts to review and revise its collection inventory delivery systems, *i.e.*, the Consolidated Decision Analytics (CDA) and the Corporate Approach to Collection Inventory (CACI) projects. In order to ensure that taxpayer interests and rights are fully incorporated into future plans materializing from these efforts, we recommend that the IRS include the National Taxpayer Advocate in the planning and analysis stages of these projects as soon as possible. We recommend that the issues and suggestions made in this report be incorporated into the development of these projects in a timely and meaningful manner.

Finally, the National Taxpayer Advocate stresses the critical importance of the need for Congress to fully fund these efforts by the IRS to modernize its collection programs. Congress needs to ensure that those who collect revenue for the United States government have the proper tools to perform their jobs effectively. Without adequate resources, the IRS will have a much more difficult time ensuring that all taxpayers receive the most effective collection treatments at the most appropriate times, to allow for the optimum resolution of their cases.

[77] *See also* Additional Legislative Recommendation, *Amend IRC 6511 to Allow Refund Claims Past the RSED When Excess Collection Is Due to IRS Error, infra.*

PROBLEM

TOPIC #6 IRS COLLECTION PAYMENT ALTERNATIVES

RESPONSIBLE OFFICIALS

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Richard J. Morgante, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The IRS does not fully utilize collection payment alternatives, such as installment agreements and offers in compromise, to resolve delinquent tax accounts. This approach means that many account problems are not addressed timely, fostering additional liabilities for the taxpayer and substantial amounts of lost revenue for the IRS.

ANALYSIS OF PROBLEM

Background

The IRS is authorized to use a variety of collection payment alternatives to address and resolve tax delinquency problems. For those taxpayers who are financially unable to immediately pay their tax balances in full, the most important options are installment agreements and offers in compromise (OICs). The IRS collects billions of delinquent tax dollars each year through these collection alternatives.[1] Particularly when emerging tax delinquency problems are identified and addressed in a timely manner, alternative payment options can provide solutions that are in the best interests of both the taxpayers and the government.

In the 2005 Annual Report to Congress, the National Taxpayer Advocate raised concerns that the IRS's methods of determining the potential for utilizing payment alternatives in many situations are overly restrictive and clearly not designed to deliver positive solutions for taxpayers trying to resolve debts.[2] We remain concerned that IRS policies and procedures unduly restrict the use of available collection alternatives, and the IRS's overall approach to evaluating collection potential in delinquent accounts too often fails to provide productive resolutions for many taxpayers' problems.

Installment Agreements – Effective combination of service and enforcement

In general, the IRS has ten years from the date of assessment of a tax to collect the debt.[3] The Internal Revenue Code (IRC) authorizes the IRS to enter into an installment

[1] IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006). In FY 2006, approximately $7.4 billion was collected via installment agreements. *See also IRS Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2005). In FY 2005, the IRS accepted approximately $326 million in offers in compromise.

[2] National Taxpayer Advocate 2005 Annual Report to Congress 270-291.

[3] IRC § 6502 provides that the length of period for collection after assessment of a tax liability is ten years. The collection statute expiration ends the government's right to pursue collection of a liability. Each tax assessment has a Collection Statute Expiration Date (CSED) which is the time period established to collect the delinquent taxes.

agreement (IA), whereby a taxpayer is permitted to pay a liability over time through payment schedules approved by the IRS.[4] If the taxpayer cannot fully pay the outstanding balance by the end of the period when the IRS could legally collect the debt (called the Collection Statute Expiration Date or CSED), but has some ability to make regular payments, the IRS may allow the taxpayer to enter into an agreement based on his or her ability to pay, even though the agreement may not fully satisfy the liability. These agreements are known as Partial Payment Installment Agreements (PPIA).[5] Although penalties and interest continue to accrue, the IRS cannot issue levies while a taxpayer's account is in installment agreement status.[6]

IRS data indicates that installment agreements lead to the collection of nearly as much delinquent revenue on balance due accounts which remain delinquent after completion of the collection notice process as all other collection treatments combined.[7] In fiscal year 2006, the IRS collected $7.4 billion through installment agreements,[8] while collections on all other active Taxpayer Delinquent Accounts (TDA) tax modules amounted to $7.2 billion.[9] These results indicate that the installment agreement is perhaps the most efficient and effective enforcement tool for collecting delinquent taxes. Particularly when a taxpayer does not have the ability to fully pay a tax liability when due, the IA provides him or her an opportunity to voluntarily resolve the debt and removes the need for the IRS to pursue more costly and time-consuming enforcement procedures.

Streamlined Installment Agreements are particularly useful and successful in the collection of delinquent accounts.

The IRS may approve streamlined installment agreements where the aggregate unpaid balance of tax liabilities is $25,000 or less, and can be fully paid within 60 months or prior to the CSED, whichever comes first.[10] These agreements do not require detailed financial statements or approval by IRS managers, and may be granted even though the taxpayer may be able to fully pay the tax balance sooner.[11] In certain situations, the availability of a streamlined IA is guaranteed by statute. The IRC requires the IRS to accept proposals of installment agreements where taxpayers owe $10,000 or less, have

4 IRC § 6159(a).

5 IRC § 6159 was amended by the American Jobs Creations Act 2004 to allow the IRS to enter into installment agreements with taxpayers that do not provide for full payment of the outstanding tax delinquencies.

6 IRC § 6331.

7 When a tax return is filed and a taxpayer does not fully pay all assessed amounts due, the IRS mails a series of notices to the taxpayer. The first is a settlement notice advising of a balance due. For individual accounts, when a balance remains on the account up to three additional collection notices will be sent at five-week intervals. Business taxpayers will receive the first notice, and in five weeks the final collection notice. The final collection notice advises taxpayers of the intent to levy and is the last notice required before a Federal Tax Lien may be filed. *See* IRM § 5.19.1-3.

8 IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

9 IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

10 IRM 5.14.5.2 (Jul. 12, 2005).

11 *Id.*

filed and paid all tax returns during the five years prior to the year of the liability; have not had installment agreements during those five years, and can fully pay the tax liabilities within three years.[12]

The "streamlined" approach is designed to allow taxpayers and the IRS to quickly agree on a payment schedule that is reasonable, realistic, and does not require an in-depth analysis of the taxpayer's finances, as in the case of traditional installment agreements and offers in compromise. As such, the streamlined IA represents a realistic and attainable payment option for many taxpayers. Streamlined agreements accounted for 96.7 percent of all IAs granted in FY 2006, and 96.2 percent of the open IA inventory at the close of the fiscal year.[13] Of the accounts that the IRS closed as full paid during FY 2006 using the installment agreement option, 98 percent involved streamlined IAs.[14] In September 2006, the IRS announced plans to implement a new system that will allow taxpayers to request streamlined agreements online via the IRS's main internet site.[15] While this initiative does not expand the criteria to allow for more streamlined IAs, it will improve taxpayer access to this important collection option and appears to be a positive step toward improving its availability to the public.

Lack of early intervention makes streamlined installment agreements unavailable for many taxpayers

The National Taxpayer Advocate is concerned that despite the successful track record of the streamlined IA, the IRS does not appear to be making optimum use of this collection alternative. In FY 2006, the IRS used installment agreements to resolve only 32.4 percent of balance due accounts[16] and 14.9 percent of field collection cases.[17] At the same time, the IRS closed 31.6 percent of balance due accounts as not collectible.[18] A key factor in the IRS's ability to maximize the benefits of the streamlined IA option is the concept of early intervention. For taxpayers who do not successfully resolve their delinquencies through the routine notice process, prompt personal contacts are critical to starting the problem-solving dialogue at the point where taxpayers can actually qualify for streamlined IAs.

Most IRS collection cases begin as relatively small balances due on recent tax periods, but over time, penalties and interest accrue and additional delinquencies may develop. Of the collection cases in which the IRS issued a final collection notice in FY 2006,

[12] IRC § 6159(c).

[13] IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

[14] *Id.*

[15] Daily Tax Report, *Tax Collection: IRS to Launch Online Tax Payment Procedure For Use By Individual and Business Taxpayers* (Sept. 13, 2006).

[16] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[17] *Id.*

[18] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006), IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Oct. 2006).

87.2 percent of individual (IMF) and 91.5 percent of business (BMF) collection cases involved delinquent balances due of less than $10,000.[19] In theory, most of these taxpayers would qualify for streamlined IAs. In practice, delays by the IRS in making meaningful contacts with these taxpayers increase the likelihood that many will not be eligible for streamlined IAs by the time the delinquencies are actually addressed.[20]

Partial Payment Installment Agreements – A new collection alternative

In April 1998, IRS Counsel determined that the IRS did not have authority to enter into IAs that would not provide for full payment of the taxpayer's liability before the collection statute expired.[21] According to IRS officials, this policy change created a situation in which some taxpayers who were willing to pay some amount would not qualify for either an installment agreement or an OIC.[22] Instead, the only option was to put the account into inactive status, creating a new group of cases for which there was no apparent resolution.[23] In the 2001 Annual Report to Congress, the National Taxpayer Advocate recommended a legislative change to amend the IRC to allow the IRS to enter into installment agreements that do not provide for full payment of the tax liability over the statutory limitations period for collection of tax where it appears to be in the best interests of the taxpayer and the IRS.[24] The IRS drafted another legislative proposal requesting the same change in the law.[25]

The authority to enter into PPIAs was enacted in the American Jobs Creation Act of 2004,[26] and the IRS implemented procedures to allow for these agreements in January 2005. These IAs are intended to provide a collection payment alternative to taxpayers who have the ability to make monthly installment payments but cannot fully pay their liabilities prior to the expiration of the CSED. The PPIA option is intended to bridge the "gaps" between those taxpayers who can fully pay their debts through traditional installment agreements, those who may qualify for offers in compromise, or those with financial conditions that warrant consideration for reporting their accounts as currently not collectible (CNC). The underlying premise behind the PPIA option makes good business sense, *i.e.*, allowing taxpayers who clearly cannot fully pay their debts or qualify for an OIC to pay what they reasonably can over the CSED period.

[19] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

[20] *See* Most Serious Problem, *Early Intervention in IRS Collection Cases, supra.*

[21] General Accounting Office, GAO-02-311, *IRS Should Evaluate the Changes to Its Offer in Compromise Program* 33 (Mar. 2002).

[22] *Id.*

[23] *Id.*

[24] National Taxpayer Advocate 2001 Annual Report to Congress 210-214.

[25] General Accounting Office, GAO-02-311, *IRS Should Evaluate the Changes to Its Offer in Compromise Program* 33 (Mar. 2002).

[26] American Jobs Creation Act of 2004, H.R. 4520, Pub. L. No. 108-357, 118 STAT. 1418 (2004).

The IRS is making limited use of partial payment installment agreements.

The National Taxpayer Advocate is concerned that the IRS's implementation of the PPIA option may have overly restricted its use. Internal Revenue Manual (IRM) procedures and IRS training material regarding the PPIA place a great deal of emphasis on determining the taxpayer's *maximum* ability to pay. For example, the training materials specify that to qualify for a PPIA the "taxpayer must agree to pay the *maximum* monthly payment" (emphasis in original).[27] The IRS will consider only reasonable and necessary living expenses, as defined by the IRS's allowable living expense standards, in determining a taxpayer's potential to qualify for a PPIA, and will allow no transition period for the taxpayer to retire expenses that the IRS finds excessive.[28] The IRM also gives this direction and states, "In most cases, taxpayers will be required to use equity in assets to pay liabilities."[29]

We acknowledge that IRM procedures go to some length to discuss situations in which PPIAs "may be granted even if a taxpayer does not sell or cannot borrow against assets with equity."[30] However, these procedures do not recognize or acknowledge that in many of these cases, the taxpayers will have a very limited ability to access equity in assets without creating an economic burden or hardship. Poor credit histories or a lack of funds to service financial instruments such as home equity loans often restrict a delinquent taxpayer's ability to "cash in" on equity in assets. Moreover, legal restrictions may bar the liquidation of assets. In these cases, it makes sense that the IRS enter into agreements to collect at least those payments immediately available. Nevertheless, the overall tone of the training and procedures used to implement the PPIA seem designed to discourage its use as a viable collection alternative. In fact, the IRS approved only 11,186 PPIAs in FY 2005, representing approximately 0.5 percent of all IAs granted.[31] It is important to remember that *the IRS specifically requested this authority*. Yet to date, it does not appear to be using this collection alternative to anywhere near the degree intended.

Offers in Compromise – IRS public policy not supported by Internal Revenue Manual procedures.

An offer in compromise (OIC) is an agreement between a taxpayer and the government that settles a tax liability for payment of less than the full amount owed.[32] It is the

[27] IRS training document, *Partial Payment Installment Agreements (PPIA), Implementation of Section 843, American Jobs Creation Act of 2004* 12 (Jan. 17, 2005).

[28] *Id.*

[29] IRM 5.14.2.2(2) (Jul. 12, 2005).

[30] IRM 5.14.2.2.2(2) (Jul. 12, 2005).

[31] Data provided by SBSE Collection Policy. The IRS does not routinely track PPIA activity through systemically generated reports, but plans to have this capability in 2007.

[32] IRC § 7122.

IRS's stated policy to accept an offer when it is unlikely that the IRS can collect the tax liability in full and the amount offered reasonably reflects collection potential.[33]

Congress has long viewed the OIC as a viable and reasonable collection alternative. This view is evidenced in the conference report for the IRS Restructuring and Reform Act of 1998 (RRA 98):

> The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.[34]

Despite the clear congressional intent that the IRS more effectively use the OIC as a viable collection payment alternative, the IRS has actually moved the program in the opposite direction. The IRS has significantly tightened its policies and procedures regarding the availability and use of the OIC as a collection alternative since the implementation of RRA 98.

In arriving at this conclusion, we conducted a historical analysis of OIC procedures set forth in the IRM. Our analysis confirms that in 1992, the IRS significantly altered its approach to the use of the OIC as a collection tool. The IRS formally articulated these changes in Policy Statement P-5-100, which was approved on January 30, 1992, and emphasized that

> [t]he Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. An offer in compromise is a legitimate alternative to declaring a case currently not collectible or to a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government.[35]

The IRS also revised IRM procedures to support the new policy and enable the acceptance of OICs in a broader range of situations. For example, consider the following IRM section:

> Rejection of an offer solely based on narrow asset and income evaluations should be avoided. The Service should attempt to *negotiate* (emphasis added) offer agreements which are in the best interests of all parties. Included in determining the government's interests are the costs of collection. If an offer is rejected because

33 IRM 5.8.1.1.3 (Sept. 1, 2005). This section includes IRS Policy Statement P-5-100.

34 IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998).

35 IRM 1.2.1.5.18 (Jan. 30, 1992). This reference provides the IRS's official policy regarding the OIC program, including the full text of IRS policy statement P-5-100.

> more can be collected than is offered, it is generally expected that the amount determined to be collectible *will actually be collected*.[36] (Emphasis added)

Although this 1992 direction seems to reflect the actual intent of the IRS's then new policy, as well as that of RRA 98 six years later, the IRS eliminated it from the IRM in the mid-90's and did not reinstate and reinforce it after RRA 98 became law.

OIC program results do not reflect IRS public policy.

Not surprisingly, a recent IRS study of the OIC program revealed that the majority of delinquent tax dollars in cases involving rejected OICs tend *not* to be collected. The study indicates that over 40 percent of tax modules associated with rejected and withdrawn OICs are ultimately reported as not collectible,[37] with many more remaining unresolved for years in "active" collection status.[38] Of the modules in rejected or withdrawn OICs that were in CNC status, 27 percent of those involving individual taxpayers were *in CNC status while the OIC was being considered*.[39] That is, the IRS *rejected* offers from taxpayers who the IRS had already determined were uncollectible! From calendar years 1998 through 2003, in 44 percent of cases involving rejected OICs from individual taxpayers, the IRS had collected less than 50 percent of the amounts the taxpayers had *offered* to pay.[40] In 31 percent of these cases, the IRS collected less than 10 percent of the offered amounts and in 21 percent the IRS collected nothing at all.[41] These results certainly call into question the degree to which current IRS procedures are aligned with its publicly articulated policy regarding OICs.

Shortly after the implementation of RRA 98, the IRS also revised IRM procedures for determining the valuation of future income in computing each taxpayer's reasonable collection potential. The "present value of future collections" concept, which had been implemented in 1992, was eliminated. This concept, as described in the IRM, stated

> [i]n cases where it is determined that the taxpayer can make installment payments, the Service normally considers that any agreement that requires more than five years to complete has a high probability of not being completed. The Service must then decide the "present value" of those five years of payment. . . . Generally, if the taxpayer can now pay us "present value", we will give serious consideration to accepting the offer.[42]

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[36] IRM 57.10.10.1 (Feb. 26, 1992).

[37] IRS Offer in Compromise Program, *Analysis of Various Aspects of the OIC Program* 10 (Sept. 2004).

[38] *Id.*

[39] *Id.* at 9.

[40] *Id.* at 11.

[41] *Id.*

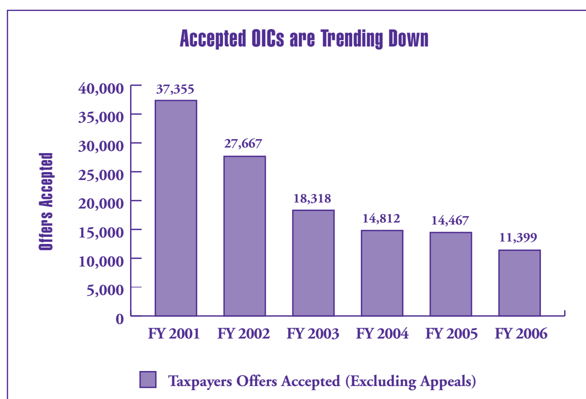
[42] IRM 57.10.10.11 (Feb. 26, 1992).

This pro-taxpayer method of determining the value of potential future tax payments was supplanted by a less taxpayer-friendly change in policy. In early 2000, the IRS revised OIC policy to state that it would not accept offers when the taxpayers could potentially fully pay the liabilities through installment agreements.[43] This change essentially eliminated the "present value of future collections" concept.

Although the IRS has recently clarified its definition of a "protracted installment agreement" as one that will remain in force beyond the collection statute expiration date (CSED), the revised position remains an unrealistic indicator of true collection potential. IRS data indicate the average installment agreement either fully pays or defaults within a year.[44] Within this context, even the projected five-year analysis in the IRS's earlier policy seems overly optimistic. Clearly, however, the approach of extending the likelihood of future collections beyond the five-year period is not based on any realistic analysis of actual results in these types of cases.

The cumulative effect of the aforementioned policy changes has been a significant reduction in the number of OICs accepted as collection alternatives. From FY 2001 through FY 2006, the number of OICs accepted by the IRS Collection operation (excluding those accepted by Appeals) *declined* by over 69 percent.[45]

TABLE 1.6.1, OICS ACCEPTED BY IRS COLLECTIONS FY 01-06[46]



[43] IRM 5.8.1.1.1 (Feb. 4, 2000).

[44] IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

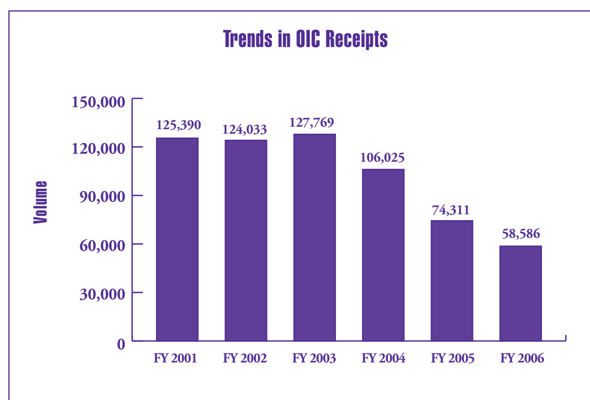
[45] IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108*. In FY 2001, 37,355 OICs were accepted. In FY 2006, 11,399 were accepted. The numbers do not include OICs rejected by IRS Collection and subsequently accepted by Appeals.

[46] IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108*. (FY 2001 – FY 2006).

External stakeholders agree: OIC no longer a viable collection alternative.
The significant reduction in cases where the OIC has been a successful alternative has contributed to a growing perception in the tax practitioner community that the IRS no longer perceives the OIC as a viable collection option. These perceptions were recently reported to the IRS in a series of OIC-related focus groups conducted during the 2005 IRS Nationwide Tax Forums.[47] The IRS received consistently negative feedback in these focus groups, particularly about the IRS's general approach to considering the merits of an OIC as a viable collection alternative. The focus group report concluded that participants mainly felt that the IRS's first task was to find a reason – any reason -- to reject the offer, and the mindset of the (OIC) specialist was "I'm not going to make this work or be viable."[48] Most participants reported they have not had positive experiences negotiating with the IRS. Overall, the participants agreed that offers are not receiving fair consideration. Many felt that the IRS looks for anything to cause an offer to be rejected, and all agreed that, in their opinion, offers are being worked by people who are predisposed to reject them. The practitioners in the focus groups raised a concern that the IRS has "another agenda" that influences the consideration of OICs to resolve tax debts.[49]

More than mere anecdotal reports, the perceptions expressed by practitioners in these focus groups appear to be manifesting themselves in actual taxpayer behavior. The table below indicates that new OIC receipts for FY 2006 will be less than half the number for FY 2003.[50]

TABLE 1.6.2, OIC RECEIPT TRENDS FY 01-06[51]



[47] 2005 IRS Nationwide Tax Forums, *Offer in Compromise Focus Group Report* (Nov. 2005).

[48] *Id.*

[49] *Id.*

[50] IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108.* The IRS reported 127,769 OIC receipts in FY 2003. OIC receipts for FY 2006 were 58,586.

[51] *Id.*

In a 2006 report on the OIC program, the Government Accountability Office (GAO) observed that from 2000 to 2004, the number of accepted offers declined by more than half while the number of delinquent taxpayer accounts remained roughly constant. According to the GAO, this fact raises the question as to whether something has happened to reduce the program's "accessibility."[52] In addition to confirming and supporting the observations of tax practitioners, the GAO analysis underscores the concerns of the National Taxpayer Advocate that the IRS does not employ the OIC option as a viable collection alternative in many situations where it is in the best interests of the government and the taxpayer to accept a reasonable offer.

OIC procedures and program results do not reflect the intent of Congress.
We again refer to the conference report associated with the IRS Restructuring and Reform Act of 1998:

> The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.[53]

Clearly, the IRS did not embrace the intent of Congress. In fact, through a series of policy changes implemented post-RRA 98, the IRS actually appears to have restricted the use of the OIC as a viable collection tool. While the impact of each of these policy changes has been significant, it does not appear that any of them were widely communicated or even discussed outside of Collection prior to implementation. Congress recently passed the Tax Increase Prevention and Reconciliation Act of 2005, which contains provisions with potentially significant impact on the OIC program and the use of OICs as a collection alternative.[54] This legislation requires taxpayers to submit substantial partial payments for offers that will be paid in a lump sum and immediately begin to make the proposed scheduled payments on deferred payment offers.[55] Congress has indicated that these changes will raise an additional $699 million in revenue over five years and $1.911 billion over 10 years.[56] These estimates again indicate the intent of the legislation is for the IRS to make more and better use of the OIC as a collection alternative. However, unless the IRS implements these changes within the spirit of RRA 98 and the IRS's own policy statement regarding the use of offers, which we have

[52] Government Accountability Office, GAO-06-525, *IRS Offers in Compromise* 20 (Apr. 2006).

[53] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2nd Sess., 288-289 (1998).

[54] Tax Increase Prevention and Reconciliation Act of 2005, H.R. 4297, Pub. L. No. 109-222, 120 STAT. 345 (2006).

[55] *Id.*

[56] Daily Tax Report, *Senate Finance Committee Summary of Conference Report on Tax Increase Prevention and Reconciliation Act of 2005* (May 10, 2006).

not found to be the case to date, this new legislation has the potential to substantially curtail the availability of the OIC as a viable collection tool. The National Taxpayer Advocate, along with other stakeholders such as the American Bar Association and the American Institute of Certified Public Accountants, has expressed strong concerns that the implementation of this new legislation will create new barriers to taxpayers applying for acceptance into the OIC program while decreasing revenue to the federal treasury.[57]

IRS financial analysis techniques: Allowable Living Expenses (ALE) and "maximum ability to pay."

In 1995, the IRS developed and implemented the allowable living expenses (ALE) approach to determining a taxpayer's financial ability to pay delinquent taxes. This system was designed to provide more consistency in the financial analysis determinations that serve as the basis for various collection alternatives, including IAs, OICs, CNC determinations, and enforced collection actions. The IRS believed then, as it does today, that without standardized criteria, financial determinations among taxpayers will be inconsistent and lead to taxpayers with similar financial conditions being treated differently.[58] RRA 98 requires the IRS to prescribe guidelines to determine whether to accept an offer in compromise, which in essence codified the Service's use of the ALE.[59]

In the 2005 Annual Report to Congress, the National Taxpayer Advocate raised concerns over the IRS's use of the ALE standards and the wide perception among tax practitioners that the standards are unreasonable and much too rigidly applied.[60] Unfortunately, rather than exploring the outcomes of cases involving the ALE approach to determine the basis for these criticisms, the IRS response to the report focused on reiterating confidence in the data used to formulate the standards. While the IRS asserts that the ALE standards were "formulated to be a reliable indicator of typical individual living expenses" and the "data sources" used in the development of these standards are "impeccable,"[61] the National Taxpayer Advocate remains concerned that the actual application of these standards to *individual* taxpayer cases often leads to erroneous conclusions regarding the appropriate use of reasonable collection payment alternatives.

Allowable Living Expenses (ALE) – "standards" do not reflect reality for many taxpayers.

The ALE standards are based on the average or median expenditures derived from U.S. government data sources, *e.g.*, U.S. Census Bureau or the Bureau of Labor Statistics

[57] Daily Tax Report, *Tax Compliance: Value and Effect of New OIC Requirements Under Debate As Effective Date Approaches* (Jun. 20, 2006).

[58] IRS Office of Research and Analysis, *Evaluation of Current Allowable Living Expense Standards* 1 (Oct.1996).

[59] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3462(a) (1998) (codified at IRC § 7122(c)).

[60] National Taxpayer Advocate 2005 Annual Report to Congress 270-291.

[61] *Id.* at 281.

(BLS), representing broad segments of the population. The IRS contends that the "data contained in the ALE is formulated from statistically valid core data that is 100 percent accurate at the time the information is collected."[62] However, as discussed in the 2005 Annual Report to Congress, the Bureau of Labor Statistics, which is a primary source for the ALE data, advises caution in interpreting its consumer expenditure data when relating averages to individual circumstances.[63] The BLS warns that "expenditures by individual consumer units may differ from the average even if the characteristics of the group are similar to those of the individual consumer unit."[64] Accordingly, the National Taxpayer Advocate remains very concerned with the manner in which the ALE standards are *applied to individual taxpayer cases*. "Standards" based on averages derived from large samples of the population simply cannot be consistently translated directly to *individuals* in a realistic manner.

Moreover, shortly after implementing the ALE standards in 1995, the IRS recognized that the standards did not accurately reflect the actual expenses of many taxpayers, particularly in the key areas of housing and transportation.[65] A study conducted in 1996 by the IRS National Office of Research and Analysis determined that 37.3 percent of all taxpayers had housing expenses that exceeded the allowable standards, and over 65 percent of those with mortgages exceeded the allowable standards by a mean of $938 and a median of $477 per month.[66] The study also concluded that the percentage of taxpayers exceeding the housing standards increased with family size. The majority of taxpayers *with children* exceeded the allowable housing standards – 51.3 percent of taxpayers with families of three exceeded the standards; 60.7 percent with families of five or more exceeded the standards.[67] In transportation, actual operating costs for taxpayers with one vehicle exceeded the standards in 31.3 percent of the study's sample of cases, and 42.6 percent of taxpayers with two vehicles exceeded the transportation operating expense allowance.[68]

These numbers indicate that the ALE standards *frequently* do not reflect reasonable living expenses when applied to individual taxpayer cases. The study also lends credence to feedback routinely received by TAS from practitioners regarding unrealistic ALE allowances for housing and transportation. While the ALE standards are periodically updated to reflect more current data, we are not aware of any significant changes to the

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[62] National Taxpayer Advocate 2005 Annual Report to Congress 282.

[63] *Id.* at 286.

[64] *See* http://www.bls.gov/cex/csxfaqs.htm#q13 (last visited Aug. 23, 2006). The U.S. Census Bureau provides similar cautionary statements about its data. *See* http://www.census.gov/prod/cen2000/doc/sf3chap8.pdf (last visited Aug. 23, 2006).

[65] IRS Office of Research and Analysis, *Evaluation of Current Allowable Living Expense Standards* 8-9 National (Oct.1996).

[66] *Id.* at 8.

[67] *Id.* at 9.

[68] *Id.* at 12.

methodology used in computing the standards since the 1996 report.[69] Clearly, the ALE standard allowances for housing and transportation expenses frequently underestimate reasonable expenses for many taxpayers in key areas of their financial lives. Further, the disconnect appears to be growing even worse. The ALE standards published for use in 2006 actually reflected *reductions* in expense allowances for taxpayers in many parts of the United States.[70]

Allowable Living Expenses (ALE) – "standards" or "guidelines"?

The Internal Revenue Code specifies that application of the ALE guidelines should be based on an analysis of the facts and circumstances of each taxpayer, to ensure that use of the ALE will not result in the taxpayer having less than adequate means to provide for basic living expenses.[71] The usual response from the IRS to concerns regarding ALE standards has been that collection employees are permitted to deviate from the standards in situations where taxpayers can document reasonable and necessary actual expenses in excess of the standards. We acknowledge that several IRM references indicate that the ALE "standards" are actually meant to be used as guidelines, and deviations are allowed when a standard amount is inadequate to provide for a specific taxpayer's basic living expenses.[72] However, these references are buried within IRM sections that indicate collection payment alternative decisions should reflect the taxpayer's maximum ability to pay. IRM direction regarding the correct use of the ALE standards acknowledges that the underlying philosophy behind the ALE approach is to allow only "necessary expenses" that "establish the *minimum* a taxpayer and family need to live."[73] (Emphasis added) Further direction in this area specifies that a deviation from an ALE standard is not allowed merely because it is inconvenient for a taxpayer to dispose of valued assets[74] and "a taxpayer who claims more than the total allowed by the national standards must substantiate and justify *each separate expense* of the total national standard amounts."[75] Is it any wonder that feedback from the public consistently indicates collection employees are reluctant to deviate from the ALE allowances? We are concerned

[69] Subsequent to the 1996 IRS Research study, the IRS revised the standards for housing and utilities to adjust for family size. Effective October 1, 2000, separate housing and utility expenses were provided for families of one or two members, families of three, and families of four or more. However, examination of these new allowances indicate that these adjustments were not adequate to remedy the significant concerns raised in the 1996 study, particularly in regard to taxpayers with mortgage payments.

[70] SB/SE Operating Division Research (Brooklyn/Hartford), *2006 Allowable Living Expenses Project* (Feb. 2006).

[71] IRC § 7122(c)(2).

[72] IRM 5.15.1.7(7) (May 1, 2004). This guidance also appears in the OIC IRM 5.8.5.5.1 (Sept. 1, 2005) and IRM 5.14.1.5 (Jul. 12, 2005).

[73] IRM 5.15.1.7(1) (May 1, 2004).

[74] IRM 5.15.1.7(9) (May 1, 2004).

[75] IRM 5.15.1.8(3) (May 1, 2004). The "national standards" define reasonable amounts for five necessary expenses. Four of them come from the Bureau of Labor Statistics (BLS) Consumer Expenditure Survey: food, housekeeping supplies, apparel and services, and personal care products and services. The fifth category, miscellaneous, is a discretionary amount established by the IRS. It is $100 for one person and $25 for each additional person in the taxpayer's household.

that the few IRM references permitting deviations from the ALE standards are lost within the overall context of the manual, which focuses on determining maximum ability to pay. This approach drives employee perceptions that collection payment alternatives, or any other resolutions that do not require full payment, are to be avoided.

IRS financial analysis often includes unrealistic determinations of realizable equity in assets.

Another component of the financial analysis techniques the IRS employs to determine a taxpayer's capacity to pay a debt is the consideration of equity in the taxpayer's assets. Generally, IRM direction requires that employees use the "quick sale value" (QSV) to determine the portion of a taxpayer's equity in assets available for full or partial payment of delinquent taxes.[76] QSV is defined as an estimate of the price a seller could obtain for the asset in a situation where financial pressures motivate him or her to sell in a short time, usually 90 days or less.[77] The IRM specifically mentions equity in real estate as a means to fully pay or reduce the tax liability.[78] The manual requires that if such equity exists, the taxpayer should be asked to secure a loan or liquidate the asset, further stating that refusal will be considered refusal to pay and appropriate enforcement actions should be pursued.[79]

The IRM does acknowledge that consideration should be given to factors that could prevent the taxpayer from liquidating the asset, such as illness, advanced age, or "other special circumstances."[80] However, this direction does not provide enough guidance to ensure a realistic determination of a taxpayer's reasonable collection potential. Issues such as the taxpayer's credit history, the relative percentage of equity in the property, and the taxpayer's financial capability to repay a loan are essential to the taxpayer's ability to refinance a mortgage or qualify for a home-equity loan. In TAS's experience with these types of cases, many taxpayers with significant tax delinquencies do not have the ability to tap into home equity. In most cases, if the taxpayer does not have the capacity to borrow, liquidating the home will likely create an economic hardship. The ambiguity of the IRM in this area appears to contribute to situations where collection alternatives such as IAs and OICs are denied, and the accounts either remain inactive or are reported as CNC.

The IRS focus on determining maximum ability to pay seems to minimize the actual collection of revenue.

IRS financial analysis techniques do not appear to assist in actually collecting much revenue or resolving many taxpayer collection accounts. IRS data indicates that relatively

[76] IRM 5.15.1.16 (May 1, 2004).

[77] IRM 5.15.1.16(2) (May 1, 2004).

[78] IRM 5.15.1.26 (3) (May 1, 2004).

[79] IRM 5.15.1.26 (3) (May 1, 2004); IRM 5.14.1.5(6) (Jul. 12, 2005).

[80] IRM 5.14.1.5(7) (Jul. 12, 2005); IRM 5.8.11.2.1 (Sept. 1, 2005).

few collection cases are resolved with alternative payment options in situations where these traditional techniques are used. For example, the IRS uses the ALE standards and equity determinations in evaluating the potential for installment agreements in non-streamlined IA situations. However, only approximately 3.3 percent of all installment agreements granted in FY 2006 were not of the "streamlined" variety.[81] Additionally, there are solid indications that IAs based on the ALE analysis tend to default at a much higher rate, *i.e., maximum ability to pay tends to produce payment expectations that are unrealistic and exceptionally difficult to maintain.*

Consider the following: While approximately 96.7 percent of all installment agreements approved by the IRS in FY 2005 were of the streamlined variety, only 27.2 percent of those approved in the Collection Field operation were streamlined.[82] The rest involved the use of the ALE standards. However, 65.1 percent of the field-based accounts removed from IA status in FY 2006 were defaulted agreements, while the servicewide figure was 38.9 percent.[83] ALE standards and equity determinations also are routinely used in evaluating requests for offers in compromise. However, only 17.8 percent of the OIC dispositions made in FY 2006 were accepted offers (excluding those accepted by Appeals).[84]

We have already noted in this report that a significant number of cases involving rejected OICs are ultimately reported as not collectible. These situations represent lost opportunities for the IRS, not only to collect additional delinquent revenue but also to improve taxpayer service and voluntary compliance. As the following table makes clear, the dollars collected through OICs compared to those reported as CNC or assigned to the collection queue inventory seem remarkably few.

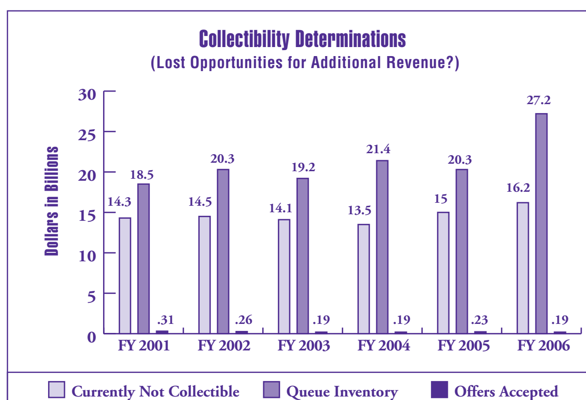
81 IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

82 *Id.*

83 *Id.*

84 IRS, *Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2006).

TABLE 1.6.3, COLLECTIBILITY DETERMINATIONS 2001-2006[85]



In a similar manner, IRS data indicates that during fiscal years 2004 and 2005, in those cases where taxpayers requested installment agreements and the requests were denied, 31 percent were later reported as not collectible. Of those, 52 percent were in CNC status at the time the request for an IA was made.[86]

It seems apparent that any process requiring taxpayers to submit detailed, multi-page financial statements, with reams of supporting documentation, to collectors trained to meticulously scrutinize each asset and expense item to determine "maximum ability to pay" is not designed to actually *collect* delinquent accounts. When compared to the positive results the IRS routinely achieves through its streamlined approach to evaluating installment agreements, the traditional, labor-intensive ALE approach seems inefficient and ineffective. In light of the characteristics of cases where the ALE approach is generally applied, *i.e.*, aged accounts with higher tax balances due, and the fact that the likely outcome of the ALE analysis will be reporting the accounts as not collectible or allowing them to remain unresolved in "active" collection status for prolonged periods, the traditional, more costly approach seems even more questionable. Moreover, this traditional, resource-intensive approach to tax administration fails to provide any type of resolution or relief whatsoever to thousands of taxpayers seeking to resolve their tax debt

[85] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (FY 2001 – FY 2006), IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (FY 2001 – FY 2006), IRS, *Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (FY 2001 – FY 2006). Data reflects the cumulative amount of revenue dollars reported as CNC during each fiscal year, the amount of revenue dollars reported as assigned to the collection queue as of the end of each fiscal year, and the cumulative amount of revenue dollars accepted in OICs during each fiscal year.

[86] IRS, *Accounts Receivable Inventory Report* (FY 2004 and FY 2005). As described in IRM 5.14.1.3, IDRS transaction code TC 971 with action code 043 should be input on tax modules involving taxpayers who have requested installment agreements, and the requests are pending review and approval. Our analysis identified those accounts reflecting the input of TC 971-43 with no subsequent indication of an approved installment agreement, *i.e.*, IDRS status code 60.

problems. The most significant question regarding this issue remains – why has the IRS not revised its methods for determining the collectibility of delinquent tax accounts?

Reasonable Collection Alternatives – Is there "another agenda"?

In our interactions with the IRS regarding reasonable collection alternatives, the Taxpayer Advocate Service has also encountered what practitioners have described to us as "another agenda:"

- The IRS appears very concerned that any increase in the use of collection payment alternatives will hurt voluntary compliance;
- The IRS does not want to appear to be a "lending institution" in the installment loan business; and
- The IRS does not want to settle tax debts through the OIC program in a manner that may encourage abusive use of this alternative.

The National Taxpayer Advocate acknowledges these concerns, but questions the degree to which they are valid in practice. The current rate of interest and penalties, along with the considerable impact of the federal tax lien, do not make an IRS installment agreement an attractive option in any realistic financial plan. Moreover, we are not aware of any study or research indicating that a significant number of taxpayers have deliberately avoided paying their taxes in hopes that they might be able to compromise with the IRS on the amount due.

On the other hand, as of September 2006, over 779,000 taxpayer cases with balance due accounts resided in the IRS collection queue.[87] Over $27 billion in delinquent taxes was associated with these accounts, and almost 27.1 percent of the accounts had been assigned to the queue for 16 months or longer.[88] In FY 2006, over 750,000 taxpayer accounts were reported as currently not collectible (CNC).[89] Of these, approximately two-thirds involved accounts that the IRS decided not to actively pursue due to their relative low priority in the IRS's inventory distribution system rather than a determination of hardship.[90] In light of these conditions, we find it extremely difficult to believe that a more reasonable and flexible approach to using collection payment alternatives would not represent a viable, appropriate resolution for many taxpayers and additional revenue for public use. Table 1.6.4 below reflects the wide disparity between the number of taxpayers who have been successful in resolving tax debt problems through the use of the OIC and those whose problems remain unresolved as accounts reported as CNC or assigned to the collection queue inventory.

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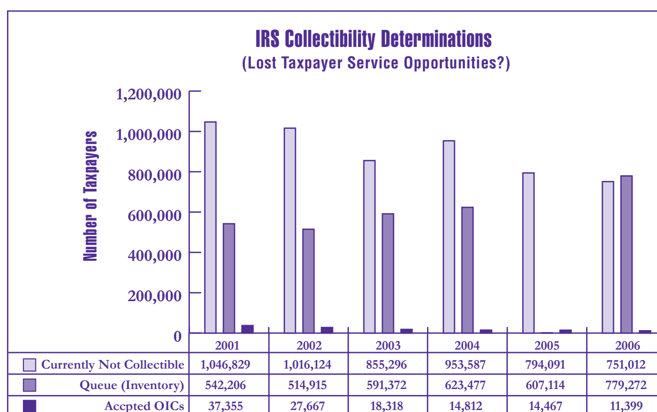
[87] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Apr. 2, 2006).

[88] *Id.*

[89] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149.* (Sept. 29, 2006).

[90] *Id.*

TABLE 1.6.4, COLLECTIBILITY DETERMINATIONS FY 2001-2006[91]



	2001	2002	2003	2004	2005	2006
Currently Not Collectible	1,046,829	1,016,124	855,296	953,587	794,091	751,012
Queue (Inventory)	542,206	514,915	591,372	623,477	607,114	779,272
Accpted OICs	37,355	27,667	18,318	14,812	14,467	11,399

In the 2004 Annual Report to Congress, the National Taxpayer Advocate noted "the IRS collection strategy too often employs a one-size-fits-all approach that does not prioritize person-to-person contacts with taxpayers."[92] In that report, we urged the IRS to place more priority on prompt person-to-person contact with delinquent taxpayers and utilize collection treatments designed to address the needs of these taxpayers. As mentioned elsewhere in this report, we are concerned that delays in the IRS's efforts to provide early, meaningful interventions contribute to long-term financial problems for taxpayers, and ultimately cost the government a significant amount of lost revenue.[93] IRS data indicate that these delays play a critical role in allowing tax debts of many taxpayers to grow into financial problems that are exceptionally difficult to overcome.

Virtually any debt-collection operation, including the IRS, acknowledges that as delinquent accounts receivable grow older, their potential to be collected declines. Yet, it appears that as IRS collection tax cases age, with corresponding increases in balances due, IRS policies and procedures become *more* rigid and make it very difficult for taxpayers to obtain reasonable collection alternatives. The IRS cannot have it both ways. We continue to believe prompt personal contact with delinquent taxpayers, particularly those who remain delinquent after the routine collection notice process, should be the top priority for IRS collection operation. In regard to the hundreds of thousands of IRS collection cases that remain unresolved because this has not occurred, the IRS

[91] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (FY 2001 – FY 2006), IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (FY 2001 – FY 2006), IRS, *Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (FY 2001 – FY 2006). Data reflects the cumulative number of taxpayer cases reported as CNC during each fiscal year, the number of taxpayer cases reported as assigned to the collection queue as of the end of each fiscal year, and the cumulative number of accepted OICs during each fiscal year.

[92] National Taxpayer Advocate 2004 Annual Report to Congress 226-245.

[93] *See* Most Serious Problem, *Early Intervention in IRS Collection Cases, supra.*

needs to provide flexible and realistic collection alternatives to afford taxpayers the opportunities to resolve tax problems in a reasonable manner.

IRS COMMENTS

Consistent with our mission of applying the tax laws with integrity and fairness to all, the IRS generally expects that all taxpayers will pay the total amount due, regardless of amount. When attempting to resolve a tax delinquency, the IRS works with taxpayers to achieve full payment of all tax, penalty, and interest imposed by Congress. Where payment in full cannot immediately be achieved, the IRS may, and often does, allow taxpayers to pay over time through an installment agreement. If full payment cannot be achieved even over time, or would cause the taxpayer economic hardship, the IRS recognizes that it is both sound business practice and good tax policy to settle some cases for less than the total amount due. The IRS actively continues to increase taxpayer access to appropriate alternative payment options such as installment agreements and offers in compromise, but it is committed to doing so within this overall collection framework.

Installment Agreements and Currently Not Collectible Determinations

The IRS used installment agreements in over 2.77 million cases in fiscal year 2006, an increase of nearly five percent over the number of agreements granted in FY05. Almost 97 percent were streamlined installment agreements. Over 1.52 million taxpayers paid their agreement balances in full within 60 months in FY06. Although our resources do not permit us to make personal contact in every case as soon as a tax delinquency arises, the Form 1040 package advises taxpayers how to request an installment agreement if they cannot pay the tax in full when they file their return. Instructions on how to apply for an installment agreement are provided in every balance due statement the IRS issues, on the IRS.gov website, and in various publications. The IRS recently made available the Online Payment Agreement internet application to allow qualifying taxpayers to submit streamlined installment agreement requests online. Many smaller accounts comprise the inventory that will receive personal contact through our Private Debt Collection initiative. The IRS initiated a test to explore having telephone assistors attempt collection of cases of liabilities up to $100,000 that otherwise might not be prioritized in field inventory. In field collection operations, we recently expanded the field authority for granting In-business Trust Fund Express agreements from $1,500 to $10,000, to increase the availability of this alternative resolution.

While the IRS clearly prefers to receive payment rather than suspend collection on accounts, the Currently Not Collectible (CNC) figures cited by the National Taxpayer Advocate do not represent the refusal to consider alternative payment options. The designation of CNC refers to a broad range of cases the IRS decided to remove from active inventory for a variety of reasons. CNC includes lower priority cases shelved for lack of resources, either after being worked extensively in ACS or being modeled as low-yield. This number is declining both in real terms and as a percentage of total cases reported CNC. In FY06, the number of shelved cases declined 21 percent in terms of

modules and 32 percent in terms of total dollars. More than 30 percent of the remaining modules reported in FY06 were determinations that collection action, including use of payment alternatives, would impose a hardship on the taxpayer.

The Partial Payment Installment Agreement allows a taxpayer to make payments against a tax debt when the payment schedule will not fully pay the liability prior to the expiration of the collection statute and compromise is not a viable alternative. In FY06, the IRS granted 13,328 partial payment agreements. While a recent review indicates that these agreements are being granted in exactly the circumstances that were intended, it is difficult to determine whether additional opportunities were missed, and, more importantly, whether more effective use of this tool would have resulted in more collected. This authority is relatively new and we will continue to explore appropriate uses for this type of agreement.

Financial Analysis and Allowable Living Expenses

The IRS agrees that it is important to accurately analyze individuals' ability to pay delinquent tax debts. Only slightly over 18 percent of installment agreements granted after financial analysis defaulted, while nearly 23 percent of streamlined agreements defaulted during the same period. As the National Taxpayer Advocate states, field cases in which IRS applied rigorous financial analysis resulted in the granting of only 3.3 percent of all IRS installment agreements concluded in FY06. The small number of installment agreements granted after a financial analysis was performed in the field reflects the focused application of professional resources on the minority of collection cases most resistant to resolution. Application of IRS financial analysis techniques to this select inventory results in a variety of resolutions that include installment agreements as only one possible option.

In determining the ability to pay in a consistent manner, the IRS uses a calculation based on what average citizens in a given income bracket spend on basic necessary living expenses, established using government survey data. While no set of standards can be expected to fit every individual circumstance, our procedures allow employees the flexibility to deviate from the standards to provide taxpayers adequate means to meet living expenses. We recently undertook a research project to explore whether the methodology used to develop allowable living expenses should be changed. Research conducted into application of the standards found that IRS employees will deviate from the standards when considering necessary living expenses. For example, IRS employees allowed housing and utility expenses that exceeded the applicable standard in 41 percent of 10,864 cases sampled. In fact, 50 percent of the taxpayers in this sample actually claimed less than the current allowable housing standard. We continue to focus our efforts on both improving the accuracy of the standards themselves and improving use of the standards so that they are not applied in an overly rigid manner.

Offers in Compromise as a Collection Alternative

The offer in compromise program is an important alternative for taxpayers that are not able to pay in full. The policy and procedures that the IRS has in place are intended to make the program accessible to those taxpayers that qualify. We have made continuous improvement to our procedures to ensure that taxpayers receive a decision on their offer in compromise in a timely manner. A recent GAO study positively acknowledged the changes we have made to the program such as improved forms, instructions, policies, and procedures. The offer program is not a viable resolution for all taxpayers and, as a result, we have adopted a number of communication strategies to educate the public about the offer program. Through education and public outreach, taxpayers now have a better understanding of who qualifies for an offer and are less likely to submit an offer that is not processable as evidenced by a 26 percent reduction in not processable offers since FY05.

We measure compromise program results against a variety of indicators, not just the number of offers received or the number accepted. We are concerned that focusing on the number of offers accepted does not adequately address our objectives of timeliness, quality, and efficiency. We believe acceptances should be based on a quality analysis of each case. A recent TIGTA study found that in 187 cases reviewed, the final decision on rejected or withdrawn offers was correct in 100 percent of the cases. The acceptance rate that is used by the National Taxpayer Advocate to calculate the percentage of offers accepted (17.8 percent) is not reflective of how the program measures acceptances. The acceptance rate has actually increased from 21 percent in FY05 to 23 percent in FY06. More importantly, when a taxpayer provides all the information that the IRS needs to fully investigate the offer, our acceptance rate in FY06 was 42 percent.

Offer in Compromise - Collection When an Offer Has Been Rejected

In many instances, rejected or withdrawn offers are placed in a currently not collectible status. The National Taxpayer Advocate is concerned about the number of rejected, returned, or withdrawn offers that are reported as not collectible. The IRS is also concerned about this issue and is exploring ways to address this concern.

We continue to disagree, however, with the National Taxpayer Advocate's analysis of the number of tax modules associated with rejected and withdrawn offers that are ultimately reported as not collectible. To reach 40 percent, the National Taxpayer Advocate looked at the CNC rate of one year's worth of data (1998) at the six year mark. In other words, of all of the modules that were rejected/withdrawn *in 1998*, 40 percent were closed as CNC in 2003. This data does not support the argument that it is unfair for the IRS to reject an offer that we ultimately determine is not collectible because it does not consider collection activities that may have occurred after the OIC was rejected or withdrawn and before the CNC closing.

The Office of Program Evaluation, Research and Analysis (OPERA) September 2004 analysis of the compromise program indicated that the IRS does succeed in collecting

a significant portion of rejected, withdrawn or returned offers. The OPERA data looks not just at the CNC for one year's worth of data, but at a snapshot of the CNC rate of all rejected/withdrawn OICs over the entire six-year period. In other words, of all of the modules that were rejected/withdrawn *between 1998 and 2003*, 20 percent were closed as CNC in 2003. This methodology better reflects the disposition method subsequent to rejected/withdrawn OICs. Further, a more recent TIGTA report validated that the IRS does act to collect when attempts to reach a compromise are not successful. TIGTA found that in a sample of 100 rejected offers, subsequent collections exceeded the offer amounts by approximately $272,000.

We do, however, agree that more can be done to address those cases where an offer is rejected because more can be collected than offered. To this end, we have piloted a Special Case Unit or "Hand-off" unit in the Brookhaven COIC site. The unit was designed to evaluate and recommend a process that will help the IRS maximize the financial information gained during the offer in compromise process.

Offer in Compromise – Program Accessibility

We are concerned about the perception among taxpayers and practitioners that the offer program is not "accessible." In response to declining receipts, we conducted a test of whether letters targeted to taxpayers with older liabilities and a recent history of compliance would lead those taxpayers to enter into installment agreements or make reasonable offers. Results of that test are pending and should help us to be pro-active in identifying appropriate installment agreement and compromise candidates in the future.

Information received in the Nationwide Tax Forum shows that tax practitioners value timeliness in the offer process, and timeliness encourages participation in the program. We have taken numerous actions to improve the processing of offers to ensure that taxpayers receive a prompt and quality decision on all offers submitted. For example, we revised the Form 656 to include detailed step-by-step instructions on how to complete an offer, a processability check sheet, a worksheet to determine an acceptable offer amount, and what the IRS needs to fully evaluate the offer. Subsequent to the Form 656 revision, processing time and age of inventory has been reduced. In FY04, 35 percent of the total inventory was more than six months old with 13 percent of the inventory over 12 months old. In FY06 only 20 percent of the year-end inventory was over six months old and only five percent of the inventory was over 12 months old. Cycle time has improved as well with 70 percent of the investigations being resolved within zero to nine months.

The Nationwide Tax Forum coupled with our recent Customer Satisfaction Survey has given us valuable feedback. We have made several changes as a result of this feedback and will continue to make improvements going forward.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes that the IRS has utilized the installment agreement (IA) collection tool to assist millions of taxpayers in resolving delinquent tax debts. Specifically, the "streamlined" installment agreement process seems to be a particularly effective mechanism that allows taxpayers and the IRS to quickly "get to yes" on fair, mutually agreeable payment plans. We applaud the IRS's recent actions designed to increase the availability of this payment option to more taxpayers, *i.e.*, the Internet-based Online Payment Agreement and the increased availability of the Trust Fund Express agreements for business taxpayers. However, while the IRS acknowledges that it is good tax policy to "settle *some* cases for less than the total amount due (emphasis added)," we continue to be concerned that current IRS policies and procedures are designed with a frequently unrealistic "full payment or nothing" perspective that is clearly evident in IRS collection program results. Consequently, the use of collection options such as the offer in compromise and partial payment installment agreement are becoming practically non-existent.

We have noted that of the approximately 2.7 million streamlined IAs granted by the IRS in FY 2006, only 25 percent involved Taxpayer Delinquent Accounts (TDAs) assigned to Collection's public contact employees, *i.e.*, the Collection Field function or the Automated Collection System (ACS).[94] In fact, only 0.4 percent of all streamlined IAs granted in FY 2006 involved accounts in the Collection Field status.[95] Although the streamlined IA appears to be one of the IRS's most effective methods for collecting delinquent revenue, its use outside of the routine collection notice process appears to be limited. The IRS reports it granted 13,328 partial payment installment agreements in FY 2006.[96] This represents less than 0.5 percent of all IAs granted during the fiscal year, which is approximately the same rate as in FY 2005.[97] The IRS specifically petitioned the Congress to pass legislation that granted the authority to accept PPIAs, yet, in practice, the use of this collection tool has been negligible.

[94] IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006). Of the 2,678,897 streamlined IAs granted in FY 2006, 9,801 were taken by the Collection Field function, 630,342 by ACS (excluding the ACS VRU automated system), and 32,103 involved accounts assigned to the Collection queue inventory. For the purposes of this report, it was assumed the IAs involving queue accounts were taken by Field or ACS employees. On the other hand, 1,017,433 streamlined IAs were granted by Customer Account Services employees via toll-free telephone contacts, 881,878 were granted on collection notice accounts by collection employees working at campus locations, and 56,371 were granted by Walk-In and W&I Field Assistance employees. We also note that the IRS walk-in and field assistance operations granted 64 percent more *total* IAs in FY 2006 than were given by revenue officers in the Collection Field operation.

[95] IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

[96] We note that the IRS comments to this section of the Annual Report to Congress did not cite any reports or supporting documentation. Consequently, in most instances, we were not able to validate the data provided by the IRS to support its positions.

[97] Data provided by SB/SE Collection Policy. The IRS does not routinely track PPIA activity through systemically generated reports, but plans to have this capability in 2007.

While the IRS publicly states that the offer in compromise is "an important alternative for taxpayers that are not able to pay in full," and that the "policy and procedures that the IRS has in place are intended to make the program accessible to those taxpayers that qualify," the fact remains that these very policies and procedures have reduced the productive use of this important collection option almost to the point of extinction. The IRS Collection operation accepted only 11,399 OICs during FY 2006.[98] This represents a 69 percent reduction since FY 2001, with the number of accepted OICs declining in every fiscal year since FY 2001.[99]

The IRS contends that reviews by internal quality review staff, as well as TIGTA, have confirmed that final decisions on rejected and returned OICs have been "correct." We note that these types of reviews generally focus on the correct application of IRS policies and procedures, *i.e.*, did the taxpayers meet the "qualifications" established by the IRS that govern the acceptability of the offers? These reviews do not typically reveal whether the OIC case decisions were in the long-term best interest of the taxpayers and the U.S. government. In consideration of the more than 750,000 taxpayers whose accounts were reported as uncollectible in FY 2006,[100] as well as the more than 779,000 taxpayers whose accounts remained inactive in the collection queue inventory at the close of the fiscal year,[101] we must question the reasoning behind the current set of rules that determine "taxpayers that qualify" for an accepted OIC.

We respectfully disagree with the IRS's interpretation of the 2004 SB/SE - OPERA analysis of OIC results, which was based on data representing all OICs closed from October 1998 through July 2003. In fact, this analysis did not involve a sample; it included every closed OIC during this six-year period. The data indicates that over time, more than 40 percent of rejected and withdrawn OICs will ultimately be closed as CNC.[102] Also, the study revealed that of the tax modules in rejected or withdrawn OICs that were in CNC status, 27 percent of those involving individual taxpayers were in CNC status *while the OIC was being considered.*[103] Contrary to the IRS's comments, these results are clearly indicative of the IRS's refusal to consider alternative payment options in appropriate situations.

The IRS's reading of the 2004 study, as reflected in the IRS comments to this report, evidences a failure to acknowledge the significantly negative impact the passage of time has on the successful collection of accounts receivable. We note, however, that

[98] IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2006).

[99] *Id.*

[100] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006).

[101] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[102] IRS *Offers in Compromise Program, Analysis of Various Aspects of the OIC Program* 10 (Sept. 2004). This analysis includes modules reported as currently not collectible (CNC), modules that became not collectible due to the expiration of the 10-year collection statute (CSED), and modules that became not collectible because they involved taxes that were discharged in bankruptcy proceedings.

[103] IRS Offers in Compromise Program, *Analysis of Various Aspects of the OIC Program* 9 (Sept. 2004).

the IRS places a great deal of emphasis on the improvements in the overall age of the OIC inventories and on the reduction in length of time needed to complete OIC investigations. While we agree that timeliness matters to both taxpayers and their representatives, taxpayers also want a positive resolution of their tax problems. As it stands today, the IRS's "timeliness" means "getting to no" on OICs much quicker than it has in the past.

As IRS collection accounts age, the agency's collection policies and procedures make it much more difficult for taxpayers to work with IRS collectors to reach mutually agreeable and beneficial payment solutions. Rather than recognize taxpayers who do not successfully resolve tax debt problems through the collection notice process as a market segment most in need of personal contacts and flexible payment options to get back into compliance, the IRS categorizes these taxpayers as "cases most resistant to resolution." We believe this approach contributes to collection program results that should concern policymakers and taxpayers alike. Consider the following: in FY 2006, the IRS collected a total of $7.2 billion on open TDA accounts, excluding payments from installment agreements.[104] However, during this same fiscal year, the IRS reported $16.2 billion as CNC, and abated $7.1 billion in open TDAs.[105] At least on the surface, it appears the IRS's "overall collection framework" is losing money.

The aforementioned 2004 OIC study also identified a very significant aspect of the program that the IRS rarely mentions – namely, the taxpayer's promise to remain in compliance. Approximately 80 percent of the taxpayers who had their offers accepted remained in compliance with their filing and paying compliance requirements during the five-year post-OIC monitoring period.[106] A subsequent review by TIGTA confirmed that "taxpayers generally do remain in compliance when offers are accepted." In fact, of the sample of cases included in the TIGTA review, 96 percent of the taxpayers were in compliance with the OIC payment terms and the five-year post-OIC compliance requirements.[107] TIGTA's review also indicates that these taxpayers tend to remain in compliance after the five-year monitoring period has concluded.[108] The IRS continues to undervalue the significant compliance benefits achieved through OICs and installment agreements.

[104] IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[105] IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006); IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

[106] IRS Offers in Compromise Program, *Analysis of Various Aspects of the OIC Program* 6 (Sept. 2004).

[107] Treasury Inspector General for Tax Administration, Ref. Number: 2006-30-100, *The Offer in Compromise Program is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes* 7 (Jul. 2006).

[108] *Id.*

RECOMMENDATIONS

We believe the underutilization of available collection payment options results in lost opportunities for the IRS to improve revenue collections and compliance through improvements in taxpayer service. In order to correct this situation, the IRS needs to revise the policies and procedures governing the use of these options with more realistic and reasonable expectations regarding their use.

1. The IRS should revise its current policies regarding the use of reasonable payment alternatives, *i.e.*, installment agreements, partial payment installment agreements, and offers in compromise. Policy guidance should clearly set expectations that in situations involving interactions with taxpayers seeking payment resolutions for tax delinquencies, the IRS will approve a payment option that is reasonable and realistic, unless the taxpayer represents a "won't pay" situation where enforcement actions are necessary to collect the appropriate amount of revenue. Moreover, taxpayers who are engaging in discussions of payment options should be viewed as individuals who are "trying to pay," but need the assistance of their government to return to the ranks of the compliant.
2. IRS policy should clearly state that a determination of reasonable collection potential (RCP) in any given collection case represents the amount the IRS actually and realistically expects to collect. IRS program results, including quality reviews of collection casework, should be evaluated on a regular basis to validate that case outcomes are based on reasonable and realistic RCP determinations.
3. In recognition of the negative impact of elapsed time on the collectibility of delinquent accounts receivable, the IRS should establish liberal and flexible installment agreement and offer in compromise acceptance policies for collection cases involving tax delinquencies that have aged more than 24 months from the due date of the tax liabilities.
4. The IRS needs to review and revise Part V of the Internal Revenue Manual and collection training materials to ensure that IRM procedural direction clearly reflects and supports IRS policy regarding reasonable payment alternatives, with particular emphasis on the sections involving offers in compromise (IRM 5.8), installment agreements (IRM 5.14), and financial analysis (IRM 5.15).
5. In consideration of OICs, the IRS should redefine "protracted installment agreement" as one that extends beyond five years, or the time remaining on the CSED, whichever is shorter. The IRS should reinstitute prior IRM direction regarding the "current value of future payments" in considering the reasonable collection potential of future installment payments for cash OICs.
6. The IRM should provide revised guidance involving the consideration of equity in assets in determining reasonable collection potential. The consideration of equity should realistically reflect the true potential for the taxpayer to secure

funds based on available equity, without creating undue economic hardship. The new IRM should provide sufficient guidance to ensure the determination of a taxpayer's realizable equity in assets is realistic, and address such issues as the taxpayer's credit history, the relative percentage of equity in the property, and the taxpayer's financial capability to qualify for and repay a loan.

7. The IRS needs to provide more clarity and direction in IRM procedures and collection training materials regarding the use of the allowable living expense (ALE) allowances as guidelines to be used as the starting point for determining a taxpayer's reasonable living expenses, and that deviations from the ALE allowances will commonly be required to reflect a realistic determination of individual taxpayer's ability to full pay a tax liability or to qualify for a collection payment alternative.
8. The IRS should develop reliable, systemic indicators for collection cases that more accurately identify "repeat delinquent" taxpayers who repeatedly seek to resolve delinquent tax accounts via collection alternatives such as offers in compromise and partial payment installment agreements, or who repeatedly default on installment agreements. IRS concerns about misuse of collection payment alternatives would be better addressed through more reliable methods of identifying taxpayers who have actually demonstrated these "high risk" tendencies.
9. The IRS should develop and implement a new "compliance" measure that routinely and accurately tracks taxpayer filing and paying compliance behaviors subsequent to entering into collection payment alternative agreements. Particularly in situations where the agreements will not result in the full payment of the outstanding tax liabilities, *e.g.*, OICs and PPIAs, the post-treatment compliance behavior of these taxpayers is a critically important component of the agreement. Any meaningful discussion regarding the use of OICs and PPIAs is incomplete without addressing the impact these agreements have on future taxpayer filing and payment compliance.
10. The IRS should reevaluate its current policies and procedures governing the use of collateral agreements in conjunction with accepted OICs. Properly designed collateral agreements can mitigate concerns that the IRS may have in entering into collection payment alternative agreements that will not result in full payment of the outstanding tax liabilities. We understand that the IRS has resisted the idea of expanded use of collateral agreements primarily due to costs associated with monitoring the agreements. In consideration of the large number of delinquent tax accounts currently reported as not collectible, which could potentially be resolved through improved utilization of the OIC, we believe these concerns are "penny wise and dollar foolish." However, we believe the costs associated with monitoring collateral agreements could be at least partially offset by implementing an additional OIC user fee for accepted offers that include collateral agreements.

PROBLEM

TOPIC #7 LEVIES

RESPONSIBLE OFFICIALS

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division
Richard J. Morgante, Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

In fiscal year (FY) 2006, the IRS served 3.74 million notices of levy upon third parties, an increase of over 36 percent from FY 2005.[1] The IRS issues these levies while making minimal efforts to personally contact taxpayers or identify those who might face the greatest risk of economic hardship. The IRS does not apply adequate screening procedures or filters, or require its employees to diligently research existing and future hardship indicators. Instead, the IRS has heightened its emphasis on systemic acceleration of the levy process, which reduces personal contact with the taxpayer before and after the levy is imposed.

The National Taxpayer Advocate recognizes the IRS's need to utilize automation to perform enforcement activities more efficiently. However, we are concerned that this automation comes at the expense of quality taxpayer service. We have identified four main issues that the IRS levy program must address to maintain the proper balance of service and enforcement:

- Accelerated issuance of levies without an attempt at personal contact;
- Systemic issuance of levies without an appropriate screening filter;
- Reliance on ineffective levy release and refund mechanisms and procedures; and
- Downstream consequences of levy actions.

ANALYSIS OF PROBLEM

Background

A levy is a legal seizure of property to satisfy a tax debt.[2] The IRS levy program is a necessary means of collection, and when used appropriately is a fundamental component of tax enforcement. Per IRC § 6331(a), if a taxpayer does not pay a tax liability in full or otherwise come to an agreement to resolve the matter, the IRS may levy against

[1] IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies- NO-5000-23-240* (Oct. 2, 2006); IRS, *Statistics of Income (SOI), Tax Stats 2005*; Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* (Mar. 2006). FY 2005 data shows that 2,743,577 levies were served while FY 2006 data shows 3,742,276. There are two levy notices issued by the IRS to third parties: Form 668-W, Notice of Levy on Salary, Wages, and Other Income and Form 668-A, Notice of Levy. Form 668-W is used to levy an individual's wages, salary or other income (including income owed the taxpayer as a result of personal services in a work relationship). Form 668-A is used to levy other property that a third party is holding for an individual or business (*e.g.*, bank accounts and business accounts receivable).

[2] IRC § 6331 provides the IRS with statutory authority to levy funds held by a third party.

any property (or right to property) that belongs to the taxpayer or is subject to a federal tax lien, unless it is exempt.[3]

To protect taxpayers from unnecessary hardship, Congress instructed the IRS to ensure that when appropriate, a supervisor reviews a determination to issue a levy prior to the action. Section 3421 of the IRS Restructuring and Reform Act of 1998 (RRA 98) outlines the steps the IRS must take.[4] An employee must:

- Review the taxpayer's information;
- Verify that a balance is due and owing; and
- Affirm that the action proposed to be taken is appropriate given the taxpayer's circumstances, considering the amount due and the value of the property or right to property.[5]

Despite this congressional mandate, the number of notices of levy served on third parties rose by 1,603 percent from FY 2000 to FY 2006.[6] The IRS processed 93 percent of the levies it issued in FY 2006 through the Automated Collection System (ACS), which, as its name implies, operates systemically, and requires minimal if any attempted contact with taxpayers before issuing levies.[7]

3 See IRC § 6334 for an enumeration of property exempt from levy.

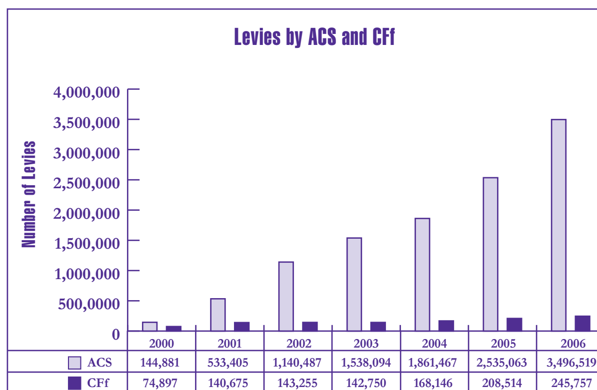
4 IRS Reform and Restructuring Act of 1998, Pub. L. No. 105-206 § 3421(b) (1998).

5 *Id.*

6 Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* 4 (Mar. 2006); IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies- NO-5000-23-240* (Oct. 2, 2006). The number of levies issued by the IRS increased from 219,778 in FY 2000 to 3,742,276 in FY 2006.

7 IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies- NO-5000-23-240* (Oct. 2, 2006). [3,496,519 (number of levies issued by ACS in 2006) divided by 3,742,276 (total number of levies issued in 2006) = 93 percent].

TABLE 1.7.1, LEVIES ISSUED BY ACS AND COLLECTION FIELD FUNCTION FY 2000-2006[8]



	2000	2001	2002	2003	2004	2005	2006
ACS	144,881	533,405	1,140,487	1,538,094	1,861,467	2,535,063	3,496,519
CFf	74,897	140,675	143,255	142,750	168,146	208,514	245,757

Levies Issued Without an Attempt at Personal Contact

The Notice Stream

Generally, the IRS collection process consists of three stages: the notice stream, the ACS, and the Collection Field function (CFf).[9] In the notice stream, the IRS typically sends a series of notices – four to individual taxpayers and two to businesses – to the taxpayer's last address of record.[10] Up to six months may lapse from the first notice to the last notice in the current process, with the IRS generally making no attempt to contact the taxpayer by phone or in person during that period.[11]

IRC § 6331(d)(2)(C) requires the IRS to issue these notices to the last known address, but does not prohibit the IRS from conducting research to obtain more current addresses during the notice process. The IRS currently has such a process, the Address Research System (ADR), but only employs ADR for letters issued beyond the final notice.[12] The ADR process is designed to systemically check existing IRS databases (*e.g.*, Integrated Data Retrieval System, or IDRS) but more importantly has the ability to retrieve data from external sources such as the U.S. Postal Service (USPS) and Choice Point. Private

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8 IRS, *Statistics of Income (SOI), Tax Stats 2000 through 2005*; IRS, *Automated Collection System (ACS) Customer Service Activity Reports* (CSAR) FY 2006 BOD Report (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies- NO-5000-23-240* (Oct. 2, 2006).

9 See National Taxpayer Advocate 2004 Annual Report to Congress 230-235 for a more detailed analysis of the IRS collection strategy.

10 The first is a settlement notice advising of a balance due. For individual accounts, when a balance remains on the account, up to three additional collection notices will be sent at five week intervals. Business taxpayers will receive the first notice and in five weeks, the final collection notice. The final collection notice advises taxpayers of the Intent to Levy and is the last notice required before a Federal Tax Lien may be filed. See IRM 5.19.1-3 (Dec. 31, 2003) for a complete description of the notice stream.

11 Government Accountability Office, GAO-07-26, *Internal Revenue Service: Procedural Changes Could Enhance Tax Collections* 4 (Nov. 2006).

12 IRS, Wage & Investment Division flowchart titled "ADR" (Jun. 26, 2006). Information was provided in response to TAS Research Request.

debt collectors have experienced great success using these outside services as well as searching the Internet and looking at Department of Motor Vehicles (DMV) and voting records. ADR processing can take up to 111 days depending on the number of sources researched, the number of letters sent, and the receipt of the response.[13] Even so, the IRS should conduct a study to further explore use of the ADR system, including ways to speed up the research, and evaluate the merits of initiating this beneficial process much earlier in the notice stream.

The Automated Approach to Collection

If the taxpayer does not pay the liability in full or otherwise respond to the notices, the IRS assigns the account to the ACS or CFf, depending on the type of tax and taxpayer. The ACS typically handles most individual taxpayer accounts and collects delinquent taxes through a combination of human and automated processes. ACS systemically searches internal databases for levy sources to allow the IRS to take levy action quickly if the taxpayer does not contact the IRS.[14] IRS systems immediately issue a final notice (LT11) if none has been previously issued or certain conditions do not exist (*e.g.*, a pending Collection Due Process (CDP) hearing, installment agreement, offer in compromise or bankruptcy proceeding). While the IRS does use systemic filters to ensure these taxpayer rights provisions are protected, the filters are monitored electronically, with no human intervention in the preliminary stages.

Similarly, when the IRS identifies levy sources, it does little else to contact the taxpayer or research the account while the final notice (LT11) is pending. IRS procedures do allow for a telephone contact prior to issuing a levy. However, the caveat to this option is "this is a management decision based on known backlogs in outcalls, quality of levy sources available and lengthy levy time frame."[15] If the IRS attempts a contact, it does so via the "predictive dialer" process in which, if the taxpayer answers, the call is quickly redirected to the next available IRS assistor.[16] If no one answers, a message is left requesting a return call. The IRS also uses this process for situations in which there are no known sources of levy but there is a valid telephone number. If the attempted contact is unsuccessful, the IRS sends these cases, along with others lacking both a valid levy source and telephone number, to an investigation inventory where internal sources are checked to identify leads.

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[13] IRM 5.19.10.4.2(2) (Dec. 23, 2002).

[14] IRC § 6331(d). Before a levy action is taken, the IRS must send a notice of its intent to levy to the taxpayer. IRC § 6330(c)(2). Before the first levy, with respect to any tax liability, the IRS must also provide to the taxpayer a notice of the taxpayer's right to a Collection Due Process hearing with the IRS Office of Appeals in which the taxpayer can raise a number of issues, including collection alternatives such as installment agreements or offers in compromise. IRC § 6331(d)(2).

[15] IRM 5.19.4.3.12(12) (Dec. 22, 2005).

[16] The predictive dialer system is outbound calling technology in which calls are placed without an attending agent on the originating telephone line. If the dialer makes contact, it transfers the call along with the other pertinent case data to a waiting IRS representative. See IRM 5.19.5.3.11 (Nov. 7, 2005) for a more detailed explanation of the process.

Issuance of Multiple Levies

The IRS adds further potential burden for the taxpayer by issuing ACS levies in a wholesale manner to all known sources of income, including situations where joint liabilities exist or community property law governs collection rights among spouses. While procedures do specify the maximum number of levies the IRS can issue at any given time, the IRS can simultaneously serve levies on both the taxpayer's bank account and wages. The levy determination process fails to consider and screen for the potentially devastating effect of this action on a taxpayer's financial condition.

FPLP Levies Without an Appropriate Screening Filter

Background of Federal Payment Levy Program

The Taxpayer Relief Act of 1997 (TRA 97) authorized the IRS to issue continuous levies for up to 15 percent of federal payments due to taxpayers who have an unpaid federal tax liability.[17] This process is known as the Federal Payment Levy Program (FPLP), an automated system that matches IRS records against those of the government's Financial Management Service (FMS) to locate federal payment recipients who have delinquent income tax debts.[18] Once a match occurs, the IRS attempts to notify the recipient of the potential levy by sending a letter with information about the liability and the taxpayer's appeal rights.[19] As an additional precaution for taxpayers who receive benefits paid by the Social Security Administration (SSA), the IRS sends a second notice before transmitting the levy to the FMS.[20] When the FMS generates a levy payment, it sends a notice to the taxpayer's address of record on file with the appropriate federal agency.[21]

Inadequate Exclusionary Safeguards Remain for Low Income Taxpayers

In January 2002, the IRS began using an income filter to systemically exclude from the FPLP those taxpayers with income below a specified threshold. This filter was implemented at the request of the National Taxpayer Advocate and was based on the amount of income reported on the taxpayer's last filed return (known as the Total Positive Income (TPI) indicator).[22] The General Accounting Office (GAO, now the Government

[17] IRC § 6331(h)(2)(A). Payments subject to the Federal Payment Levy Program include any federal payments other than those for which eligibility is based on the income or assets of the recipients.

[18] The Financial Management Service is the Department of the Treasury agency that processes payments for various federal agencies.

[19] IRM 5.19.9.3.3.2.7 (Jul. 14, 2005); CP 90/297, *Notice of Intent to Levy and Notice of Your Right to a Hearing.*

[20] IRM 5.19.9.3.2.7(5) (Jul. 14, 2005); CP 91/298, *Final Notice Before Levy on Social Security Benefits.*

[21] IRM 5.19.9.3.2.8(2) (Jul. 14, 2005).

[22] TPI is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero. IRM Exhibit 4.1.7-1(33) (May 19, 1999). For a more detailed discussion of this filter, see National Taxpayer Advocate 2001 Annual Report to Congress 202-209; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; National Taxpayer Advocate 2004 Annual Report to Congress 246-263; and National Taxpayer Advocate 2005 Annual Report to Congress 123-135.

Accountability Office) concluded in a 2003 study that the TPI criterion was "an inaccurate indicator of a taxpayer's ability to pay."[23] In response, the IRS gradually phased out all TPI levels and in January 2006 eliminated the filter altogether.

Social Security Payments Represent the Bulk of all FPLP Levies

While we agree that the income filter used prior to 2006 was imperfect, we also believe there is an inherent need for some type of screening mechanism to protect taxpayers who depend on Social Security benefits for their health and welfare. From FY 2002 through the first quarter of FY 2006, 84 percent of all FPLP levies involved SSA payments to the elderly or disabled.[24] Although the law limits FPLP levies to only 15 percent of each Social Security payment, the remainder may not be enough to avoid a financial hardship, considering that:

- Social Security provides at least half of the total income for 65 percent of beneficiaries aged 65 or over, and is the *only* source of income for more than 20 percent of this population;[25] and
- As of August 2006, Social Security recipients received an average monthly benefit of $923.30. An FPLP levy would reduce the amount to $784.80 per month. [26]

Many of these taxpayers have come to TAS for assistance with FPLP levies. Three typical examples follow:[27]

> **Example 1:** The taxpayer was 48 years old and living in a nursing home with SSA as his only source of income (a total of $8,834 for 2005). The IRS attached FPLP levies to $101.70 of these SSA payments for three months. Since all of these funds were earmarked to cover the taxpayer's nursing home rent, he was unable to make the full payment and was facing eviction when he came to TAS for assistance. TAS got the IRS to release the FPLP levy, refund all of the levied funds, and place the taxpayer's account into a Currently Not Collectible status due to his inability to pay.

> **Example 2:** The taxpayer was 75 years old, had suffered a stroke and was bedridden. Her only source of income was SSA (a total of $10,850 for 2005), which she relied on for her living expenses and multiple medications. When the IRS attached FPLP levies to $127.95 of these SSA payments for two months, the taxpayer could no longer pay for her monthly medications and came to TAS for help. TAS got the

[23] General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved* 11 (Mar. 6, 2003).

[24] IRS, W&I Operating Division spreadsheet titled *"FPLP Monthly Counts CUM"* (May 5, 2006). [Total number of SSA levies from FY 2002 through Dec. 2005 (2,572.299) divided by total number of FPLP levies from FY 2002 through Dec. 2005 (3,044,824) = 84 percent].

[25] Social Security Administration, *Fast Facts & Figures About Social Security*, 2005 (Sept. 2005).

[26] Social Security Administration, Office of Policy, Research, Evaluation and Statistics, *Monthly Statistical Snapshot*, Table 2, Social Security Benefits (Oct. 2006). [$923.30 x .15 = $138.50 and $923.30 – 138.50 = $784.80].

[27] Examples are taken from the Taxpayer Advocate Management Information System (TAMIS).

IRS to release the FPLP levy, refund all of the levied funds and place the taxpayer's account into a Currently Not Collectible (CNC) status due to her inability to pay.

Example 3: The taxpayer was 58 years old and received monthly federal assistance in the following amounts: $531 from SSA, $91 from disability payments, $200 from welfare, and $10 in food stamps. She was supporting two children and could not work due to a back injury. FPLP levies had attached to $79.65 of her SSA payments for three months, prompting her to come to TAS for assistance. TAS secured the release of the FPLP levy and a refund of one of the levy payments, but is still attempting to help the taxpayer recover the rest. The IRS also put this taxpayer's account in CNC status due to her inability to pay.

These examples demonstrate how imperative it is that the IRS develop an effective screen to eliminate the need for these low income individuals to contact the IRS and seek relief from a levy after the fact. The National Taxpayer Advocate is troubled that despite two IRS task forces, a GAO audit, and multiple Annual Reports to Congress (with specific recommendations) over the past five years, the IRS has been unable to devise a feasible method of screening out low income taxpayers from this automated process.[28]

Interestingly, the IRS identified the aging U.S. population as an emerging trend and an issue essential to its strategic planning efforts. The Wage and Investment (W&I) division's most recent Strategy and Program Plan projected that "70 million people, or one-fifth of the U.S. population, will be age 65 or older by 2030."[29] The IRS also expects a growing number of grandparents to raise their grandchildren because the middle generation cannot.[30] Still, in spite of these forecasts, the IRS conducts business as usual. There is little doubt that FPLP practices will significantly impact future generations unless the IRS changes the program considerably.

Recent FPLP Developments and Trends

In the spring of 2006, TAS and the IRS formed a task force to identify and resolve levy-related systemic issues. Although the National Taxpayer Advocate's highest priority for this project was to develop a viable income filter for the FPLP, the IRS has not yet devised one. Ironically, the most notable developments in the FPLP program for 2006 were not the exploration of a proactive screening mechanism, but the IRS's desire to expand the scope of the FPLP.

The IRS's first such action came in January 2006, when it enhanced the FPLP to enable FMS to attach to federal payments under the secondary Taxpayer Identification Number

[28] National Taxpayer Advocate 2001 Annual Report to Congress 202-209; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; National Taxpayer Advocate 2004 Annual Report to Congress 246-263; National Taxpayer Advocate 2005 Annual Report to Congress 123-135.

[29] IRS, *Wage & Investment Division, Strategy and Program Plan* ('06-'07) Document 11622 13-16 (Oct. 2005).

[30] *Id.*

(TIN) of a joint income tax liability.[31] While the IRS has a legal right to collect from both liable parties, the systemic limitations within FPLP present great concerns to the National Taxpayer Advocate.[32] For example, IRS guidance states that the FPLP levy cannot be used to levy only on one of the taxpayers since all matched TINs will be levied for their appropriate matched payments.[33] Thus, if both taxpayers receive federal payments, an FPLP levy will attach to 15 percent of each of their monthly payments. This levy will place an increasingly tighter strain on the taxpayer's household income. This system also becomes an issue when both taxpayers are eligible for FPLP but are divorced. Since the primary account controls all FPLP activities, a compliant secondary former spouse may still be subject to an FPLP levy if the IRS takes enforcement action against the primary former spouse. The IRS has no written procedures to address this potentially harmful scenario.

The second development dealt with guidance from a Wage and Investment division (W&I) Compliance operational review in May 2006 in which the IRS cited plans to add Railroad Retirement Benefits to the FPLP.[34] At the request of the National Taxpayer Advocate, the IRS placed this decision on hold until it develops a suitable filter for the entire FPLP process. We note that this type of directive, coming in the wake of long-standing and significant systemic issues, underscores the National Taxpayer Advocate's concern that the IRS's sole focus for this program is bringing in more revenue.

Finally, another related development concerning FPLP stems from the implementation of the IRS's Private Debt Collection (PDC) initiative. As part of this initiative, the IRS decided not to assign cases with active FPLP levies and cases subject to automated levy programs to private collection agencies because the Commissioner acknowledged that it would be inappropriate to do so.[35] However, the IRS has refused to recall cases back from private collectors when a taxpayer becomes subject to the levy after the case has been assigned to the private collectors. While the IRS acknowledges that cases with active FPLP levies are the wrong type for assignment to private collectors, the IRS continues to assert that taxpayers under an FPLP levy of their Social Security income will benefit from interaction from private collectors.[36] For reasons previously stated, we do not believe it is appropriate for private collectors to pursue taxpayers in these situations and have accordingly asked the IRS to reconsider its position.

[31] IRS, Wage & Investment Division, *Federal Payment Levy Program (FPLP) Matching Process Enhancements* (Feb. 3, 2006).

[32] IRC § 6013(d)(3).

[33] IRM 5.19.9.3.9.2(3) (Aug. 18, 2006).

[34] IRS, Wage & Investment Division, *Compliance (F&PC) Operational Review* (May 2006).

[35] *Private Debt Collection: Hearing Before the Subcommittee on Oversight, House Committee on Ways and Means*, 109th Cong, 2nd Sess. (May 13, 2006) (Testimony of Mark W. Everson, Commissioner of Internal Revenue).

[36] For a more detailed discussion, see Most Serious Problem, *True Costs and Benefits of Private Debt Collection, supra.*

PROBLEMS

Ineffective Levy Release Mechanisms and Procedures

Timeliness of Levy Releases

In the 2005 Annual Report to Congress, we stated that the most common levy release problem reported to TAS by taxpayers involved processing time.[37] The Internal Revenue Code and accompanying Treasury Regulations require prompt release of any existing levies on the taxpayer's property when a taxpayer is suffering an economic hardship or agrees to certain collection alternatives (*e.g.*, an installment agreement or offer in compromise).[38] We noted, and continue to observe, that this situation may be a result of ambiguity over the term *prompt*, which ordinarily means "performed readily, or immediately."[39]

The IRS normally inputs levy releases daily but does not actually mail them to the levy source (*i.e.*, the employer or other source of taxpayer income) until the end of a processing cycle, *i.e.*, one week. IRS guidance states that "generally, levy releases are mailed to save resources" and "the levy source should receive the levy release in about a week."[40] Thus, standard levy releases can routinely take ten days, including mailing time. This delay can lead to additional levy actions in the interim week cycle, causing harm to taxpayers.

Lack of Communication Regarding Expedited Procedures

While the IRS can expedite levy releases to prevent over-collection or relieve hardship, it does not adequately or effectively communicate this message to its employees or taxpayers. For example, to expedite a levy release, an IRS employee must generate a manual release and fax it to the source. Historically, the IRS has interpreted this exception to mean the taxpayer must suggest an imminent need and prove the expedited relief is warranted. Only those taxpayers who are knowledgeable about IRS procedures and persistent in their requests will achieve a favorable outcome, while others who do not know about (or fear to ask for) expedited treatment will be left to endure their hardship until the levy source is officially notified.

The IRS's response to this issue in the 2005 Annual Report to Congress was that its employees "are aware of these procedures and make use of its capability where appropriate."[41] However, the IRS seems to be sending a mixed message to its employees when it comes to making these expedited determinations. Internal Revenue Manual (IRM) 5.19.4.4.10 advises the employee that when a return call is needed to provide the correct fax number, justification for the expedited release must be documented.[42] The IRM further states, "Sites will need to reevaluate the taxpayer's request for a faxed levy release"

[37] National Taxpayer Advocate 2005 Annual Report to Congress 215.

[38] *See* IRC § 6343(a); Treas. Reg. § 301.6343-1(a).

[39] *Webster's Third New International Dictionary* 1816 (1991).

[40] IRM 5.11.2.2.3(1) (May 5, 1998); IRM 5.19.4.4.10(7) (Dec. 22, 2005).

[41] National Taxpayer Advocate 2005 Annual Report to Congress 220.

[42] IRM 5.19.4.4.10(1) (Dec. 22, 2005).

if there is not adequate justification.[43] This suggests that the taxpayer must continue to bear the burden of substantiating the need for an imminent release should a later call be necessary to provide the missing fax information. Since the taxpayer has already met the conditions for a levy release, the IRS has an obligation to timely release the levy and help the taxpayer, or at least not continue to burden him or her. The same systemic approach and technology used to issue levies should be utilized to more efficiently release them as well.

Without clear and specific written guidance *requiring* employees to discuss expeditious options with taxpayers, such as speaking directly to the third party levy recipient or requesting a fax number during the taxpayer contact, the IRS will allow inequitable and disparate treatment of taxpayers. Proactively advising the taxpayer of the right to expedited treatment would signify that enforcement and taxpayer service can co-exist, as RRA 98 intended.

Systemic Failures in Releasing Levies and Applying Levy Proceeds

As previously stated, when the IRS has levied an account but the liability is subsequently satisfied or becomes unenforceable due to lapse of time, the IRS is required to promptly release the levy to prevent over-collection.[44] In its response to the 2005 Annual Report, the IRS explained its due diligence efforts to reduce the instances of full paid accounts that continue to receive payments from the source, and referenced a systems update that could generate transcripts in these situations.[45] The IRS stated this process would enable employees to use a feature called Remittance Transaction Research to help identify the source of the payment and send levy releases.

The IRS also updated the IRM to give specific instructions for employees working these levy payment transcripts.[46] This guidance provides that employees must release levies "promptly" and fully research accounts to resolve any accounts where credits exist. The IRS also added information requiring contact with the taxpayer or levy source as well as resolution of all credit modules. We applaud the IRS's efforts to establish much- needed controls for this fundamental process. However, these controls do not address some potentially harmful situations. The following example illustrates one taxpayer's experience as a result of the IRS's lack of adequate safeguards.

> **Example:** A taxpayer in North Carolina owed several years of delinquent taxes, which eventually led to enforced collection via a levy on her retirement income. This levy attached to approximately $600 per month and subsequently paid all of the balance due on the original levy. Although this full payment occurred in 1997, the IRS received monthly payments until the levy was released in June 2005.

[43] IRM 5.19.4.4.10(1) (Dec. 22, 2005).

[44] IRC § 6343(a)(1)(A).

[45] National Taxpayer Advocate 2005 Annual Report to Congress 220.

[46] IRM 5.19.6.21 (Jan. 25, 2005).

> Rather than refunding the overpayments to the taxpayer, the IRS applied the funds to these fully paid tax modules as well as to several unassessed modules (those where a return was either not filed or there was no valid assessment of taxes). As a result, approximately $39,000 in overpayments sit stagnant on the taxpayer's account with no observable plan to provide the taxpayer any relief she may be entitled to receive.

While the revised guidance will serve to alleviate *future* cases of this nature, it fails to address the underlying issues of this and other similar cases in which taxpayers were left without adequate protection or possible relief. Based on our analysis of cases where the IRS misapplied levied funds or later moved them to the IRS's Excess Collections File (XSF), the IRS still has some significant "clean up" work to do.[47] We identified four scenarios where IRS procedures or systems apparently failed to release levies or correctly apply levy proceeds. These situations involve levy payments that were:

- Applied to accounts that have already been full paid;
- Applied to accounts not included on the original levy;
- Applied to accounts without a valid assessment of taxes; or
- Applied to accounts after the collection statute expiration date (CSED) had lapsed (under the doctrine of "fixed and determinable rights").[48]

We also identified situations where taxpayers were prevented from obtaining refunds of levy proceeds because the refund statute expiration date (RSED) had lapsed, even though the IRS was negligent in its initial and subsequent application of said funds.

Levy Payments Applied to Accounts That Have Already Been Full Paid

IRS systems are designed to generate transcripts for IRS personnel to research and determine where the funds should be applied when payments are posted to full paid modules.[49] While the IRS updated these guidelines in April 2006 to re-emphasize the need for prompt and full account research to properly resolve these situations, we continue to find credit balances that are not applied or refunded when overpayments exist. In many cases, these credits remain on the taxpayer's account indefinitely or are

[47] The IRS's Excess Collections File (XSF) is primarily used to hold payments sent to the IRS that cannot be associated with a tax liability. IRM 3.17.220 explains that funds are only to be moved to XSF after completing the necessary research to establish that the funds could not be applied to a specific account or could not be refunded to the taxpayer. For a more detailed discussion of XSF, see Most Serious Problem, *Excess Collections, infra.*

[48] Treas. Reg. § 301.6343-1(b)(1)(B)(ii) provides that a levy reaches all property rights at the time the levy is made, including the right to receive payments at some point in the future and will not be released under this condition unless the liability is satisfied. Certain streams of payments (*e.g.*, retirement and Social Security benefits, pensions, royalties, etc.) can be seized by a single levy and according to the IRS, that levy attaches to all future payments to which the taxpayer is entitled to, so long as there is a fixed and determinable right at the time of levy. Thus, the IRS can collect these payments long after the expiration of the statutory period for collecting the tax.

[49] IRM 5.19.6.21 (Jan. 25, 2005).

finally moved to the Excess Collections File. In others, the IRS continues to post levy proceeds to fully satisfied periods, and as a result incurs significant costs by generating refund checks for the overpayments. One such case involved the continual posting of $20 payments and issuance of refund checks ranging from $20.02 to $20.16 over a period of two years (25 such payments were eventually refunded). While the IRS does not publish the cost of processing a refund check, given the time an IRS or TAS employee must expend in dealing with the taxpayer and researching the request, the inefficiency speaks for itself.

Levy Payments Applied to Accounts Not Included on the Original Levy

As previously stated, in situations where the tax liabilities listed on the levy have been satisfied, it is the IRS's policy to promptly release the levy to avoid overcollection.[50] IRC § 6402(a) permits the IRS to offset these overpayments against any liability of the taxpayer.[51] IRS guidelines do advise that

> Although this is legal and we will retain funds already received, we do not intentionally allow levies to remain in effect once we are aware that the modules listed on it have been resolved. We must either release the levy, or if CDP criteria are met, reissue a new levy to include the additional modules.[52]

Additional guidance speaks to this same type of situation and reiterates that "where a taxpayer has had a wage levy, which is now full paid and is being misapplied to other tax periods," a release must be prepared.[53]

Even so, TAS has identified situations where the IRS did not follow its published guidance and continued to offset overpayments against liabilities without issuing additional levies. These offsets were not one-time occurrences but were situations where the IRS applied levy payments for two to three years or longer. In many cases, the taxpayer may not have been notified of the application since current procedures require no personal contact or correspondence. The application of such payments to a module not listed on the original levy is of particular concern to the National Taxpayer Advocate because the taxpayer may not have received a CDP notice or other recent notice for this additional collection activity.

Levy Payments Applied to Accounts Without a Valid Assessment of Taxes

Similar to the situation where proceeds are applied to an account not originally listed on the levy, we have also observed instances where the IRS posted levy payments to accounts without a valid assessment of taxes. This is disturbing because the IRS has no legal authority to collect or apply funds to an account where it has not assessed taxes.

[50] *See* IRM 5.19.6.21 (Jan. 25, 2005); IRM 5.19.4.4.10(4)(d) (Aug. 14, 2006).

[51] IRC § 6402(a).

[52] IRM 5.19.4.4.10(4)(d) (Aug. 14, 2006).

[53] IRM 5.19.2.6.8(10) (Jun. 1, 2006).

IRC §§ 6331(a) and (d) clearly require the IRS is to advise a taxpayer of the balance due and further notify the taxpayer of the proposed levy action before issuing the levy itself.[54] Section 3421 of RRA 98 further requires employees to verify that a balance is due before issuing a levy. By posting levy payments to accounts without a valid assessment, the IRS has failed to provide important taxpayer protections.

Levy Payments Applied to Accounts After the CSED (Doctrine of "Fixed and Determinable Rights")

Treas. Reg. § 301.6343-1(b)(1)(B)(ii) provides that a levy reaches all property rights at the time the levy is made, including the right to receive payments at some point in the future, and will not be released under this condition unless the liability is satisfied. Certain streams of payments (*e.g.*, retirement and Social Security benefits, pensions, royalties, etc.) can be seized by a single levy and according to the IRS, that levy attaches to all future payments to which the taxpayer is entitled to, so long as there is a fixed and determinable right at the time of levy. The IRS can collect these payments long after the expiration of the statutory period for collecting the tax.[55]

Refund of Erroneously Applied Levy Proceeds After the RSED

In the 2001 Annual Report to Congress, we noted several instances where IRS errors in the course of collecting a tax liability negatively affected taxpayers.[56] As we pointed out, the IRS was prevented from providing relief to taxpayers because of statutory limitation periods for requesting the return of proceeds, even though some of these IRS errors were deemed to be flagrant or egregious.[57] Accordingly, we recommended that the IRS be given authority to correct such errors.[58]

Five years later, we are still witnessing situations where the taxpayer was not (and is still not) aware of the fact that any levied funds were misapplied and may be available for recovery. In many instances, the IRS continued to post levy payments and failed to release the levy, exacerbating the original problem while not alerting the taxpayer to possible relief. Here, the levy release mechanism clearly failed. Therefore, we reiterate our recommendation that Congress amend the Internal Revenue Code to grant the IRS the authority to remedy harm to taxpayers brought about by improper IRS actions. This authority would extend to those errors that are flagrant or egregious in nature and would shock the conscience of taxpayers if not corrected.[59]

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[54] There is an exception for situations where the Secretary makes a finding that the collection of tax is in jeopardy. *See* IRC § 6331(d)(3).

[55] For a more detailed discussion, see Key Legislative Recommendation, *Post-CSED Levies on Fixed and Determinable Rights, infra.*

[56] National Taxpayer Advocate 2001 Annual Report to Congress 206.

[57] *Id.* at 202.

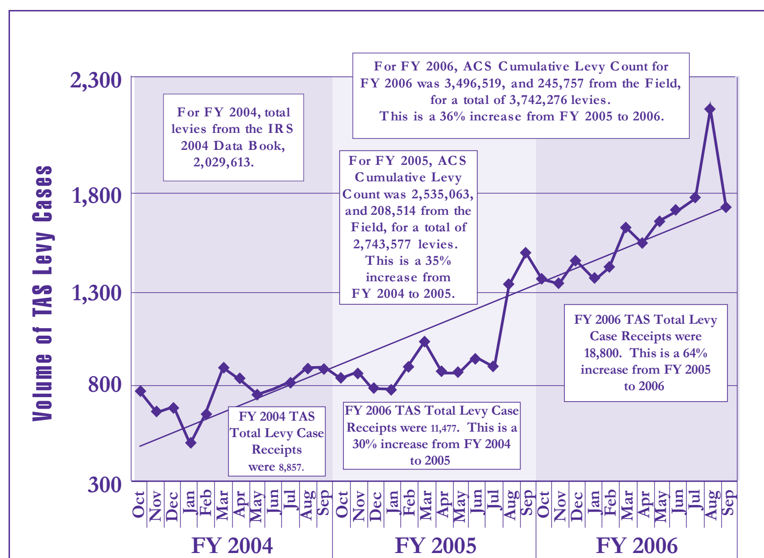
[58] See *id.* at 202-209 for a more detailed analysis of the return of levy or sale proceeds.

[59] The term "flagrant" is defined as "conspicuously bad" or "offensive". Webster's II New Riverside University Dictionary, 1st Ed., The Riverside Publishing Company, Massachusetts, 1984. For a more detailed discussion, see Additional Legislative Recommendation, *Amend IRC § 6511 to Allow Refund Claims Past the RSED When Excess Collection Is Due to IRS Error, infra.*

Downstream Consequences of Levy Activities

By not trying to proactively weed out its own defined categories of "will pay" and "can't pay" taxpayers from those who are unwilling or "won't pay" before imposing levies, the IRS creates additional work and undue hardship for itself and taxpayers alike.[60] As a result, functions such as TAS and the IRS's Office of Appeals must often deal with disgruntled or burdened taxpayers. For example, levy-related cases in TAS have risen by 64 percent from FY 2005 to FY 2006.[61] More specifically, TAS cases regarding FPLP/Social Security benefits issues have increased at a rate of 143 percent from FY 2005 to FY 2006.[62] Nearly 65 percent of the levy cases closed by TAS in FY 2006 have received some type of relief from their hardship, with almost 56 percent being given full relief (*i.e.*, release or removal from the FPLP process).[63] As the graph below indicates, the steady rise of IRS levies to third parties has resulted in a significant increase in TAS levy case receipts. It also provides an accurate depiction of the current state of IRS collection efforts and underscores our growing apprehension as to where these actions may ultimately lead.

TABLE 1.7.2, IRS LEVIES AND TAS MONTHLY LEVY CASE RECEIPTS, FISCAL YEAR 2004-2006[64]



[60] *See* IRM 5.10.1.4 (Oct. 1, 2004) for a detailed description of these three categories.

[61] Taxpayer Advocate Service, *Business Performance Management System* (as of Sept. 30, 2006). For FY 2005, there were 11,477 levy-related cases in TAS and 18,800 such cases in FY 2006.

[62] Taxpayer Advocate Service, *Business Performance Management System* (Sept. 30, 2006). For FY 2005, there were 1,707 FPLP/Social Security benefit-related cases in TAS and 4,147 for FY 2006.

[63] Taxpayer Advocate Service, *Business Performance Management System* (Sept. 30, 2006).

[64] Chart data was gathered from a variety of sources: Taxpayer Advocate Service, *Business Performance Management System* (FY 2004 through FY 2006); IRS, *Statistics of Income (SOI), Tax Stats 2004 and 2005*; IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies-NO-5000-23-240* (Oct. 2, 2006).

PROBLEMS

CONCLUSION

The National Taxpayer Advocate is concerned that based on current collection enforcement initiatives, the IRS is slowly returning to the way it did business prior to RRA 98. In fact, contrary to RRA 98 and IRC § 3422's directive to utilize better discretion in its levy processes, the IRS has now embarked on an even more narrow path towards impersonal and rigid collection procedures. The IRS should continue to use automation to perform its enforcement activities but it should do so wisely and appropriately. By employing more proactive approaches, such as the removal of potential hardship cases from FPLP and a requirement for meaningful personal contact in pre-levy activities, as well as more efficient processes for levy releases and the application of levy proceeds, the IRS can achieve the appropriate balance of enforcement and taxpayer service.

IRS COMMENTS

The IRS understands the sensitive nature of levying taxpayer assets and respects all taxpayer rights in using its levy power. The IRS enforces the tax laws through levy only after we attempt to notify the taxpayer of the tax liability and the taxpayer does not work with the IRS to resolve the outstanding balance.

Automation is an important component of IRS enforcement activities. In the wake of the IRS Restructuring and Reform Act of 1998, the IRS severely curtailed levy activity as we rewrote and refined our levy procedures. Under our new procedures and processes, as well as the systemic levy programs that have been developed in recent years, we have increased the number of levies we initiate each year and are confident we are meeting existing legal requirements. As we continue to refine our levy processes and procedures, we continue to take steps to mitigate any negative consequences that may result from our levy programs.

Contacting Taxpayer Prior to Levy Action

The IRS uses several resources to ensure our records reflect a taxpayer's most current address. We receive National Change of Address files from the United States Postal Service (USPS) and upload that information weekly to the master file. This information comes from address changes taxpayers report to the USPS. Before assigning an account to a Collection function, the IRS also uses the Address Research System (ADR) in an attempt to locate a taxpayer. Our ACS and the CFf utilize additional locator services for taxpayers whose notice was returned to the IRS as undeliverable. If we find a taxpayer's telephone number for a taxpayer whose notice was returned as undeliverable, ACS employees attempt to telephone that taxpayer prior to any enforcement action. In the Collection Field function, a revenue officer may attempt an in-person contact with the taxpayer prior to enforcement action. In any instance, the IRS issues a final notice of intent to levy and notice of a right to a collection due process hearing before taking

enforcement action. The notice must be given to the taxpayer, left at the residence or place of business, or sent by certified mail.

The IRS does not issue multiple levies systemically. We issue multiple levies on a case-by-case basis and only after an authorized Collection employee has reviewed the case and determined that issuing multiple levies is the next appropriate action. Again, we emphasize that the taxpayer can contact the IRS to resolve the liability or provide information to determine the collectibility of their unpaid tax liability at any point during the collection process.

Federal Payment Levy Program (FPLP)

The IRS disagrees that its sole focus for the FPLP is bringing in more revenue. The IRS implements the laws it is given, including the Taxpayer Relief Act of 1997 and the Railroad Retirement Act. The receipt of benefit income from the Social Security Administration (SSA) does not, in and of itself, indicate that a taxpayer is experiencing a hardship situation. To assist the IRS in identifying taxpayers who are experiencing a hardship because of the FPLP, the IRS plans to begin a research project to determine whether we can create and implement an effective income filter. As stated in the National Taxpayer Advocate's report, the GAO determined that the IRS' previous filter did not accurately reflect a taxpayer's ability to pay. We agreed with GAO and followed their recommendation to eliminate the exclusion criteria and rely on the additional final notice process to resolve taxpayer cases.

Social Security payments, levied at 15 percent, represent the majority of the FPLP levy proceeds. In addition to the general final notice issued to all taxpayers prior to enforcement action, the IRS issues an additional notice to Social Security beneficiaries prior to the FPLP levy. Every notice sent to the taxpayer provides information on how to contact the IRS if he or she cannot pay the balance. We also advise taxpayers to submit information to substantiate their inability to pay and analyze that information in determining whether a taxpayer is suffering a hardship.

The IRS is working with the SSA to improve the program. In an effort to identify Social Security recipients who could be experiencing a hardship, the IRS and SSA are working on blocking a Federal Payment Levy (FPL) on benefit payments going directly to a health care facility. Although the IRS does not receive many levy payments on these taxpayers, excluding the payments will eliminate the possibility of hardship caused by the FPLP for these taxpayers. In another instance, the IRS helped perfect SSA's records so that SSA could ensure it was honoring only appropriate paper levies.

With regard to the Private Debt Collection (PDC) program, the IRS excludes taxpayers with a FPL in place from the PDC inventory mix. Additionally, taxpayers subject to a FPL can exclude themselves from future FPLP action by resolving their tax liabilities or by substantiating their financial hardships.

Timely Release of Levy

We agree that levies must be released promptly. In non-hardship situations, levy releases are input daily, but are subject to current systemic capabilities for printing and mailing. As noted, we expedite levy releases in hardship situations. To maintain a high level of customer service for all taxpayers, we normally fax a levy release only when it is necessary to prevent a hardship situation. To advise every taxpayer of the "right to expedited treatment" could decrease our overall level of service and adversely impact our ability to assist those truly experiencing a hardship. We agree that we need to pursue other technological alternatives to improve our efficiency in releasing levies and plan to study these options in FY 2007.

The IRS has made programming changes to more quickly and efficiently identify cases where levy releases are necessary. Some payments had been sent to Excess Collections rather than being refunded to the taxpayer. To address this issue, we developed a transcript to identify levy payment of full paid accounts. As a result, levies are released earlier, eliminating the potential of surplus levy funds being remitted to Excess Collections. In addition, we developed a procedure by which our cashiers identify levy overpayment situations and share the list with ACS on a daily basis. ACS researches the account, releases levies in appropriate situations and refunds excess monies to taxpayers. Finally, we generate a transcript to identify payments misapplied to an account without a valid assessment so that we may quickly identify these types of situations and properly resolve them.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is pleased the IRS understands the sensitive nature of levying taxpayer assets and strives to respect taxpayer rights when using its levy authority. We agree that the IRS levy program is a necessary means of collection and a fundamental component of tax enforcement, but we believe such a powerful collection tool must be used with appropriate safeguards. Moreover, while automation is an important means of performing enforcement activities more efficiently, this efficiency should not come at the expense of taxpayer service.

Contacting Taxpayers Prior to Levy Action

With respect to contacting taxpayers prior to levy action, the IRS mentions several resources utilized to reflect a taxpayer's most current address – USPS, ADR, and additional locator sources. These are all excellent resources, and we see no reason for the IRS to wait until all notices have been sent before using the ADR or additional locator sources. We realize that IRC § 6331(d)(2)(C) requires the IRS to issue these notices to the last known address, but this does not prevent the IRS from conducting research to obtain more current addresses during the notice process.

Further, the IRS should utilize all available resources in its address search. Many taxpayers do not update their address changes through the Postal Service, and for those

who do, forwarding orders may expire before the IRS attempts to contact the taxpayer. As we have pointed out, private debt collectors have experienced great success expanding their search tools to include such sources as the Internet, Department of Motor Vehicles records, and voting registries.

We also remain concerned over the practice of multiple levies, particularly in situations involving a joint liability where both taxpayers are employed. We continue to see examples in our TAS casework where the IRS simultaneously issued levies on both the husband's and wife's income and a pressing economic hardship has quickly ensued. The IRS should consider multiple levies only in situations where the IRS has performed adequate research of the taxpayer's address and the taxpayer has remained unresponsive or uncooperative.

Federal Payment Levy Program (FPLP)

We applaud the IRS for its continued efforts to work with SSA to improve this highly sensitive program, particularly for benefit payments going directly to a health care facility. We are also pleased to hear of the upcoming research project to determine the effectiveness of an income filter and we have offered to partner with IRS in designing and conducting that research. These steps were both suggested in the 2005 Annual Report to Congress.[65] We urge the IRS to conduct this research with all due speed, given the vulnerable nature of the population subject to FPLP social security levies.

Finally, we are extremely disappointed by the IRS's failure to exclude FPLP taxpayers from the Private Debt Collection (PDC) inventory mix, regardless of when the levy was initiated (pre- or post-PDC assignment). As we have discussed elsewhere in this report, these taxpayers are not only subject to a social security levy but also to private debt collectors utilizing "proprietary" methods of collection.[66] The IRS should ensure these cases are removed from FPLP.

Timely Release of Levy

We are pleased that the IRS agrees levies must be released promptly. However, this issue finds itself established as a most serious problem in the Annual Report to Congress for the second year in a row. The IRS states that "we normally fax a release only when it is necessary to prevent a financial hardship" and "to advise every taxpayer of the right to expedited treatment could decrease our overall level of service and adversely impact our ability to assist truly experiencing a hardship." To not advise all taxpayers of their right to secure an expeditious release is not fair or equitable. We have continually

[65] Problems associated with the IRS's use of the "last known address" in delivering the notices of intent to issue FPLP levies were also discussed in the 2005 Annual Report to Congress, *Most Serious Problem: Levies on Social Security Payments*. In general, the IRS's last known address is based on the address provided by the taxpayer on the last tax return filed This practice is particularly problematic when applied to taxpayers who are retired or disabled, and who may not have had a legal requirement to file an income tax return for several years prior to the FPLP notice.

[66] *See* Most Serious Problem, *True Costs and Benefits of Private Debt Collection, supra.*

recommended that IRS employees be given additional training as to what constitutes "economic hardship." Given the wide variance of interpretation seen in our TAS cases, it appears there is still significant room for improvement.

We applaud the IRS's efforts to more quickly and efficiently identify cases where levy releases are necessary and the IRS's development of a transcript to identify levy payment of full paid accounts. The additional procedures involving the cashiers and ACS are also noteworthy. These efforts should greatly minimize future errors or lapses, and we urge the IRS to provide managerial oversight of the transcript process to ensure it provides the intended protections.

To summarize, while the IRS has the legal right to serve a notice of levy upon third parties, it should only do so after it has taken the necessary steps to ensure that taxpayers will not be needlessly harmed. It should also take full responsibility for the downstream consequences stemming from such actions and provide fair and equitable treatment when administering the entire levy process. The IRS should continue to utilize automation to perform its enforcement activities, but only with appropriate systemic safeguards in place.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- Conduct a study to determine the effectiveness of telephone contact versus mailed correspondence prior to issuance of a levy. If this study shows telephone contact to be more effective, the IRS should consider mandating that telephone contact be attempted prior to issuance of a levy, at least in certain situations.
- Discontinue the practice of "wholesale" or multiple levies, except in situations where the IRS has performed appropriate research of the taxpayer's address and the taxpayer has remained unresponsive or uncooperative.
- Conduct the research necessary to implement an effective filter to screen out taxpayers from the FPLP who are unable to pay.
- Remove all FPLP cases from its Private Debt Collection initiative.
- Treat all levy releases expeditiously and provide clearer guidance to ensure taxpayers are properly apprised of the levy release timeframes. A possible solution is to include such language in a notice or "stuffer" which could accompany the taxpayer's copy of levy that the IRS is required to send. Additional training may also be warranted to ensure that all employees with taxpayer contact requirements are fully aware of these guidelines.
- Implement tighter management and quality controls to ensure the levy payment transcript process is effectively working to protect taxpayer rights. A quality or diagnostic measure should be developed and utilized to ensure the transcript process provides the intended protections. The IRS should also form a task force

(with TAS as a participant) to look into the various misapplied levy proceeds situations. At any rate, the IRS must notify taxpayers as soon as it learns it has been overcollecting on an account.

- Send a detailed annual notice (much like the CP 89 notice it currently sends to all accounts with installment agreement activity) to notify taxpayers of continuous levy activity. This notice should provide a detailed accounting of the payments received, including the application of such payments, all interest and penalty charges and the remaining balance due of any existing liabilities.

PROBLEMS

PROBLEM

TOPIC #8 CENTRALIZED LIEN PROCESSING

RESPONSIBLE OFFICIAL

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

In 2005, the IRS consolidated its geographically dispersed lien units into the Centralized Case Processing Lien Unit (CCP-LU) at its Cincinnati campus. This centralization was designed to reduce operating costs, increase efficiency, and improve customer service. More than a year into the centralized process, the IRS has not achieved its goals.

The National Taxpayer Advocate is concerned that the new system has greatly increased taxpayer burden and encroached on taxpayer rights. Problems with the centralized lien process include:

- Failure to provide taxpayers with written notice of lien filings within five days;
- Failure to release liens in a timely manner;
- Inability of internal and external customers to reach the IRS; and
- Increased burden to taxpayers and IRS employees.

ANALYSIS OF PROBLEM

Background

Internal Revenue Code (IRC) § 6321 provides the IRS with a statutory lien that attaches to "all property and rights to property, whether real or personal" of taxpayers who do not pay all of their assessed federal taxes after demand. A lien imposed by IRC § 6321 arises at the time the assessment is made; however, priority over other creditors is not established until the IRS files a notice of federal tax lien (NFTL).[1]

This NFTL is one of the most effective tools for collecting outstanding taxes because it protects the interest of the federal government by serving notice to current and potential creditors of the government's priority interest in the taxpayer's current and future assets. The IRS filed approximately 522,000 liens against taxpayer property in fiscal year (FY) 2005.[2] Lien filings for FY 2006 have increased by 20 percent from the FY05 level, to slightly over 629,800.[3]

Collection Due Process (CDP) Notice

IRC § 6320 requires the IRS to notify taxpayers within five business days of the filing of an NFTL upon the initial filing for each tax period. The IRS issues a notice, which

1 IRC §§ 6322 and 6323.

2 IRS, *Data Book 2005*, Publication 55B, Table 16 (Mar. 2006). The IRS filed 522,887 tax liens in FY 2005.

3 IRS, *Business Measures Data Mart*, Measure 183 ACS Liens and Measure 239 Field Collection Liens Filed. The IRS filed 629,813 tax liens in FY 2006.

is known as the Collection Due Process (CDP) notice, explaining the taxes due and the options for an administrative appeal.[4] The notice advises taxpayers of the date by which the CDP hearing request must be filed. The date provided assumes that the NFTL is filed within five business days after the date the NFTL was mailed, and reflects a date that is 30 calendar days after that five-business-day period.

Lien Filing

Liens become effective when the IRS provides legal notice of its lien interest by filing, or perfecting, the lien with the appropriate office. For liens against real property, an NFTL is generally filed where the property is physically located in the office designated by each state.[5] For liens against personal property, the lien is generally filed either where the taxpayer resides or where the property is located in the office designated by each state.[6] In business entity situations, the NFTL is filed in the office designated by each state, such as the office of the secretary of state.[7]

Lien Release

IRC § 6325 generally requires the IRS to release liens within 30 days after the tax debt is paid. IRC § 7432 provides taxpayers a statutory right to civil damages for the IRS's failure to release a lien. The dollar amount of damages is unlimited, but must be actual, direct economic damages sustained by the taxpayer, plus the costs of bringing the action.[8]

Historical Structure of IRS Lien Units

Before the IRS centralized the lien process in 2005, lien operations were handled by geographically dispersed lien units at 33 sites.[9] Each unit offered "Lien Desk" service, with direct telephone and walk-in assistance to taxpayers seeking payoff balances, lien subordinations, and other lien-related services. Under the Lien Desk structure, each local IRS office followed specific recording office procedures and local lien filing rules. The Lien Desks also assisted other IRS personnel, lenders, escrow agents, and mortgage companies with lien issues, including requests for release, discharge, and subordination.

Centralization of Lien Processing

In 2005, the IRS consolidated the lien processing function into a Centralized Case Processing Lien Unit (CCP-LU) at the Cincinnati campus.[10] The Small Business/Self-

[4] IRS Letter 3172, *Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320* (Nov. 2004).

[5] IRC § 6323.

[6] *Id.*

[7] Treas. Reg. § 301.6323(f)-1.

[8] Treas. Reg. § 301.7432-1(a).

[9] Government Accountability Office, GAO 05-26R, *Opportunities to Improve Timeliness of IRS Lien Releases* (Jan. 10, 2005).

[10] Centralization began in August 2004 and was completed by July of 2005.

Employed (SB/SE) division's Campus Compliance Services Operations now oversees all lien processing. The IRS envisioned that it would improve its overall performance by redesigning the case processing function, which included lien processing.

Problems with Centralized Lien Processing

As noted above, by centralizing its lien operations, the IRS hoped to improve business results by reducing operating costs, increasing efficiency, and improving customer service.[11] However, the IRS has not achieved these objectives. With centralization, existing lien processing problems have become more apparent.

Failure to Provide Written Notice of Filing within Five Days

The CDP notice provides an opportunity for the taxpayer to request an Appeals hearing within 30 days of the day after the five-business-day period for sending notice of the filing of the NFTL with respect to that tax.[12] Any delay in providing this notice can erode taxpayer rights by reducing the number of days allowed for the taxpayer to request a hearing.

Despite the importance of the CDP process, the IRS fails to notify taxpayers of lien filing in a timely manner. The Treasury Inspector General for Tax Administration (TIGTA) estimates the IRS failed to mail the CDP notice timely in nearly five percent of liens from August 1, 2004, through July 31, 2005.[13] TIGTA estimates the delay could have adversely impacted more than 23,000 taxpayers in FY 2005 by potentially limiting the number of days the taxpayers had to appeal.[14]

Failure to Release Liens in a Timely Manner

Failing to timely release liens can cause undue burden to the taxpayer. A filed lien appears in the taxpayer's credit history, and may cause a lender to charge a higher interest rate or deny financing to purchase a home or car. Taxpayers may be unable to sell their homes or creditors may refuse financing to businesses, resulting in the loss of financial opportunities. Moreover, some taxpayers may be denied employment based on the existence of an NFTL.

The Government Accountability Office (GAO, formerly the General Accounting Office) has reported each year, beginning with an FY 1999 audit of IRS financial statements, that the IRS remains noncompliant in releasing liens timely as IRC § 6325 requires.[15]

[11] *See* IRS, *Implementation Plan – Case Processing*, Slide 10, 03-SBSE-CS-4Q-24 (Oct. 30, 2003); Government Accountability Office, GAO-05-26R, *Opportunities to Improve Timeliness of IRS Lien Releases* (Jan. 10, 2005).

[12] IRS Letter 3172, *Notice of Federal Tax Lien Filing and your Rights to a Hearing Under IRC 6320* (Sept. 2006).

[13] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-094, *Fiscal Year 2006 Statutory Review of Compliance with Lien Due Process Procedures* (Jun. 2006).

[14] *Id.*

[15] Government Accountability Office, GAO-06-137, Report to the Secretary of the Treasury, *IRS's Fiscal Years 2005 and 2004 Financial Statements* (Nov. 2005).

The GAO noted that as of 2006, the IRS had not addressed the following recommendations regarding management reviews of lien processing information controls:

- Implement procedures to closely monitor the release of tax liens to ensure that they are released within 30 days of the date the related tax liability is fully satisfied. As part of these procedures, IRS should carefully analyze the causes of the delays in releasing tax liens identified by GAO's work and prior work by IRS's former internal audit function and ensure that such procedures effectively address these issues.
- Research and resolve the current backlog of unresolved unmatched exception reports.[16]
- Research and resolve unmatched exception reports weekly.
- Research and resolve the current backlog of unresolved manual interest or penalties reports.
- Research and resolve exception reports containing liens with manually calculated interest or penalties weekly, as called for in the Internal Revenue Manual and the ALS (Automated Lien System) User Guide.
- Improve the current unmatched exception report by including a cumulative list of all unmatched taxpayer accounts that have not been resolved to date.[17]

The National Taxpayer Advocate recommends that the IRS design its systems to automatically release liens when accounts are satisfied. Because ALS can systemically generate an NFTL, the IRS should be able to systemically generate a certificate of lien release. The Accounts Management Services (AMS) is exploring ways to improve existing IRS information systems as a part of the Customer Account Data Engine (CADE) project.[18] SB/SE should ensure that CADE includes programming to allow the systemic release of liens.

Inability of Internal and External Customers to Reach the IRS

Centralization has compromised customer service. The IRS did not have management information systems data to establish call patterns and develop the phone system for the centralized lien unit. Without this data, the IRS could not adequately plan for the number of taxpayers who would seek assistance from the CCP-LU (and the times when they would call) or anticipate the increase in filings and releases. The initial centralization design

[16] Exception reports contain data that do not match, including names or taxpayer identification numbers, and accounts which have manually calculated interest or penalties.

[17] Government Accountability Office, GAO-06-560, *Status of Recommendations from Financial Audits and Related Financial Management Reports* 38, 58-61 (Jun. 2006).

[18] The Customer Account Data Engine (CADE) project is incrementally designing, developing, and implementing the data foundation for a modernized IRS. CADE will eventually replace the Individual Master File (IMF) and enable the replacement of the related Integrated Data Retrieval System (IDRS) components. *See* http://www.irs.gov/privacy/article/0,,id=130899,00.html.

estimated that 74 full time employees would answer 3,000 calls per week.[19] However, the calls from taxpayers, recorders, lenders, mortgage companies, and IRS employees have greatly exceeded the IRS's projection.[20] Taxpayers have consequently experienced difficulty reaching the centralized lien unit on IRS toll-free telephone numbers.

The volume of calls answered by the CCP-LU more than doubled from January 2005 (when the unit began taking calls) through FY 2006.[21] *Assistors answered approximately one-third of the approximately 717,000 call attempts to the CCP-LU in FY 2006.*[22] Taxpayers waited an average of approximately 18 minutes before reaching an assistor.[23] Although the IRS answered about twice as many calls in FY 2006 as in FY 2005, 74 percent more callers received a "courtesy disconnect" while they were waiting in queue because staffing was insufficient.[24] Another 250,000 taxpayers abandoned their calls in FY 2006 before reaching an assistor.[25] The IRS must do better at staffing its phone lines so that customers get through to employees.

Increased Burden on Taxpayers and IRS Employees

The centralized process requires third parties to provide written requests for lien payoffs, with a completed Form 8821, Tax Information Authorization, to accompany the request.[26] Taxpayers frequently make errors completing Form 8821, requiring further contacts by the lien unit and delaying receipt of a payoff from the unit. SB/SE reviewed a sample of payoff requests and determined both taxpayers and their representatives found the form was confusing and thus frequently omitted necessary information.[27] SB/SE recommended revising Form 8821 to reduce confusion or

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[19] IRS, *Implementation Plan – Case Processing*, Slide 129, 03-SBSE-CS-4Q-24 (Oct. 30, 2003); SB/SE, *Cincinnati Centralized Case Processing Lien Review* 17 (Oct. 31 – Nov. 4, 2005).

[20] The volume of weekly calls answered in FY 2005 ranged from a low of slightly over 1,100 to a high of over 6,200. See SB/SE FY 2005 Lien Processing Snapshot Report. Weekly calls answered for FY 2006 ranged from a low of slightly less than 3,000 to a high of over 5,300 callers. See SB/SE FY 2006 Lien Processing Snapshot Report; *see also* Joint Operating Center (JOC) Enterprise Telephone Data Warehouse Product Line Detail Reports.

[21] IRS, *JOC Enterprise Telephone Data Warehouse Product Line Detail Reports.*

[22] Assistors answered 226,863 of the 716,873 call attempts to the CCP-LU. IRS, *JOC Enterprise Telephone Data Warehouse Product Line Detail Reports.*

[23] IRS, *JOC Enterprise Telephone Data Warehouse Product Line Detail Reports.*

[24] SB/SE, *Internal vs. External LOS Computations.* "Courtesy disconnects" occur when callers receive a message stating to call back at another time due to high call volume. 133,849 callers received a courtesy disconnect in FY 2005 while 232,502 callers received courtesy disconnects in FY 2006.

[25] *Id.* Primary abandoned calls are where a taxpayer reaches IRS prior to being in the queue and disconnects for whatever reason at the onset of their call. Secondary abandoned calls are those where the taxpayer gets into the phone system and is waiting in the queue for an assistor, but for whatever reason does not complete the call. 250,179 calls were abandoned in FY 2006.

[26] IRS Pub. 1450, *Instructions on How to Request a Certificate of Release of Federal Tax Lien* (Dec. 2005).

[27] SB/SE, *Cincinnati Centralized Case Processing Lien Review* (Oct. 31 – Nov. 4, 2005).

developing another form for third parties.[28] To our knowledge, the form is not currently scheduled for revision.

Prior to centralization, each individual lien unit processed liens for taxpayers, and lien employees dealt regularly with the appropriate authorities in their local jurisdictions. By centralizing the process, the IRS now requires each CCP-LU employee to become familiar with the procedures and contact information for every locality. This places an extraordinary burden on the employees, since there are over 4,600 possible filing localities across the United States.[29] An operational review by SB/SE indicates various county requirements for filing liens and releases are causing difficulty for the staff.[30] For example, one county requires special wording in red lettering on the top of the lien release requests, while other counties want cover sheets. Delays and duplication of work occur when employees are not aware of a particular county's requirements and the county sends back the entire package without the necessary filing or release.

The IRS has also experienced problems paying filing fees on time, prompting some recording offices to refuse additional filings until the IRS satisfies its bill.[31] The IRS generally pays recording fees when the office submits a voucher certifying that it has recorded the lien. Some recording entities require payment when lien recordation is done, and each entity has its own requirements for filing liens and releases. For example, some counties impose a charge for additional name lines and pages. The ALS database may not include all such billing idiosyncrasies, as recording offices do not always notify the CCP-LU of fee changes. The specific payment procedures used by various localities have proved to be burdensome for the centralized unit.[32]

Downstream Consequences

When taxpayers are unable to contact the lien unit, or experience delays in lien releases, other IRS units, including TAS, spend additional time and resources resolving those cases. These downstream consequences must be taken into account when assessing the true cost of centralized lien processing. In FY 2006, TAS received 6,065 lien-related cases, an increase of 13 percent from FY 2005, suggesting that a growing number of taxpayers are experiencing difficulties.[33]

[28] SB/SE, *Cincinnati Centralized Case Processing Lien Review* (Oct. 31 – Nov. 4, 2005).

[29] IRS, *Implementation Plan – Case Processing*, Slide 132, 03-SBSE-CS-4Q-24 (Oct. 30, 2003).

[30] SB/SE, *Cincinnati Centralized Case Processing Lien Review* 14 (Oct. 31 – Nov. 4, 2005).

[31] Telephone interview with personnel in Beckley Finance Center (Sept. 24, 2006).

[32] SB/SE, *Cincinnati Centralized Case Processing Lien Review* 9 (Oct. 31 – Nov. 4, 2005).

[33] The number of lien-related TAS cases increased by 693 from FY 2005 to FY 2006. Total FY 2006 lien-related receipts were 6,065. Primary Issue Codes 720, 721, 722, 723, 724, and 729 were extracted from the Taxpayer Advocate Management Information System (TAMIS). However, many TAS cases involved complex issues (such as offer in compromise and injured spouse).

IRS COMMENTS

The IRS concurs with the importance and necessity of timely lien filing, timely notification, timely lien releases and accessibility for our customers and believes that the Centralized Lien Unit (CLU) can deliver those functions. The IRS completed its implementation of the CLU in late August 2005 and stood up the unit in October 2005. Consolidating lien operations into a single site has helped us to better identify program inconsistencies and inefficiencies in our customer service that were not obvious in the decentralized environment. We detected, and have taken steps to address, many of the issues that arose early on and we will continue to take the steps necessary to improve our service. We believe the National Taxpayer Advocate has prematurely concluded that the program is not achieving the goals of centralization.

Efforts Since Stand Up

To ensure that the CLU continued to improve after implementation and stand up, a Collection executive was assigned for over six months beginning in November 2005 to oversee the CLU and a team of stakeholders to fine tune the process and build additional efficiencies into the program. The team included functions from across the IRS and input from the Taxpayer Advocate Service. The team developed a comprehensive action plan to mitigate the various processing, systemic and accessibility issues identified by many different prior reviews.

As a result, we have taken many actions to improve service and address concerns, such as:

- Reconfiguring our teams to provide dedicated telephone support;
- Establishing a specialized billing team to provide direct coordination with county recording offices;
- Partnering with Governmental Liaisons (GLs) to solicit feedback from the more than 4000 county recording offices and correct identified payment or process discrepancies;
- Updating our automated telephone messages to provide additional customer service for incoming calls;
- Updating the Automated Lien System (ALS) to provide nationwide access for each assistor ensuring any agent can provide assistance on an incoming call; and
- Bringing all lien filing and release requests current.

Although we have completed a majority of the actions, we continue to discuss additional actions in monthly team conferences to ensure progress continues on remaining issues.

Specific Points

Failure to provide taxpayers with written notice of lien filings within five business days of the NFTL filing.

We concur on the importance of timely notification of lien filings and will continue to make efforts to improve notification processes. We do note that TIGTA conducted the review cited by the National Taxpayer Advocate during the implementation phase of the CLU. Implementation was not completed until late August 2005 – after the period reviewed and cited as evidence of the CLU's failure to notify taxpayers.

In our own reviews we found that, although the CLU sent proper notification, we needed to modify the record keeping process because the site could not always produce certifiable lists of mailing. TIGTA's FY 2006 audit showed improvement – only three of 74 certified mail lists were not locatable and one was not date stamped. Since that time, the IRS has purchased additional scanning equipment to better monitor mailing lists and the unit began scanning Form 3877, Certified Mail Listings, to ensure all mail listings are recorded and available.

Failure to release liens in a timely manner.

Timely release of liens has always been a paramount concern in the lien process. The CLU has improved customer service and accessibility with respect to lien release. Under the decentralized structure, taxpayer assistance was limited in several of the 33 sites and only some of those locations provided Walk-In assistance. Centralization enables the Walk-In service to provide immediate lien release and payoff information in over 400 sites using an internal phone line.

When the CLU stood up in October 2005, we identified processing issues that we had to address, one of which was working exception reports. Since that time, we have addressed the backlogs, identified systemic problems, and developed work processes. We are current and will remain current with the exception reports.

The ALS automatically generates lien releases when accounts are satisfied. Exceptions to this process are cases with freeze codes, credits, and zero balances. Programming these scenarios for Individual Master File was completed in January 2006. Programming for Business Master File and Non Master File will be completed in January 2007 for Business Master File and Non Master File. Programming systemic partial releases for mirror accounts, such as bankruptcy and OIC, will be completed in January 2008.

Inability of internal and external customers to reach the IRS.

The IRS initially underestimated the volume of incoming calls the centralized telephone operation would receive and acknowledges that taxpayers experienced difficulties in contacting the site in the months immediately following the full transition to the centralized site. We have improved our operations throughout the year and continue to take steps to improve the level of service for our internal and external customers. Changes in telephone routing by implementing scripts/messaging and staffing

requirements at the Centralized Case Processing – Line Unit (CCP-LU) site dramatically improved service by the product line. Although the Level of Service (LOS) for the full year was 33 percent as noted, the LOS for the last four months of the FY2006 (June 4th through September 30, 2006) was 77.5 percent. This compares favorably with the LOS delivered by most of the other IRS toll-free operations. After analyzing incoming call patterns, automated phone scripts were updated to better address the needs of our customers and provide improved routing service based on taxpayer needs.

While we will continue to improve our service through the CCP-LU, other data lends additional perspective to that cited by the National Taxpayer Advocate:

- 88 percent of the 232,502 "Courtesy Disconnect" messages referenced occurred during the first four months of the fiscal year.
- Of the 250,000 callers cited as abandoning before reaching an assistor, more than 136,000 were PRIMARY abandons. These are callers who hang up while navigating through the initial telephone scripts, *after* they hear various informational messages about the type of assistance available from the CCP-LU operation.
- Although the Average Speed of Answer (ASA) for the full fiscal year was 17½ minutes per call, the ASA for the last quarter of the year was less than nine minutes. We are continuing to focus on this area.

Increased burden to taxpayers and IRS employees.
Together with the Governmental Liaison Division, the CLU created and sent an information booklet to recording offices explaining how lien documents will be submitted. We are identifying special requirements and making contacts with recording offices to explain the Federal Lien Registration Act and how the IRS determines the format and content of lien documents.

With regard to paying recording fees, we have updated the ALS database to include the specific requirements of the recording offices and to identify which recording offices are paid by imprest and which are billing counties. We also have requested additional programming to enable all employees to have accurate county recorder information at their fingertips.

Under revised procedures, the CLU will continue to date stamp Billing Support Vouchers (BSV) used to pay recording fees and will verify that employees are timely and accurately following revised procedures through semiannual reviews during FY 2006 & FY 2007. Further, we have enhanced the ALS to allow employees to edit BSVs and plan to upgrade ALS to allow systemic monitoring of BSVs.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate appreciates that migrating to a centralized system is a challenging endeavor, and commends the IRS for its efforts during the transition period. However, the National Taxpayer Advocate also recognizes that much work remains to be done, and is concerned that the centralized approach to lien processing may be detrimental to taxpayer service.

Timely notification

The FY 2006 TIGTA report referenced in the IRS response covered approximately six months of centralized lien processing and identified a continued lack of improvement in timely mailing lien notices. TIGTA did note the improved procedural control of certified mail listings over the five prior years. The National Taxpayer Advocate is hopeful that the improvement in management controls over the certified listings, and the purchase of additional scanning equipment, will help the IRS eliminate the problem of missing listings.

Failure to release liens in a timely manner

Despite the IRS's claim that taxpayer accessibility to customer service has expanded, the National Taxpayer Advocate remains concerned about the ability of the IRS to timely release NFTLs. The GAO recently identified the failure to timely release NFTLs after centralization as a continuing weakness for the IRS.[34]

The National Taxpayer Advocate continues to receive complaints from practitioners that the IRS has not immediately released liens when taxpayers have presented certified checks to cover the outstanding liability. Although IRS guidance specifies that "accounts satisfied by cash, postal money order, certified check, cashiers check, official bank check or guaranteed draft drawn on any federally chartered or state licensed financial institution, may be released immediately upon payment," it appears that this guidance is not always being followed.[35] Employees must understand this provision and sense the urgency in releasing the lien.

Addressing exception reports in a timely manner is also critical to resolving release discrepancies. The CCP-LU needs to resolve discrepancies as soon as possible, with adequate monitoring in place to ensure releases are generated. We applaud the IRS for scheduling the necessary programming changes, and encourage the IRS to ensure that these changes are implemented in a timely manner.

Inability of internal and external customers to reach the IRS

The National Taxpayer Advocate is encouraged by the significant increase in the level of service provided by the centralized telephone operation, and hopes this high level of

[34] Government Accountability Office, GAO-07-136, *IRS's Fiscal Years 2006 and 2005 Financial Statements* 12, 124, 142 (Nov. 2006).

[35] IRM 5.12.2.3.1.

customer service continues in FY 2007 and beyond. However, the National Taxpayer Advocate remains concerned about the ability of taxpayers to contact the CCP-LU in the first place.

During FY 2006, 54 percent of the abandoned calls fell into the "primary abandon" category, which means these callers abandoned their calls while trying to navigate telephone messaging prompts. The other 46 percent of the abandoned calls were "secondary abandons," meaning the caller gave up after successfully navigating telephone prompts and was on hold awaiting an assistor. The IRS needs to pay close attention to the abandoned call rates and ensure that its messaging prompts adequately address taxpayer needs.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- Program its systems to automatically release liens when the account is satisfied.
- Work proactively with Governmental Liaisons to contact recording entities yearly to identify fee schedule changes and update ALS accordingly.
- Propose revisions to Form 8821, Tax Information Authorization, and the accompanying instructions, or develop a new form to reduce confusion.
- Reexamine whether centralization is more cost effective and provides better service to taxpayers than the previous local lien desk structure, and conduct a comprehensive cost analysis, including downstream costs such as TAS cases and Taxpayer Assistance Center contacts.
- Examine primary disconnect rates to determine if additional staffing is necessary or if menu items need to be revisited for ease of taxpayer use.
- Issue additional guidance or training regarding IRS authority to issue an immediate lien release when a taxpayer satisfies an account by cash or cash equivalents, including certified check, cashiers check, official bank check, or guaranteed draft drawn on any federally chartered or state licensed financial institution.

PROBLEM

TOPIC #9 COLLECTION ISSUES OF LOW INCOME TAXPAYERS

RESPONSIBLE OFFICIALS

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Richard J. Morgante, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The IRS's collection operations fail to provide the meaningful services that low income taxpayers need to meet their obligations regarding federal tax delinquencies. In handling routine collection cases involving low income taxpayers, the IRS frequently fails to offer personal contacts and flexible payment options, even though many low income taxpayers require this type of service to fully resolve problems in a timely manner. While low income taxpayers generally incur relatively small debts, which the IRS considers low priority collection cases, these balances still cause serious financial problems for the individual taxpayers.

ANALYSIS OF PROBLEM

IRS Collection Practices:
Low Income = Small Balances Due = Low Priority = Little or No Personal Attention

Collection cases involving income tax liabilities of low income taxpayers are affected in a particularly negative manner by IRS case assignment practices, which are designed to treat relatively small balances due as low priority cases. As a result, these taxpayers will likely never receive personal contacts from IRS collection representatives if their cases are not successfully resolved through the routine collection notice process. These accounts carry a high probability of being "surveyed," *i.e.*, systemically reported as not collectible. If cases go unresolved, penalties and interest will continue to accrue on these accounts, and taxpayers who are already struggling to make ends meet will quickly see their tax debts grow even larger.[1] Further, without meaningful intervention early in these cases, the IRS creates the appearance of being an unconcerned creditor. This perception may lead to the accrual of additional liabilities and larger tax debt problems that are exceptionally difficult for the low income taxpayer to resolve.

IRS collection practices do not encourage or support efforts by low income taxpayers to resolve tax debts.

Even when low income taxpayers proactively attempt to resolve their delinquency problems, IRS collection practices often serve as barriers to mutually beneficial solutions. User fees for installment agreements (IA), offers in compromise (OIC) application

[1] *See* Most Serious Problem, *Early Intervention in IRS Collection Cases, supra.*

fees, and the new OIC payment requirements mandated by the TIPRA legislation[2] make alternative payment arrangements even less attainable for struggling low income taxpayers. Rather than reaching out and encouraging these taxpayers to seek positive resolutions for their tax debt problems, these requirements may very well act as disincentives to even make the attempt. For example, in a recent review of the OIC program, the Treasury Inspector General for Tax Administration (TIGTA) noted that the decline in OIC receipts attributable to the implementation of the OIC application fee was notably higher among low income taxpayers, including those who would qualify for the low income waiver.[3]

IRS Installment Agreement User Fee – One Size Fits All?

The IRS recently announced plans to raise the IA user fee from $43 to $105 for taxpayers entering into new IAs. However, taxpayers who opt to make payments via direct debits from their bank accounts will only pay a $52 fee.[4] Some responses to the IRS's notice of the proposed changes have noted that the changes appear to discriminate against low income taxpayers, particularly those too poor or financially unsophisticated to maintain bank accounts.[5] While those taxpayers with the financial capacity to make their IA payments via direct debit will pay only $9 more than the current fee, the "unbanked" poor will have to pay almost 150 percent more than the current amount.[6]

Further, the IA fee does not appear to be directly related to the size of the delinquent tax balance, the income level of the taxpayer, or even the amount of effort required by the IRS to establish and monitor the agreement. For example, a taxpayer with a six figure income owing $50,000 in delinquent taxes who agrees to have the IA payments automatically drawn from a bank account would pay a fee of $52, even if the IRS had to assign the case to a field-based revenue officer for resolution. On the other hand, an unbanked low income taxpayer seeking a monthly payment plan to resolve a $500 tax debt would be charged $105 – over 20 percent of the balance due – even if the IA

[2] Tax Increase Prevention and Reconciliation Act of 2005, H.R. 4297, Pub. L. No. 109-222, 120 STAT. 345. A taxpayer is now required to submit with the OIC application an initial payment of 20 percent of the amount offered with a cash OIC, or immediately begin to make the proposed scheduled payments in a deferred payment OIC. Otherwise, the OIC request will not be processed by the IRS.

[3] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-100, *The Offer in Compromise Program Is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes* 11 (Jul. 2006).

[4] Daily Tax Report, *User Fees: IRS Proposes Increased User Fees for Direct Debit Installment Agreements* (Aug. 30, 2006).

[5] "The proposal to increase the user fee fails to meet the requirements of the Independent Offices Appropriations Act (IOAA), codified at *31 USC section* 9701 and cited in the Notice of Proposed Rulemaking. Quite simply, the proposed fee increase is not fair and represents poor public policy because it discriminates against low income taxpayers – more specifically, those too poor to be able to maintain bank accounts." Tax Analysts Tax Notes Today, *Legal Aid Group Says Proposed Regs To Increase Installment Agreement Fees Would Discriminate Against Poor*, Oct. 4, 2006, at 2.

[6] A recent survey indicates that 91.6 percent of households that do not maintain a bank account have annual incomes of less than $25,000. The Center for Financial Services Innovation, *A Financial Services Survey of Low- and Moderate-Income Households* 6 (Jul. 2005).

was established in a streamlined manner during the collection notice process.[7] It seems impossible not to notice the inequity of this situation. While the IA fee represents a relatively small amount for most taxpayers, it could be a significant amount for those already financially burdened. The IRS does not provide a low income waiver for the installment agreement user fee.

IRS collection practices do not realistically determine the reasonable collection potential of cases involving low income taxpayers.

Elsewhere in this report, we discuss in detail concerns with the manner in which the IRS applies the national standards for allowable living expenses (ALE) to individual taxpayer cases to determine reasonable collection potential.[8] These concerns are clearly illustrated by the manner in which the IRS employs these standards in evaluating the collection potential of cases involving low income taxpayers. Because ALE standards are based on actual expenditures at differing income levels, rather than cost of living estimates, the use of these standards in evaluating the collection potential of low income taxpayers provides unrealistic results. For example, the IRS provides current ALE "national standards," which primarily represent allowances for food and clothing, for taxpayers at eight income stratifications.[9] For a family of four, the stratifications representing the lowest three income levels are actually *below the poverty income level* as defined by the U.S. Department of Health and Human Services.[10] The six lowest income levels represented in the standards are below 250 percent of the poverty level. As defined by the ALE, a family of four living at the lowest defined income level is only entitled to $11 more per month for food than a family of three! Further, the ALE national standards fail to recognize evidence that low income taxpayers often face higher food prices because they tend to live in urban or rural parts of the country, where prices tend to be higher than in the suburbs.[11]

We believe that assigning "allowable" expenses to taxpayers at these income levels is highly impractical and unrealistic. This methodology fails to recognize that these taxpayers may be hard pressed to simply meet basic living expenses. The IRS should not confuse actual expenditures with realistic cost of living allowances. As we recommended in the 2005 Annual Report to Congress, the IRS should develop reasonable allowable expense standards that recognize the need for taxpayers to retain sufficient net income to rise above the poverty level, as measured by federal poverty guidelines (or some reasonable

7 *See* Most Serious Problem, *IRS Collection Payment Alternatives, supra*, for a more detailed discussion of the streamlined installment agreement process.

8 *Id.*

9 IRS, *National Standards for Allowable Living Expenses*, at http://www.irs.gov/businesses/small/article/0,,id=104627,00.html.

10 United States Department of Health and Human Services, *Poverty Guidelines Research and Measurement* at http://aspe.hhs.gov/poverty.

11 Phil Kaufman and Steven M. Lutz, Food and Rural Economics Division, U.S. Department of Agriculture, *Competing Forces Affect Food Prices for Low Income Households*, Food Review (May-Aug. 1997).

percentage above them). The IRS should also apply these standards without documentation.[12] A fair and reasonable application of the ALE concept must acknowledge and account for the taxpayer's ability to meet basic living expenses. ALE allowances that drop below this level, or "floor," simply do not reflect realistic allowances.

Collection options for low income taxpayers tend to have a narrow focus – "full pay" or "not collectible."

Typically, the IRS response to concerns in this area indicate the IRS does not require payments from taxpayers at or below the poverty level, *i.e.*, it usually reports these accounts as currently not collectible (CNC).[13] We acknowledge the CNC option can represent a reasonable and realistic collection decision for taxpayers who do not have the financial capacity to make payments on delinquent taxes. However, the CNC status is not the optimal solution for the problems of many taxpayers, particularly those who have not been personally contacted by the IRS, or have actually offered alternative payment options which the IRS has denied. As discussed elsewhere in this report, a significant number of rejected OICs are subsequently reported as CNC.[14] In a recent IRS study, of those rejected OICs subsequently reported as CNC, 27 percent of the cases involving individuals (Individual Master File) and 49 percent of those involving businesses (Business Master File) were already in CNC status *at the time the OICs were rejected*.[15] Additional IRS data indicates that during fiscal years 2004 and 2005, in cases where taxpayers requested installment agreements and the requests were denied, 31 percent were later reported as not collectible. Of those, 52 percent were in CNC status at the time the taxpayer requested an IA.[16]

In a recent focus group conducted by TAS with professionals considered to be experts in matters involving low income taxpayers, it was reported that the IRS seems very reluctant to accept low-dollar OICs, even though these offer amounts may realistically reflect the taxpayers' reasonable collection potential.[17] The focus group comments included observations that IRS employees seem to believe the IRS is doing the low income taxpayer "a favor" by reporting the account as CNC, with no recognition that these taxpayers are looking for a sense of closure to their debt problems, which the CNC decisions do not provide. This group also reported that because accepted OICs are a matter of public record, it appears the IRS is reluctant to accept and disclose low-dollar offer amounts. Members of the group stated that it was their experience that low-dollar offers from low income taxpayers bring "automatic" rejections from the IRS's centralized OIC

[12] National Taxpayer Advocate 2005 Annual Report to Congress 291.

[13] *Id.* at 284.

[14] *See* Most Serious Problem, *IRS Collection Payment Alternatives, supra.*

[15] IRS, *Analysis of Various Aspects of the OIC Program* 9 (Sept. 2004).

[16] IRS, *Accounts Receivable Inventory Report* (FY 2004 and FY 2005).

[17] Taxpayer Advocate Service, *Focus Group Discussion: Negative Impact of IRS Collection Practices on Low Income Taxpayers.* (Aug. 29, 2006).

operations in Brookhaven, New York and Memphis, Tennessee.[18] It should be noted that these perceptions exist despite the specific direction of the Internal Revenue Code that the IRS shall not reject OICs from low income taxpayers solely on the basis of the amounts offered.[19]

The concerns of the focus group may have received some validation from the proceedings in *Oman v. Commissioner*, a recent case before the United States Tax Court.[20] In this case, a low income taxpayer intermittently failed to file and pay his income taxes timely from 1990 through 2001, accruing a $169,146 delinquency. Although the IRS determined it would be unlikely to collect anything from the taxpayer (*i.e.*, his "reasonable collection potential" was zero) because he had no assets and his income, which was below poverty level, did not cover his allowable expenses each month, the IRS did not accept his $1,000 offer.[21] The IRS rejected the taxpayer's offer as not in the "best interest of the government" because of his "egregious history of past non-compliance" and because the IRS's analysis of the taxpayer's current finances gave rise to concerns that he could not "remain in compliance during the offer terms."[22] The court remanded the case back to the IRS because the IRS had not adequately explained the reason for its decision.

The circumstances in this case clearly illustrate how the lack of early IRS intervention in a collection case can lead to a tax debt that may be impossible for the taxpayer to fully resolve, as well as the reluctance of the IRS to use collection tools, such as the offer in compromise, as reasonable alternative solutions. This case is a classic example of how IRS collection practices harm low income taxpayers, and waste considerable resources – including tax court litigation expenses – to deny relief in cases where the only other realistic alternative is to report the account as not collectible.

Tax delinquencies represent more than "dollars and cents" problems for the low income individuals involved.

The focus group also reported that the psychological harm associated with the inability to resolve lingering tax problems with the IRS should not be discounted.[23] Tax debts, particularly if the IRS has filed a notice of federal tax lien, can have serious consequenc-

[18] Taxpayer Advocate Service, *Focus Group Discussion: Negative Impact of IRS Collection Practices on Low Income Taxpayers*. (Aug. 29, 2006).

[19] IRC § 7122(c)(3).

[20] *Oman v. Comm'r,* TC Memo 2006-231.

[21] The taxpayer's allowable expenses of $1,012 per month exceeded his monthly income of $653 (or $7,836 per year) by $359 per month. Since the early 1990s he had held a series of seasonal and odd jobs relied on friends and family for necessities. He entered a rehabilitation program for alcohol, drugs, and depression in 2003. At the time he submitted an offer to the IRS, he was unemployed, lived with friends, and received money from his parents from time to time.

[22] *Oman v. Comm'r,* TC Memo 2006-231.

[23] Taxpayer Advocate Service, *Focus Group Discussion: Negative Impact of IRS Collection Practices on Low Income Taxpayers* (Aug. 29, 2006).

es in various aspects of these taxpayers' lives. Tax debts can negatively impact taxpayers' credit ratings, which may in turn result in higher rents, steeper automobile insurance rates, and generally higher interest rates for individuals classified as poor credit risks.[24] Further, employers increasingly use credit scores in screening job applicants, and there is evidence that negative credit ratings can adversely affect job offers.[25] Other studies indicate that stress related to financial difficulties can lead to decreased productivity in the workplace and a variety of additional costs for employers.[26]

Automatic refund offsets associated with taxpayer accounts in CNC status may encourage non-compliant behavior, *i.e.*, inadequate withholding from wages or failure to make estimated tax payments, which in turn lead to additional tax delinquencies. In some instances, failure to successfully negotiate a mutually agreeable payment alternative could lead taxpayers to drop out of the tax system altogether and become part of the non-compliant cash economy. The focus group participants also emphasized that for many taxpayers whose debts are reported as CNC, the tax problems are not resolved and the lingering, growing debts are significant psychological weights. The group reported many of these taxpayers sincerely want to solve their tax problems and have a good sense of what they can realistically pay, but need the IRS to be more flexible and help them solve their problems in a reasonable and realistic manner.[27]

While personal contacts and flexible payment alternatives are often not available to low income taxpayers, automated enforcement actions on these accounts are becoming much more common.

Elsewhere in this report, we discuss in detail concerns with the manner in which the IRS is increasingly utilizing its authority to levy on the assets of taxpayers to collect delinquent taxes, even in situations where there has been no meaningful attempt at personal contact, *i.e.*, "systemic levies."[28] These concerns are most clearly evident in the Federal Payment Levy Program (FPLP), an automated system that matches IRS records against those of the government's Financial Management Service (FMS) to locate recipients of federal payments who have delinquent tax debts. The IRS is authorized to use the FPLP program to issue continuous levies on these income sources to capture up to 15 percent of these payments.[29]

[24] State of Washington, Office of Insurance Commissioner, *A Report to the Legislature: Effect of Credit Scoring on Auto Insurance Underwriting and Pricing* 2 (Jan. 2003); State of Missouri, Department of Insurance, *Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri* 1-2 (Jan. 2004).

[25] Better Business Bureau, *The Wise Consumer News Letter*, available at http://www.bbb.org/wise/issues/0604.asp (Jun. 2004).

[26] Association for Financial Counseling and Planning Education, *"The Negative Impact of Employee Poor Personal Financial Behaviors On Employers,"* E. Thomas Garman, Irene E. Leech, John E. Grable, 157 (Vol. 7, 1996).

[27] Taxpayer Advocate Service, *Focus Group Discussion: Negative Impact of IRS Collection Practices on Low Income Taxpayers* (Aug. 29, 2006).

[28] *See* Most Serious Problem, *Levies, supra*.

[29] IRC § 6331(h)(2)(A).

While it is our understanding that the FPLP program was originally developed as a collection tool to address delinquent taxpayers who were also the beneficiaries of contracts with the federal government, in recent years approximately 84 percent of all FPLP levies have involved payments from the Social Security Administration (SSA) to taxpayers who are elderly and/or disabled.[30] The IRS makes no attempt to identify and exclude from the FPLP those taxpayers with income below a specified threshold.[31] Although current law limits FPLP levies to only 15 percent of each Social Security payment, this reduction in income can be highly significant for low income taxpayers already surviving on income at or near the poverty level.

FPLP Particularly Harmful to Low income Taxpayers

Recently, Professor Scott A. Schumacher, Director of the University of Washington's low income taxpayer clinic (LITC), published an insightful discussion of the harmful effects of the FPLP program on low income taxpayers. In his article, Schumacher explains that "many elderly and disabled taxpayers rely on Social Security as their sole source of income, with the average amount of Social Security benefits paid to those taxpayers being $900 per month."[32] Many of these taxpayers have had their benefits levied by the IRS, often without actual prior contact or notice, "rendering them unable to pay their living expenses."[33]

Because IRS procedures only require notices of intent to levy be mailed to the taxpayer's "last known address," these taxpayers frequently do not receive actual notice until the IRS has already levied upon their benefits.[34] These levies invariably result in economic harm when retired or disabled low income taxpayers are involved. However, without actual notice, these taxpayers have no opportunity to exercise their collection due process (CDP) rights to prevent the issuance of these levies.[35] Schumacher reports that once the FPLP levy is issued, it can take a month if not longer for the IRS to agree to release it. The IRS may levy upon some taxpayers' benefits for several months before the matter is resolved. The University of Washington LITC has "seen a dramatic increase in FPLP levies over the past year. Without exception, the IRS has released those

[30] IRS, Wage & Investment Operating Division, *FPLP Monthly Counts CUM* (May 2006).

[31] *See* Most Serious Problem, *Levies, supra.*

[32] Tax Analysts Tax Notes Today, *Unnecessary Harm: IRS Levies On Social Security Benefits*, Oct. 17, 2006, at 2. As of October 2006, Social Security recipients received an average monthly benefit of $923.30. Social Security Administration, *Office of Policy Research, Evaluation and Statistics, Monthly Statistical Snapshot*, Table 2, Social Security Benefits (Oct. 2006).

[33] Tax Analysts Tax Notes Today, *Unnecessary Harm: IRS Levies On Social Security Benefits*, Oct. 17, 2006, at 2.

[34] Problems associated with the IRS's use of the "last known address" in delivering the notices of intent to issue FPLP levies were also discussed in the NTA's 2005 Annual Report to Congress, *Most Serious Problem: Levies on Social Security Payments*. In general, the IRS's last known address is based on the address provided by the taxpayer on the last tax return filed. This practice is particularly problematic when applied to taxpayers who are retired or disabled, and may not have had a legal requirement to file an income tax return for several years prior to the FPLP notice.

[35] *See* IRC § 6330.

levies because it determined the levy was causing financial hardship, but not before it had wrecked havoc on the taxpayer."[36]

In the 2005 Annual Report to Congress, the National Taxpayer Advocate identified levies on Social Security benefits as one of the most serious problems encountered by taxpayers.[37] We reported concerns that taxpayers subject to FPLP may not receive adequate prior notification of the intent to levy, and the IRS lacked adequate safeguards to prevent harm to low income taxpayers in these situations. The IRS response to this report has done little to reduce these concerns. In fact, the problem appears to be growing worse. TAS cases involving the IRS levy program have increased by 69 percent from FY 2005 to FY 2006.[38] TAS cases regarding FPLP levies on Social Security benefits have increased by 143 percent from FY 2005 to FY 2006.[39] Cases involving the FPLP program have been particularly disturbing. Consider the following taxpayers upon whom this levy was systemically imposed:[40]

- Taxpayer is 70 years old, paralyzed and confined to a wheelchair, and has resided in a nursing home since 1994. SSA income for 2005 was just under $13,000, which was supplemented by a pension of approximately $10,500. All income is paid to the nursing home to cover necessary living expenses.
- Taxpayer is 75 years old and bedridden as a result of a stroke. The only income is Social Security, which provides for medicine and necessary living expenses. SSA income for 2005 was just under $11,000. The taxpayer's last tax return filed was 1995.
- Taxpayer is 72 years old, suffers from heart disease that resulted in triple bypass surgery, and is now working part-time to help pay for medications. SSA income for 2005 was approximately $6,700, supplemented by wages of approximately $4,600. The taxpayer has had individual income tax liabilities already reported as not collectible by the IRS. The FPLP levy involved taxes incurred by a business that has been closed since 1999.
- Taxpayer is 58 years old and relies on Social Security benefits, along with welfare payments and food stamps, to meet basic living expenses. The total monthly income was $832. TAS involvement led to release of the FPLP levy. The IRS initially refused to refund any levy payments because the taxpayer had "no apparent hardship."

[36] Tax Analysts Tax Notes Today, *Unnecessary Harm: IRS Levies On Social Security Benefits*, Oct. 17, 2006, at 4. See Most Serious Problem, *Levies, supra* for a more detailed discussion of problems with IRS policies and procedures regarding the release of IRS levies.

[37] National Taxpayer Advocate 2005 Annual Report to Congress 123-135. *See also* Most Serious Problem, *Levies, supra.*

[38] Taxpayer Advocate Service, *Business Performance Review* 50 (Oct. 11, 2006).

[39] Taxpayer Advocate Service, *Business Performance Review* (Sept. 30, 2006). For FY 2005, there were 1,707 FPLP/Social Security-benefit related cases in TAS and 4,147 for FY 2006.

[40] Taxpayer Advocate Management Information System (TAMIS).

TAS has many, many more examples of situations where the FPLP program has created financial and emotional harm to low income taxpayers. During FY 2006, we have noted that 56 percent of the TAS cases involving FPLP levies on Social Security benefits were given full relief, *i.e.*, the levies were released.[41] It is very difficult to believe that anyone reviewing these cases would conclude that IRS levy activity was appropriate. However, the basic underlying problem with the systemically generated FPLP levies is that they were not reviewed by anyone prior to issuance.

FPLP Levies Require the Use of Good Judgment and Proper Discretion.

In the 2005 Annual Report, the National Taxpayer Advocate expressed concern with the lack of managerial approval required by the FPLP levy process.[42] The report noted that to protect taxpayers from unnecessary hardship, Congress has instructed the IRS to develop procedures to ensure a determination to file a levy would, where appropriate, be reviewed and approved by a supervisor before levy action was taken. Section 3421 of the IRS Restructuring and Reform Act of 1998 (RRA 98) requires that a supervisor, where the Secretary deems appropriate, take the following steps prior to the issuance of a levy: (1) review the taxpayer's information; (2) verify that a balance is due; and (3) affirm that the action proposed to be taken is *appropriate given the taxpayer's circumstances*.[43]

The RRA 98 language implies that this review was intended to be more than a measure to ensure the technical accuracy of levies. Rather, this part of the legislation was designed to ensure the IRS exercised proper judgment and discretion in the application of its considerable levy authority. The IRS response to concerns regarding the application of this requirement to the FPLP program has been that the Taxpayer Relief Act of 1997 (TRA 97) allows for the use of continuous automated FPLP levies. However, we do not agree that TRA 97 authorizes the use of systemic levies without adequate research and screening to prevent unintended economic harm on vulnerable segments of the population.

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[41] Taxpayer Advocate Management Information System (TAMIS).

[42] National Taxpayer Advocate 2005 Annual Report to Congress 127-128. *See also* Most Serious Problem, *Levies, supra.*

[43] Section 3421 of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998) provides as follows:
(a) IN GENERAL.–The Commissioner of Internal Revenue shall develop and implement procedures under which–
(1) a determination by an employee to file a notice of lien or levy with respect to, or to levy or seize, any property or right to property would, where appropriate, be required to be reviewed by a supervisor of the employee before the action was taken; and
(2) appropriate disciplinary action would be taken against the employee or supervisor where the procedures under paragraph (1) were not followed.
(b) REVIEW PROCESS.–The review process under subsection (a)(1) may include a certification that the employee has–
(1) reviewed the taxpayer's information;
(2) verified that a balance is due; and
(3) affirmed that the action proposed to be taken is appropriate given the taxpayer's circumstances, considering the amount due and the value of the property or right to property.

We believe the IRS's legal right to take an action does not automatically mean it is the right action to take. Although the systemic issuance of FPLP levies is technically legal, we believe that without proper research, analysis, and screening mechanisms in place to protect taxpayers from economic harm and undue burden, the IRS's current practices in this area are intolerable. While RRA 98 permits the Commissioner to exercise discretion regarding the application of Section 3421, we believe levies involving Social Security benefits clearly fall within the category of levy actions for which this legislation was intended.

Conclusion: Quality customer service should not be dependent on the taxpayer's level of income

For a voluntary tax system to work, it is important that it work well for *all* taxpayers. RRA 98 required the IRS to develop and implement a system of "balanced measures" to gauge the organization's effectiveness in delivering business results, customer satisfaction, and employee satisfaction. With regard to the service provided to low income taxpayers, the National Taxpayer Advocate believes the IRS collection operations are failing in all three areas.

The IRS routinely gives very low priority to collection cases involving low income taxpayers, and generally provides "service" on these accounts through computer-generated collection notices and automated levies. As a result, collection employees have relatively few opportunities to offer these taxpayers the services needed to help them fully resolve their problems. Frequently, cases involving low income taxpayers are simply set aside as "not collectible" even if the taxpayers are seeking alternative payment options. The taxpayers may also be subjected to automated levies on retirement and disability income sources, often without actual prior notice, even in situations where the taxpayers are surviving on incomes below or near the poverty level. Without the financial means to secure adequate representation, low income taxpayers can easily find themselves lost in a tax system that appears to be indifferent, uncaring, and sometimes actually hostile. Nevertheless, these taxpayers are part of the federal government's voluntary tax system. The IRS *must* do a better job in treating them accordingly.

IRS COMMENTS

We disagree with the National Taxpayer Advocate's assessment that the IRS is not providing the services low income taxpayers need to resolve their Federal tax delinquencies. The IRS generally expects that all taxpayers will try to pay the total amount due, regardless of that amount and whether it is solely tax or includes penalties and interest. Within an overall Collection framework, we assist taxpayers in fulfilling their obligations regardless of income levels.

The IRS' collection strategy places priority on rapidly working the largest number of cases with the highest potential risk to future compliance. All new cases above a minimum liability receive some form of collection treatment and we provide contact options

in Campus, Field, and electronic environments to maximize opportunities for early resolution for all taxpayers.

To optimize enterprise efficiency and effective collection practices across our entire accounts receivable inventory, we recently chartered a working group to review our current case routing practices to assess whether we can use recent technological improvements to develop alternative treatment streams, including those for small debts owed by low income taxpayers. Also, while the IRS does not have the resources to personally contact every low income taxpayer regarding a delinquent account, our Private Debt Collection initiative uses contractors to attempt personal contact on many smaller debts that might otherwise go unaddressed because of higher priority work.

Offer in Compromise

An offer in compromise (OIC) remains a viable payment alternative for low income taxpayers. Regardless of economic bracket, the OIC program is not an option for all taxpayers. We evaluate each case individually. The OIC application fee and payments imposed by § 509 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) are currently waived for individuals whose income falls at or below IRS Low Income Guidelines. The upcoming revision of Form 656 will define "low income" to include those taxpayers with incomes at or below 250 percent of the federal poverty level as defined by the Department of Health and Human Services. To address the Treasury Inspector General for Tax Administration's concerns, as noted in the National Taxpayer Advocate's report, the IRS conducted a media campaign to educate the public about the OIC eligibility requirements and exemptions. Further, the IRS recently piloted the "OIC Candidate" program under which the IRS sends OIC outreach information to compliant taxpayers already identified as a Currently Not Collectible (CNC) "hardship."

Installment Agreements

The IRS grants streamlined installment agreements (IAs), where taxpayers choose their own repayment schedule within certain guidelines, for liabilities up to $25,000. In fiscal year 2006, streamlined IAs accounted for ninety-seven percent of all IAs granted. When applying for a streamlined IA, taxpayers do not have to submit financial analysis or other documents for review; they simply sign up and choose a repayment schedule. In other words, it is unlikely that the IRS will have cause to apply the Allowable Living Expense (ALE) standards in low-dollar tax cases. In the unlikely situation that the ALE would be applied to a taxpayer with an income at or near the poverty level, however, recent IRS research shows that, almost invariably, we would place the taxpayer in CNC status. If we determine that we should not take further collection action because of the risk of hardship, but the taxpayer chooses to pay, the IRS accepts the payments and may place the account in a "backup" CNC status to prevent enforcement if the taxpayer fails to make the voluntary payments.

The amount of liability paid through an IA does not impact the cost of granting the agreement. In Notice of Proposed Rulemaking, 71 Fed. Reg. 51538 (Aug. 30, 2006), the Office of Management and Budget (OMB) directed federal agencies to charge user fees that reflect the full cost of services. The proposed increase in user fees for IAs will bring the IRS's fees in line with actual processing costs. The IRS charges the user fee upon accepting the IA, not upon application for the IA. Further, we do not require the taxpayer to pay the user fee "up front", but rather deduct the fee from the initial installment payments so that taxpayers may pay the fee in increments. In addition, the IRS will study the possibility of being able to either waive or reduce the IA user fees for individuals with incomes less than 250 percent of federally established poverty levels.

Federal Payment Levy Program

The National Taxpayer Advocate states that the Federal Payment Levy Program was originally developed to collect debts from beneficiaries of contracts with the Federal government. The Taxpayer Relief Act of 1997 specifically authorized the IRS to use the FPLP to levy up to 15 percent of Social Security payments. The House of Representatives Committee Report on P.L. 105-34 states, in part,

> "…the provision amends the Code to provide that a continuous levy is also applicable to non-means tested recurring Federal payments. This is defined as a Federal payment for which eligibility is not based on the income and/or assets of a payee. For example, Social Security payments, which are not subject to levy under present law, would become subject to continuous levy."

In addition to the general final notice issued to all taxpayers prior to enforcement action, the IRS issues an additional notice to Social Security beneficiaries prior to the FPLP levy. Every notice sent to the taxpayer provides information on how to contact the IRS if he or she cannot pay the balance. We also advise taxpayers to submit information to substantiate their inability to pay and analyze that information in determining whether a taxpayer is suffering a hardship.

As stated in the National Taxpayer Advocate's report, the Government Accountability Office determined that the IRS's previous filter to pre-screen FPLP levies for hardship situations did not accurately reflect a taxpayer's ability to pay. We agreed with GAO and followed their recommendation to eliminate the exclusion criteria and rely on the additional final notice process to resolve taxpayer cases. A subsequent IRS task force, including TAS representatives, was unable to design a valid replacement filter. In an effort to identify Social Security recipients who could be experiencing a hardship, the IRS and SSA are working on blocking a FPL on benefit payments going directly to a health care facility. Although the IRS does not receive many levy payments on these taxpayers, excluding the payments will eliminate the possibility of hardship caused by the FPLP for these taxpayers. In another instance, the IRS helped perfect SSA's records so that SSA could ensure it was honoring only appropriate paper levies.

We agree, however, that the FPLP should be used in a manner that causes the minimum amount of financial hardship. Therefore, we will begin a new research project to create and implement an effective income filter to assist the IRS in identifying taxpayers who may experience a hardship because of the FPLP. We also agree that levies must be released promptly in hardship situations, and we do expedite levy releases in those cases. We plan to study options for improving our efficiency in releasing levies during FY 2007.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes and acknowledges current and past efforts by the IRS to mitigate the negative impact collection activity may have on low income taxpayers. Most notably, we are pleased with recent decisions to modify the new payment requirements for OICs that were implemented this past year as part of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). The decision to waive these requirements for taxpayers with income at or below 250 percent of the poverty level as defined by the Department of Health and Human Services is a very significant step in the right direction. Also, we view the decision to apply the same low income definition to the requirement for the OIC application fee as a significant accomplishment, which not only mitigates the economic impact these requirements have on low income taxpayers, but also simplifies the OIC application process for these individuals. We are also pleased to note that the application for OIC consideration, Form 656, has been revised to include instructions for taxpayers regarding these issues. We look forward to seeing the new revision in the near future.

We have worked closely with the IRS on these issues during the past year, and have found IRS management to be genuinely concerned about integrating fair and reasonable expectations into the practical application of these requirements. The IRS is to be commended for its efforts in this area. Further, we are encouraged by current discussions between the IRS and the Treasury Department regarding the implementation of a similar "low income" waiver for the installment agreement user fees. We view this decision as a logical, realistic extension of the concepts now embedded in the OIC process, and optimistically look forward to these proposed changes to the IA fee becoming reality in the near future.

We remain concerned, however, that the "overall Collection framework" mentioned in the IRS comments to this report does not reflect a true commitment to provide adequate service to the low income segment of the taxpayer population. As discussed in this report, the IRS collection framework takes a very rudimentary approach to servicing low income taxpayers with tax debts, *i.e.*, collection notices sent to the taxpayer's last known address, systemically generated levies, and what appears to be an almost automatic default position of reporting the accounts as CNC if the notice or levy processes fail to resolve the delinquencies. We continue to believe that these methods

clearly do not provide a service-oriented approach to helping these taxpayers resolve their collection problems.

As we have discussed at length in this year's report to Congress, timely, meaningful interventions are critical to the successful collection of delinquent accounts.[44] Probably more than any other taxpayer group, low income taxpayers will likely have problems with the IRS collection notice process, particularly if those notices are sent to incorrect addresses. Low income taxpayers are the least likely to have the financial ability to obtain professional representation to assist them in navigating the IRS collection process. Additionally, the practice of issuing notices to the last known address, which is typically the address of the last tax return filed, will likely fail to reach many of these taxpayers, particularly if their line of employment makes them transient, or if their levels of income do not require them to file returns for a period of time.

Further, low income taxpayers are the segment of the population most in need of flexible, realistic payment options. While the IRS is quick to acknowledge that many collection accounts involving low income taxpayers are reported as CNC, we continue to question the reasoning behind the significant number of cases involving taxpayer requests for OICs and installment agreements that are rejected by the IRS and subsequently reported as CNC.[45] Many of these taxpayers sincerely wish to resolve their tax debts, but have been unable to do so because IRS policies and procedures restrict the availability of realistic payment options. In fact, we find it interesting to note that in FY 2006, more installment agreements were granted by the IRS taxpayer assistance offices, *i.e.*, those servicing "walk-in" taxpayers, than were approved by the entire Collection Field operation.[46]

We continue to be very concerned about the negative impact of the IRS Federal Payment Levy Program (FPLP) on low income taxpayers. We strongly disagree that the additional notice issued by the IRS to Social Security beneficiaries prior to the FPLP levies provides an adequate safeguard for taxpayers in these situations. These pre-levy notices are issued to the last known address, which is generally the address on the last return filed. Many of these taxpayers have not had filing requirements for years. We understand that the collection workload of the IRS is considerable. We also appreciate that with limited resources, the IRS must address this workload as efficiently as possible. However, we do not believe that the IRS levy program is the appropriate place for cost-cutting initiatives. We are concerned that because FPLP levies collect delinquent revenue at relatively low cost, the efforts to identify and implement a suitable replacement for the income filter, which had previously been used to screen out potential hardship situations, may have been abandoned prematurely. Levies are very significant enforcement actions with the potential to create considerable economic and

[44] *See* Most Serious Problem, *Early Intervention in IRS Collection Cases, supra.*

[45] *See* Most Serious Problems, *IRS Collection Payment Alternatives, supra.*

[46] IRS, *Collection Activity Report, Installment Agreement Cumulative Report,* NO-5000-6 (Oct. 2, 2006).

emotional harm for the affected taxpayers. As discussed elsewhere in this report, TAS cases involving imprudent levy actions have increased substantially in recent years.[47]

We do not agree with the IRS that assigning the collection accounts of low income taxpayers to private collection agencies is an acceptable substitute for the quality taxpayer service many of these individuals need to fully resolve their tax debts. We believe the interests of these taxpayers are best served through meaningful interactions with IRS employees, who have the ability to exercise judgment and discretion, including access to the full range of collection payment alternatives needed to meet the needs of the low income population.

We are pleased to note that the IRS recognizes the need to use the FPLP in a manner that does not create undue hardship for low income taxpayers, and plans to renew its efforts to develop an effective income filter, work with the Social Security Administration to block FPLP levies in situations where benefits are paid directly to a health care facility, and study options that will ensure levy releases are issued promptly in hardship situations. We urge the IRS to complete its work to improve the FPLP program with a sense of urgency, and we offer the continued assistance of TAS to further these efforts.

RECOMMENDATIONS

While the National Taxpayer Advocate recognizes and appreciates a number of significant actions recently taken by the IRS to address the collection concerns of low income taxpayers, much work remains to be done in this area. We recommend that the following actions be considered, and implemented, as soon as possible:

1) The IRS should continue its efforts to develop and implement a low income waiver for the installment agreement user fee, similar to what is currently used in administering the OIC application fee. Also, we recommend that the IRS establish a graduated scale of IA user fees that reflect the amount of work required, i.e, lower fees should be required for streamlined IAs than those that require more financial analysis and extended periods of monitoring by the IRS.
2) The IRS needs to develop an alternative to the Allowable Living Expenses (ALE) methodology for determining the reasonable collection potential (RCP) of collection cases involving low income taxpayers. The ALE standards, as currently applied, are neither reasonable nor realistic in analyzing the RCP of taxpayers with incomes below or near the poverty level. Use of the ALE standards should constitute a reasonable "floor" in these situations, and the IRS should be flexible in accepting documentation of basic living expenses that exceed that "floor."
3) In recognition of the limited collection potential of delinquent collection accounts involving low income taxpayers, the IRS should establish liberal and

[47] *See* Most Serious Problem, *Levies, supra.*

flexible installment agreement and offer in compromise acceptance policies for taxpayers in this segment of the population who are seeking resolution and closure for their tax debt problems.

4) The IRS needs to expand its current procedures to ensure that notices of intent to levy on Social Security benefits via the FPLP program are mailed to the best addresses available, and not simply the last known addresses. At a minimum, the IRS should utilize address research resources that are readily available via the Internet, and coordinate with the SSA to determine if the IRS's "last known address" for the taxpayer is the most recent one available.
5) The IRS should develop and implement a realistic screening process to eliminate low income taxpayers from FPLP levies on Social Security benefits. Also, the IRS should incorporate procedures into the FPLP process that require legitimate attempts at personal contacts prior to the issuances of these levies.
6) The IRS should develop and implement procedures to require managerial review and approval of any levy involving retirement and/or disability income from the Social Security Administration, within the spirit of § 3421 of RRA 98.
7) The IRS should develop procedures in conjunction with the SSA to ensure FPLP levies are released in an expedited manner in situations where failure to do so will cause financial hardship for the taxpayer. Designated points of contact, designated fax numbers, and similar measures should be developed and implemented to ensure expedited resolution for problems involving FPLP levies.
8) The National Taxpayer Advocate acknowledges and supports the IRS's efforts to review and revise its methods of addressing the collection problems faced by low income taxpayers, particularly those seeking to ensure timely, meaningful contacts for these taxpayers in regard to their collection accounts, and those designed to improve the administration of the FPLP program in situations involving low income individuals. In order to ensure that the interests of the low income taxpayer population are adequately represented and considered in these efforts, we recommend that the IRS include the National Taxpayer Advocate in the planning and analysis stages of these efforts as soon as possible. We recommend that the IRS also include the participation of the Low Income Taxpayer Clinics (LITC) and the Taxpayer Advocacy Panels (TAP) for their improvement efforts in this area. These groups have significant experience with the needs of this population and can offer valuable perspective about how to effectively communicate with these taxpayers.
9) Finally, the National Taxpayer Advocate recommends that Congress exempt Social Security payments altogether from IRS levy by amending IRC § 6334(a)(6) to include payments under the Social Security Act. This legislative recommendation was also included in 2005 Annual Report to Congress. We believe this action continues to be needed to protect the rights of low income taxpayers.

PROBLEM

TOPIC #10 EXCESS COLLECTIONS

RESPONSIBLE OFFICIALS

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Division

Nancy J. Jardini, Chief, Criminal Investigation

Steven T. Miller, Commissioner, Tax Exempt and Government Entities

Richard J. Morgante, Commissioner, Wage & Investment Division

Deborah M. Nolan, Commissioner, Large & Mid-Size Business Division

DEFINITION OF PROBLEM

The Excess Collections File (XSF) is a cumulative file within the IRS's Integrated Data Retrieval System (IDRS), which reflects payments that either cannot be identified or cannot be applied to a specific taxpayer account.[1] Taxpayers pay in excess of $2 trillion dollars to the IRS each year,[2] so it is not surprising that the IRS needs a temporary account to house payments until they are associated with the correct taxpayer or the correct tax return. However, because a transfer to the XSF signifies that a taxpayer's payment may not have been credited as intended, clear and consistent guidelines should govern these transfers. In approximately four and one half years (from March 1999 to October 2003), the XSF grew at a rate of 65 percent, from approximately $2.3 billion to $3.8 billion.[3] Although the IRS has since made progress in reducing the size and volume of the XSF, as of May 31, 2006 the file still contained nearly $3.5 billion in unapplied credits.[4]

IRS procedures require the IRS to correspond with the taxpayer in an effort to determine the proper disposition of the credits before transferring them to the XSF.[5] However, despite the guidance established to assist IRS personnel in handling these issues, both the Taxpayer Advocate Service (TAS) and the Treasury Inspector General for Tax Administration (TIGTA) have found the IRS routinely moves funds into the XSF with very little research or personal contact with the taxpayer to correctly ascertain if a

[1] IRM 3.17.220.2(1) (Jan. 1, 2006). IDRS is a computer system with the capability to instantaneously retrieve or update stored information which works in harmony with the Master File system of taxpayer accounts. A non-revenue receipt is defined as a payment received for items other than taxes (*i.e.*, bulk forms, photocopy fees, court fees, installment agreement user fees, erroneous refund payments, etc.).

[2] Statistics of Income, *IRS Data Book, 2004-2005*, available at: http://www.irs.gov/taxstats/article/0,,id=102174,00.html.

[3] Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* 1 (Jan. 2005). TIGTA reviewed 88 taxpayer accounts with at least one tax module totaling $1 million or more in at least one tax period.

[4] IRS spreadsheet, *XSF National Totals FY 2003-2007* (using volumes taken from URF6040 Reports, (Oct. 2005 through May 2006). A credit can be an amount paid directly to the IRS by the taxpayer (*e.g.*, payment with a tax return), an amount withheld by an employer to be credited to a taxpayer's account upon filing of a tax return (*e.g.*, credit for withholding taxes) or statutory entitlements based on facts and circumstances (*e.g.*, earned income tax credits or child tax credit).

[5] IRM 3.17.220.1.5 (Jan. 1, 2006) and numerous related IRM sections. See IRM 3.17.220.1.6 for a comprehensive listing.

taxable return should be filed, and if not, where such funds should be applied.[6] Thus, the IRS cannot properly determine whether it has collected the correct amount of tax or it owes the taxpayer a refund.

Inadequate management of the XSF can lead to negative consequences for taxpayers. Our analysis focuses on three concerns that should be addressed to ensure proper governance of taxpayer funds:

- The need for meaningful personal contact at the earliest possible opportunity;
- The need for substantive research and clear procedural guidance to more efficiently resolve the credit issues; and
- The potential disparate treatment of taxpayers that results from placing a $100,000 credit balance limit on the proposed XSF enhancements.

ANALYSIS OF PROBLEM

Background

What is Excess Collections?

Within the IRS, the term excess collections is somewhat of a misnomer. It does not actually relate to "extra" or "surplus" funds, but rather to monies received by the IRS which, for a variety of reasons, the IRS cannot apply to a specific tax liability. All money received by the IRS initially goes to the Treasury General Fund, broken down by a specific tax class or type of payment received.[7] If a payment cannot be associated with a taxpayer's account or a tax return is not filed, the IRS will, after following prescribed procedures, transfer the payment to the XSF for more research.[8]

How Are These Funds Maintained?

The IRS maintains payments and credits transferred to the XSF within two separate accounts on the IDRS database.[9] The funds in these two accounts are mainly comprised of taxpayers' payments or "credits" for which the taxpayers can no longer seek refunds due to the expiration of the applicable statutory period for claiming a refund (statute-

6 Treasury Inspector General for Tax Administration, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collection Accounts Could Be Credited to Taxpayers* (Jun. 2000) and Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* (Jan. 2005).

7 IRM 3.8.44.2 (Jan. 1, 2005).

8 *See* IRM 3.17.10 (Jan. 1, 2006) and 3.17.220 (Jan. 1, 2006).

9 IRM 3.17.10 (Jan. 1, 2006) and 3.17.220 (Jan. 1, 2006). These accounts are Account 6800 (Excess Collections) and Account 9999 (Revenue Clearance Accountability). Credits may remain in Account 6800 for up to one year, at which point they are automatically transferred to Account 9999. Any unapplied credits will remain on IDRS in the XSF for seven years after the initial entry date of the payment, and then appear on a dropped listing.

expired credits).[10] These credits include payments for withholding taxes and earned income tax credits (EITC) for which a return has been filed, and other payments that appear to be intended for association with a tax return but for which no return has been filed (credits/no return). The IRS systemically transfers the statute-expired credits from the Individual Master File (IMF) to the XSF each week but must manually move the other payments on an as-needed basis.[11]

Who is Involved in the XSF Process?

The Submission Processing organization in the IRS's Wage and Investment (W&I) division exercises line authority over the XSF process and is responsible for completing the necessary research and administering the file's daily operations. These functions serve as the primary processing arm of the XSF as well as the clearinghouse when other IRS business units request credit applications be moved into or out of the file. Accounts Management also contains a statutory function that is responsible for addressing any situations related to credits that are either imminent or beyond the statutory period for refunds.[12] However, at least eight other IRS operating divisions or functions have direct ties to the XSF process.[13] Eight IRS campuses maintain XSF activities, with each retaining a separate Account 6800 and Account 9999.[14] These campuses generate reports to show the monthly national inventory activity of both accounts.[15]

[10] IRC § 6511(b) provides that if the claim is filed within the three-year period prescribed in IRC § 6511(a), the amount of the credit or refund may not exceed the portion of the tax paid during the period immediately preceding the filing of the claim equal to three years plus the period of any extension of the time to file the return. If no return is filed by the taxpayer, the amount of the refund or credit may not exceed the portion of tax paid within two years from the filing of the claim.

[11] IRM 3.17.220.2.1(2) (Jan. 1, 2006).

[12] IRC § 6511(a).

[13] These organizations and their XSF relationships are:
- *Collection Field Function (CFf)* – This function is responsible for face-to-face collection activities related to filing and payment compliance. When investigating delinquent tax returns, field personnel (*e.g.*, revenue officer) initiate contact with the taxpayer to determine the nature of any liability to resolve the specific account.
- *Compliance Services Campus Operation (CSCO) and Automated Collection System (ACS)* – These functions attempt to resolve credit balance accounts through correspondence, telephone contacts, or letters and notices. Credit balance accounts are worked by verifying whether the credit was properly applied.
- *Automated Underreporter (AUR)* – This function is responsible for corresponding with taxpayers when a previous notice proposed an adjustment to the taxpayer's account.
- *Examination and Centralized Case Closing* – These functions research instances where credits may reside on an account that was originally flagged for an examination.
- *Tax Exempt and Government Entities (TE/GE)* – This operating division is responsible for addressing compliance issues involving tax exempt organization or government agencies. Like CFf, it identifies and resolves situations where a taxpayer fails to file a return.
- *Criminal investigation (CI)* – This function is responsible for investigation of potential criminal violations of the Internal Revenue Code and related financial crimes.

[14] IRS, W&I Operating Division Response to TAS Research Request (Jun. 14, 2006).

[15] A campus is a facility that processes paper and electronic submissions, corrects errors and forwards the data on for analysis and posting to taxpayer accounts. The following IRS campuses conduct XSF activities: Andover, Atlanta, Austin, Cincinnati, Fresno, Kansas City, Ogden and Philadelphia (with Cincinnati maintaining Memphis and Brookhaven Campus XSF activities on separate reporting systems).

Problems Signify Need for XSF Reform

TIGTA first raised concerns over the IRS's administration of the XSF process in 2000 and re-addressed those same issues in a follow up review in 2005.[16] TIGTA noted that too many XSF transfers resulted from insufficient IRS employee research, lack of employee contact with the taxpayer, or improper adjustments to taxpayer accounts. The report concluded that if IRS controls had been adequate, 25 percent of the dollars in the XSF could have been credited to those accounts.[17]

TIGTA's findings ultimately led to the creation in February 2005 of the Excess Collections Task Group (XSFTG), with representation from all IRS business units, including TAS. The group's objective was to analyze TIGTA's findings, evaluate procedures for working unresolved credit accounts and develop suitable recommendations.

The group identified proposals to improve the XSF process, including an allowance for additional employee research and taxpayer contact to obtain needed information, mandatory approval of XSF credit transfers and establishment of points of contact at each campus for each business unit to facilitate resolution of large dollar credit balances, *i.e.*, balances $100,000 and over.[18] However, because these proposals were limited to credits involving high dollar amounts, they would not benefit low or middle income taxpayers.

A recent TAS case demonstrates how the lack of specific guidelines for proper research and contact with the taxpayer leads to taxpayer burden and IRS re-work.[19]

> **Example:** The taxpayer made two estimated tax payments in October 2001 but failed to file a 2001 return until February 25, 2005. Although the return showed the 2001 payments, the IRS had erroneously moved these credits to XSF prior to the statutory limitation period for a refund and did so without additional research. The taxpayer came to TAS for assistance. After TAS completed its research and located the payments in XSF, the IRS agreed to return the funds to the tax year in question and reduced the liability to a minimal balance due, which the taxpayer paid.

Transferring payments to the XSF without sufficient research and taxpayer contact can cause serious downstream effects for both the taxpayer and the IRS. As noted in the above example, this impact can take the form of unwarranted or incorrect billing notices when credits are misapplied and a subsequent return is filed. Further, some IRS

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16 Treasury Inspector General for Tax Administration, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collection Accounts Could Be Credited to Taxpayers* (Jun. 2000) and Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* (Jan. 2005).

17 Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* 3 (Jan. 2005). TIGTA reviewed 88 taxpayer accounts with at least one tax module totaling $1 million or more in at least one tax period.

18 IRS Excess Collections Task Group Report 2, 3 (Mar. 6, 2006). The XSFTG conducted a statistically valid sample of credit balance accounts equal to or greater than $100,000. Thus, the group's report defines large dollar credit balances as $100,000 and over.

19 Examples are taken from the Taxpayer Advocate Management Information System (TAMIS).

functions that transfer funds into the XSF lack any written guidance as to when it is appropriate to make such transfers. The Criminal Investigation Division's operation of the Questionable Refund Program provides one such example.

Criminal Investigation's Use of XSF

Criminal Investigation (CI) operates the IRS's Questionable Refund Program (QRP), which uses data mining techniques to identify suspicious refund claims and subject those claims to further investigation.[20] In the 2005 Annual Report to Congress, we identified serious problems within the QRP, such as the high rate of TAS QRP cases that resulted in full or partial relief, and the IRS's failure to provide taxpayers with notice of their frozen refunds or an opportunity to provide exculpatory evidence.[21] We have also learned that in fiscal years 2005 and 2006, CI transferred some of the EITC payments and withholding payments associated with these frozen refunds into the XSF.[22] By taking this step, CI was moving payments belonging to taxpayers out of the taxpayers' accounts *before* the taxpayers even knew the IRS suspected fraudulent activity and *before* the expiration of the period in which the taxpayers could file suit to recover the refunds.[23] Thus, an innocent taxpayer with a frozen refund who contacted the IRS about the status of the refund would have been told the IRS had no record of a credit balance.

CI has advised TAS it has no written policies or procedures regarding transfer of payments to the XSF but would adopt appropriate written guidance for its employees as part of the overall reorganization of the QRP. It is imperative that the IRS implement these procedures prior to the start of the 2007 filing season.

Misapplication of Levy Proceeds and Transfer to XSF

We have also uncovered instances where the IRS inappropriately moved credits to the XSF during the application of levy proceeds without properly notifying the taxpayer. In these situations, the IRS has initiated enforcement action against a taxpayer, served a notice of levy to collect the delinquent liabilities, and then either posted the proceeds to

[20] For discussion of CI's QRP program, see National Taxpayer Advocate 2005 Annual Report to Congress 25. *See also* Most Serious Problem, *Criminal Investigation's QRP, infra*.

[21] In a study of Taxpayer Advocate Service QRP frozen refund cases, TAS found that in 66 percent of the decided cases taxpayers were innocent of fraud and were fully entitled to their refunds; nearly three-quarters (74 percent) of the affected taxpayers had claimed the Earned Income Tax Credit (EITC) and a majority of those taxpayers ultimately received the EITC. National Taxpayer Advocate 2005 Annual Report to Congress Vol. II, at 10-12.

[22] Data provided by CI shows that for CY 2005, 336 accounts totaling $981,586 moved to XSF. For CY 2006, these figures rose to 1133 accounts and $2.15 million. IRS, Criminal Investigation Response to TAS Research Request (Aug. 23, 2006).

[23] IRC § 6532 provides that taxpayers cannot file suit for refund until the expiration of six months from the filing of a claim and must file the suit within two years of a notice from the IRS disallowing the claim. Because taxpayers whose refunds were frozen in the QRP did not receive claim disallowances, or at the earliest, received them in FY 2006 following the 2005 Annual Report to Congress review, their rights to file suit to recover the funds would not have expired.

tax periods which were already satisfied or were not listed on the original levy.[24] Instead of conducting research to determine if these funds should be refunded, the IRS simply transferred them to the XSF, and in many cases never notified the taxpayer. Some of these payments have now passed the two-year statutory period for the taxpayers to file a claim for the return of these proceeds.[25]

Although W&I exercises ultimate line authority for the XSF, the actions of the other interrelated parties still significantly impact the process and are not subject to clear checks and balances.[26] Thus, the IRS must closely administer and follow the guidance and expectations associated with the XSF process to ensure taxpayers are protected at all stages.

Need for Meaningful Personal Contact

Current IRS guidance allows employees to attempt personal contact with taxpayers only rarely, and then only with management approval.[27] Accordingly, in its final report to IRS management, the XSFTG acknowledged that the "primary weakness is [that] the current process relies almost exclusively on notices and letters with relatively few instances in which personal contact is made with the taxpayer."[28]

The XSFTG reached this conclusion by reviewing a Large and Mid-Size Business (LMSB) division initiative to deal with unresolved credit balances on cases inside the division's purview. LMSB conducted research to determine if a taxpayer was actually liable to file the return in question, and after culling out those who were not required to file, attempted to personally contact the remainder using Internet resources if IRS databases did not yield a contact name or phone number. *This approach enabled LMSB to secure several hundred delinquent tax returns and shrink the division's initial unresolved credit balance from $3.1 billion to $240 million.*[29]

The task group then developed and tested a hypothesis that Internet research and telephone contact with the taxpayer would not only resolve a vast number of credit balance accounts but would do so faster than the current processes, thus reducing the credits moving to XSF.[30] The task group's conclusions were:

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[24] A levy is a legal seizure of property to satisfy a tax debt. IRC § 6331 provides the IRS with statutory authority to levy funds held by a third party.

[25] For a related and more detailed discussion of levies, specifically situations involving the erroneous application of levy proceeds after expiration of the statutory period for claiming a refund, see Most Serious Problem, *Levies, supra*.

[26] The XSFTG report did recommend new research procedures in IRM 3.17.220.2 which will be effective in January 2007. These procedures specify what will cause the rejection of the Form 8758 if the submitting function does not take the required action.

[27] IRM 3.17.220(8)(5) (Jan. 1, 2006).

[28] IRS, *Excess Collections Task Group Report* 4 (Mar. 6, 2006).

[29] *Id.* at 7.

[30] *Id.*

- Internet and telephone contact provided the IRS with updated taxpayer information for its internal systems;
- Approximately half of the taxpayer phone contacts resulted in returns secured or credit balances resolved; and
- The process allowed credit resolution on first contact, which ultimately decreases the need to repeatedly handle cases.[31]

Early Intervention Yields Positive Results

By virtue of these findings the XSFTG concluded that, "IRS processes would improve considerably if personal contact with the taxpayer is made."[32] The group also recognized that the earlier these actions could be taken, the better for all involved. We agree with the task group recommendation for meaningful personal contact with the taxpayer and the need for earlier intervention. In its second review TIGTA noted (and we concur) that studies have shown "taxpayers do not send payments to the IRS unless they anticipate incurring a tax liability."[33] In fact, an LMSB study of income tax non-filers concluded, "The presence of a credit balance is indicative that the taxpayer expects to file a return which shows tax due."[34] Many cases reviewed by TIGTA, the XSFTG and TAS contain clear indications that the IRS does not always follow procedural guidelines before transferring the associated credit balance to XSF.[35] Such failure to follow existing guidance compounds the harm to these taxpayers.

Time Sensitivity of "Statute-Expired Credits" Issues

The IRS needs to attempt more personal contact with taxpayers who file delinquent returns or claim for credits close to or beyond the applicable statutory timeframes. Taxpayers filed nearly 270,000 refund due returns with statutory expiration dates of April 15, 2005 in calendar year 2005.[36] While not all were filed after April 15, 2005, the sheer volume indicates the IRS missed many opportunities to contact taxpayers and address the credit issues much earlier in the process. Currently, the IRS sends a systemic notice to the taxpayer every six months until the refund limitation period expires, and makes little or no attempt at personal contact. A personal contact with the taxpayer at the earliest possible interval would enable the IRS to better educate him or her about the credit issue and statutory limitations associated with these payments.

[31] IRS, *Excess Collections Task Group Report* 4 (Mar. 6, 2006).

[32] *Id.* at 8.

[33] Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* 1 (Jan. 2005).

[34] *Id.*

[35] *Id.* at 5,6 (Jan. 2005); IRS, *Excess Collections Task Group Report* 9 (Mar. 6, 2006).

[36] IRS Compliance Data Warehouse, *Individual Returns Transaction File (Processing Year 2005 for Tax Year 2001).*

Need for Substantive Research

In addition to the need for personal contact, the XSFTG studies also revealed a need for employees to take their research beyond the normal IRS databases and systems. Currently, this research is limited to internal records, mainly on the IDRS system, and focuses on items such as pending transactions, prior tax return information, or related entities in an attempt to help locate the proper placement of the credit.[37] If the research is inconclusive, the next step is to generate a standardized letter to inquire about proper disposition of the credit. The IRS mails this letter to the last address of record but does not require the employee to first attempt personal contact with the taxpayer or try to identify any other potential addresses.[38] In fact, for situations where the taxpayer's account was previously reported as unable to locate, XSF procedures actually advise the employee not to send any additional correspondence.[39]

Current Guidance Lacks Clarity and Consistency

The majority of IRS guidance associated with XSF research activities lacks the clarity needed to provide the proper level of service to resolve the taxpayer's credit issue. Moreover, several XSF procedures are confusing and contradictory. For example, one Internal Revenue Manual (IRM) section states that certain types of cases require no research at all.[40] This reference applies to "statute-expired" cases and others where the IRS may have "frozen" credits due to pending audits or criminal investigations.[41] However, another IRM section related to statute-expired cases advises the employee to conduct an initial analysis to determine if the credit "meets the legal criteria for expiration of the statute for either assessment or credit/refund and the taxpayer has not been injured through IRS mishandling of his/her case."[42] This same IRM further explains in a later section that "statute-expired credits represent a wide range of situations which may require detailed analysis to determine whether further action [sic] need be taken to protect the taxpayer."[43]

The obvious question is: *"How can an employee determine that further action is necessary if initial guidance dictates there is no need for research?"* Even if the employee does recognize such a situation, the guidance is not clear as to how the other applicable function (Accounts Management Statutes, in this case) becomes involved.

[37] IRM 3.17.220.2.7 (Jan. 1, 2006).

[38] IRM 3.17.220.8(1) (Jan. 1, 2006).

[39] IRM 3.17.220.2.8(4) (Jan. 1, 2006).

[40] IRM 3.17.220.1.5(2) (Jan. 1, 2006).

[41] *Id.*

[42] IRM 3.17.220.2.2(4) (Jan. 1, 2006).

[43] IRM 3.17.220.2.7.1.1.1(1) (Jan. 1, 2006).

Research Timeframes are Too Stringent

The restrictive timeframes allotted for XSF research further compound the inadequacy of that research. TIGTA's second report concluded the IRS took incorrect or insufficient actions in nearly 50 percent of the cases reviewed, and "contributing to this situation are several related sections of the IRM that may be preventing employees from expending additional time to research or contact taxpayers before deciding to transfer payments to the XSF."[44]

For example, IRS procedures provide that when a payment cannot be directly applied to a taxpayer account, the employee must add these credits to the XSF within five workdays, including any action necessary to remove the original credit from its previous location.[45] The guidance further states these credits must be thoroughly researched within two workdays of their addition to the XSF. The rigidity of the research timeframes does not allow employees to properly consider the specific facts of each case and explore all means of resolution before applying these funds to the XSF. It is unreasonable to assume an employee can complete all necessary research, including taxpayer contact (should the need arise) in two days. This timeframe is also inadequate for situations where the taxpayer is contacted but cannot call or write back within these same two days.[46] TIGTA reached a similar conclusion and remarked, "It is highly probable that by transferring these payments so expeditiously, the employee may not be taking sufficient action to ensure the proper resolution."[47] These seemingly abrupt and inflexible parameters can lead to improper application of payments, poor customer service, and additional work.

Need for Equitable Treatment Regardless of Dollar Amount

In its final report to IRS management, the XSFTG proposed that the IRS engage in personal contact and additional research on credit balances over $100,000.[48] While we recognize it is reasonable for the IRS to leverage its resources and define priority work for its employees, this approach will clearly result in disparate treatment for taxpayers with credit balances below the $100,000 threshold. IRS guidance already understates the importance of cases involving lower credit balances by stating, "Both large and small cases are to receive equal attention but large-dollar cases will be worked first."[49]

[44] Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* 7 (Jan. 2005). Of the 57 cases in which TIGTA determined the IRS should have been able to resolve the credit, they found that 28 occurred because the IRS had insufficient research, taxpayer contact or improper adjustments.

[45] IRM 3.17.220.1.3 (Jan. 1, 2006).

[46] IRM 3.17.220.2.7(1) (Jan. 1, 2006).

[47] Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* 8 (Jan. 2005).

[48] IRS, *Excess Collections Task Group Report* 8 (Mar. 6, 2006). The XSFTG conducted a statistically valid sample of credit balance accounts equal to or greater than $100,000. Thus, the group's report defines large dollar credit balances as $100,000 and over.

[49] IRM 3.17.220.1.5 (Jan. 1, 2006).

Also, certain managerial reports are geared to highlight cases with balances greater than $25,000.[50] Thus, it seems the IRS's focus is not truly on equal attention and service. From a taxpayer-focused point of view, the need for a $1,000 refund to a low or middle income taxpayer is as great as (and possibly even greater than) a refund of $100,000 for a Fortune 500 company. Accordingly, we believe the IRS should provide this same service to all taxpayers, regardless of the dollar amount.

Recent and Noteworthy Procedural Change by IRS

We are pleased that upon the specific recommendation of the XSFTG, the IRS took steps to ensure proper research on future cases by requiring the input of a transaction code to indicate research has been completed prior to transfer to XSF and making it mandatory to note managerial approval on all required forms.[51] This approach will allow for the maintenance of a clear audit trail, avoid duplicate or inefficient actions, and ensure the adequacy of the XSF transfer given the facts of the case. However, we also note this new change does not include the previously referenced concerns relating to the need for personal contact and clearer guidance of what constitutes "complete" research.

CONCLUSION

The Excess Collections File represents an important opportunity for the IRS to help taxpayers meet their filing and payment responsibilities. The IRS has a fiduciary responsibility for these funds and it is critical that the XSF process be improved so as to reinforce voluntary compliance and instill public confidence in the tax system. The IRS can accomplish this goal by establishing meaningful personal contact with taxpayers at the earliest possible stage, and conducting substantive research to assist when such contact is not as forthcoming. The guidance needed to effectively carry out these tasks must be put forth in a clear and specific manner, with proper training given to ensure all IRS employees have the same set of expectations when considering XSF-related decisions. In doing so, not only will the taxpayer's credit balance issues be resolved more efficiently but their level of satisfaction will significantly improve.

IRS COMMENTS

The Excess Collections File involves credits and payments that cannot be identified or are for accounts for which returns have not been filed. Since 2000, the IRS has been making steady progress in reducing the number of credits that are moved to the XSF account. Recently, with the support and assistance of the Taxpayer Advocate Service, as many as ten Internal Revenue Manual (IRM) procedural changes and other system changes have been initiated or implemented that involve operations of Accounts Management, Submission Processing, and Compliance. Criminal Investigation is

[50] IRM 3.17.220.2.16(6) (Jan. 1, 2006).

[51] IRM 21.5.8.1(8) (Jun. 30, 2006). However, management approval is needed only on cases of $100,000 or more.

also working with other IRS functions to develop and implement uniform procedural improvements. These changes affect the way accounts are worked prior to determining whether payments should be moved to XSF and will help us properly identify millions of dollars of unresolved credits. We believe these changes will ensure proper action is taken to resolve most large dollar credit balance accounts as we continue to explore the feasibility of applying similar changes to the resolution of lower dollar credits.

As acknowledged in the National Taxpayer Advocate's assessment of this problem, in 2005, the IRS formed the Excess Collections Task Group (XSFTG) to address concerns cited in a 2005 TIGTA report regarding the growth of large dollar credits in the XSF. That group, with representatives from all business units including TAS (except Criminal Investigation) completed a comprehensive review of the way credits were processed and identified improvements that will significantly reduce large dollar credits of $100,000 or more moving to the XSF. Many of these changes have already been adopted or are pending implementation beginning in 2007.

One of the major changes initiated by the XSFTG is the requirement for employees to conduct additional research on large dollar credit balance accounts. This primarily involves BMF accounts, which were cited by TIGTA as the major contributing factor to the growth of the XSF. In 2005, the XSFTG sponsored a statistically valid sampling of 822 unresolved IMF and BMF large dollar XSF accounts. In this test, additional research enabled the IRS to resolve approximately 20 percent of the cases, representing $2.2 billion in previously unapplied credits. However, the employee productivity rate significantly decreased from 7.9 cases closed per hour to 3.1 per hour, or a 60 percent reduction. While these procedures are now mandatory for all large dollar credits, we have not extended these procedures to lower dollar credits pending an analysis of whether we can expect the same positive results from the increased expenditure of our limited staff resources.

Another procedural change initiated by the XSFTG was the development of a better research tracking system for credit balance accounts on IDRS. The existing system generates an Accounts Maintenance Research (AMRH) transcript for virtually all credit balance accounts after 25 to 82 weeks of inactivity, depending on the type of credit and the due date of the return. At that point, the account is reviewed by an Accounts Management employee and notices are generated to the taxpayer's last known address on IDRS. However, previously there was no history on IDRS to verify the issuance of these notices. The XSFTG initiated a requirement for employees to input a new transaction code (TC Code 971 Action Code 296) to show that all research of the primary and related Taxpayer Identification Numbers was completed prior to a transfer of credits to XSF. An additional enhancement that will be effective in January 2007 will create an audit trail to record issuance of the CP 80/81 letters which request the taxpayer to provide information on how they want the IRS to apply the credit balance on their account.

We agree with the National Taxpayer Advocate that personal contact may improve the resolution of some credits. As previously mentioned, when a taxpayer has an unresolved credit balance on an account, the IRS sends a series of notices to the taxpayer's address of record advising of the credit balance and asking how they want it applied to their account. This notification continues until the statute expires on the account. However, the IRS believes there is a very low response rate to these notices and as a result, the process for working large dollar credits has been changed to require additional research to locate the taxpayer. When this research identifies a telephone number, we also attempt to make telephone contact with the taxpayer to determine the proper disposition of the unapplied credit.

Regarding the National Taxpayer Advocate's commentary regarding the transfer of levy proceeds to the XSF, the IRS fully appreciates the sensitive nature of levying taxpayer assets. Currently, the IRS uses several resources to ensure our records reflect the taxpayer's most current address. We receive National Change of Address (NCOA) files from the United States Postal Service (USPS) and the Address Research System (ADR) as part of the process to locate taxpayers in the notice stream prior to the assignment of an account to a Collection function. In addition to ADR, our Automated Collection System (ACS) and the Collection Field function (CFf) utilize additional locator services on taxpayers whose notice was return to the Service as undeliverable. If a telephone number is located on taxpayers whose notice was returned undeliverable, our ACS policy directs employees to attempt a telephone contact prior to any enforcement action. In CFf, a revenue officer may attempt an in-person contact with the taxpayer prior to enforcement action. In all these instances, a final notice of intent to levy and notice of a right to a collection due process hearing is issued prior to enforcement action. The notice must be given to the taxpayer, left at the residence or place of business or mailed certified. In addition to these taxpayer notification procedures, we have taken other actions specifically aimed at reducing movement of levy proceeds to the XSF. Among these are programming changes to more quickly identify cases where levy releases are necessary, including automatically generating transcripts whenever a levy payment is more than necessary to full pay an account. Prior to these changes, some payments were being sent to the XSF rather than being refunded to the taxpayer. Because we now have a method to identify these situations, levies are released earlier, thereby eliminating a potential for surplus levy funds being transferred to the XSF. Further, the IRM was changed to require cashiers to provide information to ACS Support on any levy proceeds for accounts without a balance. ACS Support then performs research to resolve the credit and immediately release the levy, if appropriate, and initiate a refund.

While we agree that opportunities remain to further improve our management of XSF accounts, we disagree with the National Taxpayer Advocate's position that the majority of IRS guidance associated with XSF research activities is confusing or lacks the clarity needed to resolve unapplied credit issues. We believe that the procedural guidance

provided to our employees are sufficiently clear and that the recent IRM and systems changes implemented or planned for January 2007 will further enhance that guidance.

As previously noted, the specific enhancements being implemented from the XSFTG are aimed at large dollar accounts. We believe that extending these research requirements to substantially lower dollar accounts may not yield significantly better results while substantially increasing IRS costs. However, we will evaluate the possibility of lowering dollar thresholds based on our ability to improve resolution of additional credits through the same or similar methods now in use for large dollar cases.

In summary, the IRS agrees that the movement of payments and credits to Excess Collections were a problem for taxpayers and for the IRS. As a result, an IRS-initiated study has already resulted in significant procedural and systems changes to require enhanced research, additional taxpayer contact, improved levy procedures, and the creation of audit trails to better manage the movement of funds to the XSF. Several additional improvements are scheduled for implementation in 2007. We are also exploring the feasibility and cost-effectiveness of expanding new research and personal contact requirements for credits of less than $100,000.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the efforts and progress made by the IRS in reducing the number of credits that are moved to the XSF account. However, we express cautious optimism given the fact that as of May 31, 2006 the file still contained nearly $3.5 billion in unapplied credits.[52] As mentioned, TAS was an active participant in the XSFTG and lent much support and assistance to the numerous IRM procedural changes and systemic enhancements that have recently taken shape. With so many intricacies and players involved, we admit the XSF process is a daunting task to administer. Yet, the IRS's desire to develop and implement uniform procedural improvements to help properly identify millions of dollars of unresolved credits is encouraging.

One of the major changes initiated by the XSFTG was the requirement for employees to conduct additional research on large dollar credit accounts. In the test administered by the XSFTG (and cited in the IRS's response), additional research enabled the IRS to resolve approximately 20 percent of the cases, representing $2.2 billion in previously unapplied credits. There is no denying the success of this venture; however, we must point out the XSFTG's comprehensive review was limited to identifying improvements that would significantly reduce large dollar credits of $100,000 or more moving to the XSF. The IRS cited a significant decrease in productivity rates and offered this decrease as one of the main reasons why procedures requiring additional research have not been extended to lower dollar credits (at least until an analysis can be performed to see if the

[52] IRS spreadsheet, *XSF National Totals FY 2003-2007* (using volumes taken from URF6040 Reports (Oct. 2005 through May 2006).

same positive results can be expected from the increased expenditure of their limited staff resources).

We recognize it is reasonable for the IRS to leverage its resources. However, when the IRS only performs additional treatment on credits satisfying the $100,000 threshold, it is disparately treating taxpayers with credit balances below the threshold. As we have previously stated, from a taxpayer-focused point of view, the need for a $1,000 refund can be significant to a low or middle income taxpayer. We believe the IRS should provide the same service to all taxpayers, regardless of the dollar amount and thus, we would welcome participation in a study or task group to explore the feasibility of such a plan. This task group should study ways to automate the additional research, thereby minimizing productivity declines.

The development of a better tracking system and an audit trail to record the issuance of notices are both noteworthy procedural changes. However, if the IRS continually sends notices to the same outdated addresses without conducting research for new information, this process will remain an exercise in futility. The IRS response even acknowledges this futility. It is discouraging to note that although the IRS will admit that its notice process has very little impact, it does not perform additional research or attempt a personal contact unless the balance is $100,000 or more. It may be that the extra cost for additional research will be recouped by the postage costs no longer expended for multiple letters to wrong addresses.

We also maintain that the majority of IRS guidance associated with XSF research activities is confusing or lacks the clarity needed to resolve unapplied credit issues. We acknowledge that recent and planned IRM changes should help to improve guidance, but it is still difficult to maneuver through the IRM provisions without the benefit of a desk guide or job aid. With at least ten IRS functions conducting XSF activities, it is paramount that each respective IRM clearly define the role and responsibility of each function. A good example is Criminal Investigation, which does not have any written or procedural guidance for the use of XSF, yet placed upwards of $2.15 million in credits into XSF for FY 2006.[53] The establishment of clear, written procedures as well as training for all functions involved with XSF activities would prove beneficial. The additional guidance would only further enhance the efforts and progress already accomplished toward assisting taxpayers with their filing and payment requirements.

[53] Data provided by CI shows that for CY 2005, 336 accounts totaling $981,586 moved to XSF. For CY 2006, these figures rose to 1133 accounts and $2.15 million. IRS, Criminal Investigation Response to TAS Research Request (Aug. 23, 2006).

RECOMMENDATIONS

To improve the administration of the Excess Collections File, the National Taxpayer Advocate recommends that the IRS:

- Evaluate the costs (*e.g.*, postage, downstream resolution, etc.) expended and saved by performing additional research as well as explore other methods to automate this additional research. The IRS should ensure that all employees responsible for the placement and maintenance of funds into XSF have full IRS intranet and Internet access to research internal and external sources for potential addresses and leads. The IRS should clarify the extent of this research, mandate such research on all cases regardless of dollar amount and provide sufficient time for employees to accomplish such duties (preferably a minimum of 14 days to allow for an attempted personal contact and taxpayer response). Furthermore, the IRS should mandate an attempted personal contact be made prior to the manual placement of any funds into XSF, regardless of dollar amount.
- Provide mandatory training for all employees to reiterate the need to resolve the applicable credit issue at the earliest possible interval. This training should include examples based on actual cases to illustrate the benefits of substantive research and early intervention. The IRS should also develop and implement a desk guide or handbook, similar to the IRS's Reasonable Cause handbook.
- Require managerial approval on all transfers to XSF, regardless of dollar amount. W&I should conduct quality and operational reviews to ensure all transfers include such documentation.
- Send a detailed annual notice (much like the CP 89 notice the IRS currently sends to all accounts with installment agreement activity) to notify taxpayers of continuous levy activity. This notice should provide a detailed accounting of the payments received, including the application of such payments, all interest and penalty charges, and the remaining balance due of any existing liabilities.
- Establish clear, written procedures for Criminal Investigation regarding transfers of payments to the XSF and ensure implementation prior to the conclusion of the 2007 processing year.

PROBLEM

TOPIC #11 SMALL BUSINESS OUTREACH

RESPONSIBLE OFFICIAL

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Division

DEFINITION OF PROBLEM

There are 45 million small business or self-employed taxpayers in the United States tax system today.[1] These taxpayers use a wide range of services and products and are increasingly diverse in terms of education, language, and geography. To fulfill their tax obligations, small business taxpayers must deal with tax law complexity, extensive recordkeeping, and regulatory requirements. Many of these taxpayers cannot afford professional tax advice, or see a tax professional only once a year. Still others need face-to-face communication with the IRS.

IRS research indicates that small business and self-employed taxpayers account for about 44 percent[2] of the $345 billion tax gap,[3] which is the single largest element of the gap.[4] To make any meaningful dent in the tax gap, the IRS must ascertain why small business and self-employed taxpayers have such difficulty in complying with their tax obligations and educate these taxpayers about how to avoid problems.

The IRS's Small Business/Self-Employed division (SB/SE) is not adequately helping its taxpayer base to understand and comply with its tax obligations. Problems with SB/SE's current outreach program include:

- SB/SE's recent reorganization of its taxpayer education office reduced staffing dedicated to outreach and education, leaving 12 states without a local stakeholder liaison;[5]

[1] Small Business/Self-Employed Division At-a-Glance at http://www.irs.gov/irs/article/0,,id=149199,00.html.

[2] One hundred fifty-three billion dollars of the $345 billion gross tax gap is attributable to SB/SE taxpayers as follows: underreported business income by individuals (*i.e.*, self-employed Schedule C filers): $109 billion; underreported self-employment tax: $39 billion; underreported income by small corporations: $5 billion. The gross tax gap also includes $15 billion in underreported FICA and unemployment taxes and $32 billion in overstated adjustments, deductions, exemptions, and credits. A substantial portion of these latter three amounts is likely attributable to SB/SE taxpayers, but the exact amount is not known. *See* IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

[3] The "tax gap" or "gross tax gap" is the gap between the amount of tax imposed by law and the amount voluntarily and timely paid by taxpayers for a given tax year. The "net tax gap" is the portion of the gross tax gap that will remain uncollected after all IRS and taxpayer actions have been completed for a given tax year. Taxpayers who underreport business income on individual returns account for $109 billion of the gross tax gap and those who underreport self-employment taxes account for another $39 billion – a yearly total of $148 billion. *See* IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

[4] *See* IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

[5] Communications, Liaison, and Disclosure Org Charts, Stakeholder Liaison Field (May 2006). The states without Stakeholder Liaison representatives are: Delaware, Hawaii, Idaho, Mississippi, Missouri, Montana, New Hampshire, New Mexico, North Dakota, Vermont, West Virginia, and Wyoming.

- SB/SE does not have a five-year plan for addressing the taxpayer service, outreach, and educational needs of small business and self-employed taxpayers, including the needs of the Limited English Proficiency (LEP) and disabled populations;[6]
- SB/SE does not conduct research or focus groups to obtain information about the characteristics and needs of small business and self-employed taxpayers;
- SB/SE does not measure or monitor the effectiveness of its outreach activities; and
- SB/SE focuses its outreach efforts on practitioner and professional organizations, hoping that the information passed on to these organizations will trickle down to actual taxpayers, but this approach presents practical problems.

Because small business and self-employed taxpayer education and outreach are critical to voluntary compliance, the IRS must target, monitor, and measure its education and outreach efforts to ensure that they have the maximum possible impact.

ANALYSIS OF PROBLEM

Characteristics of SB/SE Taxpayers

Small businesses play an important part in the U.S. economy. Small businesses with less than 500 employees represent 99.7 percent of all employer firms, employ over half of all private sector workers, and pay more than 45 percent of the total U.S. private payroll.[7] In addition, small businesses created 60 to 80 percent of net new jobs annually over the past decade.[8]

Diversity among small businesses is increasing. Hispanic Americans are opening their own businesses at a rate of three times the national average.[9] Immigrants have also increased their share of the self-employed sector, representing 14.7 percent of the total self-employed in 2003 – up from 10.9 percent in 1994.[10]

Information from a 2002 U.S. Census Bureau survey of 20.5 million business owners indicates 28 percent of the owners of non-employer firms have a high school education or less. A bachelor's degree was the highest level completed by over 20 percent of all

6 For a further discussion of LEP taxpayers see Most Serious Problem, *Limited English Proficiency Taxpayers: Language and Cultural Barriers to Tax Compliance, infra*. For a further discussion of difficulties that taxpayers with disabilities face, see Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities, infra*.

7 The U.S. Small Business Administration (SBA) defines small businesses as those having less than 500 employees. The IRS defines small businesses as corporations and partnerships with assets of $10 million or less, and self-employed taxpayers. Small Business/Self-Employed Division At-a-Glance at http://www.irs.gov/irs/article/0,,id=149199,00.html.

8 U.S. Small Business Administration, *Frequently Asked Questions*, at http://app1.sba.gov/faqs/faqIndexAll.cfm?areaid=24.

9 President's address to the Small Business Week Conference at http://www.whitehouse.gov/infocus/small-business/ (Apr. 13, 2006).

10 Robert W. Fairlie, *Self-Employed Business Ownership Rates in the United States*: 1979-2003 Research Summary 6 (2004) at http://www.sba.gov/advo/research/rs243tot.pdf.

owners of both employer and non-employer firms.[11] The survey was not exclusive to small businesses, but almost 15 million of the 20.5 million owners responding represented firms with no employees.

Unfortunately, small businesses bear a disproportionate share of the federal regulatory burden. Small businesses with less than 20 employees pay 67 percent more per employee for tax compliance than large businesses with over 500 employees. Medium size firms, with 20 to 499 employees, pay 21.5 percent more than large firms.[12]

Small Business Taxpayers and the Tax Gap

The gross federal tax gap, which stands at approximately $345 billion,[13] is the difference between what taxpayers should have paid and what they actually paid on a timely basis. The "net tax gap," an estimated $290 billion, is the portion of the gross tax gap that will remain uncollected after the IRS and the taxpayer complete all actions for a given tax year.[14] Although nonfiling, underreporting, and underpayment all contribute to the tax gap, its single largest component, about 44 percent, is attributable to underreporting by self-employed taxpayers.[15] Because these taxpayers account for the largest portion of the tax gap, the IRS strategy for addressing the gap must include an understanding of noncompliance by small business and self-employed taxpayers.

The IRS and the Small Business Taxpayer

The Small Business/Self-Employed Division

Like the other IRS operating divisions, the Small Business/Self-Employed Division (SB/SE) was formed in 2000 as a result of the IRS Restructuring and Reform Act of 1998 (RRA 98). RRA 98 required the IRS to realign its operations around groups of taxpayers with similar needs and place a greater emphasis on serving taxpayers and meeting these needs.[16]

SB/SE has stewardship over seven million small businesses, including corporations and partnerships with assets of $10 million or less, and approximately 33 million self-employed taxpayers and supplemental income earners.[17] SB/SE is responsible for

[11] U.S. Census Bureau, *Characteristics of Business Owners: 2002*, at http://www.census.gov/csd/sbo/cbosummaryoffindings.htm

[12] W. Mark Crain, *The Impact of Regulatory Costs on Small Firms, Small Business Research Summary* at http://www.sba.gov/advo/research/rs264tot.pdf (Sept. 2005).

[13] IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006).

[14] *See id.* (accompanying charts).

[15] *See* footnote 2, *supra.*

[16] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998) §§ 1001-1002.

[17] Small Business/Self-Employed Division At-a-Glance at http://www.irs.gov/irs/article/0,,id=149199,00.html (last visited Oct. 24, 2006).

ensuring these taxpayers are compliant, but also for helping them understand and comply with their tax obligations.

The Small Business/Self-Employed Taxpayer's Compliance Burden

Like all taxpayers, SB/SE taxpayers must determine their taxable income and the tax they owe on that income. But unlike most of their wage or salary earning counterparts, SB/SE taxpayers generally must make determinations that can be quite complex. Numerous sets of layered rules dictate which expenses a business can deduct, how many of these expenses are deductible, and even when the business is entitled to take the deductions. To complicate matters even more, the rules governing income and expenses for tax purposes are often different than the rules a business must use to determine its income for internal bookkeeping and financial reporting purposes. Further, determining taxable income and the applicable tax is just the beginning of the complexity that businesses face. SB/SE taxpayers must also navigate the numerous rules governing employment taxes, overlapping filing and deposit requirements, and various factors that govern whether a worker should be classified as an employee or an independent contractor.

Large corporations also face complexities, but they generally have full-time tax experts on staff and can afford the help of outside tax professionals as well. Many SB/SE taxpayers, on the other hand, must deal with comparable tax complexities on their own or with limited professional assistance.[18] There is also evidence suggesting that many taxpayer errors are inadvertent, rather than deliberate attempts at noncompliance.[19] For these reasons, small business and self-employed taxpayers carry a disproportionate share of tax compliance burdens and need additional assistance from the IRS to prevent errors and underreporting.[20]

The TEC Vision

When SB/SE "stood up" after RRA 98, it contained three functional organizations: Compliance, Customer Account Services (CAS), and Taxpayer Education and Communications (TEC). TEC was created to proactively deliver the specialized education and outreach programs that small business taxpayers need to comply with their tax obligations.

[18] *See* Russell Marketing Research, Inc, *Findings* From Task 149 – The Taxpayer Advocate Service Research Program (Sept. 2002) (on file with the Taxpayer Advocate Service).

[19] *See A Closer Look at the Size and Sources of the Tax Gap, Hearing before the Senate Subcommittee on Taxation and IRS Oversight, Committee on Finance* (July 26, 2006) (statement of Nina E. Olson, National Taxpayer Advocate) (available at http://finance.senate.gov/hearings/testimony/2005test/072606no.pdf).

[20] A recent study by the U.S. Small Business Administration Office of Advocacy found that small firms pay 67 percent more to comply with the tax laws than do their counterparts at large firms. *See* W. Mark Crain, *The Impact of Regulatory Costs on Small Firms* (2005), available at http://www.sba.gov/advo/research/rs264tot.pdf.

Taxpayer education was an essential component of the IRS when it restructured under RRA 98.[21] Compliance and CAS existed before then, but TEC was a new unit with new responsibilities. The IRS designed TEC to serve small business and self-employed taxpayers, primarily by educating them about their tax obligations.[22] The IRS believed that providing up-front education and assistance to business taxpayers would reduce the need for future compliance actions, thereby reducing taxpayer burden and IRS operating costs.[23] TEC was to advance its education and outreach programs through partnerships with government agencies, small business organizations, tax practitioner groups, and other stakeholders.

These stakeholders expressed a strong interest in TEC. At a Senate Small Business Committee meeting in May 2000, witnesses stated the creation of TEC was the most important change the IRS was making.[24] One witness testified:

> The strategy behind the establishment of TEC, which I think is excellent, is to assist taxpayers initially to avoid or reduce problems and burden in the filing and post-filing phases. Basically, if you solve a problem on the front or educate the taxpayer on the front end, you will not have problems later on.[25]

The IRS planned to start TEC with approximately 329 employees in FY 2001 and increase staffing incrementally.[26] By FY 2002, TEC was to have over 1,200 staff in 15 major field locations and an annual budget of $60 million.[27] IRS management believed this approach would be consistent with its vision of maintaining program quality while developing new products and work processes.[28] TEC initially appeared to be meeting this challenge, but recent developments have called its effectiveness into question.

[21] National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS* 8 (Jun. 25, 1997).

[22] General Accounting Office, GAO-03-711, *Workforce Planning Needs Further Development for IRS's Taxpayer Education and Communication Unit* 2 (May 7, 2003).

[23] Treasury Inspector General for Tax Administration, Ref. No. 2000-30-149, *Management Advisory Report: The Small Business/Self-Employed Division Will Substantially Stand Up on October 1, 2000* 6 (Sept. 2000).

[24] *IRS Restructuring: A New Era for Small Business, Hearing before the Senate Comm. on Small Business*, 106th Cong. 2nd Sess (May 23, 2000) (testimony of Sandra A. Abalos, CPA, President, Abalos & Associates, P.C., Phoenix, Arizona and testimony of Roy M. Quick, Jr., Enrolled Agent, Principal, Quick Tax & Accounting Service, St. Louis, Missouri).

[25] *IRS Restructuring: A New Era for Small Business, Hearing before the Senate Comm. on Small Business*, 106th Cong. 2nd Sess. (May 23, 2000) (testimony of Roy M. Quick, Jr., Enrolled Agent, Principal, Quick Tax & Accounting Service, St. Louis, Missouri).

[26] Treasury Inspector General for Tax Administration, Ref. No. 2000-30-149. *Management Advisory Report: The Small Business/Self-Employed Division Will Substantially Stand Up on October 1, 2000* 8 (Sept. 2000).

[27] General Accounting Office, GAO-03-711, *Workforce Planning Needs Further Development for IRS's Taxpayer Education and Communication Unit* 2 (May 7, 2003).

[28] Treasury Inspector General for Tax Administration, Ref. No. 2000-30-149, *Management Advisory Report: The Small Business/Self-Employed Division Will Substantially Stand Up on October 1, 2000* 8 (Sept. 2000).

The TEC Reality

Initial Praise for TEC

At the outset, TEC was generally considered a success by the IRS and external stakeholders alike. Former IRS Commissioner Charles Rossotti stated in his September 2002 report to the IRS Oversight Board that, "Seriously engaging key stakeholders as a regular part of the decision-making process has shown that it improves the final product; shortens the time for decisions and implementation; and strengthens relationships."[29] TEC was named the Small Business Administration's (SBA's) agency of the year in 2002 for what the SBA called its outstanding progress in creating an effective education and compliance assistance program for small businesses and the self-employed.[30]

TEC Realignment

In October 2005, SB/SE merged TEC with other outreach and communications organizations in the division to form the Communication, Liaison, and Disclosure (CLD) function.[31] The new organization includes five program areas:

- Communications;
- Stakeholder Liaison – Headquarters (SL – HQ);
- Stakeholder Liaison (SL – Field);
- Office of Governmental Liaison and Disclosure (GLD); and
- Policy and Strategic Planning (PSP).[32]

Upon realignment of TEC into CLD, SB/SE stated, "greater emphasis will be given to using technology to leverage messages and activities, ensuring the level of service will not diminish."[33] Within CLD, Stakeholder Liaison is the functional unit formerly known as TEC. In February 2005, prior to the realignment, TEC had 536 employees.[34] After the realignment, Stakeholder Liaison staffing included 183 employees in the field and 36 in headquarters.[35] *These 219 employees are fewer than the 329 employees TEC had at its inception and considerably fewer than the 1200 that SB/SE first envisioned for a successful*

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[29] IRS Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board Assessment of the IRS and the Tax System* 7 (Sept.2002).

[30] *See Closing the Tax Gap and the Impact on Small Businesses*, Hearing Before the H. Comm. On Small Business, 109th Cong (Apr. 27, 2005) (testimony of John Satagaj, President and General Counsel, SBLC).

[31] When SB/SE stood up there were three operating divisions, CAS, TEC, and Compliance. Government Liaison and Disclosure (GLD), which was originally aligned with IRS Communications and Liaison, was subsequently realigned under SB/SE in March 2004. SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006).

[32] SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006).

[33] "It's Official: CLD Stands Up" (Oct. 11, 2006) available at http://sbse.web.irs.gov/dd/NEWCLD_Organization.htm.

[34] SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006).

[35] *Id.* During FY 2005, prior to the realignment of TEC into CLD, SB/SE offered a voluntary return to compliance positions to TEC employees who were interested and qualified. Approximately 157 employees took advantage of the offer.

educational and communications organization.[36] Twelve states have no Stakeholder Liaison representative within the state.[37]

Current Delivery of Education and Outreach

In its FY 2006 program letter, SB/SE committed that the new CLD unit would:

- Work with the Taxpayer Burden Reduction (TBR) unit to deliver key messages and products through appropriate stakeholder channels;[38]
- Ensure effective and timely communications with key stakeholder groups;
- Collaborate with appropriate business owners to develop outreach products targeted towards sectors of greatest non-compliance;
- Use this information to develop and implement a strategy to deliver key messages through liaison activities;
- Determine appropriate liaison channels and activities in order to consistently implement the delivery of key messages targeting identified sectors of non-compliance; and
- Conduct routine focus groups at the national and local levels with practitioners and stakeholders to ensure the overall effectiveness of communications and delivery channels.[39]

The Taxpayer Advocate Service (TAS) asked SB/SE to provide the number and details of outreach events it has conducted. SB/SE gave us the total number of events but provided only limited information about the different types of outreach within the total.

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[36] In FY 2004, 93 TEC FTEs were devoted to compliance. SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006).

[37] CLD Org Charts, SL Field (May 2006). The states without Stakeholder Liaison representatives are: Delaware, Hawaii, Idaho, Mississippi, Missouri, Montana, New Hampshire, New Mexico, North Dakota, Vermont, West Virginia, and Wyoming.

[38] The IRS formed the Office of Taxpayer Burden Reduction (TBR) in 2002 as part of the effort to reduce unnecessary burden on taxpayers. TBR's efforts to reduce taxpayer burden include: simplifying forms and publications, promoting less burdensome rulings and laws, and streamlining internal polices and procedures. TBR Handbook, *Taxpayer Education and Communication* 1-3 (April 2004).

[39] SB/SE Communications, Liaison and Disclosure (CLD) *FY 2006 Program Letter*, provided in SB/SE Response to Taxpayer Advocate Information Request (Oct 5, 2006).

TAS reconstructed the chart below from the CLD calendar of outreach events during 2006.[40]

TABLE 1.11.1, SB/SE 2006 OUTREACH EVENTS

Event Type	Number of Events
Payroll and Practitioner Local Liaison Meeting, Seminar or Event	545
Tax Practitioner Institute Classes	22
Leveraged Small Business Tax Workshops	285
Small Business Industry	99
Governmental Liaison	37
Other Event	70
Total Events	**1,058**

The Leveraged Small Business Tax Workshop is the only type of outreach event that specifically targets small business owners directly.[41] Although SB/SE conducted 285 of these workshops nationwide during this period, it held no workshops at all in 25 of the 50 states.[42] The other types of outreach are delivered to practitioners and small business industry organizations. Of the 545 Payroll and Practitioner Local Liaison Meeting Seminar outreach events, SB/SE delivered more than half by phone forum or "virtual seminar."[43] Since SB/SE does not measure the effectiveness of outreach activities, the division cannot determine if these efforts were successful and which types of events are more successful than others.[44]

[40] The Calendar of Events reflects information from February through December 2006. It includes details such as type of event (small business workshop or payroll & practitioner liaison meeting, etc) format (phone forum or actual meeting); location; and for some events, estimated number of attendees. This chart includes events conducted from February 2006 through September 30, 2006. CLD Calendar of Events on SB/SE website at http://sbse.web.irs.gov/cl2/sl/Events_Calendar/default.asp.

Payroll and Practitioner Local Liaison Meeting, Seminar, or Event is a meeting or seminar for the tax professional community. Tax Practitioner Institute Classes are events that qualify for CPE credit and are performed in conjunction with a university, college or other educational institution. Leveraged Small Business Tax Workshops are workshops designed to help the small business owner. Small Business Industry is an event where the audience is a small business or industry stakeholder. Other Events are events that do not fit into the other categories. The CLD Calendar of Events also includes Governmental Liaison which includes events for federal, state, or local government agencies.

[41] *User's Guide Small Business and Self-Employed Communications, Liaison & Disclosure (CLD) Calendar of Events*, Appendix A, Types of Events 7 (Jul. 2006), available at http://sbse.web.irs.gov/cl2/sl/Events_Calendar/default.asp.

[42] CLD Calendar of Events on SB/SE website at: http://sbse.web.irs.gov/cl2/sl/Events_Calendar/default.asp The states that had no Leveraged Small Business Workshops between February 2, 2006 and September 30, 2006 are Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Indiana, Kansas, Kentucky, Maine, Massachusetts, Mississippi, Montana, Nevada, New Hampshire, New Jersey, Rhode Island, Vermont, Washington, West Virginia, and Wyoming.

[43] CLD Calendar of Events on SB/SE website at http://sbse.web.irs.gov/cl2/sl/Events_Calendar/default.asp. Of the 545 outreach events classified as Payroll and Practitioner Local Liaison, Meeting, Seminar, or Event, 331 were conducted by telephone (either by phone forum or virtual seminar via telephone).

[44] SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006). ("There are no measures for outreach activities for any period.").

Delivery Methods and Channels

The Internet has dramatically changed the way the IRS communicates with taxpayers. The IRS website at http://www.irs.gov is one of the most frequently visited sites in the world, with 121.9 million "hits" during the 2006 filing season.[45] SB/SE has made commendable efforts to educate small business taxpayers with online resources such as:

- The Small Business and Self-Employed Online Classroom;
- The Small Business Resource Guide; and
- The Virtual Small Business Forum.

Taxpayers can order this information in a number of formats, such as CD- ROM or DVD, directly from the IRS website or by telephone.

While SB/SE has developed impressive products to provide outreach and education to small business taxpayers through electronic channels, the IRS needs to assess the effectiveness of this method of delivery. Some small businesses may be best served by face-to-face meetings with IRS representatives. The IRS website may be difficult to navigate for taxpayers who have little or no computer skill, or may be hard to understand for those who are unfamiliar with tax law and procedures. While surveys show that approximately 73 percent of American adults use the Internet,[46] only 54 percent of these users reported they had sought information from a government website.[47] The effectiveness of SB/SE's outreach materials on the IRS website is unclear. SB/SE has conducted research to gauge the effectiveness of its web-based outreach materials with respect to tax practitioners, but TAS is unaware of any SB/SE research designed to determine whether actual small business or self-employed taxpayers access the IRS site, and if they do access it, how well they are able to navigate and use the site.[48] Thus, it is possible that a significant number of small business and self-employed taxpayers will not obtain compliance information from the IRS site.

Tax Practitioners

In April 2006, then-SB/SE Commissioner Kevin Brown testified that CLD has built an outreach and education program to reach thousands of stakeholders, and through them, millions of small business taxpayers.[49] These stakeholders are "national and local partners, including practitioner organizations, small business and industry associations,

[45] There were 121,859,609 hits to IRS.gov in 2006 as of the week ending April 22, 2006. W&I Strategy & Finance Survey Administration & Analysis, 2006 Filing Season Reports.

[46] Pew Internet & American Life Project, *February 15 – April 6, 2006 Tracking Survey*, available at http://www.pewinternet.org/trends/User_Demo_4.26.06.htm.

[47] Pew Internet & American Life Project, *Tracking surveys (March 2000-April 2006)*, available at http://www.pewinternet.org/trends/Internet_Activities_7.19.06.htm.

[48] SB/SE conducted focus groups in 2003 with practitioners regarding the practitioners' use of the IRS website. 2003 Nationwide Tax Forums Focus Groups, *Taxpayer Education and Communications* 5-13 (2003).

[49] *IRS's Latest Enforcement: Is the Bulls-Eye on Small Businesses? Hearing before the H. Comm. On Small Business*, 109th Cong. 2nd Sess. (Apr. 5, 2006) (testimony of Kevin M. Brown, Commissioner, SB/SE).

and federal and state agencies and governments."[50] SB/SE believes the information provided to these stakeholders will trickle down to taxpayers.[51] Thus, Stakeholder Liaison (SL) has concentrated most of its efforts on these practitioner and trade associations. These efforts can be effective in providing important information to practitioners and trade association representatives, but there are practical problems with attempting to reach the large number of varied and diverse small business and self-employed taxpayers in this manner.

Concerns with SB/SE Outreach

In addition to concerns with SB/SE's methods of delivering taxpayer education, services, and outreach, the National Taxpayer Advocate also has concerns about the overall effectiveness of the division's taxpayer outreach and education programs.

Planning, Focus, and Measures

While CLD does have a mission statement and issues annual program letters, there is no indication that SB/SE's Stakeholder Liaison program has developed a five-year strategic plan.[52] CLD's fiscal year 2007 program letter divides Stakeholder Liaison into Headquarters and Field functions ("SL HQ" and "SL Field," respectively). SL HQ "focuses on national engagement of the payroll and practitioner community and stakeholder organizations to provide information about IRS policies, practices, and procedures to ensure compliance with the tax laws, both by voluntary means and through enforcement programs; [and] oversees IRS involvement in disaster assistance and emergency relief activities."[53] SL Field:

> Focuses on local engagement of the payroll and practitioner community and stakeholder organizations to provide information about IRS policies, practices and procedures to ensure compliance with the tax laws; aligns SL Field activities with

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50 *IRS's Latest Enforcement: Is the Bulls-Eye on Small Businesses? Hearing before the H. Comm. On Small Business*, 109th Cong. 2nd Sess. (Apr. 5, 2006) (testimony of Kevin M. Brown, Commissioner, SB/SE) ("Some of these relationships include the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the U.S. Chamber of Commerce, the National Association of the Self-Employed, the National Federation of Independent Businesses, the Small Business Legislative Council, the Small Business Administration, the Federation of Tax Administrators, and the National Association of State Workforce Agencies").

51 *See IRS's Latest Enforcement: Is the Bulls-Eye on Small Businesses? Hearing before the H. Comm. On Small Business*, 109th Cong. 2nd Sess. (Apr. 5, 2006) (testimony of Kevin M. Brown, Commissioner, SB/SE).

52 CLD's mission statement says, "The mission of CLD is to develop and deliver integrated strategic communications and educational products to SB/SE employees and taxpayers and to our key SB/SE partners in tax administration including federal, state and local governmental agencies, practitioners, and industry groups. CLD is responsible for programs and activities in support of both the SB/SE and the IRS Strategic Plans including the administration of IRC §6103, the Freedom of Information and Privacy Act, and coordinates the IRS National Disaster Assistance Program." SB/SE Communications, Liaison and Disclosure, *Fiscal Year 2007 Program Letter.*

53 SB/SE Communications, *Liaison and Disclosure Fiscal Year 2007 Program Letter.*

> the IRS goals to improve taxpayer service, enhance enforcement of tax law and modernize the IRS through its people, processes and technology.[54]

Neither of these statements indicates that Stakeholder Liaison has developed a plan to ensure that SB/SE taxpayers receive *effective* education and assistance.

Additionally, neither these statements nor the fiscal year 2007 program letter indicate any planned research or focus groups to help the IRS better understand the characteristics and needs of small business and self-employed taxpayers. Without this information, SB/SE cannot tailor its outreach and education efforts to best serve these taxpayers and meet their specific needs.[55]

Further, SB/SE has not implemented a system to determine whether the new Stakeholder Liaison program is providing taxpayers with the same level of service they received under TEC. In fact, SB/SE does not measure its outreach efforts at all and has no measure of what constitutes a success with respect to its outreach and educational activities.[56] Without a measurement system, it is not possible for SB/SE to honor its commitment to provide its customers with the same level of service[57] under the new organization because SB/SE cannot know what "level of service" it is providing. The absence of planning, focus, and measures represents serious deficiencies in the Stakeholder Liaison program.

The Taxpayer Assistance Blueprint (TAB) initiative may serve as a model for SB/SE to correct some of these deficiencies. In July 2005, Congress instructed the IRS, the IRS Oversight Board, and the National Taxpayer Advocate to "undertake a comprehensive review of its current portfolio of [IRS] taxpayer services and develop a 5-year plan that outlines the services it should provide to improve services for taxpayers."[58] The TAB is headed by the IRS Wage and Investment Division (W&I) and is focused on individual taxpayers.[59]

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[54] SB/SE Communications, *Liaison and Disclosure Fiscal Year 2007 Program Letter.*

[55] Notably, the fiscal year 2007 program letter does indicate that SB/SE recognizes the increasing Spanish speaking taxpayer population. The program letter says that CLD's Communication function will partner with SL HQ to "consider minority-based outreach, including multi-lingual products, as appropriate." Additionally, CLD's Governmental Liaison and Disclosure arm will partner with SL Field to "provide effective outreach to their government and industry stakeholders, especially on issues related to the small business Spanish Speaking Taxpayer." SB/SE Communications, Liaison and Disclosure *Fiscal Year 2007 Program Letter*. Because Spanish speaking small business and self-employed taxpayers are the fastest growing segment of SB/SE's taxpayer base, CLD should make efforts to more clearly define and expedite its outreach and education efforts to these taxpayers.

[56] SB/SE response to Taxpayer Advocate Service Request. (Sept. 5, 2006). ("There are no measures for outreach activities for any period.").

[57] "Greater emphasis will be given to using technology to leverage messages and activities, ensuring the level of service will not diminish." "It's Official: CLD Stands Up" (Oct.11, 2006) available at http://sbse.web.irs.gov/dd/NEWCLD_Organization.htm.

[58] S. Rep. No. 109-109, 133-34 (2005).

[59] *See* IRS, *The 2006 Taxpayer Assistance Blueprint: Phase I*, 19.

The TAB is a two-phase process. In Phase I (which has been completed), the TAB team identified and developed numerous research projects to quantify the services individual taxpayers need from the IRS and the channels through which they prefer to receive these services. Based on its preliminary research in Phase I, the team developed specific strategic improvement themes.

Phase II of TAB is now underway, and has the following objectives:

- Refine the IRS's understanding of taxpayer needs, preferences, and expectations;
- Identify and prioritize taxpayer services improvement recommendations;
- Develop customer-centric and efficiency service metrics;
- Establish an ongoing process to assess customer needs and correlate that assessment with compliance findings from the National Research Program; and
- Address the challenges of effectively and efficiently aligning service content, delivery, and resources with taxpayers' and partners' expectations.[60]

To meet these objectives, the TAB is conducting 27 major research studies to learn more about general tax services offered, the taxpayers who use the services, and their impact.[61]

Although the TAB is a major undertaking, TAS believes that SB/SE must do the research necessary to understand the characteristics and needs of its taxpayers, and should develop an interactive five-year plan for delivering effective outreach and education to small business taxpayers. It may not be necessary for SB/SE to do all of this work on its own. SB/SE can and should use information available from other IRS functions and other government agencies.[62] But to effectively serve taxpayers, SB/SE must clearly understand its customer base and what these taxpayers need.

Outreach Through Practitioners

As explained above, SB/SE has concentrated its outreach efforts on practitioners, generally through outreach to practitioners and trade associations. While this approach may appear efficient, and in many cases does provide important information to practitioners and trade associations, it presents at least four practical problems:

- First, some business taxpayers cannot afford the regular advice of tax professionals. Most small business taxpayers hire preparers to prepare their annual returns,

[60] *See* Taxpayer Assistance Blueprint (TAB) Phase 2 Congressional Status Briefing (Sept. 28, 2006).

[61] *Id.*

[62] Global Hue, *Qualitative Hispanic Market Research 9* (May 2003); Global Hue, *Hispanic LEP Taxpayer Research Quantitative Report* (June 2003); U.S. Census Bureau News Release, *Growth of Hispanic-Owned Businesses Triples the National Average* (Ma. 21, 2006) http://www.census.gov/Press-Release/www/releases/archives/business_ownership/006577.html; Robert W. Fairlie, *Self-Employed Business Ownership Rates in the United States*: 1979-2003 Research Summary 6 (2004) at http://www.sba.gov/advo/research/rs243tot.pdf; U.S. Census Bureau, *Characteristics of Business Owners: 2002*, at http://www.census.gov/csd/sbo/cbosummaryoffindings.htm. *See also* Most Serious Problem, *Limited English Proficiency Taxpayers: Language and Cultural Barriers to Tax Compliance, infra.*

but handle other IRS matters without assistance.[63] Some "mom and pop" type businesses may deal with the IRS by themselves. According to IRS research, approximately 21 percent of small business taxpayers do not use practitioners to prepare their returns.[64] While leveraging IRS resources through practitioners and professional associations may be an economical use of limited resources, the IRS should also consider the needs of business taxpayers who do not use or cannot afford professional tax assistance. The messages delivered through practitioners do not reach these taxpayers. Face-to-face outreach gives taxpayers a chance to address their questions and concerns directly to the IRS and helps the IRS to identify areas of taxpayer confusion and concern.

- Second, SB/SE does not measure the effectiveness of its outreach to practitioners and trade associations. Without a plan to determine whether the actual small business and self-employed taxpayers are receiving the messages SB/SE communicates with its "partners," the IRS does not know if conducting outreach through practitioners and industry groups is an effective way to target these taxpayers – or even if these taxpayers are receiving the messages at all.
- Third, because Stakeholder Liaison has no presence in a dozen states, it may not be able to develop effective relationships with the practitioner community in these areas. Even if SB/SE attempts to provide outreach to practitioners in these states on a regional or even a "traveling" basis, without establishing a permanent, continuing relationship with these stakeholders, practitioners may not know when the substitute outreach events are being held. These practitioners will also be less likely to turn to Stakeholder Liaison when specific issues come up because the practitioners will not know who to contact or may not feel a local connection with the IRS liaison. This arrangement may set the Stakeholder Liaison up for failure, or at best, limit its effectiveness.
- Fourth, IRS relationships with practitioner and professional organizations can be damaged by miscommunication. For example, we are aware of at least one instance where SB/SE solicited input from a practitioner organization at the organization's annual IRS liaison meeting, invited representatives to attend a meeting in IRS headquarters to discuss their concerns, received suggestions on how to better administer a particular SB/SE program, and failed to act on these suggestions – or to communicate to the practitioner organization whether it was even considering the suggestions. This organization expressed displeasure and frustration with the IRS at its next liaison meeting. When SB/SE fails to maintain its practitioner and

[63] *See* Russell Marketing Research, Inc, *Findings From Task 149 – The Taxpayer Advocate Service Research Program* (Sept. 2002).

[64] IRS, *Business Master File, BMF-2006-0039*. The report, which SB/SE requested, analyzed the percentage of forms 1040 Schedule C, Forms 1065, Forms 1120S, and Forms 1120 for corporations with assets less than $10 million that did not use paid tax preparers. The report used data from processing years 2004 and 2005. Twenty-six percent of 1040 schedule C's were self-prepared; 14 percent of Forms 1065, five percent of Forms 1120S and 13 percent of the corporate returns were self-prepared. Overall, 21 percent of small business and self-employed tax returns were self-prepared.

professional organization relationships, it loses credibility and decreases the likelihood that these organizations will distribute outreach information to their clients and members.

SB/SE Research

Although it can and must do more to understand the characteristics and needs of its customer base, SB/SE has recently performed some industry specific research to gauge the effectiveness of certain outreach initiatives. SB/SE's research unit looked at the effect of targeted outreach to taxpayers in the restaurant and construction industries (Targeted Research Study) with the goal of finding out whether these targeted programs are effective in general.[65] In the restaurant industry, three out of five tests indicated outreach has a significant effect.[66] However, the study of the construction industry found no evidence that outreach increased compliance in the issuance of Form W2, Employee's Wage and Tax Statement, and Form 1099-MISC, Miscellaneous Income.[67] Although inherent differences between the industries could explain the divergent results, there was also a difference in how the outreach was delivered. SB/SE provided one-on-one, face-to-face outreach to restaurant owners and managers[68] but delivered outreach to the construction sector through industry publications and association meetings.[69] This research project was not designed to test the effectiveness of one outreach program over another and is not conclusive. Still, the results indicate SB/SE needs to measure more closely the effect of particular methods of outreach.

Another SB/SE research project (Construction Study Phase I) sought to measure the effect of TEC outreach on the construction industry's employment tax filing compliance.[70] The survey showed relative improvement in these areas:

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[65] SB/SE Research Report, Project No. SEA0004, *The Effect of Targeted Outreach on Compliance* 2 (May 2006).

[66] I*d. at 7.* The restaurant industry outreach was delivered during November and December of 2003. The primary measure included the change in proportion of taxpayers or entities in compliance. Specifically, for tip reporting compliance, the measure was the proportion of taxpayers reporting any tip wages on Form 941. The tip reporting outreach appeared to have a significant positive effect on compliance, except among those taxpayers not reporting this before and among taxpayers new to the market segment.

[67] *Id*. The construction industry outreach has been delivered continually since 2003. The effectiveness of the construction industry outreach was tested using three measures: issuance of Form W2, Issuance of Form 1099-MISC (Non Employee Compensation) and filing those forms electronically. Form 1099-MISC is used to report rents, royalties, prizes, awards, and other fixed determinable income including nonemployee compensation. The study also looked at growth in e-filing of these forms which is a compliance issue. An important IRS goal is to increase the number of tax returns e-filed because RRA 98 established the goal for the IRS of having 80 percent of all federal tax and information returns filed electronically by the year 2007.

[68] *Id.* at 16.

[69] *Id.* at 25.

[70] SB/SE Research Report, Project NO. 06.08.004.03, *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes* 27 (July 2004). The project compared each business's third-quarter 2002 Form 941 against that of the third quarter 2003. The fourth-quarter 2003 Form 941 was also analyzed. This project was a panel study in which the same businesses were tracked each quarter. The market segment of interest was the construction industry. The control groups were retail, transportation, and real estate industries, which were used to determine if the changes in the construction industry's compliance represent random fluctuation or a response to the general outreach.

- Failure to Deposit (FTD) penalties increased at a slower rate than in the control industries;
- The percentage of the industry's Failure to File (FTF) penalties decreased;
- The average amount of the FTF penalty assessed was reduced;
- The number of cases "open beyond First Notice"[71] decreased; and
- The average balance of cases in "open beyond First Notice" inventory declined.[72]

The conclusions of the report support the hypothesis that TEC general outreach had a measurable impact on compliance.[73] The outcome of this research seems to contradict the previously discussed Targeted Research Study involving the construction industry which showed no evidence that targeted outreach increased compliance.[74] Again, the method of delivery may make a significant difference. The outreach in Construction Study Phase I was delivered through various means. TEC personnel visited local and national trade shows and spoke at industry organization meetings. TEC also delivered part of the outreach through a pair of specialized advertisements provided on a website or in newsletters.[75] The contradiction between the outcomes of the two studies serves to emphasize the need for SB/SE to conduct more research so it can determine what works and why it works.

SB/SE conducted a second study (Construction Study Phase II) on the effect of TEC outreach on the construction industry's employment tax filing compliance.[76] This subsequent study concluded that general outreach does have a positive effect on the percentage of businesses receiving certain penalties, the average amount of delinquency penalties, and payment compliance.[77] SB/SE found:

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[71] In addition to analyzing the frequency and amount of penalties, this report considered the difficulty in collecting accounts receivable. The report examined each industry during the second action taken by the IRS. The first standard action is always a notice. This analysis was based upon accounts receivable during the next action. The next action was found to be a final demand, an installment agreement, a suspension (i.e., payment tracer or credit transfer) or assignment to collection division. The aggregate of these conditions is called 'open beyond First Notice' for this report.

[72] SB/SE Research Report, Project No. 06.08.004.03, *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes* 29 (Jul. 2004).

[73] *Id.*

[74] *Id.* at 7.

[75] *Id.* at 1.

[76] The study was conducted to measure the ability of general outreach to influence e-Filing, penalty, and payment compliance. The project compared the changes in the aspects of e-filing, Federal Tax Deposit (FTD) penalty, Failure to File (FTF) penalty and Balance Due beyond the First Notice. The construction industry was compared with three control groups – retail, transportation and real estate industries, from the base quarter to the end of every test period, starting with the third quarter of 2003 and ending at the fourth quarter of 2004. The measurement requirement was that the construction industry outperform two out of the three control groups. The data represents a panel of taxpayers consisting of one percent of Form 941 filers. SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II* 23 (January 2006).

[77] SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II* 51 (January 2006).

- General outreach appears to reduce the percentage of filers receiving FTD penalties.[78] The construction industry showed negative improvement during the project but still outperformed the control groups in five of six tests;[79]
- General outreach appeared to decrease the rate and average amounts of FTF penalties;[80] and
- Overall, general outreach seemed to reduce accounts receivable in the construction industry.[81]

TIGTA Findings on TEC Performance Measures

The Treasury Inspector General for Tax Administration (TIGTA) also reviewed TEC outreach to small business taxpayers in 2005 and evaluated TEC's efforts to help small businesses understand and fulfill their tax obligations.[82] TIGTA found many of TEC's performance measures were questionable. For example, TEC used the number of taxpayers reached through practitioner organizations as an indirect measure of outreach impact. TIGTA believed TEC may have been taking credit for the work of these third parties (*i.e.*, practitioners) rather than work done by its own staff. Because SB/SE does not measure the effectiveness of its outreach activities, the accuracy of the measures depended upon the practitioners.[83]

Local Taxpayer Advocate Questionnaire on TEC Realignment

TAS Local Taxpayer Advocates (LTAs) support TAS's operational priority of increasing public awareness of TAS by partnering with the IRS operating divisions in conducting outreach events in local communities. The LTAs participate in joint outreach activities with CLD's Stakeholder Liaisons in an effort to reach small business owners and tax professionals, inform them of TAS services, and learn about both their case specific

[78] Federal Tax Deposit (FTD) penalties are an excellent indicator of payment compliance. If a business deposits its employment taxes properly, there is no penalty.

[79] SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II* 51 (January 2006).

[80] At the end of the project, the construction industry had a noticeable improvement in the decrease in percentage of filers being assessed the FTF. The project also showed that general outreach reduced the average amount of filing penalties. SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II* 51 (Jan.2006). Due to limitations, we cannot be certain that the effects came entirely from the general outreach program. The limitations are due to environmental factors. Part of the tests involved analyzing e-filing; an increase in e-filing should be highly correlated with a reduction in FTF penalties. The environmental factors affecting e-filing could be e-filing outreach by other parts of the IRS which could affect the measured industry e-filing rates and the improving economy which could affect e-filing rates. The measure of the environmental effects is unknown.

[81] In addition to analyzing the frequency and amount of penalties, the report considered the difficulty in collecting accounts receivable. The project examined each industry during the second action taken by the IRS. The first standard action is always a notice. SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II* 51 (January 2006).

[82] Treasury Inspector General for Tax Administration, Ref. No. 2005-30-132, *Opportunities Exist to Improve the Efforts of the Taxpayer Education and Communication Organization to Assist Small Businesses in Understanding and Fulfilling Their Tax Obligations* 1 (Aug. 2005).

[83] *Id.* at 8-9.

and systemic problems with the IRS. TAS's Office of Systemic Advocacy submitted a questionnaire to LTAs to solicit their observations about specific ways the realignment of TEC into CLD has affected outreach in the field.[84] Although some LTAs have not noticed a negative impact, others have seen a decrease in outreach. The impact varies by locality, with LTAs generally reporting a greater impact in states that do not have a Stakeholder Liaison representative. Further, 31 of the 42 LTAs who responded to our survey stated they have noticed a decrease in Stakeholder Liaison representatives since TEC realigned into CLD.[85] Three LTAs reported SB/SE has asked their offices to provide outreach for events that TEC used to cover.

Small Business Administration Concerns

The Small Business Administration (SBA) has also expressed concern about the lack of an appropriate balance between IRS enforcement and outreach and education to small business taxpayers. In April 2006, Thomas M. Sullivan, the SBA's Chief Counsel for Advocacy, told the House Committee on Small Business that the small business community is concerned that the IRS's plans for closing the tax gap focus primarily on increasing enforcement.[86] Mr. Sullivan expressed his belief that IRS attempts to improve compliance should also include "taxpayer education and compliance assistance … to balance an appropriate level of enforcement."[87] This statement was based in part on a study showing the connection between enforcement and compliance is not certain, and excessive enforcement may actually lead to decreased compliance.[88]

Other Stakeholders' Concerns

John Satagaj, President and General Counsel of the Small Business Legislative Council (SBLC), testified before the Small Business Committee of the House of Representatives that:

> The message now being delivered to the small business community from the IRS is that education is no longer a priority and that enforcement is the way to increase

[84] The questionnaire to the LTAs provides anecdotal rather than quantitative evidence.

[85] Forty-two LTAs responded to our survey, 31 of them reported a decrease in Stakeholder Liaison (formerly TEC) representatives, two reported no decrease, and nine either did not know or had no response. The survey had a 56.8 percent response rate. Although non-response error is likely, we did not analyze the results for non-response error; therefore, the results may not extend to the whole population of 73 LTAs.

[86] *IRS's Latest Enforcement: Is the Bulls-Eye on Small Businesses? Hearing Before the House Comm. On Small Business*, 109th Cong. (Apr. 5, 2006) (testimony of Thomas M. Sullivan, Chief Counsel for Advocacy, U.S. Small Business Administration).

[87] *Id.*

[88] "Important insight on tax compliance and tax evasion can be gained by looking at how the tax authority deals with the taxpayer. Taxpayers respond in a systematic way to how the tax authority treats them. In particular, the taxpayer's willingness to pay their taxes, or *tax morale, is supported or even raised, when the tax officials treat them with respect. In contrast, when the tax officials consider taxpayers purely as 'subjects' who have to be forced to pay their dues, the taxpayers tend to respond by actively trying to avoid taxation.*" Frey, Bruno S. and Feld, Lars P., "Deterrence and Morale in Taxation: An Empirical Analysis" 23 (Aug.2002). CESifo Working Paper Series No. 760, available at SSRN, http://ssrn.com/abstract=341380.

> compliance. One of the great successes of the IRS Restructuring and Reform Act of 1998 was the creation of the Small Business Self Employment Division and its Taxpayer Education and Communication (TEC) section. We at SBLC believe that a greater emphasis on education can have a significant impact by helping to bring in those individuals that want to pay their taxes but for one reason or another are not doing so. That is why we were disheartened recently to learn that TEC is being cut substantially and many of the employees there will be moving into enforcement roles.[89]

The SB/SE Perspective

The former SB/SE Commissioner has stated that enforcement alone will not close the tax gap. At an August 2006 meeting of the National Association of Tax Professionals, then-Commissioner Kevin Brown said that increasing audit rates and selecting better returns for audit can help, but "even if [the IRS] doubles the number of revenue agents [auditors] ... I don't think that is going to close the gap." SB/SE Commissioner Brown said that audit coverage rates for individual taxpayers, partnerships, and S corporations are each less than one percent and are only three percent for Schedule C filers. "We are simply not going to close the [tax] gap auditing one individual at a time."[90]

According to the figures reported by former SB/SE Commissioner Brown, the vast majority of small business and self-employed taxpayers will have little or no interaction with the IRS apart from outreach and education.[91] To accurately comply with their tax obligations, these taxpayers must understand how to navigate the complex landscape of rules, regulations, and procedures that apply to their situations. Many small business and self-employed taxpayers embark on this annual journey with only limited assistance from professional tax advisors, and some have no assistance at all. It is imperative, therefore, that the IRS provide these taxpayers with the instruction and information necessary to make voluntary compliance easier.

CONCLUSION

To fulfill their tax obligations, small business taxpayers must deal with ever increasing tax law complexity. They also must keep extensive records, comply with regulatory requirements, and meet numerous tax deadlines. Many of these taxpayers cannot afford professional tax advice. Many small business owners also need face-to-face communication with the IRS. We believe that reducing small business education resources is a mistake, particularly since the IRS does not measure the effect of outreach activities

[89] *Closing the Tax Gap and the Impact on Small Businesses, Hearing before the House Comm. On Small Business*, 109th Cong (Apr. 27, 2005) (testimony of John Satagaj, President and General Counsel, SBLC).

[90] Crystal Tandon, *Legislative Fixes Needed to Close Tax Gap, IRS Official Says*, 2006 TNT 162-2, Aug. 21, 2006.

[91] *See* Crystal Tandon, *Legislative Fixes Needed to Close Tax Gap, IRS Official Says*, 2006 TNT 162-2, Aug. 21, 2006. Because the IRS audits small business and self-employed taxpayers at rates of only three and one percent, respectively, more than 97 percent of these taxpayers will have no contact with the IRS beyond IRS outreach and education efforts.

on small business taxpayers' behavior, including compliance. The downstream consequences of reducing outreach to the small business community may include decreased compliance, and potentially an increase in the tax gap. The IRS needs to provide adequate and effective education to taxpayers who want to comply and need more information and assistance to do so.

IRS COMMENTS

The IRS disagrees with the National Taxpayer Advocate's conclusions and statements concerning the outreach and education function of the Small Business/Self-Employed (SB/SE) Division. Since its inception, SB/SE has been committed to balancing service and enforcement in order to properly inform SB/SE taxpayers about the tax laws and IRS policy regarding those laws. SB/SE has always employed a leveraged approach through an education and outreach function – currently, the Communication, Liaison & Disclosure Division (CLD). In addition, we regularly perform extensive reviews, and have redesigned our functions when necessary, to maximize the value of our outreach to the small business community.

Staffing Dedicated to Outreach and Education

The staffing dedicated to outreach and education has not diminished since SB/SE standup. Although the design of the original Taxpayer Education & Communication (TEC) division included approximately 1200 staff, many of those staff equivalents were not going to fully engage in outreach and education. Many of the TEC employees had outreach duties, but also would have supported the filing season – a duty that had fallen to many Compliance employees over the past several years. With TEC employees fulfilling that function, Compliance employees could perform their enforcement duties year round, thereby completing their casework more expeditiously and providing better customer service to those taxpayers in the enforcement process. The number of TEC staff that would have been dedicated fully to outreach is approximately the same as the number of staff in the redesigned Stakeholder Liaison (SL) function, which is fully committed to outreach and education.

Stakeholder Liaison Placement

The IRS used a strategic approach to placing SL employees. We used research data to determine locations with the highest concentration of SB/SE taxpayers and placed our Stakeholder Liaisons there. External stakeholders in all 50 states and Washington, D.C. have a liaison contact in the SL function, even though the contact may not be physically located within the same state or city.

The IRS efficiently uses advancements in technology to deliver liaison activities so that activities do not diminish when the liaison contact is in a different state than the stakeholder. In FY 2006, there were 283 SL events conducted in the 12 states without the physical presence of a Stakeholder Liaison employee. These ranged from two events in

Hawaii to 90 events in Missouri. During the design of CLD, we also wanted to ensure there was coverage from at least one CLD employee in each state, which we accomplished in all but two states. There are also plans to hire SL employees in states that currently have a vacancy.

We also work through our partners so that small business workshops are now fully leveraged by external stakeholders, such as Small Business Development Centers and SCORE. We support these stakeholders by providing products and approved presentations for key message delivery. We also audit classes to ensure quality and market classes to our stakeholders to inform small business owners regarding class availability. The decision to conduct a workshop is driven by identified demand and the availability of a leveraged stakeholder to deliver the workshop.

CLD Strategic Planning

SB/SE's planning consists of a Concept of Operations (CONOPS), which provides a three to five year plan; a strategic plan for the next two consecutive fiscal years; and a program letter requirement for each function, which more specifically lays out the mission, strategy and activities for the current fiscal year. The SB/SE Strategic Plan covers two years so it will align with the Treasury and OMB budgetary process. CLD closely follows this process and has a CONOPS and program letter aligned to the SB/SE Strategic Plan.

The CLD plan includes actions to address limited english proficiency. In FY 2006, Stakeholder Liaison launched Hispanic Small Business Forums with the Spanish speaking small business community in states strategically determined to have the highest concentration of Hispanic small business taxpayers. This included California, Florida and New York. We also conducted forums in South Carolina and New Jersey – states that showed significant Hispanic populations. We plan to expand this outreach nationwide. These forums provided us an opportunity to identify specific issues and concerns impacting Spanish speaking small business owners. Also, the new Small Business Workshop DVD provides lessons in English, Spanish and Mandarin Chinese. The disability credits available to small business owners are not currently addressed, as credits like this are geared more toward Wage & Investment outreach activity.

Although strategic planning is important, CLD also feels it is critical to maintain flexibility in its outreach approach to react to emerging issues and provide up-to-the-minute education to taxpayers. One recent example is our outreach to the entertainment industry regarding the taxability of celebrity gift bags. This was not in our outreach plans for FY 2006, but we seized upon the tax compliance issue and quickly rolled out a nationwide strategy to deliver the IRS's message.

Using Research

CLD partners with SB/SE Research to obtain research data and conduct focus groups to assist in identifying and developing future outreach activities. During FY 2006, for example, SB/SE Research provided a comprehensive library of existing research targeted toward the non-filer community. Stakeholder Liaison Headquarters is currently using this research to develop an outreach strategy aimed at small business taxpayers who are not complying with their filing requirements.

CLD is also currently working with SB/SE Research on a specific project using the Examination Operational Automated Database (EOAD) to determine whether significant portions of the tax gap can be isolated and then addressed by industry and geography. Also, in a tax gap related project, we plan to work with Research, pending the availability of funds, on behavioral methods to influence small business owners in the cash economy to report their income. This study will be on two levels: how practitioners perceive and deal with their "cash economy" clients and how "cash economy" business owners view their income tax responsibility related to reporting cash receipts.

CLD also partners with Research to conduct focus groups with practitioners at the Nationwide Tax Forums. One of this year's focus group questions concerned expanding communications with practitioners. The Research Summary stated, "Our primary observation is that there is a high level of satisfaction". The communication products discussed were Tax Talk Today, Headliners, e-News and irs.gov website.

Effectiveness of Outreach Activities

SB/SE monitors the effectiveness of outreach activities through direct contact with stakeholders. In these "level of service" calls, we directly sample stakeholders and inquire about the effectiveness of outreach activities. We solicit feedback from stakeholders at each hosted event and use the feedback to improve future events. It is true that we do not measure outreach quantitatively; however, we believe that quality content is more important. We also believe that stakeholder satisfaction is a better measurement of our effectiveness. We do not have any specific examples where we have failed to meet the challenge of effectively providing education related to tax obligations and IRS policies to our stakeholders.

Individual Interaction with SB/SE Taxpayers

The outreach and education arm of SB/SE was never designed to meet one-on-one with small business owners, as there are more than 45 million small business taxpayers. The outreach mission has always been to educate the small business community by leveraging stakeholder relationships and networks. We continue to expand our network each year in order to reach more of the small business community. We believe that this approach is working and have not encountered any practical problems with it.

An example of our expanding network is the "SB/SE Mailing List" that has accumulated 90,000 subscribers over the last five years and includes small business owners as well as other external tax professional and industry stakeholders. Beginning in January 2007, we are renaming this "list" to "e-News for Small Businesses" and will launch regular editions aimed at helping small business owners and self-employed persons voluntarily comply with their tax responsibilities, including:

- Important upcoming tax dates;
- What's new for small businesses on the IRS Web site;
- Reminders and tips to assist small businesses with tax compliance; and
- IRS News Releases and special announcements.

Finally, we strongly believe in the cohesiveness of CLD with all liaison activities housed within one function - liaison to external stakeholders, business owners within the small business community, state departments of revenue, and governmental liaison and Congressional offices. This one organization with a focused liaison mission affords the small business community with the most consistent outreach and education approach regarding tax compliance responsibilities.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes that SB/SE must balance taxpayer service, education and outreach with its responsibility to enforce the tax laws. The National Taxpayer Advocate supports SB/SE's efforts to improve compliance among nonfilers, and the Taxpayer Advocate Service is a partner of SB/SE (and other IRS organizations) on a task force focusing on noncompliance in the cash economy. The National Taxpayer Advocate continues to believe, however, that compliance cannot be achieved without effective outreach and education to small business and self-employed taxpayers.

The IRS's response to our concerns about outreach and education efforts to small business and self-employed taxpayers indicates that the IRS plans to continue its present course in serving these taxpayers. The IRS does not appear to be willing to contemplate additional approaches that may enhance the reach and effectiveness of its outreach and education. While the IRS is doing a lot under the status quo, it can do more. Given the amount of the tax gap attributable to the self-employed, it *must* do more.

The IRS claims that a loss of 157 employees from the TEC organization[92] has not resulted in diminished taxpayer service because during filing season, these employees supported IRS compliance functions. Thus, the IRS argues, this staff reduction has not decreased taxpayer services because the number of employees devoted to full time outreach and education has essentially remained constant during the transition from

[92] In February 2005, prior to the realignment TEC had 536 employees; after the realignment, Stakeholder Liaison staffing included 183 employees in the field and 36 in Headquarters. CLD Org Chart (February 2005) Prior to the realignment, in February 2005, 157 TEC employees voluntarily returned to full-time compliance positions. SB/SE response to TAS request (Sept. 5, 2006).

TEC to CLD. We, however, fail to see how a loss of 157 employees – even if they only work part-time – *cannot* result in diminished customer service.[93] Moreover, TEC staffing never approached the 1200 employee level that SB/SE envisioned as necessary for a successful small business/self-employed taxpayer education and communications organization.

The IRS also asserts that the absence of Stakeholder Liaison offices in 12 states does not diminish taxpayer service because the IRS used a "strategic approach" when it closed these offices and that "external stakeholders in all 50 states and Washington, D.C. have a liaison contact in the SL function, even though the contact may not be physically located within the same state." Again, we fail to see how removing IRS small business outreach contacts from nearly a quarter of all states does not diminish taxpayer service.

TAS recognizes that SB/SE has limited resources and must sometimes make difficult staffing decisions. We do not understand, however, why SB/SE refuses to acknowledge that reduced staffing may lead to reduced taxpayer service. SB/SE cannot develop and maintain an effective outreach and education program unless it has an accurate understanding of its own resources.

We recognize that both SB/SE and CLD have created strategic planning documents (such as the Concept of Operations and Program Letter) and commend the IRS for CLD's plans to address Limited English Proficiency taxpayers.[94] However, we are unaware of any specific five-year plan to develop, deliver, and measure a small business/self-employed taxpayer outreach and education effort through Stakeholder Liaison. The IRS suggests one reason a specific five-year plan does not exist is because such a plan would limit the IRS's flexibility to "react to emerging issues and provide up-to-the-minute education to taxpayers." The prospect of limited flexibility is not a valid reason to neglect planning. Strategic plans provide focus and goals, but they are not set in stone and can easily be adapted to changing circumstances. Moreover, they are part of an interactive process. Without specific plans, an organization can lose focus as it attempts to deal with inevitable changes and budgetary limitations. It is precisely for this reason that the IRS cannot provide effective outreach and education to small business and self-employed taxpayers without a specific five-year strategic plan for the SB/SE Stakeholder Liaison function.

The National Taxpayer Advocate commends SB/SE for the behavioral research it plans to do, but it appears that this research may be a postscript to the IRS's tax gap closure initiatives. Rather than conducting *ad hoc* research studies, we encourage SB/SE to use

[93] We also note that SB/SE reported that 93 TEC FTE's provided cross-functional support during FY 2004, but 157 TEC employees retuned to full-time compliance positions in FY 2005. SB/SE response to TAS Request (Sept. 5, 2006).

[94] We note that the SPEC organization's CONOPS did not diminish the need for a five-year Taxpayer Assistance Blueprint.

W&I's TAB as a model for research, namely research conducted as part of an integrated strategic approach.

We agree that the IRS should continue to leverage its outreach efforts through practitioners and trade association representatives and through the excellent small business education materials on IRS.gov. In this respect, the National Taxpayer Advocate does not believe that SB/SE should meet "one-on-one" with small business owners, as the IRS suggests. She does believe, however, that the IRS should be aware that it will not reach a significant number of small business and self-employed taxpayers by leveraged outreach alone. As noted in our discussion, most small business and self-employed taxpayers do use tax practitioners, but many of these taxpayers hire practitioners only to prepare their returns. Most tax planning and compliance decisions are made without the advice of a practitioner. A practitioner leveraged outreach program is not the best method of educating these taxpayers. The IRS should find other ways to reach them. Likewise, providing materials to taxpayers through IRS.gov is another good way to leverage resources, but it will not reach small business and self-employed taxpayers who lack Internet access or do not regularly use computers.

The National Taxpayer Advocate believes that rather than dismissing her concerns about small business and self-employed taxpayer outreach, the IRS should use them as a springboard to evaluate its outreach and education programs. If the IRS is willing to engage in this exercise, it will find that it is, in fact, providing excellent information to certain practitioners and trade association representatives, and to those taxpayers who have Internet access and know how to use it. We believe the IRS will also find, however, that it is not reaching a large portion of small business and self-employed taxpayers and its current outreach initiatives to these taxpayers could be revised and improved.

As a final note, the National Taxpayer Advocate is astonished by SB/SE's complete abdication of responsibility for outreach to disabled small business owners or small business owners who hire disabled employees or provide accommodations for those employees. In its response, the IRS claims that SB/SE does not "currently address" outreach to these small businesses because the disability credits available to small business owners are "geared more toward Wage & Investment outreach activity." The IRS provides no legal or administrative authority for this assertion. Outreach to these *small business* owners is not W&I's responsibility. SB/SE must develop a program to educate and serve these taxpayers.

RECOMMENDATIONS

- Undertake an initiative similar to the Taxpayer Assistance Blueprint (TAB) to access needs of the small business taxpayers. Develop a strategic five-year plan that outlines the services the IRS should provide and determines the most effective way to deliver and improve outreach and education to small business taxpayers and provides for an interactive process of assessing and meeting these needs.

PROBLEMS

- Conduct research or focus groups to obtain information about the characteristics and needs of small business and self-employed taxpayers, including their usage of computer technology and practitioners.
- Establish a measure for the effectiveness of outreach activities. At a minimum, the IRS should survey small business owners and self-employed taxpayers to ascertain that outreach delivered through practitioners and small business organizations reaches the taxpayers and remains accurate.
- Evaluate and reconsider staffing levels in SB/SE's outreach and education division. At a minimum, there should be a Stakeholder Liaison in each and every state.
- SB/SE must develop a specific outreach and education strategy to serve disabled small business owners and small business owners who hire disabled employees or provide accommodations to these employees. At the very least, SB/SE should include on the IRS website more detailed information regarding the deductions and credits to which small businesses may be entitled, either for hiring employees with a disability, providing accommodations to employees with a disability, or removing architectural barriers for taxpayers with a disability.

PROBLEM

TOPIC #12 OVERSIGHT OF UNENROLLED RETURN PREPARERS

RESPONSIBLE OFFICIALS

Kathy Petronchak, Commissioner, Small Business/Self Employed Division

Stephen Whitlock, Director, Office of Professional Responsibility

DEFINITION OF PROBLEM

Taxpayers are harmed by the absence of a comprehensive federal program to regulate unenrolled return preparers. Over 61 percent of all individual income tax returns received by the IRS during the 2006 filing season (through May 5, 2006) were prepared by paid preparers.[1] Although the exact number is unclear, it is likely that unenrolled preparers handled a large percentage of those returns.

The National Taxpayer Advocate acknowledges that a significant percentage of unenrolled preparers are well trained and maintain high ethical standards. However, as evidenced by the findings of a 2006 limited study performed by the Government Accountability Office (GAO),[2] untrained and unscrupulous preparers present a serious problem. The National Taxpayer Advocate has repeatedly raised concerns about the lack of IRS oversight of unenrolled return preparers[3] and has proposed legislation that would create a system to register and certify these preparers, as well as enhance due diligence and signature requirements, increase preparer penalties, and assess and collect those penalties as appropriate. However, the IRS has declined to support such a system, and none is currently in place.

The following issues exist within IRS guidance and procedures:

- The National Taxpayer Advocate is concerned about the proposed amendments to Circular 230, which would eliminate the authority of unenrolled preparers to practice on a limited basis on examination issues.[4] Rather than punish all unenrolled preparers and their clients, the way to deal with incompetence is to require unenrolled preparers to learn the tax law and pass a basic exam.
- The procedures for a taxpayer or IRS employee to file a complaint about preparer misconduct are confusing. Further, a taxpayer's complaint may bounce around within the IRS, the Treasury Inspector General for Tax Administration (TIGTA),

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1 IRS, *Taxpayer Usage Study (TPUS), Weekly Report* 14.

2 Government Accountability Office, GAO-06-563T, Paid *Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors,* 2 (April 4, 2006) (Statement of Michael Brostek, Director Strategic Issues before the Committee on Finance, U.S. Senate).

3 Unenrolled return preparers are return preparers who are not Certified Public Accountants, attorneys, enrolled agents, or enrolled actuaries. *See* National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; House Committee on Ways and Means, Testimony of Nina. E. Olson, National Taxpayer Advocate (Jul. 20, 2005).

4 REG-122380-02.

and the Department of Justice, while the preparer continues to practice and potentially harm other taxpayers.

- The IRS Office of Professional Responsibility (OPR) has proposed a nationwide database to track return preparers, which would contain complete information on reported preparers and would be accessible by all IRS functions with preparer oversight responsibility. The proposed centralized database has inherent benefits and is under development. Before supporting the development of the database, the National Taxpayer Advocate needs assurance that the IRS will not use it as a mere catalogue of complaints. Accordingly, the IRS must carefully design the database and procedures for access and use of the data contained therein to ensure safeguards are in place to prevent IRS employees from unfairly labeling preparers as "bad preparers" without protecting preparers' due process rights.
- Over the last five fiscal years, the IRS collected only 13 percent of the net assessed return preparer penalties.[5]
- The IRS does not require preparer signatures on Form 656, Offer in Compromise, or the accompanying Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals and Form 433-B, Collection Information Statement for Business. As a result, the IRS has no way to track or regulate "offer mills" or the activities of offer preparers who are not authorized to practice before the IRS.
- The IRS fails to adequately monitor Electronic Return Originators (EROs) from the application process and throughout the period of registration.
- The IRS has not sufficiently expanded access to its e-Services program to include Circular 230 practitioners regardless of whether they have met a threshold number of *e-file*d returns.
- IRS regulations under IRC § 7216 need revision to safeguard taxpayers' privacy in both electronic and paper filing environments.

ANALYSIS OF PROBLEM

GAO Findings on Limited Study of Chain Preparers

The Government Accountability Office (GAO) recently conducted a limited study of several commercial chain preparers by visiting 19 retail offices in one major metropolitan area.[6] The GAO auditors posed as taxpayers and presented one of two carefully developed but relatively straightforward tax fact patterns. The findings of the study are alarming, and many of the preparers' errors as well as their consequences are significant.

[5] IRS ERIS Data as of September 2006, IRC 6694 and 6695 Preparer Penalty Data.

[6] Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* (Apr. 4, 2006) (Statement of Michael Brostek, Director Strategic Issues before the Committee on Finance, U.S. Senate).

All 19 preparers made mistakes, and 17 ultimately computed the wrong refund amount. The most serious problems included the following:

- Failure to report business income in ten of 19 cases. Several preparers advised the GAO "taxpayers" that reporting business income was discretionary because the IRS would not otherwise discover the income;
- Failing to ask relevant questions or ignoring GAO responses with respect to the Earned Income Tax Credit (EITC). Preparers claimed an ineligible child for the EITC in five of the ten applicable cases;
- Failure to take advantage of education tax incentives in three of the nine applicable cases;
- Failure to properly itemize deductions in seven of nine applicable cases; and
- Overstated refunds of almost $2,000 in five cases and understated refunds of over $1,500 in two cases.[7]

The IRS has stated these preparers could have been subject to penalties for negligence and willful or reckless disregard of tax rules.[8]

Proposals to Regulate Unenrolled Return Preparers

Since 2002, the National Taxpayer Advocate has advocated the establishment of minimum levels of competency for return preparation by developing a federal system to register, test and certify unenrolled return preparers. She has also proposed to strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.[9] The IRS has declined to support such a proposal to establish a federal system to register, test, and certify preparers on two grounds.

- First, the IRS claims there is insufficient data to warrant regulation and its related costs; and
- Second, the IRS asserts that the proposed program would impose burdens on both the IRS and unenrolled preparers.[10]

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[7] IRC §§ 6694 and 6695.

[8] Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors, 26-27* (April 4, 2006) (Statement of Michael Brostek, Director Strategic Issues, before the Committee on Finance, U.S. Senate).

[9] National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; *Regulation of Federal Tax Return Preparers, Hearing Before U.S. House of Representatives Committee on Ways and Means, Subcommittee on Oversight*, 108th Cong. (July 20, 2005) (statement of Nina. E. Olson, National Taxpayer Advocate, Internal Revenue Service); *Tax Return Preparation Options for Taxpayers, Hearing Before the U.S. Senate Committee on Finance*, 109th Cong. (April 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

[10] *See* IRS Comments, National Taxpayer Advocate 2004 Annual Report to Congress 82-85.

The National Taxpayer Advocate continues to find these concerns unpersuasive. The GAO audit and other data illustrate that there is a sufficient problem to warrant regulation. The method of administrating such a regime in California, which already imposes regulatory requirements on unenrolled return preparers, demonstrates that the program can be run at a low cost to preparers and virtually no cost to the government.[11]

Our proposal to regulate unenrolled return preparers has received a favorable response from the tax-writing committees and from practitioner groups. In the 109th Congress, the Senate Finance Committee approved legislation that would require the Treasury Department to prescribe regulations to establish a system to regulate compensated preparers. The bill, S.1321, the Telephone Excise Tax Repeal Act of 2005, would also require Treasury to establish and administer, through OPR, an eligibility examination designed to test preparers' knowledge of ethical standards as well as their technical knowledge and competence. The bill directs the Secretary to issue regulations that would require unenrolled preparers to renew eligibility every three years, at which time the preparer must show that he or she has completed continuing professional education requirements. The program would include monetary sanctions for failure to meet eligibility or renewal requirements. S.1321 also would increase preparer penalties and authorize OPR to use the collected penalties for a public awareness campaign on preparer eligibility and practice requirements.[12]

In addition to its passage by the Finance Committee, the proposal has received widespread backing from groups representing practitioners. At a hearing held by the House Ways and Means Committee Subcommittee on Oversight in 2005, the American Bar Association, American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Tax Professionals and National Society of Accountants all testified in support of the proposal.[13]

[11] For more information on the California program, see the California Tax Education Council website at www.ctec.org. *See also* IRS Comments, and the corresponding Taxpayer Advocate Service response, to the Most Serious Problem and the associated Taxpayer Advocate Service Comments in National Taxpayer Advocate 2004 Annual Report to Congress 82-88.

[12] S.1321, §203, Telephone Excise Tax Repeal Act of 2005; Joint Committee on Taxation, Description of the Chairman's Modification to the Provisions of S. 1321, the "Telephone Excise Tax Repeal Act of 2005" and S. 832, the "Taxpayer Protection and Assistance Act of 2005," JCX-28-06 (Jun. 28, 2006).

[13] Hearing on Fraud in Income Tax Preparation, U.S. House Committee on Ways and Means, Subcommittee on Oversight, (Jul. 20, 2005) (Statement of Kenneth W. Gideon, Chair, Section of Taxation, American Bar Association); U.S. House Committee on Ways and Means, Subcommittee on Oversight, (Jul. 20, 2005) (Statement of Tom Purcell, Chair, Tax Executive Committee, American Institute of Certified Public Accountants); Hearing on Fraud in Income Tax Preparation, U.S. House Committee on Ways and Means, Subcommittee on Oversight, (Jul. 20, 2005) (Statement of Francis X. Degen, President, National Association of Enrolled Agents); Hearing on Fraud in Income Tax Preparation, U.S. House Committee on Ways and Means, Subcommittee on Oversight, (July 20, 2005) (Statement of Larry Gray, Government Liaison, National Association of Tax Professionals); U.S. House Committee on Ways and Means, Subcommittee on Oversight, (Jul. 20, 2005) (Statement of Robert L. Cross, Chairman, Right to Practice Committee, National Society of Accountants).

Proposed Revocation of Limited Practice for Unenrolled Preparers in Circular 230

Circular 230 governs the practice of attorneys, certified public accountants, enrolled agents, and enrolled actuaries before the IRS.[14] The regulations detail the duties and restrictions of representatives authorized to practice before the IRS.[15] Sanctions for incompetence, disreputable conduct, and violations of the provisions include censure (public reprimand), suspension, or disbarment of the practitioner from practice before the IRS.[16] Circular 230 does not impose monetary penalties.

Circular 230 currently permits unenrolled preparers to practice before the IRS on a limited basis if they have a valid Form 2848, Power of Attorney and Declaration of Representative, on file with the IRS. As long as the preparer signs the return for the relevant tax period (unless the tax form in question has no place for preparer signatures), the preparer is permitted to represent the taxpayer before customer service representatives, revenue agents, and similar officers and employees during an examination of the return.[17] Unenrolled preparers are not permitted to:

- Represent taxpayers before the IRS's Collections, Appeals, or Counsel functions;
- Execute closing agreements, claims for refund, or waivers on restriction on assessment or collection of a deficiency;
- Extend statutory periods for tax assessment or collection; or
- Receive refund checks.[18]

In February 2006, the Department of Treasury published proposed regulations, REG-122380-02, which revoke the authorization of unenrolled preparers to engage in limited practice before the IRS. The preamble to the proposed regulations states the revocation is due to the inconsistency of limited practice with the requirement that all individuals practicing before the IRS demonstrate their qualifications to advise and assist persons in presenting their cases to the IRS.[19] Further, the IRS has indicated that unenrolled preparers will still be able to assist their clients in an examination if a taxpayer signs a

[14] 31 C.F.R., Part 10. Practice before the IRS includes the presentation to the IRS of all matters relating to a taxpayer's rights, privileges, or liabilities under laws and regulations administered by the IRS. 31 C.F.R. § 10.2(d).

[15] Such duties and restrictions include diligence as to accuracy; required actions upon learning of client's non-compliance, error or omission; the prompt disposition of pending matters, restrictions on fees, advertising, and the negotiation of taxpayer checks. 31 C.F.R §§ 10.20-.38.

[16] 31 C.F.R. § 10.50.

[17] If a carryback or carryforward is involved in a tax return, an unenrolled preparer will not be recognized as the taxpayer's representative with respect to the taxable year in which the carryback or carryforward arose, unless the preparer also prepared and signed the return for that year or years. IRS Pub 470, *Limited Practice Without Enrollment*, § 4.

[18] 31 C.F.R. § 10.7(c); IRS Pub 470, *Limited Practice Without Enrollment*, § 4

[19] REG-122380-02, I.R.B. 2006-10, available at http://www.irs.gov/irb/2006-10_IRB/ar10.html. The proposed regulations would still allow unenrolled return preparers to exchange information with the IRS, provided the taxpayer has specifically authorized the preparer to receive confidential information from the IRS by signing a Form 8821, Tax Information Authorization.

Form 8821, Tax Information Authorization, which allows the IRS to exchange confidential information with the preparer. Thus, an unenrolled preparer can still accompany the taxpayer to the exam and assist the taxpayer in responding to questions regarding the return.

The National Taxpayer Advocate does not support the revocation of authority for unenrolled return preparers to engage in limited practice. The correct approach to incompetence is to require unenrolled preparers to demonstrate proficiency in tax law by passing a basic competency exam, and thereby acquiring the ability to represent taxpayers at the earliest administrative level. Treasury and the IRS should not address incompetence by eliminating authorizations for all unenrolled preparers.[20]

In addition, the proposed regulations do not take into account the basic expectations of taxpayers. From a taxpayer perspective, the taxpayer has engaged an individual who has perceived expertise in the tax law. If the IRS challenges a tax return, many taxpayers would reasonably expect the preparer of that return to be able to contact the IRS to answer questions and negotiate on their behalf.

The existing distinction between authorizations granted to unenrolled preparers who have clients with exam issues as opposed to appeals conferences or collection issues is an important one. In an examination, the practitioner must know black letter tax law and produce books and records to substantiate a position taken on the return. An appeal requires the practitioner to weigh hazards of litigation, and conduct settlement negotiations based on the likelihood of success of the taxpayer's position. Collection requires knowledge of valuation, state property and family law, and federal due process rights. An examination case requires totally different skills than an appeal or collection case. The work performed by the unenrolled preparer lends itself to assisting the taxpayer in an exam. This arrangement enables the IRS to determine firsthand the information presented to and relied on by the practitioner in preparing the return. It allows the IRS to correct the preparer's errors and misconceptions so they are not replicated, and to identify negligent or unscrupulous preparers, so they will not continue to harm taxpayers. Thus, taxpayers and tax administration interests are served by permitting unenrolled – but regulated – preparers to represent their return preparation clients before exam. Accordingly, the existing distinction in Circular 230 allowing unenrolled preparers to represent taxpayers on exam issues, but not appeals or collection issues, should stand.

[20] It is important to note that TIGTA recently found that OPR does not adequately perform background checks on enrolled agents. Thus, it is considering punishing unenrolled preparers but does not perform adequate federal tax obligation and criminal background checks on individuals who are granted the complete ability to practice before the IRS on exam, appeals and collection issues. Specifically, TIGTA found that the IRS does not take a proactive approach to monitoring tax compliance for enrolled agent's renewing their authorizations. Furthermore, OPR does not adequately check the criminal backgrounds of both new applicants and agents renewing their authorizations. Treasury Inspector General for Tax Administration, Ref. No. 2006-10-170, *The Office of Professional Responsibility Does Not Always Ensure Enrolled Agents Are Qualified, and System Limitations Prevented Identification of Ineligible Representatives* (Sept. 29, 2006).

More Outreach and Coordination Necessary in Preparer Complaint Process

Process to File Complaints Against Preparers

Taxpayers and IRS employees have the following venues to file complaints against preparers: the IRS Office of Professional Responsibility (OPR), Area Return Preparer Coordinators within the IRS's Small Business/Self-Employed (SB/SE) Operating Division, and the Treasury Inspector General for Tax Administration.

Complaints Filed with the Office of Professional Responsibility

IRS employees are required to promptly file a Form 8484, Report of Suspected Practitioner Misconduct,[21] with OPR if they have reason to believe a Circular 230 practitioner has violated any provision of regulations governing practice before the IRS.[22] OPR reviews the submissions and determines whether the problems can be addressed by a simple phone call to the practitioner or whether disciplinary proceedings are warranted.

OPR provides instructions for taxpayers who wish to file complaints against Circular 230 practitioners. If the evidence indicates the allegations, taken as true, would constitute a violation of Circular 230, OPR will send a letter informing the practitioner of the charges and affording him or her the right to respond in writing or by requesting a conference.[23]

Complaints filed with the Area Return Preparer Coordinators

IRS employees and taxpayers who suspect misconduct on behalf of a return preparer, whether a Circular 230 practitioner or an unenrolled preparer, are instructed to contact an Area Return Preparer Coordinator (RPC) in SB/SE. The IRS provides its employees with a list of RPC contacts based on localities, while members of the public are encouraged to file complaints by completing and mailing Form 3949-A, Information Referral.[24]

Each RPC maintains a local level database or spreadsheet to track reported return preparers. However, the IRS does not coordinate or consolidate these local tracking systems on a national basis; nor do the local systems include other enforcement information, such as criminal investigations or Lead Development Center promoter

[21] OPR requires management approval for misconduct reports to ensure that reports are based on objective, generally understood standards of practitioner service and professionalism. Form 8484, Part E.

[22] 31 C.F.R. § 10.53.

[23] IRS, *Complaints Against Tax Professionals – Frequently Asked Questions*, available at http://www.irs.gov/taxpros/agents/article/0,,id=123392,00.html#how. The complaint should be written in a letter format and include the tax practitioner's name, address, telephone number, designation (*i.e.* attorney, CPA, enrolled agent, etc.), a detailed description of the allegations, and any documents that support those allegations.

[24] IRS, *Complaints Against Tax Professionals – Frequently Asked Questions*, available at http://www.irs.gov/taxpros/agents/article/0,,id=123392,00.html#how; Reporting Abusive Shelters, Fraud & Unscrupulous Preparers, available at http://www.irs.gov/newsroom/article/0,,id=121584,00.html (Information on filing a complaint is not obvious on the IRS official website and requires several steps to access. The Site Map is also not useful to locate this information); Small Business/Self-Employed Response to Information Request (Aug, 15, 2006).

investigations.[25] The RPCs have discretion to review all available information to determine whether a Program Action Case (PAC) is warranted. The PAC involves selecting for examination 30 randomly sampled returns of the preparer's clients. The PAC's overall goal is to support penalties against the preparer.[26]

National guidelines indicate that RPCs should consider the following information when determining whether to initiate a PAC:

- The egregious nature of the conduct, which depends on whether the misconduct is widespread or intentional;
- The number of taxpayer clients affected by the misconduct;
- The types of returns and the tax years involved;
- The significance of the questionable issues;
- The dollar amounts involved; and
- The examination group's available resources in the geographic area where the preparer is located.[27]

Before developing and proposing a PAC, the RPC must confirm that it will not conflict with another pending enforcement action by contacting the Criminal Investigation function (CI) and the Lead Development Center for promoter investigation. The RPC must also seek the approval of the Penalty Screening Committee (PSC).[28] We note that the EITC Program Office is not currently represented on the PSC, notwithstanding that 79.1 percent of tax year 2004 EITC returns audited by the end of June 2006 and reflecting an audit change were prepared by a paid professional.[29] As of August 15, 2006, SB/SE had approximately 582 open PACs nationwide. Because SB/SE receives referrals from many different sources and only tracks its information locally, it is unclear what percentage of reported preparers are the subject of PACs.[30] It is interesting to note that

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[25] Lead Development Centers conduct promoter investigations under IRC §§ 6700 and 6701.

[26] Small Business/Self-Employed Response to Information Request (Aug. 24, 2006).

[27] Draft IRM § 4.1.4.10.3.2 (Aug. 15, 2006).

[28] Draft IRM §§ 4.1.4.10.3.3 (Aug. 15, 2006), 20.1.6.1.6. The multifunctional Penalty Screening Committee (PSC) includes the following representatives: Area Office Electronic Filing Coordinator (DOEFC), Examination Return Preparer (RPC), and a Criminal Investigation (CI) representative. The PSC contacts service center representatives from Criminal Investigation (CI) and Examination as needed. The PSC will be responsible for planning and coordinating the implementation of Area and National Headquarters Return Preparer strategy. The PSC also establishes communication lines between Planning and Special Programs (PSP), the Area Electronic Filing (ELF) Coordinator, the CI Questionable Refund Program Coordinator (QRPC), the Service Center Examination RPC, and the CI RPC. A major goal of the committee is to more effectively identify patterns of preparer abuse and prevent duplication of efforts within the Areas and Service Centers. IRM 20.1.6.1.1.

[29] Information from the Audit Information Management System (AIMS) closed case database (Nov. 20, 2006) showed that the original return of 286,281 of the 361,834 tax year 2004 EITC returns audited through June 30, 2006 reflecting disposal codes other than "no change" were completed by a paid preparer. The determination of whether a return was audited for an EITC issue was based on AIMS Project Codes provided by the EITC Project Office.

[30] Small Business/Self-Employed Response to Information Request (Aug. 15, 2006).

a taxpayer faces fewer hurdles in lodging a complaint against and starting an investigation of a Circular 230 preparer than an unenrolled preparer.

IRS Programs Identifying Problem Preparers

Both SB/SE and CI have programs to identify potentially problematic preparers. SB/SE identifies preparers through PACs, while CI's Office of Refund Crimes identifies preparers through patterns and schemes detected by Fraud Detection Centers (FDCs). Both offices refer cases to each other. For example, if a PAC identifies a problematic preparer and SB/SE suspects fraudulent behavior, the division will contact CI. In addition, if an FDC identifies a scheme but CI does not work the case for some reason, CI is supposed to recommend that SB/SE open a PAC.[31] Investigations performed by these offices may lead to either civil or criminal penalties imposed on the preparers.

Complaints Filed with the Treasury Inspector General for Tax Administration

The Treasury Inspector General for Tax Administration (TIGTA) also receives complaints of practitioner misconduct. IRS employees and members of the public are encouraged to contact TIGTA if they suspect practitioners of falsifying their qualifications, theft of IRS tax remittances, or theft of refunds.[32]

More Outreach and Education Necessary on Complaint Process

The existing preparer misconduct referral procedures are confusing and ineffective. Depending on the type of preparer and misconduct, the complaint can either go to an Area Return Preparer Coordinator (RPC), OPR, or TIGTA. Where and on what grounds to file a complaint are not sufficiently clear to IRS employees, and are even less clear to taxpayers. Taxpayers and preparers need to search the IRS official website to find information on the process of reporting preparers. This search is exponentially more difficult for taxpayers who are unfamiliar with the structure of the IRS. The resulting general lack of awareness of the complaint process is a serious problem. TIGTA has conducted outreach among the preparer community at IRS Nationwide Tax Forums, and the OPR website includes instructions on the process. However, the IRS needs to conduct more outreach and education on this topic to reach IRS employees, the preparer community, and taxpayers.

Example: TAS's Recent Experience with One Complaint

Our office was recently involved with a case in which preparer misconduct was clearly identified and the IRS and TIGTA investigated the complaint. Specifically, the practitioner falsified qualifications on several submitted Forms 2848, Power of Attorney and Declaration of Representative. The IRS and TIGTA were both aware of the misconduct, and the Department of Justice (DOJ) declined to prosecute. After DOJ declined prosecution, the case was routed to OPR for further investigation, because the preparer

[31] EITC Preparer Meeting (Sept. 20-21, 2006).

[32] *See* http://www.treas.gov/tigta/contact_report.shtml.

claimed to be a Circular 230 practitioner. At this writing, OPR has taken no formal action against the preparer, the IRS has assessed no preparer penalties, and the Forms 2848 remain on file at the IRS with no indication of a problem. During this entire process, the unscrupulous preparer continues representing taxpayers and misrepresenting qualifications to practice before the IRS.[33]

This case illustrates the need for the IRS to address the preparer complaint process. Once the IRS becomes aware of a potential preparer issue, it needs to thoroughly research the complaint for immediate resolution. The IRS harms taxpayers if it does not promptly and adequately address preparer complaints. The IRS has procedures and programs in place to identify potential problem preparers through patterns and schemes. However, when either a taxpayer or employee identifies an actual case of putative preparer misconduct, the IRS should *not* "shelve it" in some database. The IRS needs to take immediate action to address the issue.

The IRS should also consider developing a formal procedure to temporarily flag potentially problematic Forms 2848 on file. The IRS should clearly delineate what type of behavior warrants placing an internal indicator on the file, such as misrepresenting qualifications or requesting to receive refunds on behalf of the taxpayer. Once this yet-to-be-determined threshold behavior is met, this indicator should not lead the IRS to freeze a taxpayer's account, but would be maintained for internal informational purposes. In addition, the IRS should delete the temporary indicator automatically after a period of time determined to be reasonable to conduct a thorough preparer investigation, so that preparers are not unfairly flagged. During the entire process, the IRS must take extreme care to provide the preparer with due process rights to defend him or herself and appeal any IRS determination. Information concerning a temporary indicator or alleged preparer misconduct should not be available to the public until a full investigation is concluded, a final determination is made and the preparer is afforded due process rights.

In her 2003 Annual Report to Congress, the National Taxpayer Advocate proposed a legislative recommendation to impose a $1,000 penalty, per instance, against practitioners who willfully and intentionally misrepresent professional status on a Form 2848, and thus practice before the IRS without proper authorization.[34] If Congress had enacted such legislation, the IRS would have had a meaningful penalty to impose on the practitioner in the TAS case discussed above.

TIGTA'S Findings on OPR Oversight

In a 2006 report, TIGTA found serious shortcomings in OPR's oversight of Circular 230 practitioners, specifically that OPR fails to adequately identify practitioners whose conduct warrants disciplinary action. TIGTA found instances where state authorities

[33] Information provided by Local Taxpayer Advocate (Nov. 8, 2006).

[34] National Taxpayer Advocate 2003 Annual Report to Congress 273.

convicted tax practitioners of tax-related crimes or suspended or revoked their licenses, but the practitioners continued to practice before the IRS. Further, the IRS did not have sufficient procedures in place to notify OPR when a practitioner failed to meet his or her own tax obligations. Finally, TIGTA found OPR did not have written procedures to control and review referrals to the office. While the IRS may have procedures to route referrals to OPR, the function does not maintain a record or list of referrals received. In response, OPR agreed to seek out information on practitioner misconduct from state authorities and other IRS functions. OPR also implemented a new case management system for quality control.[35]

The Case for a National Preparer Database

The Office of Professional Responsibility has actively promoted the creation of a national database, which would centralize and coordinate complaints made throughout the country to any organization within the IRS. This system would supplant the local databases and spreadsheets kept by SB/SE's RPCs and provide full information to each organization investigating a particular preparer.

Before the National Taxpayer Advocate can support the development of a national preparer database, it is imperative that the IRS commit to instituting safeguards in the program. The IRS must strictly limit access to the database to only those IRS employees who are well-trained on the use of the database and the significance of the data contained therein. The IRS must also set clear guidelines on which types of preparer behavior warrant inclusion in the database. Without these safeguards, data entered by one function may be misinterpreted by another function to the detriment of the preparers and their clients. The database should not enable IRS employees to go on "fishing expeditions" or label practitioners and preparers who are merely taking aggressive, but lawful positions.

Notwithstanding these concerns, a national database makes sense due to the lack of central oversight over IRS employees making determinations regarding preparer misconduct. Keeping many databases in different geographical locations and at different IRS enforcement functions is not feasible. Further, it makes sense that different functions within the IRS coordinate with each other for a complete set of facts pertaining to a preparer in question. The database would also allow the IRS to manage and assess the inventory of preparer complaints/referrals and spot trends. However, the IRS has not developed the database beyond a few initial screens.[36]

[35] In the IRS management response to the draft report, the IRS noted that TIGTA reviewed state level actions against attorneys and CPAs. Because a significant portion of the actions involve attorneys and CPAs who do not practice before the IRS, the Service screens the list for individuals who have represented taxpayers. If there is evidence of tax practice, the IRS stated that OPR records information on the case. If there is no evidence of tax practice, the IRS has no jurisdiction and the information is not tracked. Treasury Inspector General for Tax Administration, Ref. No. 2006-10-066, *The Office of Professional Responsibility Can do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* (Mar. 2006).

[36] Office of Professional Responsibility Response to Information Request (Jul. 28, 2006).

Assessment and Collection of Preparer Penalties

Penalty assertion is the IRS's key enforcement vehicle for punishing noncompliance among preparers. SB/SE is responsible for assessing and collecting monetary penalties.[37] The following table details SB/SE assessment and collection of return preparer penalties under IRC §§ 6694 and 6695.

TABLE 1.12.1, IRS ASESSMENT AND COLLECTION OF IRC §§ 6694 AND 6695 RETURN PREPARER PENALTIES FOR FY 2002-2006

Fiscal Year	Total Return Preparer Penalties Assessed	Total Return Preparer Penalties Abated	Total Return Preparer Penalties Collected
2002	$1,402,033	$80,493	$187,898
2003	$2,724,248	$250,000	$226,586
2004	$1,142,626	$50,725	$245,980
2005	$960,758	$65,600	$224,083
2006	$1,913,962	$44,900	$117,823
Totals	**$8,143,627**	**$491,718**	**$1,002,370**

As illustrated in the table above, the IRS has only collected 13 percent of net assessed return preparer penalties under IRC §§ 6694 and 6695[38] in the last five fiscal years with only six percent collected in fiscal year 2006. However small the assessed penalties may be relative to the IRS's other efforts, they may effectively deter noncompliance by preparers. In assessing but not collecting these penalties, the IRS is sending a mixed message about whether it will tolerate poor performance.[39]

Regulation of Offer Mills

Late night television is filled with advertisements from businesses that offer to settle IRS debts "for pennies on the dollar." These offer mills are a problem for both taxpayers and the IRS. In calendar year 2002 through September 12, 2006, the IRS received 134,132 offers that were not processable, 61,451 (46 percent) of which have a power of attorney indicator on the record.[40] The Taxpayer Advocate Service has handled many

[37] IRM § 4.10.6.8.2, Return Preparer Penalties. Civil penalties and rights of action are set forth in IRC §§ 6694, 6695, 6713, 7407, and 7408. Criminal penalties are included in IRC § 7216. For a detailed discussion of civil and criminal penalties applicable to preparers and the National Taxpayer Advocate's legislative proposals with respect to preparer penalties, *see* National Taxpayer Advocate 2003 Annual Report to Congress 270-301. *See also* Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, 9-11 (Apr.4, 2006) (Statement of Michael Brostek, Director Strategic Issues before the Committee on Finance, U.S. Senate).

[38] Net penalties assessed are equal to the total amount of preparer penalties assessed, minus the total amount of penalties abated. IRS ERIS Data as of September 2006, IRC 6694 and 6695 Preparer Penalty Data.

[39] For a detailed discussion on the impact of penalty enforcement on compliance, see Joint Committee on Taxation, *Committee Print: Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* 31-37, JCS-3-99 (Jul. 22, 1999).

[40] IRS Response to TAS Information Request (Sept. 29, 2006). In CY 2005, 9,558 (49 percent) out of a total 19,675 "not processable" offer submissions had a POA indicator on record.

cases in which the taxpayer engaged an "offer mill" to preparer an offer submission. The taxpayer believes he or she hired a representative who will resolve a tax problem. Then, although the IRS continues to mail notices to the taxpayer about the problem, the taxpayer thinks the preparer is handling the issue by working with the IRS, and does not respond to the notices.[41]

The IRS has taken the position that the mere act of *preparing* an OIC does not constitute practice before the IRS. Thus, unenrolled return preparers, who are not regulated by Circular 230, can prepare OICs. However, unenrolled preparers are not entitled to represent taxpayers before the IRS in discussions regarding the processing of OICs or any collection matter. The Collection function and the Office of Professional Responsibility have issued guidance to Collection employees clarifying the limited representation authority of unenrolled return preparers, and emphasizing that employees should not honor a Form 2848 designation of an unenrolled preparer as a representation in a collection matter.[42]

The National Taxpayer Advocate believes the IRS should deem the preparation of an offer in compromise or request for a collection due process hearing for a fee as practice before the IRS and covered by Circular 230. Accordingly, by allowing unenrolled preparers to prepare these forms, the IRS would be permitting unauthorized practice in violation of Circular 230.

Further, even if the IRS does not deem the mere act of preparation as practice before the IRS, it is reasonable for a taxpayer to expect a preparer to see the submitted offer through and continue representing the taxpayer before IRS Collection, unless the taxpayer and preparer explicitly agree otherwise. However, unenrolled preparers are strictly prohibited from representing taxpayers in offers where Collection has jurisdiction.[43] If an unenrolled preparer attempts to *represent* a taxpayer before Collection, the IRS does not have the authority to impose monetary sanctions for this unauthorized practice. The IRS's only remedy is to seek an injunction against the preparer under IRC § 7407.[44] The National Taxpayer Advocate has previously identified problems resulting from the lack of a significant monetary sanction in these circumstances and recommended enacting a $1,000 penalty for unauthorized practice before the IRS by a return preparer or other persons.[45]

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41 Local Taxpayer Advocates' Response to Information Request (Sept. 2006).

42 IRS Comments to Draft Most Serious Problem on Regulation of Offer Mills Prepared for 2005 Annual Report to Congress; IRS Response to TAS Information Request (Sept. 29, 2006); IRM 5.1.1.7, Exhibits 5.1.1-1 & 5.1.1-2, Processing Third Party Authorizations.

43 CCA 200431015 (June 1, 2004).

44 IRC § 7407 authorizes the U.S. government to bring an action in the District Court to enjoin a preparer from acting as a return preparer or from further engaging in misconduct.

45 National Taxpayer Advocate 2003 Annual Report to Congress 291.

Individuals who prepare Form 656, Offer in Compromise, or the accompanying Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, and Form 433-B, Collection Information Statement for Business, are not required to sign these forms. The absence of a signature line on Forms 433-A and 433-B and the lack of enforcement of the signature on Form 656 make it difficult for the IRS to determine whether a taxpayer or a paid preparer prepared an offer. Because the IRS cannot track offer mills, it cannot regulate them, which allows negligent or unscrupulous preparers to operate with a complete lack of accountability.

Through routine case advocacy and outreach projects, Local Taxpayer Advocates (LTAs) encounter a significant number of complaints about offer mills. LTAs have reported that some prepare the offers, collect money from the taxpayers, and refuse all subsequent follow-up calls from the taxpayers.[46] Requiring practitioners to sign the offers and enforcing the requirement may alleviate this problem by adding an element of accountability into the transaction.

Current IRS Oversight of Electronic Return Originators[47]

To become an Electronic Return Operator (ERO), applicants must submit an application to the IRS Electronic Tax Administration function and pass suitability checks, which also cover the applicant's designated Principals and Responsible Official(s). The checks may include criminal background, credit history, tax compliance, and prior non-compliance with IRS *e-file* requirements.[48]

Once the IRS accepts applicants to participate in IRS *e-file* as Authorized IRS *e-file* Providers, the IRS monitors them in several ways. EROs must comply with Rev. Proc. 2005-60; Publication 3112, IRS *e-file* Application and Participation; Publication 1345, Handbook for Authorized IRS *e-file* Providers of Individual Income Tax Returns; and Publication 1345A, Filing Season Supplement for Authorized IRS *e-file* Providers of Individual Income Tax Returns. The IRS monitors the EROs' compliance with tax regulations and submission of taxpayer signature documents. SB/SE is responsible for all field aspects of the monitoring of ERO operations. Monitoring is generally accomplished through visits to the ERO's operation to verify compliance with IRS *e-file* rules. If an ERO is found to be in noncompliance, the violation(s) may result in a warning, written reprimand, suspension, or expulsion of the ERO, depending on the seriousness of the infraction.[49]

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[46] Local Taxpayer Advocates' Response to Information Request (Sept. 2006).

[47] For a detailed discussion of the IRS's regulation of EROs, see National Taxpayer Advocate 2005 Annual Report to Congress 223-237.

[48] For a more detailed discussion of suitability checks, see National Taxpayer Advocate 2005 Annual Report to Congress 223-237.

[49] IRS Publication 3112, IRS *e-file* Application and Participation.

In the 2005 Annual Report, the National Taxpayer Advocate pointed out the inadequacies in both the ERO application process and *e-file* monitoring. The IRS has indicated it does not perform all elements of the suitability check either before authorizing an ERO or during the period of certification.[50] With no stringent procedures in place during the application process or thereafter, the IRS cannot be certain that only qualified individuals are registered.[51]

Further, the IRS continues to inadequately monitor compliance with ERO requirements found in Publication 1345, Handbook for Authorized IRS *e-file* Providers of Individual Income Tax Returns.

TABLE 1.12.2, IRS ERO SANCTIONS[52]

Year	Active EROs	Visits	Percentage of visits per active EROs	Warnings	Written Reprimands	Proposed Suspensions	Suspensions
2002	85,194	1,412	1.7%	No Data	117	38	60
2003	99,049	1,062	1.07%	139	124	67	29
2004	89,320	1,294	1.45%	224	154	90	31
2005	105,250	1,104	1.05%	143	124	26	29

Based on the above data, it appears the IRS does not adequately enforce the ERO regulations. Even as the number of EROs has continually risen, the percentage of EROs visited has generally fallen. In addition, the fact that more than 29 percent of ERO visits in 2005 led to either a warning or a sanction indicates the IRS needs to more actively monitor EROs. The IRS has asserted the high rate of ERO noncompliance found during *e-file* monitoring is due to an effective selection methodology. The IRS also claims it found a 7.8 percent noncompliance rate during past random visits.[53] However, without more information regarding the selection process, we cannot apply the random rate of noncompliance to the general population. We invite the IRS to work with TAS regarding the methodology used to select ERO sites at random.

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50 IRS Response to TAS Information Request (Sept. 18, 2006).

51 TIGTA recently identified the same issues with the Office of Professional Responsibility's enrolled agent program. Specifically, TIGTA found that the IRS does not take a proactive approach to monitoring tax compliance for enrolled agent's renewing their authorizations. Furthermore, OPR does not adequately check the criminal backgrounds of both new applicants and agents renewing their authorizations. Treasury Inspector General for Tax Administration, Ref. No. 2006-10-170, *The Office of Professional Responsibility Does Not Always Ensure Enrolled Agents Are Qualified, and System Limitations Prevented Identification of Ineligible Representatives*, (Sept. 29, 2006).

52 IRS Responses to TAS Information Request (Sept. 29, 2006, Nov. 30, 2006). As of September 20, 2006, SB/SE planned to complete 1,129 visits in 2006 and 1,270 in 2007. Electronic Tax Administration, IRS *e-file* and *e-file* Monitoring (Presentation on Sept. 20, 2006). Beginning in 2004, active ERO numbers reflect those EFINs filing more than 25 returns.

53 IRS Comments on Most Serious Problem on Refund Anticipation Loans, National Taxpayer Advocate 2005 Annual Report to Congress 177.

Further, based on the questions included on the ERO Visitation Checksheet used by SB/SE employees, the IRS appears to focus on infractions affecting the quality of the *e-file* program rather than tax administration in general.[54] It is encouraging that the visits now verify compliance with EITC due diligence requirements in IRC § 6659(g). However, the IRS should take advantage of the time spent in the ERO's office to take a broad-based look at whether the provider's activities affect the entire tax system, such as observing the marketing of ancillary tax products, including refund anticipation loans (RALs).[55] In addition, due to the fundamental importance of safeguarding confidential tax return information, the monitoring visits should also include a comprehensive review of the ERO's procedures to comply with IRC § 7216 use and disclosure requirements. The checksheet does not include any questions to determine whether the ERO's procedures to obtain the taxpayers' written consent to use or disclose confidential tax information comply with the requirements of the IRC § 7216 regulations, which are discussed in more detail below.

Access to E-Services

In the 2005 Annual Report to Congress, the National Taxpayer Advocate stated the IRS should expand access to e-Services to all Circular 230 practitioners regardless of their *e-file* rate.[56] In response, the IRS stated it was pursuing options to add additional groups to e-Services.[57] In November 2006, the IRS announced plans to extend the program to enrolled agents and reporting agents.[58] However, the National Taxpayer Advocate believes the planned expansion is still insufficient. As discussed in her 2005 Most Serious Problem on e-Services, the suite of services included in e-Services, especially the Transcript Delivery System (TDS) and Electronic Account Resolution (EAR), are extremely useful to Circular 230 practitioners who do not meet the current *e-file* threshold but who represent taxpayers in controversies and other dealings with the IRS. There is no legitimate reason to expand access to enrolled agents and reporting agents and continue to exclude other highly qualified Circular 230 practitioners. Moreover, such an approach harms taxpayers who have disagreements and disputes with the IRS by delaying their access to account information.

[54] IRM Exhibit 4.21.1-6, ERO Visitation Checksheet (Jan. 2003). Items monitored during the visits include *e-file* signature authorizations, reviewing compliance with signature requirements, advertising materials, documentation, inspecting acknowledgment files, and very basic RAL items.

[55] For a more detailed discussion of the RAL related practices overlooked during the *e-file* monitoring visits, see National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, Vol. II (Jun. 30, 2006).

[56] E-Services is a suite of web-based products available to practitioners who are active in the IRS *e-file* Program. The following services are available through e-Services: Registration, Preparer Tax Identification Number (PTIN) Application, Online *e-file* Application, Taxpayer Identification Number (TIN) Matching, Disclosure Authorization, Electronic Account Resolution (EAR), and Transcript Delivery System (TDS).

[57] National Taxpayer Advocate 2005 Annual Report to Congress 249-259. The IRS generally limits access to e-Services to practitioners who have *e-file*d five or more accepted individual or business returns.

[58] *CERCA Conference Showcases Controversy Over Potential IRS E-Filing Portal*, Tax Notes (Nov. 3, 2006). Reporting agents are companies that perform payroll services for other businesses and act as a conduit between the employers and the IRS.

Restrictions on Disclosure of Tax Return Information

Internal Revenue Code § 7216 imposes a criminal penalty on preparers of income tax returns who knowingly or recklessly make unauthorized uses or disclosures of tax return information.[59] The statute and the regulations issued thereunder establish privacy protections by placing limitations on a tax return preparer's ability to use or disclose confidential information. The existing statute and regulations permit a tax return preparer, with the written consent of the taxpayer, to use tax return information to promote non-tax products and services currently offered by the preparer or a member of the preparer's affiliated group.[60] Moreover, with written taxpayer consent, a tax return preparer may disclose tax return information to any third person as directed by the taxpayer.[61] Further, after the initial disclosure of tax return information to a third party, the tax laws and regulations do not place any restrictions on the redisclosure of information by that party.

The IRS and Treasury, after consulting with the National Taxpayer Advocate, have issued proposed regulations and a related draft revenue procedure. The preamble to the proposed regulations states the proposed rules address taxpayers' consent to the disclosure or use of tax return information in an electronic environment. The proposed changes also focus on provisions designed to ensure that taxpayers give knowing, informed, and voluntary consent. The proposed regulations allow preparers to obtain written consents for solicitation of services or facilities furnished by any person rather than limiting solicitations to the services or facilities offered by the preparer or a member of the preparer's "affiliated group." The proposed regulations also include provisions requiring written consent by the taxpayer before the preparer releases information overseas, even when the recipient is with the same firm.[62]

Notice 2005-93 contains the proposed revenue procedure detailing the format and contents of consents to use and disclose tax return information by tax return preparers under IRC § 7216. The proposed revenue procedure contains mandatory language to include in consents addressing the limitations and duration of the consent. It also contains mandatory language detailing contact information for TAS, so taxpayers can learn more about taxpayer rights under IRC § 7216, as well as contact information to report suspected violations to TIGTA.[63]

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[59] IRC § 6713 imposes civil penalties on the improper use or disclosure of tax return information by return preparers of income tax returns.

[60] Treas. Reg. § 301.7216-3(a)(1)(i).

[61] Treas. Reg. § 301.7216-3(a)(2).

[62] REG. 137243-02, 2006-3 I.R.B. (containing Prop. Treas. Reg. §§ 301.7216-1 to -3); Notice 2005-93, 2005-52 I.R.B. 1204 (containing Proposed Revenue Procedure 2005-93). For a more detailed discussion of the benefits included in the proposed regulations and revenue procedure, see *Tax Return Preparation Options for Taxpayers: Hearing Before the Senate Comm. on Finance*, 109th Cong. 2nd Sess. (Apr. 4, 2006) (Statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

[63] IRS Notice 2005-93, 2005-52 I.R.B. 1 (Dec. 7, 2005).

After the IRS and Treasury released the proposed regulations and draft revenue procedure for public comment, the proposed rules came under fire for not protecting taxpayers enough. A number of consumer protection groups argued the proposed rules would allow commercial tax preparers to share and even sell confidential taxpayer information to third party marketers and database brokers.[64]

While the National Taxpayer Advocate firmly believes the proposed regulations provide far more protection than existing regulations, she plans to work closely with the IRS and Treasury to consider and potentially incorporate comments from the public into the regulations. However, it is of utmost importance that the revision process continue and receive the highest priority, because the worst possible outcome would be to leave intact the existing regulations which are clearly inadequate in electronic and paper filing environments.[65]

Concerns about the proposed rules have also received congressional attention. Section 512 of S.1321, The Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act, directs the Secretary to amend the regulations under IRC § 7216 to prohibit the disclosure or use of information to or for any person unless such disclosure or use is in connection with preparing or filing, or providing services in connection with the preparation or filing of, a tax return. In addition, the bill directs the Secretary to amend the regulations to prohibit use or disclosure of information to or by any tax return preparer located outside of the United States unless the taxpayer has granted consent to such disclosure or use, a provision that is consistent with the approach taken in the proposed regulations.[66]

In the Senate Report issued in connection with S.1321, the Senate Finance Committee stated it found the use of tax information as a source of clients or data in non-tax preparation lines of business "troubling." Specifically, the Committee stated "tax return preparers are exploiting their position of trust to market products and services unrelated to the preparation of a tax return." Taxpayers may not understand how these products work and may provide consent to the products as a part of a stack of forms signed during the return preparation process. To address these concerns, the Committee stated it is appropriate to prohibit the use or disclosure of tax return information for a nontax preparation purpose. The Committee also stated it is important for a taxpayer with or without multinational dealings to provide knowing consent to the transmission of tax

64 *See, e.g.*, National Consumer Law Center, IRS Proposal Would Let Tax Preparers Sell Citizen Tax Records to Third Parties (March 8, 2006).

65 The Department of Treasury and the IRS have placed the IRC § 7216 regulations project on the Office of Tax Policy and Internal Revenue Service 2006 – 2007 Priority Guidance Plan, Tax Administration, Item 35 (Aug. 15, 2006).

66 Several commentators objected to the requirement to obtain written consent for use or disclosure involving overseas activities by tax return preparers, because this requirement would add unnecessary and burdensome steps to the current tax return processes of many multinational practices. *See, e.g.,* American Institute of Certified Public Accountants, Comments on Proposed Regulations, REG-137243-02 Regarding Guidance to Facilitate Electronic Tax Administration – Updating of Section 7216 Regulations (Mar. 8, 2006).

return information to tax return preparers overseas, because it is difficult to police IRC § 7216 violations outside the United States.[67] The Committee also recommended that both IRC §§ 6713 and 7216 expand the definition of "tax return preparer" to reflect current technology and business practices. Thus, the term should include preparers of returns other than income tax returns, volunteers, individuals who perform other businesses in addition to tax return preparation, and contractors performing services in connection with tax return preparation.[68]

The National Taxpayer Advocate acknowledges the difficult balancing act between permitting the legitimate use of tax return information and preventing the effect of software and electronic filing on making this information a commodity by persons who have no tax-related products. For example, it is important to preserve the ability of certified public accountants and attorneys, who are bound by legal and ethical responsibilities, to use tax return information or disclose the information to another employee or member of the firm for purposes of rendering legal or accounting services, including estate planning or closely-held business planning.[69]

In conclusion, the National Taxpayer Advocate looks forward to working closely with Treasury and the IRS to develop the final regulations under IRC § 7216. While the proposed regulations provide far more protections than the existing regulations, commentators raised legitimate concerns. Because protecting the privacy of tax return information is fundamental to taxpayer compliance, this issue must receive utmost priority and concerns raised by consumer groups must be thoroughly reviewed and potentially incorporated into the final regulations.

IRS COMMENTS

Proposals to Regulate Unenrolled Return Preparers

The National Taxpayer Advocate acknowledges the existence of 582 Program Action Cases as of August 15, 2006. This is up from approximately 100 a year earlier. In addition, the IRS currently has over 1,000 active promoter investigations underway and has worked with the Department of Justice to enjoin well over 200 tax return preparers since inception of the Lead Development Center in April 2004. The IRS recently developed a new IRS-wide strategy to ensure noncompliant preparer leads are effectively coordinated resulting in work being delivered to the appropriate function at the appropriate time. In addition to monthly conference calls, the strategy includes an annual planning meeting to coordinate leads that involve Criminal Investigation, SB/SE, Large and Mid-Size Business (LMSB), Tax-Exempt and Government Entities (TE/GE), Appeals and the Office of Professional Responsibility (OPR).

[67] S. Rep. No. 109-336, 109th Cong., 2d Sess. 86-90 (2006).

[68] *Id.* at 84-86.

[69] *See* Treas. Reg. § 301.7216-2((e)(2); Prop. Treas. Reg. § 301.7216-2(h)(1).

Example: TAS's Recent Experience with One Complaint

The National Taxpayer Advocate's report describes a situation involving a preparer who misrepresented his or her credentials on Forms 2848. Based on the description, it appears the IRS followed appropriate referral processes for a case of that nature. The Treasury Inspector General for Tax Administration (TIGTA) conducted a criminal investigation involving False Statements under Title 18 USC 1001. If the practitioner "falsely" claimed to be a Circular 230 practitioner, OPR would not have jurisdiction to impose a sanction. The IRS has procedures for the Return Preparer Coordinators or OPR personnel to correct the preparer's designation on the Centralized Authorization File (CAF) when misrepresentation is verified. The preparer would still "appear on the CAF", but with the proper designation.

We cannot confirm whether these procedures were followed in the specific case since the Taxpayer Advocate Service (TAS) would not provide the name of the preparer. However, it should be noted that OPR has recently assigned several TIGTA Reports of Investigation that involve misrepresentation of credentials and some pending assignment. The IRS will correct the CAF designation of these individuals as appropriate.

TIGTA'S Findings on OPR Oversight

The NTA accurately describes the TIGTA report on OPR oversight, but does not correctly reflect our response. With respect to "referrals," TIGTA looked at reports OPR collects from state attorney and CPA discipline authorities on actions taken at the state level. The vast majority of these state level actions involve attorneys and CPAs who do not practice before the IRS. When OPR receives a list of state actions, we screen it for people who have represented taxpayers. We individually track those we identify when we open a Circular 230 case. If we have no evidence of tax practice (as would be the case for an attorney in a criminal defense or domestic relations practice for example), we have no jurisdiction and we do not track information on those attorneys and CPAs.

The Case for a National Preparer Database

OPR has presented the concept of a centralized system to other functions and Business Units of the IRS to determine whether the project is feasible and has the necessary support. OPR has been focusing on identifying system requirements including potential data sources, users, and business purpose. OPR has also identified a number of related tasks that we must accomplish, such as a new System of Records Notice, before we can develop a system.

We are beginning the required Enterprise Life Cycle (ELC) process and, where appropriate, will address the concerns the National Taxpayer Advocate raises. Part of the ELC process includes an approved Privacy Impact Assessment (PIA) through the IRS' Office of Privacy. The PIA will help us to identify potential privacy risks in the system and limit the information collected, used, and maintained to what is relevant to achieve a

legitimate business purpose. The PIA process will also address what data is to be used, how the data is used, and who will have access to the data.

Assessment and Collection of Preparer Penalties

With regard to collection of preparer penalties, the IRS uses an enterprise-wide approach to working collection cases. Cases, including those involving preparer penalties, are assigned to an appropriate treatment stream based on case characteristics and expected collection outcome.

The figures cited in the National Taxpayer Advocate's report do not accurately represent collection efforts. Five percent of the tax preparers owe 68 percent of the dollars assessed. Many of these accounts were assigned and worked, and were closed as currently not collectible. Others are in the notice stream or inventory queue, awaiting assignment. Rather than percentage of dollars collected, the percentage of preparer penalties that are paid in full more appropriately reflects the effort to collect preparer penalties.

Excluding abatements, the percentages of cases that are currently paid in full are:

TABLE 1.12.3, FULL PAID PREPARER PENALTY ACCOUNTS UNDER $25,000

Year Assessed	Number of Accounts	Total Fully Paid	Percent Fully Paid
FY 03	146	64	43%
FY 04	151	67	44 %
FY 05	204	49	24 %

Many of the remaining cases will be collected through installment agreements, subsequent payments, and refund offsets over the statutory life of the accounts. There are six to eight years remaining to collect the penalties.

The IRS's Collection Division in SB/SE pursues the delinquent preparer penalty accounts in excess of $25,000 and often finds that the cases are uncollectible. By the time the penalties are appealed, adjudicated, and assessed, assets are typically encumbered or have been sold. These accounts include cases in which preparers have been prohibited from tax practice, convicted of tax fraud, sent to prison, filed bankruptcy, or have otherwise become unable to pay the large penalties assessed against them.

Regulation of Offer Mills

The IRS shares the National Taxpayer Advocate's view that it is difficult to track and regulate offer mills and is trying to reduce the negative effects of offer mills on taxpayers. In 2004, we issued a consumer alert about abusive mills that use deceptive advertising. We also have issued instructions to the Offer in Compromise (OIC) staff on how to identify offer mills and make referrals to OPR. The OIC staff has also been trained to work directly with the taxpayer when an unenrolled return preparer has pre-

pared the Form 656, Offer in Compromise, or attempts to represent the taxpayer during the offer process.

The OIC program has methods in place to capture data about practitioners. However, the quality of the data depends on participation. The Form 656 has a section for the paid preparer to complete and a section for the taxpayer to identify who helped prepare the application. This information is not always submitted with the application, however, because completion is not mandatory.

Current Oversight of Electronic Return Originators

The National Taxpayer Advocate does not adequately explain or support her conclusion that the IRS cannot be certain that only qualified individuals are registered. The IRS does not require individuals to register. Firms apply to be Authorized IRS *e-file* Providers and include individuals who are Principals and Responsible Officials of the firm on the application. The National Taxpayer Advocate is correct that the IRS does not check all elements of the suitability on every individual Principal and Responsible Official. We do not have evidence to show that completing all elements of suitability on all individuals would improve tax administration significantly.

IRS ERO Sanctions

Non-compliance outside of the IRS *e-file* rules should not be addressed during an *e-file* monitoring visit, but a referral should be made to the appropriate function.

Restrictions on Disclosure of Tax Return Information

The Treasury Department and the IRS have proposed amendments to Circular 230 and the regulations under § 7216. The guidance is proposed, not final, at this time. We received numerous comments, in addition to the National Taxpayer Advocate's report, and held public hearings on the proposed rules. We are considering all comments in drafting final regulations and will address the comments in the preamble to the final regulations.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS for its efforts to improve the oversight of unscrupulous preparers. However, the National Taxpayer Advocate believes that more needs to be done. The IRS's current approach concentrates on identifying preparers after they have committed egregious misconduct. While it is important to address problem preparers, a more balanced approach would be to couple enforcement with a system of regulation, which would allow the IRS to better track preparers and ensure preparer competency in the tax laws.

Proposal to Regulate Unenrolled Return Preparers

We are pleased that the IRS is increasing its efforts to identify and correct behavior of the most egregious noncompliant preparers. The substantial increase in the number of Program Action Cases is encouraging. We are also confident that the IRS-wide strategy to coordinate noncompliant preparer leads will improve the effectiveness and efficiency of preparer oversight. However, we request that the planning meetings include a representative from the Taxpayer Advocate Service.

Assessment and Collection of Preparer Penalties

The IRS provided an explanation for the low percentage of preparer penalties collected. We understand that the low collection percentage is caused by the currently not collectible status of preparers with large penalty accounts. In fact, the SB/SE Collection Division focuses on preparer penalty accounts in excess of $25,000. Given that experience shows such accounts are uncollectible, the IRS needs to also concentrate on lower dollar balances. We understand that the IRS has limited resources, but the assessment and collection of penalties is a way to correct the behavior of preparers, regardless of the dollar value of their penalty accounts. By sending a message to the preparer community through the assessment and collection of penalties, the IRS may actually reduce downstream compliance costs. Moreover, placing preparer penalties on preparers who are already convicted of fraud is not much of a deterrent. The IRS's limited resources would have a greater deterrent effect by applying preparer penalties for negligent – not just fraudulent - misconduct

Regulation of Offer Mills

While issuing consumer alerts on abusive offer mills is important, the National Taxpayer Advocate believes the IRS can do more to track and regulate offer mills. The OIC program's ability to capture practitioner data is limited by the data it actually receives. Requiring and actually enforcing signature requirements is a very powerful tool to improve the amount of data captured by the OIC program. Another way to address the problem of offer mills would be to deem the preparation of an offer in compromise or request for a collection due process hearing for a fee as practice before the IRS and covered by Circular 230. Thus, unenrolled preparers who prepare these forms would be performing unauthorized practice in violation of Circular 230.

ERO Oversight

The IRS states it does not have evidence to prove that noncompletion of all elements of the ERO suitability checks affects tax administration significantly. However, we are unaware of any analysis performed by the IRS to support its decision to not complete all elements of the checks. It seems reasonable to check an applicant's criminal background, credit history, tax compliance, and prior non-compliance with IRS *e-file* requirements before accepting an individual into an IRS program that significantly impacts taxpayers and their compliance with the tax laws.

Further, the IRS takes the position that non-compliance outside the IRS *e-file* rules should not be addressed on an *e-file* monitoring visit. The National Taxpayer Advocate believes it is cost efficient to include these issues on the ERO Monitoring Checksheet used by SB/SE employees, so they can take a broad-based look at the ERO's operations while they are physically located in the ERO's place of business. Once the SB/SE employee spots a potential issue, a referral can be made to the appropriate function.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS take the following actions:

- Research the preparer community to better design an approach to regulate unenrolled return preparers. The following information would be useful in this analysis:
    1. Types and number of returns prepared by unenrolled preparers;
    2. Assessment and collection of preparer penalties broken down by type of preparer;
    3. Assessment and collection of penalties and interest against taxpayers who use paid preparers, broken down by type of preparer and type of penalty;
    4. Adjustments in tax liabilities on returns prepared by paid preparers, broken down by line item and type of preparer;
    5. Experience of the preparer programs in California and Oregon to determine their effectiveness and costs of administering.
- Reevaluate the proposed rules under Circular 230 to eliminate the authority of unenrolled return preparers to engage in limited practice before the IRS consider amending Circular 230. The National Taxpayer Advocate recommends that Treasury and the IRS retain the current limited practice provisions.
- Establish a multi-function task force, including the EITC program office, to design a program to receive and investigate preparer complaints filed by taxpayers or referred by IRS employees. The group should evaluate the feasibility of a national preparer database and address the necessity of safeguards to provide preparers due process and protect preparers from unfair treatment; procedures to limit access, content and use of the information contained therein; and strict guidelines

pertaining to making information public. The group should also design a comprehensive outreach campaign targeted to both taxpayers and IRS employees.

- Submit the National Preparer Database to the Office of the Taxpayer Advocate for review and issuance of a Taxpayer Rights Impact Statement (TRIS).[70]
- Prioritize both the assessment and collection of preparer penalties.
- Deem the preparation of an offer in compromise or request for a collection due process hearing for a fee as practice before the IRS covered by Circular 230.
- Further, to better track practitioners, the IRS should require a preparer signature on Forms 433-A and 433-B and enforce the signatures on Form 656.
- Work in conjunction with TAS to determine a methodology for SB/SE to select ERO sites at random for *e-file* monitoring visits. Revise the ERO Visitation Checksheet to review ERO procedures to comply with the use and disclosure requirements under IRC § 7216.
- Expand access to e-Services to include all practitioners authorized to practice before the IRS under Circular 230, without regard to whether they satisfied an *e-file* threshold.
- Prioritize the process to revise the regulations under IRC § 7216.

70 *See* National Taxpayer Advocate's Fiscal Year 2005 Objectives Report to Congress 2-5.

PROBLEM

TOPIC #13 CORRESPONDENCE DELAYS

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Division

DEFINITION OF PROBLEM

The IRS too often does not respond to taxpayer correspondence in a timely manner. Conflicting IRS quality measures overstate actual correspondence "timeliness," and allow many delays and problems to remain undiagnosed. Surveys of taxpayers indicate untimely correspondence remains a leading source of dissatisfaction and frustration with the IRS.

ANALYSIS OF PROBLEM

IRS Correspondence Policy: Action 61 Interim Letter Requirements

Taxpayers write to the IRS to respond to notices or letters about a variety of issues: for example, a balance due, a failure to file a return, or a potential income-reporting discrepancy. Taxpayers may also contact the IRS to inquire about refunds or the status of their accounts, or to request an abatement of penalties or an installment agreement.

In response to these types of taxpayer correspondence issues, during the 2005 fiscal year the IRS sent nearly 2.9 million "interim" letters advising taxpayers to expect delays of 30 days or more in processing their correspondence, over and above the IRS's "acceptable" 30-day initial processing period.[1] The IRS issues "interim letters" (to inform taxpayers of IRS processing delays) – in the "interim" – while the taxpayers continue to wait for a substantive IRS reply to their correspondence concerns. Internally, the IRS refers to all interim responses as "stall" letters.[2]

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1 IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes*; IRM 3.0.273.19.4.1 (Jan. 1, 2006).

2 The term (used in IRS "jargon") referring to all interim letters as a single group is "stall letters." In fact, it is so commonly used that it has actually been incorporated within Internal Revenue Manual (IRM) sections such as IRM 4.19.3.25(2), Unpostable AUR Transactions (Sept. 1, 2005). However, there are actually four primary interim letter variations generated through the Integrated Data Retrieval System (IDRS). These four interim letters have been assigned alpha-numeric codes (*i.e.*, 2644C, 2645C, 2644SP, and 2645SP) which appear in the top right corner of each interim letter a taxpayer receives. Letters ending with a "C"-suffix are considered "national" variations. This means that a "C"-letter has been standardized for use by any function within the IRS. The "SP"-suffix letters are the national Spanish-language translations of the "C"-letters. For example, the "2644C" letter is titled, "Second Interim Response." The Spanish-language variation of the "2644C" letter is the "2644SP" letter. Specialized functions within the IRS will modify a "C" letter to incorporate specialized wording which enables a taxpayer to have a clearer understanding of that letter. For example, the Ogden Campus has modified the initial "stall" letter a taxpayer generally receives, the 2645C letter. The 2645C letter is titled "Interim Letter," and has been changed to include a few additional paragraphs. Since this modified letter is unique to the Ogden Campus, the modified "2645C" letter designation has also been modified to reflect these alterations as the "2645O" letter. In this instance, the "O" stands for the "Ogden" campus. Other IRS campuses have made similar changes to IRS letters, which can also be identified by an altered alpha-suffix (*e.g.*, "AN" stands for the Andover campus). IRS, *Servicewide Electronic Research Program (SERP) Home Page, Correspondex Letters, Numeric Index*, and IRS, *Office of the Notice Gatekeeper.*

Interim letters generally contain standardized paragraphs with a blank, "fill-in" option in which an IRS employee enters the number of additional days that a taxpayer's correspondence processing will be delayed. The first interim letter that a taxpayer receives will typically notify him or her that a final IRS response will be delayed between 30 and 45 days. However, if an IRS caseworker will need even longer to respond to a taxpayer, the caseworker also has the option of manually scheduling a second interim letter to the same taxpayer–adding 30-45 more days to that taxpayer's wait. Therefore, second interim letters actually represent the *third* correspondence delay a taxpayer will experience.[3]

In May 1994, the IRS issued a memorandum entitled, "Action 61 Interim Letter Guidelines."[4] Those 1994 correspondence guidelines, now simply referred to as "Action 61," directed the former IRS service centers (later reorganized into "campuses") to review the interim letter process and set improvement objectives. Action 61 defined the specific types of casework the IRS considers to be taxpayer "correspondence." In addition, Action 61 established that each response to a taxpayer's correspondence must be "…initiated within 30 days of the initial IRS received date."[5]

Action 61, now embedded within the Internal Revenue Manuals (IRMs) of Accounts Management, remains the IRS's current correspondence policy.[6] Despite the intent of this policy, however, millions of taxpayers continue to be plagued by correspondence delays which the IRS can and should avoid. The 2.9 million IRS interim letters issued in FY 2005 indicate that Action 61 has not resolved the IRS's problems with responding to taxpayer correspondence in a timely manner.

Campus Specialization as a Result of the Internal Revenue Service Restructuring and Reform Act of 1998

Accountability and Business Measures

The IRS Restructuring and Reform Act of 1998 (RRA 1998) generated a major IRS reorganization,[7] which was designed to meet the unique needs of specific taxpayer groups, and created four new IRS operating divisions: Wage and Investment, Small Business/Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. Before the reorganization, each service center was controlled by its own single

3 The "acceptable" response time for initial correspondence contains a built-in delay of 30 days, per the Action 61 policy. The first interim letter to the taxpayer typically adds a 30 to 45 day delay to the initial response time. The second interim adds at least 30 more days to the taxpayer's wait. In total, the taxpayer must sometimes experience three different waiting periods or delays.

4 The IRS established an internal Correspondence Task Force in August of 1990. The IRS did not adopt all of the task force's recommendations right away. "Action 61" was the sixty-first action recommended by the team. The IRS implemented Action 61 beginning with an IRS memorandum in May of 1994. General Accounting Office, GGD-94-118, *Tax Administration: More Improvement Needed in IRS Correspondence* (Jun. 1, 1994), and GGD-95-66 (Feb. 1995).

5 IRM 3.0.273.19.5 (Jan. 1, 2006).

6 IRM 3.0.273.19, Taxpayer Correspondence, (Jan. 1, 2006).

7 Pub. L. No. 105-206, 112 Stat. 685 (Jul. 22, 1998).

director, with interrelated business measures among the three major functions (*i.e.*, the former Submission Processing, Customer Service I [Accounts] and Customer Service II [Compliance]).

When the new organizational structure officially "stood up" on October 1, 2000, the service centers split into specialized "campus" operations, with the three primary functions typically placed under three separate directorships (*i.e.*, Submission Processing, Compliance Services, and Accounts Management). At the campus level, individual programs, including correspondence variants (*e.g.*, installment agreement requests, account adjustment requests, lost payment concerns etc.), were broken up into the three new directorships, with redefined and differing responsibilities and measures. Therefore, in its effort to specialize services to taxpayers, the IRS has lost its single point of accountability for resolving correspondence delays at the campus level.

Local Procedures and Case Routing

Some campuses developed local procedures to clarify their new roles, based on varying levels of authority. For example, within a campus, a taxpayer's letter may be routed from Accounts Management to Compliance Services, based upon instructions in a local desk reference guide[8] or job aid.[9] However, if a second function is not operating at the same location, the IRS may issue a different type of delay notification to the taxpayer, the 0086C letter, "Referring Taxpayer Inquiry/Forms to Another Office."[10] Combined, referral letters (those transferring taxpayer correspondence to another IRS location for resolution) and interim letters (those extending the delay on an IRS response) accounted for 19 percent of all IRS letters in FY 2005, translating to almost 3.3 million correspondence delays for taxpayers.[11]

8 For example, if Accounts Management (AM) receives taxpayer correspondence which displays collection activity on IDRS, it is routed to Compliance Services. However, amended returns in a similar status on IDRS will be retained in Accounts Management. Should Accounts Management receive an amended return which also contains taxpayer correspondence attached, then AM will work **both** the amended return, as well as the response to the taxpayer correspondence. But, when Accounts Management receives an amended return containing an attached letter with "collection criteria" (*e.g.*, taxpayer can't pay, won't pay, or will pay later), AM will **only** work on the attached amended return portion. The correspondence will be detached and routed to Compliance Services for a response. IRS, *Ogden Accounts Management Campus (OAMC) Desk Reference Guide, Accounts in Status 22, 24, 26* (Jul. 11, 2006).

9 One example of local correspondence processing variation can be found in a checklist in the Atlanta AM campus, which states, "If TP issues are not worked in AM, route to appropriate area using TPI (Taxpayer Inquiry) routing guide." But there is no nationally approved "TPI routing guide." IRS, *Atlanta Accounts Management Center (ATAMC) Correspondence TPI Checklist* (June 2, 2005).

10 IRS, *0086C letter, "Referring Taxpayer Inquiry/Forms to Another Office"* (May 1, 2006).

11 Figures are compiled from the IRS, Office of the Notice Gatekeeper's FY 2005 totals. [(2,888,840 total of FY 2005 IRS 2644/2645 interim letters sent) + (376,502 total FY 2005 IRS 0086 referral letters sent] / (16,932,474 total volume of FY 2005 IRS "C" and "L" letters of any type sent) = (the percentage of all IRS letters which are delay notifications, or 19.28 percent). NOTE: As described in footnote #2 above, "C" letters are standardized national IRS letters which contain a "C"-suffix. Letters which have been modified for localized use retain the suffix of the site which has modified the letter (*e.g.*, "O" for Ogden; "AN" for Andover). Totals for all local letter suffixes are combined by the IRS Office of the Notice Gatekeeper, and listed under "L" letters. The "L" denotes the letters are "local" variations of IRS letters.

Transshipment (which triggers an 0086C letter) increases correspondence delays. However, the Government Accountability Office (GAO) FY 2005 audit of the IRS found that extremely poor tracking, follow-up, and review procedures – specifically with transshipped taxpayer information – increased the risk of errors, theft, or loss of taxpayer information.[12]

TABLE 1.13.1,[13] COMBINATION TOTALS FOR INTERIM LETTERS AND REFERRAL LETTERS

FY05 Correspondence Interim Letter Totals				
	All Letters	Interims	1st (2645)	2nd (2644)
1st Qtr (Oct-Dec, 2004)				
National Versions	3,104,216	407,697	378,053	29,644
Local Versions	162,199	11,925	11,925	0
Spanish Versions	23,150	84	80	4
2nd Qtr (Jan-Mar, 2005)				
National Versions	3,085,782	403,258	378,954	24,304
Local Versions	171,082	16,201	16,201	0
Spanish Versions	19,708	111	111	0
3rd Qtr (Apr-Jun, 2005)				
National Versions	5,837,417	1,112,348	1,073,543	38,805
Local Versions	213,998	26,746	26,746	0
Spanish Versions	33,203	94	94	0
4th Qtr (Jul-Sept, 2005)				
National Versions	4,197,878	873,799	821,548	52,251
Local Versions	159,902	36,866	36,866	0
Spanish Versions	22,346	115	114	1
FY05 Combined Totals				
National Versions	16,225,293	2,797,102	2,652,098	145,004
Local Versions	707,181	91,738	91,738	0
National/Local Combined	16,932,474	2,888,840	2,743,836	145,004
Spanish Versions[14]	98,407	404	399	5

[12] Government Accountability Office, GAO-06-543R, *Management Report: Improvements Needed in IRS's Internal Controls* 5 (May 12, 2006).

[13] Figure contains volumes recorded by the IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes* (Sept. 22, 2006). The Notice Gatekeeper records all IRS letters generated through the IDRS system. Standard versions are recorded as "National" letters, while "Local" contains site-specific variations.

[14] The IRS Office of the Notice Gatekeeper combines both the English and Spanish variations of its national letters ("C" and "SP" letters) under one heading. The combined total of these letters has been displayed under the heading, "National Versions." However, for comparison purposes, volumes for all Spanish versions have also been separated from "National Versions," and appear again as stand-alone totals. For example, in the chart above, the IRS sent 378,053 national "2645" letters in the 1st Quarter of FY 2005. Of the 378,053 letters sent, 80 were sent in Spanish as the 2645SP letter. The remaining 377,973 were sent using the English version, the 2645C.

Training Gaps and Subject Matter Experts

Taxpayer correspondence that involves a combination of individual and business account issues faces another barrier to timely resolution. The IRS no longer conducts Business Master File (BMF) training classes in sites designated to work individual income tax issues, nor does it conduct Individual Master File (IMF) training classes in its BMF locations. Therefore, the alternate skill base for the employees in both IMF and BMF campuses is diminishing. To address these new limitations, some campuses have developed procedures to deliver service in the post-RRA 98 era by creating specialized Subject Matter Experts (SME) to work combination IMF-BMF issues.[15]

IRC § 6012 establishes the filing requirements for both individual and business tax returns.[16] For example, based on this code section, a taxpayer files a Form 1040, U.S. Individual Income Tax Return, with a Schedule C to report a self-employment tax liability incurred from running his or her own business. In addition, as a self-employed business owner with employees, this taxpayer also files a Form 941, Employer's Quarterly Federal Tax Return, to report an employment tax liability. The taxpayer mails both returns to the IRS and receives balance due notices for each one. The taxpayer contacts an IRS business campus to discuss the accuracy of the balances owed, and if necessary to make payment arrangements to resolve it. However, the IRS assistor receiving this taxpayer's request to discuss the BMF balance cannot respond to questions about the individual balance, and correctly routes the taxpayer's inquiry to the designated SME, creating a delay. If the taxpayer calls an IMF campus to discuss the Form 1040 balance instead, the taxpayer experiences the same problem, but in reverse. Although both of the taxpayer's tax obligations have stemmed from running his or her own business, neither IRS assistor is fully-equipped to answer the taxpayer's questions. The post-RRA 98 combination of IMF-BMF issues is the root cause of both delays.

Unfortunately, in this example, either IRS employee must route the case to a specialist as the IRS reorganization has created gaps in the responding worker's training.[17] The first (BMF) employee cannot resolve any combination IMF-BMF issues because he or she has only been trained in business taxes. The second (IMF) telephone assistor is untrained in any business issues. Meanwhile, interest and penalties will continue to accrue on both the individual and business accounts, while the taxpayer awaits an IRS response. This is just one example of the delays resulting from RRA 98 reorganization, specialization, established local procedures, and case routing. Routing correspondence to specialists – rather than cross-training employees in commonly reoccurring issues – results in further correspondence delays for taxpayers.

[15] IRS, *Ogden Accounts Management Campus (OAMC) Desk Reference Guide* (Aug. 1, 2006) and IRS, *Fresno Campus Technical Issues & Local Support Accounts Management* (undated).

[16] IRC § 6012(a) and IRC § 6012(b).

[17] IRS, *Ogden Accounts Management Campus (OAMC) Managers Handbook, "SME Listing"* (undated).

Campus Inventory Resources and Measures

Seasonal Inventory and Workforce Management

Traditionally, based on the filing deadlines for the most common tax forms, IRS inventory levels fluctuate on a seasonal basis. In each of these tax "seasons," inventory levels reach their peak along predictable timelines. The IRS recalls its seasonal workforce during these periods to meet the increasing workload. For example, the peak processing season for individual tax returns (which must be filed by April 15th each year) always occurs during the second quarter of the calendar year. Typically, the second quarter also exhibits the highest volume of correspondence delays.[18]

Although it could be assumed that increased staffing should actually reduce correspondence delays, an inverse relationship actually exists. One reason that both staffing levels and correspondence delays rise simultaneously is that customer service representatives (CSRs) comprise 24 percent of the IRS's "mission critical" workforce.[19] These same customer service representatives are responsible for answering toll-free telephone calls from taxpayers as well as taxpayer correspondence.[20] Cyclical increases in toll-free contacts generate higher levels of staffing for customer service representatives, but the increased telephone assistors generate corresponding volumes of electronic taxpayer inquiries, or "e-4442s."[21]

Electronic case referrals generated by the IRS's toll-free telephone assistors at both call centers and campuses exacerbate the correspondence delay problem. Once these e-4442s are input into the IRS's electronic referral system – although primarily received via telephone contacts – they actually become part of its "correspondence" inventory and are worked alongside traditional correspondence inventory. Then, to compensate for any delays, the IRS systemically generates interim letters on its e-4442 inventory before the 30 days have elapsed.

Initially, when the IRS automated the interim letter process, it did so to keep taxpayers apprised of the status of their correspondence. However, the automated process has since deviated from its original intent. As a result, in FY 2005, nearly 11 percent of the

[18] April through June 2005 interim letter totals from the letter number 2645, "Interim Letter," and 2644, "Second Interim Response." IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes.*

[19] The IRS Human Capital Office defines "Mission Critical Occupations" as those series or occupations critical to frontline enforcement and direct support to front-line operations needed to meet the stated IRS goals. IRS, Human Capital Office, *IRS Human Capital Strategic Plan 2005-2009* (undated).

[20] IRS, *Critical Job Elements, Performance Plan for Customer Service Representative, Document 11480*, (Dec. 2004) and IRS, *Standard Position Description, GS-0962-08, Contact Representative, SPD No. 96208*, (Aug. 15, 2002).

[21] Prior to the adoption of the electronic referral system, taxpayer referrals were hand-written or typed onto a paper Form 4442, "Inquiry Referral," (Revision 11/2004). For example, a taxpayer arrived at a walk-in site. The assistor cannot help him because the taxpayer's account is assigned to another IRS employee located in a campus. The walk-in assistor writes up a referral on a Form 4442, and tells the taxpayer that someone else will get back to him in X number of days. The hard copy of the Form 4442 was then shipped to the second employee at the campus for final resolution. When the automated process began, the inquiries input into the new system were re-designated "e-4442s."

e-4442 "correspondence" received an automatically-generated interim letter.[22] Therefore, rather than adjusting its staffing levels to answer these taxpayer inquiries more quickly, the IRS has instead automated the "delay-notification" process.

Conflicting Measures

A priority conflict exists because the IRS employs the same personnel to provide timely responses to taxpayer correspondence, as well as to staff its toll-free telephone lines. By comparing the IRS's quality measures for both applications, the IRS's emphasis on the "telephones" begins to materialize. Action 61 (the IRS correspondence policy) standardizes the response time for correspondence "timeliness" at 30 days. However, the Joint Operations Center (JOC),[23] the IRS organization responsible for scheduling and monitoring telephone traffic on the toll-free lines, uses an entirely different timeliness measure.

For example, the JOC may schedule a site for ten CSRs on the toll-free line for installment agreements from 10:30 a.m. to 11:00 a.m. Then, from 11:00 a.m. to 11:30, the site commitment for that same line may jump up to a requirement of 35 CSRs. As one of its quality measures, the JOC tracks the site's adherence to each 30-minute segment during business day.

The IRS's FY 2005 Program Letter for Accounts Management states under "Application Staffing Adherence (Site)," "…Sites must meet or exceed 95 percent of each half hourly staffing requirement for 85 percent or more of the total half hours of operation…"[24] Using the example above and the FY 2005 program letter requirements, the site must ensure all 10 CSRs are staffing the toll-free line from 10:30 to 11:00 a.m. to exceed the 95 percent requirement. But during the subsequent half-hour, only 34 CSRs would be necessary to exceed 95 percent, and the site has some leeway in the event of an employee sick day.

Overall, if this site's hours of operation run from 7:00 a.m. to 7:00 p.m., it must monitor its staffing commitment (for 95 percent adherence) in each of the 24 half-hours scheduled by JOC. Finally, to achieve the 85 percent daily quality measure dictated in the FY 2005 program letter, this site must ensure it does not "miss" more than three half-hours overall.

[22] The IRS supplied data for all FY 2005 interim letters generated by the automated e-4442 system (68,669 automatic interim letters sent / 633,968 e-4442s = 10.8 percent). IRS, Wage and Investment and Small Business/Self-Employed Operating Divisions, (Aug. 23, 2006).

[23] JOC is responsible for coordinating nationwide telephone traffic on the IRS toll-free lines. Its mission statement states: *"To provide world-class service, support, and technology for Operating Divisions and Functional Organizations to achieve their desired service levels for all telephone, correspondence, and electronic media inquiries within agreed resource and staffing parameters."* One of its roles is to establish staffing commitments for each half-hour of operation in every campus and call site, and to monitor levels of service. IRS, Joint Operations Center website (http://joc.enterprise.irs.gov/), *Mission Statement.*

[24] IRS, Wage and Investment Operating Division, *2005 Program Letter, Measures and Operating Guidelines, Final FY05 Program Letter* (Oct. 25, 2004).

In addition to monitoring each campus and call site for half-hourly adherence, the JOC monitors individual employees using another quality measure, Average Handle Time (AHT). AHT includes the total time that an assistor spends with a taxpayer. This measure includes the following: time spent actually speaking with the taxpayer, time the taxpayer spends waiting on "hold," and time spent wrapping up the case after the taxpayer has hung up the phone. Unlike the Action 61 correspondence measurement in "days," AHT results are compiled in "seconds."[25]

In comparing these three IRS measurements for basic (timeliness) quality against one another – "minutes" and "seconds" for telephones, versus "days" for correspondence – the emphasis is clear: The IRS directs its resources to telephone traffic before the timely resolution of paper correspondence.

Action 61 as a Timeliness Measure

Inflated Quality Reporting

Far too often, even the IRS's "interim" responses are actually delayed. In FY 2005, the IRS issued nearly 16 percent of the required interim letters for individuals,[26] and 31 percent of the business interim letters,[27] late or not at all. Moreover, using its adherence to Action 61 requirements as a quality measure for timeliness, the IRS records its final responses to taxpayers as "timely" as long as those taxpayers have received "timely" interim letters.

As discussed previously, the IRS may issue a taxpayer both a first and a second interim letter to notify him or her of processing delays. But, if the IRS meets its own extended timeframes (cited within the two interim letters), regardless of the multiple delays experienced by a taxpayer, it reports externally that its quality measurements for "timeliness" have been met – misrepresenting its overall service to taxpayers. Therefore, high adherence to Action 61 serves only to mask systemic correspondence delays through inflated IRS quality measures that do not reflect actual correspondence timeliness.

[25] Initially, in both campuses and call sites, JOC monitors the IRS target of keeping a taxpayer's telephone wait-time (on "hold") below 300 seconds. Then, using a comprehensive, weighted measurement methodology (primarily based on AHT) it evaluates delivery of the overall services goal. IRS, Wage and Investment operating division, *2005 Program Letter, Measures and Operating Guidelines, Final FY05 Program Letter* (Oct. 25, 2004); and, IRS, Joint Operations Center website.

[26] Representative sampling data (936 reviewed; 147 incorrect; 84.3 percent accuracy) from FY 2005 NQRS Enterprise Individual Master File (IMF) correspondence quality rates for "Timeliness" attribute #901, "Interim Contacts (National Quality Review Staff Only)," supplied by the Wage & Investment and Small Business/Self-Employed Operating Divisions (Aug. 23, 2006).

[27] Representative sampling data (157 reviewed; 49 incorrect; 68.8 percent accuracy) from FY 2005 NQRS Enterprise Business Master File (BMF) correspondence quality rates for "Timeliness" attribute #901, "Interim Contacts (National Quality Review Staff Only)," supplied by the Wage & Investment and Small Business/Self-Employed Operating Divisions (Aug. 23, 2006).

Timeliness Tolerances

The IRS does not maintain statistical records of the average time it takes to resolve taxpayer correspondence.[28] However, based on the standards contained in its program letter, this period can be quite protracted.[29] Per the FY 2005 IRS Program Letter for Accounts Management, "Each individual W&I AM campus, and W&I overall, should meet the following targeted overage percentages in *at least 75 percent* of the weeks in FY 2005."[30] Performance data (for the FY 2005 target overage percentages for tax returns) was extracted during the pre-identified periods shown below, with each allowable overage percentage shown at the right.

TABLE 1.13.2,[31] W&I FY 2005 ACCOUNTS MANAGEMENT ADJUSTMENTS OVERAGE PERCENTAGE TIME PERIODS

Time Periods	Objective
10/09/04	<13 %
10/16/04 to 10/30/04	<10 %
11/06/04 to 11/27/04	<10 %
12/04/04 to 01/01/05	<15 %
01/08/05 to 01/29/05	<15 %
02/05/05	<13 %
02/12/05 to 02/26/05	<10 %
03/05/05 to 04/02/05	<7 %
04/09/05 to 04/30/05	<7 %
05/07/05 to 05/28/05	<7 %
06/04/05 to 07/02/05	<10 %
07/09/05 to 07/30/05	<15 %
08/06/05 to 09/03/05	<15 %
09/10/05 to 09/30/05	<15 %

For the majority of FY 2005 (nine months), the IRS overage quality standards allowed a minimum of 10-15 percent of its taxpayers to wait for more than 30 days for a correspondence reply. Moreover, as the program letter requires only 75 percent adherence (to

[28] The General Accounting Office (now the Government Accountability Office) stated in 1994, "(The) IRS' measure of timeliness focuses on providing an interim or a final response... (and) does not include the time that elapses after an IRS employee puts a letter or notice into the computer system until it is mailed…not measuring timeliness from a taxpayer's perspective…" General Accounting Office, GGD-94-118, *Tax Administration: More Improvement Needed in IRS Correspondence* 2 (Jun. 1, 1994).

[29] IRS, Wage and Investment operating division, *2005 Program Letter, Measures and Operating Guidelines, Final FY05 Program Letter, Attachment V* (Oct. 25, 2004).

[30] The IRS defines "overage" timeframes based on the specific work types. "Correspondence" becomes overage on the 45th calendar day following the IRS received date. For example, if the IRS receives a taxpayer's letter on January 1st, it becomes "overage" 45 days later on February 15th. IRM 3.30.123.2.10(13), Taxpayer Correspondence (Jan. 1, 2006).

[31] "Adjustments" refers to AM's paperwork inventory, which includes taxpayer correspondence. IRS, Wage and Investment operating division, *2005 Program Letter, Measures and Operating Guidelines, Final FY05 Program Letter, Attachment V* (Oct. 25, 2004).

meet "timeliness" standards), for up to 25 percent of the entire FY 2005 period, the IRS placed no limit on the number of taxpayers who could be impacted by delays. These were the "quality" measures the IRS used to externally report its correspondence "timeliness."

Refund Delays

In response to taxpayer complaints, TAS recently collaborated with the Gallup Organization to conduct a survey (the "TAS Cognitive Survey") of taxpayers who had filed amended tax returns.[32] Although amended returns are not typically considered "correspondence" unless a letter is also attached, as previously discussed, the IRS uses the same personnel to work both taxpayer correspondence and amended returns. Both inventory types commonly require similar account actions.[33] Eighty-eight percent of all taxpayers surveyed were expecting a refund.[34]

The IRS provided about two-thirds of the respondents with a processing timeframe.[35] Of those taxpayers given any timeframe at all, the IRS told almost 90 percent that it

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[32] The Taxpayer Advocate Service (TAS) conducted a 12-month study under contract with the Gallup organization, involving the selection and polling of a sample of TAS customers who had recently opened cases under Core Issue Code 330, Processing Amended Returns. This core issue code is the largest category of work that TAS receives from SB/SE accounts. At the beginning of the survey period, TAS case advocates were given instructions to ensure they documented each Core Issue Code 330 case completely. Before initiating any taxpayer contacts, Gallup screened the TAS supporting documentation on all Core Issue 330 cases for the prerequisite TAS case advocate documentation. It deemed 1,197 Core Issue 330 cases to have had the proper documentation, and used those TAS cases as the basis for the survey. It called 1,197 taxpayers or Powers of Attorney (POA) and asked them to answer a series of questions. Using the survey questions, Gallup attempted to determine what had occurred (in the eyes of the respondent) that caused the taxpayer to qualify for the services of TAS. The study gathered information regarding the taxpayer's circumstances, his experiences prior to presenting a request to TAS for assistance and his perspective about where IRS may have failed to provide him with the level of service he expected. After all the contacts had been made, Gallup returned the results (from the 1,197 contacts) to TAS for analysis. Taxpayer Advocate Service/The Gallup Organization, *"Cognitive Study of Small Business/Self Employed (SB/SE) Customers"* (May 2006).

[33] Generally, amended returns are "structured" submissions by taxpayers that contain change requests, or are provided simply for information-only. Their structure comes from the numbered lines which correspond to specific entries on various tax items. However, taxpayer correspondence–while more "unstructured" in its format–contains similar (if not identical) taxpayer account issues to those found in amended returns. Campus personnel in Accounts Management are trained to work either type of work, as well as (for customer service representatives) telephone account adjustments.

[34] Question #4 on the TAS-Gallup Cognitive Survey was, "Did you owe money to the IRS, or did you expect a refund from the IRS as a result of your amended return?" Of the 1,197 taxpayers surveyed, 1,056–or 88.2 percent–responded, "Expected a refund." Taxpayer Advocate Service/The Gallup Organization, *"Cognitive Study of Small Business/Self Employed (SB/SE) Customers"* (May 2006).

[35] (574 taxpayers responding affirmatively to the TAS-Gallup Cognitive Survey question #7f, "Did the person you spoke to indicate how long it might take to process your return?) / (875 taxpayers responded to this question [from the 1,197 total in the survey]) = (Taxpayers in the survey who received an IRS timeframe, or 65.6 percent). Taxpayer Advocate Service/The Gallup Organization, *"Cognitive Study of Small Business/Self Employed (SB/SE) Customers"* (May 2006).

would take at least a month for them to receive their refunds.[36] More than half were told it would take three months or more before the IRS could process their refund claims.[37] If we apply the taxpayer rates for refund claims (from the TAS-Gallup Cognitive Survey) to taxpayer letters, then delayed correspondence processing primarily impacts taxpayer refund requests.

TABLE 1.13.3,[38] TAS SURVEY

Taxpayer Advocate Service Survey Results: How long did the IRS say it would take?

Period*	Survey Responses
Less than 1 month	8 %
1 month or more	89 %
6 weeks or more	76 %
2 months or more	66 %
3 months or more	52 %

**Note: "Period" figures are cumulative, and exceed 100 percent.*

Taxpayer and Downstream Impact

Delayed correspondence resolution negatively impacts a variety of corrective actions to a taxpayer's account. Data from the TAS Cognitive Survey indicate the primary reasons for account changes involve taxpayer claims for refunds. Refund delays can increase the potential for economic harm to the taxpayer (*e.g.*, eviction, inability to buy medication, or bankruptcy.)

Correspondence delays generate additional follow-up contacts from concerned taxpayers, including duplicate tax return filings, duplicate correspondence, calls to the toll-free lines, and referrals to TAS, all of which mean re-work for IRS employees. Taken cumulatively, the total cost (*e.g.*, labor, postage, paper, and printing costs) for the nearly three million interim letters sent in FY 2005 was not inexpensive. These funds could have been better spent on hiring additional customer service representatives and tax examiners to provide quality taxpayer correspondence resolution.

[36] Question #7g on the TAS-Gallup Cognitive Survey asked taxpayers, "How long did they (the IRS) say it would take (to process your amended return)?" From the original 1,197 participants, 561 respondents answered this question, indicating the IRS had provided a timeframe for processing. The responses ran anywhere from "1 week or less" to "97+" weeks. The responses in the chart have been placed in categories. For example, if a taxpayer was told "eight-weeks," that response is included in three of the periods listed. Eight-weeks is "1 month or more," "6 weeks or more," and also, "2 months or more." Therefore, from the data, it can be stated that, "89 percent were told it would take at least a month. Of those taxpayers, 76 percent were actually told that it would take "6 weeks or more." NOTE: 3.4 percent of taxpayers responded either "Don't Know, "or "refused" to answer this question. Taxpayer Advocate Service/The Gallup Organization, *"Cognitive Study of Small Business/Self Employed (SB/SE) Customers"* (May 2006).

[37] *Id.*

[38] *Id.*

Spanish Correspondence

Another related problem is evident in the figures previously displayed in Table 1.13.1. The IRS Office of the Notice Gatekeeper tracks all letters generated through Integrated Data Retrieval System (IDRS),[39] including the Spanish variations of interim letters (called the 2645 and 2644 letters).

According to the U.S. Census Bureau's 2005 American Community Survey, 12 percent of the U.S. population over age five, or 32 million people, speak Spanish at home.[40] Over 15 million of these Spanish-speaking persons, or nearly six percent of the U.S. population, speak English less than "very well."[41] However, of the 2.7 million first interim letters sent by the IRS in FY 2005, only 399, or 0.01 percent, were written in Spanish.[42] Ratios for the second interim letter were even lower, as the IRS sent only *five* of these letters in Spanish all year,[43] or 0.003 percent of the total issued.[44] Clearly, the IRS is not meeting its obligation to provide service to Spanish-speaking taxpayers.[45]

Comparative data from the IRS's own FY 2005 toll-free lines can be used to estimate appropriate FY 2005 levels for Spanish interim responses. Of the approximately 22 million calls scheduled for the top five (by volume) IRS toll-free lines for which a Spanish

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[39] The Integrated Data Retrieval System (IDRS) is a mission critical steady state system that consists of databases and operating programs that support Internal Revenue Service employees working active tax cases within each business function across the entire Internal Revenue Service. This system manages data that has been retrieved from the tax Master File allowing Internal Revenue Service employees to take specific actions on taxpayer account issues, track status, and post transaction updates back to the Master File. It provides for systemic review of case status and notice issuance based on case criteria, thereby alleviating staffing needs and providing consistency in case control. IRS, www.IRS.gov website, at http://www.irs.gov/privacy/article/0,,id=131489,00.html (last accessed Sept. 28, 2006).

[40] U.S. Census Bureau, *2005 American Community Survey, Table R1602*, Percent of People 5 Years and Over Who Speak Spanish at Home; and, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

[41] (15,396,674 Spanish-speakers over age five speak English less than "very well" / 268,110,961 total U.S. population over age five) = 5.7 percent of the Spanish-speaking U.S. population which speaks English less than "very well.") U.S. Census Bureau, 2005 American Community Survey, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

[42] (399 total FY 2005 2645SP letters sent by IRS) / (2,743,836 total FY 2005 first interim letters [2645] sent by IRS) = (The percentage of Spanish-language first interim letters sent to taxpayers, or .0145 percent). The letter data was extracted from the website operated by the IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes*. (Sept. 22, 2006).

[43] Five Spanish-language second interim letters (2644SP) were sent by IRS to taxpayers in FY 2005. IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes* (Sept. 22, 2006).

[44] (5 total FY 2005 2644SP letters sent by IRS) / (145,004 total FY 2005 second interim letters [2644] sent by IRS) = (The percentage of Spanish-language second interim letters sent to taxpayers, or .0034 percent). The letter data was extracted from the IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes* (Sept. 22, 2006).

[45] Per IRM 21, "…if Spanish-language correspondence is received, you must reply using the Spanish version of the appropriate C letter, if one is available." The caveat only stipulates an exception "…if one is (not) available." However, the Spanish-English disparity is not solely limited to interim letters. During FY 2005, the IRS sent the English-language 105C letter (used to disallow a taxpayer's claim, and to provide him or her with "Appeal Rights") to 425,443 taxpayers. The Spanish-language equivalent, the 105SP, was only issued 148 times, or .03 percent of all 105-series disallowance letters. IRM 21.3.3.4(2)a, Correspondence Procedures (Jan. 24, 2006), and IRS, Office of the Notice Gatekeeper, *Correspondex Letters Statistical Reports On-line*.

option exists, the IRS planned for nine percent of those taxpayer contacts to occur on the Spanish-language lines.[46]

If scheduled rates for Spanish telephone contacts are applied to interim letters using the same nine percent standard, the IRS would have expected to send approximately 260,000 Spanish interim letters to Spanish-speaking taxpayers in FY 2005, or 644 times the number actually issued.[47] Given the disparity between the volumes of English- and Spanish-language interim letters, there is evidence of a serious lapse in the IRS's service to the Spanish-speaking population.[48]

Taxpayer Feedback

Taxpayer satisfaction surveys routinely report the "Length of Time to Resolve Your Issue" is a major source of taxpayer dissatisfaction.[49] For example, when the IRS separated statistical groups of taxpayers who had responded on both extreme ends of its "satisfaction spectrum," the spotlight was further focused on overall timeliness. These divergent groups of taxpayers, labeled as either "satisfied" (those scoring a four or a five on a five-point scale), or "dissatisfied" (those scoring a one or a two on the same scale), cited "timeliness" as a top priority for change.[50] It was the only issue consistently cited by both divergent groups in separate "Top Three" listings. Taxpayers' historical "Top Three" responses are displayed in Table 1.13.4.

[46] The IRS Joint Operations Center (JOC) uses historical IRS telephone traffic to schedule staffing levels for subsequent periods. Therefore, the JOC's FY 2005 "Calls by Site by Pay Period" reflects predictive planning by the IRS that nine percent of its telephone contacts will be on the Spanish lines. For the purposes of this report, FY 2005 figures were extracted from the "Calls by Site by Pay Period" table created by (JOC). The IRS's English-language toll-free lines were matched for services provided to determine the equivalent Spanish-language toll-free lines. Totals from the five highest (scheduled call volume) matching Spanish-language lines were compared against the English-language equivalents. In actuality, the English-language (business) toll-free lines are further specialized than the Spanish equivalent. English toll-free line (business) numbers 25, 28, and 30 are consolidated for Spanish business calls into a single toll-free line (line #31). Therefore, the top five Spanish-language toll-free lines take seven English-language lines to match the services they provide. Adding the FY 2005 scheduled call volumes for the seven top English lines to the equivalent top five Spanish lines, the total approached 22 million calls. The calculations were as follows: English Total 19,921,969 (Line #5 =1,824,297; #10W = 958,455; #13 = 207,284; #20WI = 13,137,446; #25 = 2,395,756; # 28 = 119,127; #30 = 1,279,604) + Spanish Total 1,968,428 (Line # 6 = 125,420; #11 = 99,328; #14 = 7,833; #21 = 1,578,238; #31 = 157,609) = 21, 890,400 scheduled calls. Therefore, (1,968,428 Spanish calls) / (21,890,400 total calls) = (9 percent of the calls scheduled for the Spanish lines). IRS, Joint Operations Center, *Site Level Measures Bucket File Extracts, Calls by Site by Pay Period* (Sept. 4, 2004).

[47] 2,888,840 (total interims sent in FY05, per the Notice Gatekeeper) x .09 (the percentage of taxpayers scheduled by IRS for the Spanish toll-free lines) = 259,996 (letters which should have been issued in Spanish) 259,996 (letters which should have been issued in Spanish) / 404 (FY05 Spanish interims per the Notice Gatekeeper) = 643.55 (the number of times the Spanish volume should have been increased).

[48] *See* Most Serious Problem, *Limited English Proficient (LEP) Taxpayers; Multilingual and Cultural Barriers, infra.*

[49] The IRS hired an independent research company, the Pacific Consulting Group (PCG), to design and administer customer satisfaction surveys. PCG surveyed eleven areas of the IRS, including Toll-free telephone and Walk-in services, Examination, Collection, Automated Collection System (ACS), Employee Plans and Exempt Organizations (EP/EO), Service Center Examination, and Appeals. IRS Office of the Chief Financial Officer, *Customer Satisfaction Quarterly Reports, Thirty-Second Quarterly Reports* (Feb. 2006), Adjustments Summary (Oct – Dec 05).

[50] IRS Office of the Chief Financial Officer, *Customer Satisfaction Quarterly Reports, Thirty-Second Quarterly Reports* (Feb. 2006), Adjustments Summary (Oct – Dec 05).

TABLE 1.13.4, IRS CUSTOMER SATISFACTION SURVEY SUMMARY: IMPROVEMENT PRIORITIES (OCT—DEC 2004 VS. OCT—DEC 2005)[51]

Improvement Priorities for All Customers

Period of Survey Administration	Highest Priority	Second Priority	Third Priority
Oct—Dec 2005	Keeping you informed of the status of your case	Length of time to resolve your issue	Ease of getting more information about your issue
Oct—Dec 2004	Ease of getting more information about your issue	Length of time to resolve your issue	Keeping you informed of the status of your case

Improvement Priorities for All Satisfied Customers

Period of Survey Administration	Highest Priority	Second Priority	Third Priority
Oct—Dec 2005	Length of time to resolve your issue	Keeping you informed of the status of your case	Ease of understanding information provided by IRS
Oct—Dec 2004	Ease of understanding information provided by IRS	Ease of getting more information about your issue	Length of time to resolve your issue

Improvement Priorities for All Dissatisfied Customers

Period of Survey Administration	Highest Priority	Second Priority	Third Priority
Oct—Dec 2005	Explanation regarding the resolution of your issue	Ease of getting more information about your issue	Length of time to resolve your issue
Oct—Dec 2004	Length of time to resolve your issue	Fairness of treatment by IRS	Explanation regarding the resolution of your issue

TECHNOLOGICAL IMPACT

Correspondence Imaging System (CIS)

The IRS has implemented the Correspondence Imaging System (CIS), which scans electronic images of taxpayer correspondence, at seven campuses.[52] However, CIS is limited to individual taxpayer correspondence, and its expansion to business return processing sites is only in the planning stages. Further, CIS guidelines within campuses may conflict with a CSR's ability to provide taxpayers with quality service.

For example, one campus posted its CSR's "Frequently Asked Questions" (FAQ) on its website. One FAQ in particular highlights the ongoing difficulties taxpayers face:

> **CSR Question:** If (an) open CIS case is (available online) and I am on the phone (with the taxpayer), can I take over the case?

[51] IRS Office of the Chief Financial Officer, *Customer Satisfaction Quarterly Reports, Thirty-Second Quarterly Reports* (Feb. 2006), Adjustments Summary (Oct - Dec 05).

[52] IRS, *Memphis Accounts Management, Talking Paper for Managers, "Correspondence Imaging (CIS): What's it all about?"* (Jun. 14, 2006).

> **Answer:** No, the (contact representative) cannot take over a CIS case. This would be giving preferential treatment to the taxpayer. The (contact representative) is to advise the (taxpayer) of the processing timeframes for the case. If the timeframe has expired, follow the instructions in the IRM. If necessary, follow Taxpayer Advocate Service (TAS) procedures…" [53]

CIS has also automated the correspondence delay notification process (similar to the automated e-4442 process discussed previously).[54] Based on the automated interim process, and the FAQ procedures outlined above, here is a potential scenario of how this policy could play out for taxpayers calling the toll-free lines:

> **Taxpayer:** Hi, you sent me two notices now that said I owed you money. So, I wrote you a letter last month which explained the problem with my 1040, and why I really don't owe you anything. In fact, I'm still actually expecting a refund.

> **CSR:** Yes, I'm reading your correspondence right now. It seems like you've explained the situation quite well. And, it looks like we've just sent you a letter. You'll probably get it sometime next week, but basically that letter's just going to say we need more time to process your case. I can't verify exactly what our letter to you says specifically, but – normally – these letters ask you to wait approximately 30 more days for our response. But, if you don't hear anything from us by then, you should probably call back, and we can check on the status again…

In the example listed above, the IRS guidelines for processing correspondence cases in the order they are received (basically, a "first come, first serve" policy) has failed to evolve with the "new" CIS technology. Though the CSR can access a scanned image of the taxpayer's correspondence – per the policy – he or she must inform the taxpayer to endure further delays, unless TAS intervention is required.

Electronic IDRS Enhancement Tools

Campus-based groups of employees have begun developing programming tools designed to improve productivity for IDRS users, including the creation of a more user-friendly IDRS interface. These tools (*e.g.*, IDRS Decision Assisting Program [IDAP], Standard Workflow Tools [SWFT], and others) are designed to increase productivity by streamlining common or repetitive actions. The IRS Integration Development for Enterprise

[53] IRS, *Fresno Accounts Management Campus, "Correspondence Imaging System Frequently Asked Questions"* (undated document).

[54] Interim letters will be automatically generated, when required, on the 23rd day to ensure receipt by the taxpayer within 30 days. If required, a second interim letter will be generated after an additional 45 days. IRS, Brookhaven Campus Accounts Management, *Correspondence Imaging System* website.

Automation (IDEA) Lab has tested and approved 131 of these tools.[55] However, none appears to be primarily targeted toward resolving correspondence delays.

IRS Electronic Services

RRA 98 establishes a goal for the IRS to receive 80 percent of all returns electronically by 2007, and authorizes the IRS to promote and encourage electronic filing (e-file).[56] As a result, the IRS has taken steps to modernize its technical infrastructure to support its Electronic Tax Administration (ETA) program, including the development of the e-services suite to enable tax professionals and payers to conduct business with the IRS electronically.[57]

One of the e-services products is Electronic Account Resolution, which allows tax professionals to make inquiries and to expedite closure on clients' account problems by electronically sending or receiving account related inquiries. Using the Electronic Account Resolution tool, tax professionals may inquire about individual or business account problems, refunds, installment agreements, missing payments or notices. The IRS delivers its response to a secure electronic mailbox within three business days. As an alternate means for taxpayers to contact the IRS with concerns regarding account issues, the e-services' Electronic Account Resolution tool has the potential to eliminate many of the current (paper) correspondence delays which negatively impact taxpayers.

Online Privacy[58]

The e-services website uses temporary session "cookies" to give users a single, uninterrupted session when they are online. Each "cookie" contains a system-generated session ID only, and is immediately deleted upon leaving the site. The IRS also monitors network traffic to identify unauthorized attempts to upload or change information or otherwise cause damage to the web service. It does not attempt to identify individual users unless it suspects illegal behavior.

[55] The IRS Integration Development for Enterprise Automation (IDEA) Lab is testing the effectiveness of new programming. For example, the IDEA Lab's programming can track the individual keystrokes of both old and new processes, and calculate a percentage increase in productivity. Or, the lab can run simulations for the "load testing," to determine if programming will bog down other systems shared on a terminal. The lab's approval means these programs have been proven effective and safe. The 131 tools are the groups' combined total. IRS, *IDRS Decision Assisting Program (IDAP), "IDAP Briefing*," (May 25, 2006).

[56] The IRS's electronic filing (e-file) program allows taxpayers to electronically file (*e.g.*, a taxpayer complete and submit a Form 1040 from a home computer) an accurate tax return or get an extension of time to file without sending any paper to the Internal Revenue Service. RRA 1998 set a requirement for the IRS to receive an 80 percent electronic filing rate by the 2007 tax year. Public Law No. 105-206, 112 Stat. 723, Section 2001 (July 22, 1998) and IRS, Publication 3187, *The IRS e-Strategy for Growth: Expanding e-Government for Taxpayers and Their Representatives* (Jan. 2005).

[57] The IRS website, www.IRS.gov, provides 24 hour services for those tax professionals registered to use its e-services tools. IRS, www.IRS.gov, e-services–*Online Tools for Tax professionals*, at http://www.irs.gov/taxpros/article/0,,id=109646,00.html.

[58] All information cited under this subheading has been extracted from the IRS e-services website. IRS, *e-services Online Policy Statement* at http://www.irs.gov/taxpros/article/0,,id=138814,00.html.

The IRS has modified its Online Privacy Policy for e-services to address the use of data for conducting anonymous, voluntary surveys. Providing the required registration information implies a tax professional's consent. Any information the IRS collects and maintains in the course of responding to tax preparers is handled in accordance with the access and privacy protection requirements of the Privacy Act, the Freedom of Information Act, and the Internal Revenue Code. The IRS will not share information provided with anyone unless required by law.

Taxpayer Limitations and Enhancement Timeframes

Unfortunately, e-services is not available to individual taxpayers. Only approved IRS business partners, such as e-filing tax professionals and payers, are eligible to participate. The IRS has placed its focus on enabling the "value-added" e-services requested by the preparer community as "incentives" to promote and encourage the IRS e-file program. The IRS's decision to cater solely to tax preparers (in an attempt to meet its RRA 1998-imposed, 80 percent e-file requirement by 2007) has relegated taxpayer access to a secondary status. In the IRS's January, 2005 release of its e-services implementation phases, "Taxpayer Account Access" is listed as "3-5 years" away from implementation.[59]

SUMMARY

The IRS does not respond to taxpayer correspondence in a timely manner. Action 61 has not resolved the IRS's correspondence delay problems, as evidenced by the 2.9 million "stall" letters sent to taxpayers in FY 2005. In addition, conflicting IRS quality measures overstate actual correspondence "timeliness."

An unfortunate outcome of IRS reorganization (RRA 1998) has been the loss of single accountability for monitoring correspondence measures within campuses. In addition, IRS employees' training gaps present a barrier to timely one-stop resolution. Local procedures include routing correspondence to cross-trained specialists, and result in further delays to correspondence resolution.

Rather than adjusting campus resources to answer taxpayer correspondence more quickly, the IRS has automated the "delay-notification" process. The IRS directs its resources to telephone traffic before the timely resolution of paper correspondence. The current correspondence policy (Action 61) masks systemic delays with artificially inflated IRS quality measures, which do not reflect actual correspondence timeliness. IRS

[59] The IRS timeframes for additional e-services appear in IRS Pub 3187, The IRS *e-Strategy for Growth: Expanding e-Government for Taxpayers and Their Representatives* (Jan. 2005). However, the IRS's decision to place individual taxpayer services below those provided to tax preparers and other business professionals was again demonstrated in a recent press release. The IRS announced that it would cut the time it takes to respond to mortgage firms with a new Income Verification Express Service (IVES). Using IVES, mortgage lenders will receive an electronic transcript on either personal or business tax returns in two business days. As this service is only available to lenders, taxpayers still must contact IRS customer service representatives by phone. The IRS timeframe provided for mailed transcripts is 7-10 business days. IRS, Internal Revenue Bulletin: 2006-42, Announcement 2006-74, Income Verification Express Service (IVES) Program (Oct. 16, 2006), and IRS, *Ogden Accounts Management, Lessons Online*, TDS CENTRA Conference Call Transcript (undated).

correspondence "overage" measures allow taxpayers to wait for more than 30 days for a correspondence reply, and require only 75 percent adherence to standards.

Not only are costs for nearly three million FY 2005 interim letters to taxpayers significant, but the disparity between the volumes of English- and Spanish-language interim letters demonstrates a serious lapse in the IRS' service to the Spanish-speaking population. Overall, taxpayer satisfaction surveys continue to reflect that "timeliness" is a major source of taxpayer dissatisfaction.

The IRS's technological advances, while demonstrating potential, are not available to all taxpayers. The CIS program is currently limited to individual taxpayer correspondence, and contains guidelines which limit the IRS's ability to provide taxpayers with quality service. IDRS enhancement tools have not been designed specifically to reduce correspondence delays, and the multiple campus based programs lack national oversight. The e-services suite of tools enabling tax professionals and payers to conduct business with the IRS electronically shows promise, but remains three to five years away from its availability to individual taxpayers.

IRS COMMENTS

The IRS recognizes and endorses the National Taxpayer Advocate's desire that all taxpayer correspondence be responded to in a timely manner. We share that goal and are committed daily to delivering timely and quality service to each of our customers regardless of the channels they choose to contact us. We offer the following points in response to issues raised in the National Taxpayer Advocate's description of this problem.

Inventory and Workload Management

Each year the IRS strategically employs its limited resources to address shifts in customer service demands as both the volumes and channels of demand change. The planning and scheduling staff of our JOC work in conjunction with Accounts Management to develop staffing schedules. These schedules establish the staffing needed to handle the anticipated call volumes in the different telephone applications. However, in real time application, these schedules become dynamic and can change as call demand fluctuates. The Accounts Management staff works closely on a daily basis with the JOC to minimize temporary variances in staffing requirements for both telephones and correspondence.

During FY 2005, approximately 15,000 Accounts Management employees answered over 33 million telephone calls. These employees also responded to approximately 10 million pieces of correspondence and other Adjustment receipts. Correspondence represented 44 percent (4.4 million) of the paper workload and amended returns and other account related issues comprised the remainder.

Forty-four percent of the 33 million calls answered in FY 2005 were received during the period of January 1 through April 16. The call volumes received throughout this period

were not received in a consistent equal pattern, but rather in compressed, intermittent time bursts. For example, 6.6 million telephone calls were answered within a six week period. In contrast, as the volume of calls begin to subside, the correspondence and adjustment receipts climb at a rapid, consistent rate. Forty-five percent of all new receipts for correspondence and adjustments in fiscal year 2005 were received during a 90 day period from April 1 through June 25. It is during this same time period that 40 percent of all the interim letters were issued in FY 2005.

Telephone call demand in FY 2005 far exceeded all other channels of assistor services. For example, in FY 2005 the Taxpayer Assistance Centers serviced approximately seven million taxpayers and there were approximately ten million Correspondence/Adjustment receipts in Accounts Management (correspondence, amended returns, and other written account related inquiries). When compared to 33 million telephone calls answered, it becomes apparent that the telephone is the predominant method used by taxpayers to contact the IRS.

In response to customer demand for telephone service, the IRS is committed to providing toll-free callers an 82 percent Level of Service (LOS). In addition to staffing our phone operations to meet this goal, both the IRS and taxpayers benefit from the fact that callers often receive more thorough and expeditious service. In this interactive setting, assistors are able to probe for needed information and in most cases either deliver one-stop service or provide guidance necessary for the taxpayer to resolve their inquiry.

In addition to having a significantly different receipt pattern from telephone contacts, taxpayer correspondence, amended returns, and other account-related written inquiries vary significantly in complexity. As a result, the amount of time needed to resolve a particular case also varies significantly. Interim letters are issued when taxpayer correspondence can not be resolved within 30 days. The interim letters are used both in times of processing delays due to peak volumes, as well as those cases where the complexity or the nature of the case requires additional time to resolve the taxpayer's issue. Of the 2.9 million interim letters issued in FY 2005, it is not possible to distinguish the percentage applicable to peak volume or complexity delays.

Conflict of Measures

There are different measures for correspondence timeliness and telephone timeliness because the nature and customer expectations of these communication channels differ. The different measures do not reflect, as asserted by the National Taxpayer Advocate, any conflict in IRS priorities. Resolving taxpayer correspondence issues often requires a number of steps. For example, resolution of the issue may require multiple coordinated actions, it may be necessary to request additional information, or it may be necessary to secure a copy of a tax return. As a result, the desired response time for taxpayer correspondence is measured in days and the IRS established a goal to resolve all correspondence issues within 30 days. In those cases where the issue can not be resolved within 30 days, Action 61 established guidelines and requirements for the issuance of

interim letters to inform taxpayers of the delay and to provide an expected timeframe for issue resolution.

The automated process of issuing interim letters through the Correspondence Imaging System (CIS) serves to ensure the timeliness measure has been met when an interim letter is necessary. Automated interim letters are also generated through other IRS systems, such as the Automated Underreporter (AUR) System and the Audit Information Management System (AIMS). In numerous Customer Satisfaction Surveys, taxpayer's have repeatedly stated they want to be kept informed on the status of their case. In part, this measure also ensures that timely case actions have been taken while a case is being worked. Each functional area is aware of the importance of this standard and both management and employees maintain listings to control and manage overage case inventories.

Telephone contacts are also measured for timeliness but these measures are based on various elements of the call duration. For example, the Average Speed of Answer (ASA) is a common call center industry metric. ASA is the number of seconds the taxpayer must wait to speak to an assistor. Telephone measures are established to measure and improve performance as well as to set standards and identify anomalies. Accounts Management is committed to delivering a balanced overall program with quality service to both our correspondence and telephone customers. However, it is not reasonable to suggest correspondence and telephone inquiries should be measured by the same time increments. Customer expectations, as well as IRS capabilities, dictate these differences. For example, callers expect the IRS to answer their calls in a matter of minutes but they have no such expectation when it comes to written inquiries.

Campus Reorganization, Specialization and Employee Training Gaps

The National Taxpayer Advocate contends that both the IRS reorganization and the IRS's effort to specialize services to taxpayers have resulted in a reduction in the level of accountability for resolving correspondence delays. In fact, the functional lines of Submission Processing, Compliance, and Accounts Management (previously Customer Service) existed before the reorganization. Under the prior campus organizational alignment, correspondence was routed according to the functional lines that were essentially the same as they are today. As a result, campus organizational changes have not affected the work flow.

The National Taxpayer Advocate states that the alternate skill base for IRS employees in both the Individual Master File and Business Master File campuses is diminishing because IMF training is not provided at BMF campuses and BMF training is not provided at IMF campuses. However, accuracy trends indicate that specialization has improved quality for both telephone and Adjustment account related contacts. It also should be noted that campus employees assigned to work Accounts Management correspondence have historically been trained to work both IMF and BMF accounts.

The National Taxpayer Advocate suggests that the lack of cross training is the cause of delays in working combined IMF/BMF issues. However, a National Quality Review sample of 1,300 calls (1,000 were IMF and 300 were BMF) was reviewed to determine the percentage of callers with both IMF and BMF issues. None were identified. Regardless of the actual volume, callers with both IMF and BMF issues may call either of the IMF or BMF toll-free numbers. The Customer Service Representative (CSR) that answers their call would be able to provide assistance in their trained area and then transfer the caller to the appropriate location where employees with the necessary training and experience are available to address the remaining issue. It is also important to note that as a result of such specialization, business callers have experienced improved service compared to prior years when the work was combined.

Disparity in Service to Spanish-speaking Taxpayers

The IRS provides Spanish toll-free assistance. In addition, each functional area has staffing that is trained and skilled to process Spanish written correspondence so that correspondence received in Spanish is responded to in Spanish. The National Taxpayer Advocate's assessment of this issue is based on an assumption that the volume of Spanish language correspondence is comparable to the number of Spanish language calls. In practice, the IRS actually receives very few pieces of correspondence written in Spanish (less than one percent of all written inquiries).

Technological Impact

The Correspondence Imaging System (CIS), which provides electronic images of taxpayer correspondence, has been tested for our BMF sites and will begin to roll out in January 2007. In addition, while CIS does not allow an individual CSR to take control of a CIS case that is already controlled to another employee, this does not mean that the CSR can not work the taxpayer's issue. The CSR's authority to work the issue is the same regardless of whether or not there is a CIS case/control. An Internal Revenue Manual (IRM) change will be made to clarify this issue.

Accounts Management has developed Integrated Data Retrieval System (IDRS) Accessory Management programming tools; the JEEDA tool for IMF and the Standard Work Flow Tools (SWFT) for BMF. This innovative software retrieves data from up to fifteen different data sources and compiles the data on a single viewing screen. These tools streamline research, provide consistent treatment to taxpayers and increases timeliness. These tools are used by Accounts Management employees in answering both telephone and correspondence inquiries.

Currently only tax preparers have access to e-Services. The e-Services will become available to reporting agents in fiscal year 2007 and current plans call for the IRS to deliver online account and transcript access to taxpayers in 2009. However, several electronic services are currently available to assist individual taxpayers. For instance, the IRS provides electronic services that allow taxpayers to establish an online installment agree-

ment. The Internet application "Where's My Refund" allows customers to check the status of their refund online. Additionally, IRS.gov affords customers the ability to access forms, publications, and a wide variety of information online.

In summary, we agree the IRS should respond to taxpayer's written inquiries in a timely manner. However, just as toll-free customers experience times when peak call volumes limit their ability to reach us by telephone, there are times when responses to correspondence are delayed because of their complexity or overall receipt volumes. We make every effort to plan and schedule our finite Accounts Management staffing to minimize these delays and to provide the best possible services for taxpayers that write or call us for assistance.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate appreciates the services provided by the IRS to respond to a combined 43 million phone calls, letters, and other adjustments receipts. The National Taxpayer Advocate also commends the IRS's attempt to target its finite resources to meet the needs of taxpayers. However, the intention of this Most Serious Problem is to point out the need for increased balance in the services the IRS provides, and for the IRS to resolve taxpayer correspondence delays.

Inventory and Workload Management

The IRS maintains historical records detailing the time periods during which it receives both telephone contacts and paper receipts. Not surprisingly, the IRS response states that in FY 2005, 44 percent of the telephone contacts occurred before the April 16 filing deadline for IMF taxpayers. Equally predictable, as calls decreased after the deadline, taxpayer correspondence – following a historical trend – began to climb. These letters would include taxpayers' responses to IRS math error notices, information omitted from original tax returns, requests for payment arrangements, and similar correspondence. The IRS response states that fully 45 percent of these correspondence and adjustments receipts occurred within a 90-day window from April to June, which was the reason it issued 40 percent of its interim letters during the same period. However, since historical patterns are already known to the IRS, the National Taxpayer Advocate believes that the IRS should redirect its resources to meet the "wave" of taxpayer correspondence that naturally occurs in April of each year.

The National Taxpayer Advocate appreciates the IRS's commitment to offering high levels of telephone service. There is no question that taxpayers and the IRS mutually benefit from the direct one-on-one communication shared through telephone contacts. But what was the IRS' commitment to the approximately ten million "other" taxpayers who sent Correspondence/Adjustments receipts (instead of calling) in FY 2005? The IRS states that written responses can vary significantly in their complexity. However, it is unable to distinguish how many of its 2.9 million correspondence delays resulted from "complex issues," versus how many were caused through "ordinary" delays.

Conflict of Measures

The National Taxpayer Advocate appreciates that the IRS must develop different measures for its correspondence and telephone timeliness based on taxpayer expectations. The measures cited in the Most Serious Problem were used to demonstrate the present imbalance in the IRS toward answering taxpayers' telephone calls at the expense of timely resolving correspondence. However, the National Taxpayer Advocate does not believe automating the "delay notification process" meets the spirit of the customer satisfaction survey responses to "(keep) taxpayers informed on the status of their case." Merely standard form letters, interim responses do not "inform" taxpayers on anything – except how much longer they must continue to wait. While a taxpayer may not expect an IRS answer to his or her correspondence in a matter of minutes, he or she still has expectations that the IRS will respond in a timely manner. Customer satisfaction survey responses confirm this sentiment (*i.e.*, "Length of Time to Resolve Your Issue.") Therefore, while each functional area may be aware of its correspondence inventory responsibilities, if the correspondence measurements used are not weighted as heavily against campuses (as telephone measurements), or are much more easily achieved (than telephone measurements), taxpayer correspondence will remain underserviced.

Campus Reorganization, Specialization and Employee Training Gaps

The National Taxpayer Advocate acknowledges that correspondence routing, according to functional lines, is essentially the same as it was prior to reorganization. However, there were two important changes. First, within campuses, a single point of accountability (Service Center Director) no longer exists to address overall correspondence delays cross-functionally. Using the examples of systems generating automated interim letters provided in the IRS response (*i.e.*, CIS, AUR, and AIMS), the responsibility would fall under two separate campus field directors, working in two separate business operating divisions (*i.e.*, W&I and SB/SE).

Second, despite the accuracy trends for increased quality cited in the IRS response, the IRS does not adequately provide employees with the technical knowledge needed to resolve complex IMF-BMF issues, thus creating a source of correspondence delays. The IRS response cites a sample of 1,300 calls reviewed for IMF-BMF issues, and states that "None were identified."[60] Yet, the IRS tracks the volume of phone calls its CSRs transfer from an IMF line to a BMF line and vice-versa, so repetition and delays do occur. The IRS response states that campus employees in Accounts Management have historically been cross-trained to work both IMF and BMF accounts. But since Accounts Management's CSRs work the bulk of its correspondence inventory, and are transferring callers to specialized employees, cross-training is no longer the current practice. As the IRS experiences attrition in this area, there will be no employees with past cross-training to even properly recognize issues.

[60] The IRS response did not provide information to verify the appropriateness of the sample methodology.

Disparity in Service to Spanish Speaking Taxpayers

The IRS response implies that no disparity exists in the services provided to its Spanish speaking taxpayers (versus English speakers), as less than one percent of its correspondence is received in Spanish. However, it would not be unreasonable to assume that the IRS's vast majority of outgoing, English correspondence primarily generates English responses. The IRS sample is not necessarily reflective of those who wished to correspond with the IRS in Spanish, but could not. The IRS does not allow an option for Spanish speakers to select "Spanish," as a communication preference (*e.g.*, a checkbox on tax returns). Moreover, the IRS's Spanish-language interim response ratio (.01 percent for FY 2005) denotes a response-rate that is still up to 99 times lower than expected.[61] The National Taxpayer Advocate's position is based not only on IRS data, but also on current data from the U.S. Census Bureau which shows 32 million people speak Spanish at home.[62] Therefore, the IRS's own correspondence data, as well as the Census Bureau's figures confirm the disparity exists.

Technological Impact

The National Taxpayer Advocate is pleased that the IRS will clarify its Internal Revenue Manual regarding CIS casework, and CIS will now be available for BMF sites in 2007. However, the National Taxpayer Advocate is still concerned that this new technology is not being used to its fullest extent. For example, assume a CIS case is assigned to a CSR at the Fresno Campus. High call volumes on the toll-free line prevent the Fresno CSR from working his or her CIS inventory in a timely manner. The taxpayer subsequently grows concerned over the correspondence delay, calls the toll-free line, and reaches a CSR in Atlanta. This CSR cannot fully resolve the taxpayer's issue, even though he has full access to the taxpayer's original correspondence through CIS, because the CIS case has already been controlled (assigned). At best, the Atlanta CSR may only resolve the minor issues covered under "oral statement authority" guidelines.[63] The CSR then refers the case to TAS for resolution.

Current IRM rules regarding control bases were originally written prior to the adoption of CIS. Previously, CSRs would have no knowledge of the specific content of a taxpayer's correspondence, unless the "paper" document was physically in his or her

[61] To validate that Spanish-speakers received services equal to English-speakers, the Spanish interim response rate should mirror the volume of Spanish correspondence received. For example, if 50 percent of the IRS's correspondence were received in Spanish, then it would be expected that approximately 50 percent of the IRS's interim letters should also be generated in Spanish (50 percent Spanish correspondence / 50 percent Spanish interims = 1, or a 1:1 ratio of service. The IRS response states that Spanish-language correspondence accounts for "less than one percent." However, the percentage of Spanish-language interims issued in FY 2005 was only .01 percent. Therefore, if the IRS's actual Spanish-language correspondence is .99 percent, then the interim response-rate is 99-times lower than expected (.99 percent Spanish correspondence / .01 percent Spanish interims = 99, or a 99:1 ratio of underservice).

[62] U.S. Census Bureau, 2005 American Community Survey, Table R1602, Percent of People 5 Years and Over Who Speak Spanish at Home; and, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

[63] IRM 21.1.3.20, Oral Statement Authority, (Oct. 1, 2006).

possession. Therefore, if another CSR wished to make an account adjustment, he or she would first be required to contact the original CSR maintaining physical possession of the original correspondence. The second CSR would then ask for verification of the correspondence content and permission to take over the first CSR's control, prior to performing an account adjustment. However, with the inception of CIS, CSRs now have nationwide access to any taxpayer correspondence scanned into CIS. In addition, Desktop Integration (DI), the tool used by CSRs to input detailed case histories and account actions, is also available nationwide. The IRM should be revised to take full advantage of these expanded technologies to benefit taxpayers.

The IRS's e-services suite displays the most potential for providing taxpayers with direct access to current IRS information and eliminating many correspondence delays. However, due to budgetary constraints, taxpayers will wait at least two more years for even the most basic online transcript access of the sort that most financial institutions have possessed for years. The National Taxpayer Advocate believes Congress should earmark additional funding for this program, to enable the IRS to provide e-services access to all taxpayers as soon as possible.

In conclusion, the National Taxpayer Advocate recognizes that the IRS may well need additional staffing for which they are not currently funded. Additional IRS staffing assigned to resolve taxpayer correspondence (and answer telephone calls) may have a significant impact on resolving correspondence delays – particularly during the filing season. The IRS should develop a hiring initiative that addresses its correspondence delay problem, and Congress should increase taxpayer service budgets accordingly.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS implement the following changes to alleviate the numerous correspondence delays experienced by taxpayers. First, the IRS should incorporate the following corrections to its system of measuring "timeliness":

- Solicit input from taxpayers regarding "acceptable" correspondence processing timeframes, and balance those desires along with reasonable staffing; and
- Develop a system to recognize and accelerate the treatment of correspondence that has received prior interim contacts.

Then, the IRS should re-think its previous specialization effort, and consider the following actions:

- Increase the balance within the specialization processes. Re-organizational fallout has created measures without clear accountability for "timeliness" in its responses to the taxpayers. Campuses must align goals and measures, and establish processes – including a single point of accountability – to address barriers created

by specialization (*e.g.*, transshipment, subject-matter-experts, unrelated business measures).

Next, the IRS should balance the utilization of resources allocated to its toll-free lines and correspondence inventory:

- Avoid utilizing the same personnel to answer the bulk of both taxpayer correspondence and toll-free telephone calls, especially during the peak of tax filing season;
- Eliminate policies designed to automatically generate form letters (interims) to taxpayers. For planning purposes, the IRS should get behind the problem by coding and tracking the reasons for interim letters. Then, initiate solutions that benefit both the IRS and the taxpayer. Where interim responses are necessary due to complexity, IRS responses should be substantive;
- Redirect the dollars currently spent on postage and work toward hiring additional employees to perform its correspondence and telephone casework; and
- Develop a new hiring initiative that specifically addresses the need to provide taxpayers with timely correspondence resolution, which becomes particularly acute during filing season, for congressional funding consideration.

The IRS should rewrite its current correspondence policy statement:

- Develop proper measures for timeliness, based on taxpayer expectations. Create ongoing advisory teams consisting of front-line workers and management, who are the most familiar with current, procedural issues and taxpayers' common correspondence complaints, to identify emerging issues and technology, and problem resolution.

The IRS should make the following corrections in its handing of its Spanish language correspondence:

- Acknowledge the evolving demographics of the nation's taxpayer population, and enhance efforts to communicate with Spanish speaking taxpayers in their primary language;
- Record taxpayer requests for all future communications to be issued in Spanish by providing a checkbox option on each of its notices, letters, and forms to use as indicators; and
- Determine proper staffing levels for Spanish speaking assistors and hire to the appropriate level.

Regarding the coordination of its own internal systems, the IRS should:

- Maintain a proactive focus on increasing taxpayer-satisfaction. Adopt a nationally-coordinated IDRS tool development process (for SWFT, JEEDA, and IDAP) to support further developments, while still encouraging "homegrown" solutions.

The development of an IDRS tool designed specifically to reduce correspondence delays should be made a priority.

- Ensure that the e-services suite of products will be made available to taxpayers as soon as possible. As these products allow a taxpayer to access his or her own account instantly, in many instances, the taxpayer's need to correspond with the IRS at all will be eliminated.

Finally,

- Congress should provide sufficient funding to the IRS to enable it to provide world-class taxpayer services to its taxpayers.

PROBLEM

TOPIC #14 DISASTER RESPONSE AND RECOVERY

RESPONSIBLE OFFICIALS

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Richard J. Morgante, Commissioner, Wage and Investment Division

Steven T. Miller, Commissioner, Tax-Exempt and Government Entities Division

Deborah M. Nolan, Commissioner, Large and Mid-Sized Business Division

Carl Froehlich, Chief, Agency Wide Shared Services

DEFINITION OF PROBLEM

Each year, many thousands of people have their lives unexpectedly altered by disasters. Disasters do not discriminate; they hurt the rich and the poor, the old and the young, men and women. Disasters affect all geographic regions of the country. A disaster may strike as a hurricane, tornado, fire, flood or winter storm. It may be a terrorist attack or pandemic. The only thing we know with certainty about disasters is that they will occur in some form or fashion.

Over the years, the IRS has successfully responded to many disasters. For example, the IRS provided and staffed toll-free FEMA phone assistance lines for Hurricane Katrina victims and answered approximately 950,000 calls.[1] The IRS also implemented numerous tax law changes to help the victims in disaster areas and to encourage individuals donating to charities to support the victims.

Notwithstanding its successes, the IRS has room for improvement in planning for disaster relief. The IRS has yet to establish comprehensive short-term and long-term strategies to assist victims of Presidentially declared disasters. This failure to incorporate the lessons of the past into a fluid planning and response process may harm the victims of the next disaster. The IRS must take steps to correct these problems before future disasters strike.

[1] *See Hearing On 2006 Tax Return Filing Season and the IRS Budget For Fiscal Year 2007, Subcomm. on Oversight, House Comm.* On Ways and Means, 109th Cong. 2nd Sess (Apr. 6, 2006) (Statement of Mark Everson, Commissioner, Internal Revenue. *See also* IRS Oversight Board, IRS Oversight Board Commends IRS's Katrina Response and Progress on Modernization: Points to Importance of Critical Infrastructure (Oct. 6, 2005), available at http://www.ustreas.gov/irsob/releases/2005/0905.pdf. IRS Oversight Board Chairman Raymond Wagner, Jr., said, "The IRS is to be applauded for getting out of the blocks quickly and getting ahead of the problem."

ANALYSIS OF PROBLEM

Background

From 2001 through 2005, the United States has averaged 53 Presidentially declared disasters each year.[2] Seven of the ten most costly disasters in U.S. history occurred during that same five-year period.[3]

The Insurance Information Institute classified half (24) of the 48 Presidentially declared disasters in 2005 as catastrophes.[4] The Federal Emergency Management Agency (FEMA) offered assistance to individuals in 14 of these disasters.[5] In contrast, the IRS provided automatic relief in only three of them.[6]

TABLE 1.14.1, THE TEN MOST COSTLY CATASTROPHES IN THE UNITED STATES[7]

Rank	Date	Event	Insured loss ($ millions)	
			Dollar when Occurred	In 2005 dollars (2)
1	Aug. 2005	Hurricane Katrina	40,600	40,600
2	Aug. 1992	Hurricane Andrew	15,500	21,576
3	Sep. 2001	World Trade Center, Pentagon terrorist attacks	18,800	20,732
4	Jan. 1994	Northridge, CA earthquake	12,500	16,473
5	Oct. 2005	Hurricane Wilma	8,400	8,400
6	Aug. 2004	Hurricane Charley	7,475	7,728
7	Sep. 2004	Hurricane Ivan	7,110	7,351
8	Sep. 1989	Hurricane Hugo	4,195	6,607
9	Sep. 2005	Hurricane Rita	5,000	5,000
10	Sep. 2004	Hurricane Frances	4,595	4,751

(1) Property coverage only.

(2) Adjusted to 2005 dollars by the Insurance Information Institute.

After surviving a disaster, victims start to try to put their lives back together. This process calls for the victims to determine the financial impact of the disaster, including its tax implications.

[2] Federal Emergency Management Agency (FEMA), *Declared Disasters by Year or State.* According to FEMA, there were 48 declared disasters in 2005, 68 in 2004, 56 in 2003, 49 in 2002, and 45 in 2001; *See* http://www.fema.gov/news/disaster_totals_annual.fema (Sept 2006).

[3] Insurance Information Institute, *The Ten Most Costly World Insurance Losses, 1970 – 2005*, available at http://www.iii.org/media/facts/statsbyissue/catastrophes/content.print/.

[4] The Insurance Information Institute classifies as a catastrophe any disaster or terrorist event with insured losses greater than $25 million. *See* http://www.iii.org/media/facts/statsbyissue/catastrophes/content.print/ (Sept. 2006).

[5] If FEMA designates a disaster as eligible for Individual Assistance, victims may receive financial assistance for housing expenses under its Individuals and Households Program. *See* http://www.fema.gov/media/fact_sheets/individual-assistance.shtm (Sept. 2006).

[6] In 2005, the IRS designated victims of Hurricanes Dennis, Katrina and Rita, for automatic relief.

[7] Insurance Information Institute, *The Ten Most Costly World Insurance Losses, 1970 – 2005*, available at http://www.iii.org/media/facts/statsbyissue/catastrophes/content.print/.

The tax law governing disaster relief is complex and burdensome. When dealing with the aftermath of a disaster, taxpayers must navigate a maze of statutes, regulations, and recordkeeping tasks to learn about and satisfy tax filing requirements. These include:

- How to determine and claim a casualty loss;
- Whether payments received related to the disaster are taxable; and
- What relief, if any, is available from the IRS.

In 2005, Congress simplified the disaster relief process by expanding Internal Revenue Code (IRC) § 139 to exclude from income mitigation payments received from government entities by disaster victims.[8] Still, disaster victims must make critical tax decisions while dealing with trauma and other emotional distress and trying to meet basic needs, at a time when they lack access to records and expert assistance.

Overview of the Federal Disaster Response Process

In 1988, Congress enacted the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the "Stafford Act") to support state and local governments and their citizens when disasters overwhelm them.[9] This law, as amended, establishes a process for requesting and obtaining a Presidential disaster declaration, defines the type and scope of assistance available from the federal government, and sets the conditions for obtaining that assistance.[10] FEMA, now part of the Emergency Preparedness and Response Directorate (EPR) of the Department of Homeland Security, is tasked with coordinating the response. Section 401 of the Stafford Act requires that "all requests for a declaration by the President that a major disaster exists shall be made by the Governor of the affected State."[11]

The government does not, however, activate all of its programs for every disaster. The determination of which programs to activate is based on damage assessments and any

8 H.R. 1134, 109th Cong. (2005), amended IRC § 139 by adding subsection (g) Qualified Disaster Mitigation Payments:
(1) IN GENERAL. Gross income shall not include any amount received as a qualified disaster mitigation payment.
(2) QUALIFIED DISASTER MITIGATION PAYMENT DEFINED. For purposes of this section, the term 'qualified disaster mitigation payment' means any amount which is paid pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act (as in effect on the date of the enactment of this subsection) or the National Flood Insurance Act (as in effect on such date) to or for the benefit of the owner of any property for hazard mitigation with respect to such property. Such term shall not include any amount received for the sale or disposition of any property.
(3) NO INCREASE IN BASIS. Notwithstanding any other provision of this subtitle, no increase in the basis or adjusted basis of any property shall result from any amount excluded under this subsection with respect to such property.

9 42 U.S.C. §§ 5121-5206.

10 42 U.S.C. § 5170.

11 FEMA, *Guide to the Disaster Declaration Process*. A "state" also includes the District of Columbia, Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. The Marshall Islands and the Federated States of Micronesia are also eligible to request a declaration and receive assistance. Available at: http://www.fema.gov/pdf/rebuild/recover/dec_proc.pd.

information subsequently discovered. FEMA/EPR disaster assistance falls into three general categories:

- Individual Assistance – aid to individuals and households;
- Public Assistance – aid to governments (and certain private non-profit) entities for certain emergency services and the repair or replacement of disaster damaged public facilities; and
- Hazard Mitigation Assistance – funding for measures designed to reduce future losses to public and private property.

Some declarations provide only public assistance or only individual assistance while others provide both. Hazard mitigation opportunities are assessed in most situations.[12]

Internal Revenue Code and Other IRS-Provided Relief

Just as relief under the Stafford Act varies by disaster, so does the relief the IRS provides. The IRS has the authority to activate relief provisions that grant extensions for filing and paying taxes, remove penalties, and abate interest for affected disaster victims.[13] The IRS may grant this relief without a Presidential declaration or FEMA determination.

The Code permits the IRS to grant additional relief if the President declares an area a disaster. The additional disaster relief authorized by statute includes the authority by the Secretary to:

- Postpone deadlines by reason of Presidentially declared disaster or terrorist or military actions;[14]
- Grant a reasonable extension of time for filing returns;[15]
- Extend the time for payment of tax;[16]
- Provide relief from penalties due to "reasonable cause";[17] and
- Provide special rules for property damaged by presidentially declared disasters and provide key definitions of terms.[18]

12 FEMA, *The Disaster Process and Disaster Aid Program*, available at http://www.fema.gov/hazard/dproc.shtm (Sept. 2006).

13 IRM 1.2.52.5 (11-18-2002) *Granting Relief to Taxpayers Affected by Disasters or Terrorist or Military Actions*, Delegation Order 25-11 (formerly DO-268).

14 IRC § 7508A.

15 IRC § 6081.

16 IRC § 6161.

17 IRC § 6656.

18 IRC §1033(h).

The IRS's Initial Decision Making and Response Options

After a disaster, the IRS State Disaster Assistance Coordinator is required to complete a State Disaster Assistance Coordinator Assessment and Recommendations Checklist and send it to the National Disaster Assistance Coordinator within 72 hours of the disaster. The checklist asks for the state coordinator's recommendations on specific relief, duration of tax relief, whether to suspend enforcement contacts and for how long.[19] However, the IRS provides no guidelines or criteria for the state coordinator to use when making these recommendations. Further, the coordinator may not be in the disaster area and is not required to make an on-site assessment. Without such an assessment, the state coordinator's recommendations on relief lack a crucial perspective.

After the President declares a disaster area and FEMA offers individual assistance, the IRS issues a "Disaster Relief Memorandum" and an accompanying press release. However, the IRS may invoke relief provisions without a determination by FEMA or even a declaration by the President. The IRS has not established criteria for deciding which available relief provisions should apply for a particular disaster. We found the IRS extended relief beyond the Presidentially declared individual assistance areas (*e.g.*, zip codes) only once in the past three years – for Hurricane Katrina.[20]

When the President declares a disaster area and FEMA decides to offer individual assistance, the IRS may offer services in addition to statutory relief. Some of these services are:

- *Press Releases.* The IRS may issue press releases identifying the disaster area and offering guidance about how to get relief. The IRS also provides information on its website (http://www.irs.gov).
- *Outreach and Education.* The IRS sends staff to FEMA recovery sites as part of the federal government's interagency task force assistance plan. The IRS Stakeholder Liaison Area Manager is responsible for the IRS operation.

Besides outreach and education, the IRS offers services to disaster victims at FEMA sites, IRS Taxpayer Assistance Centers (TACs), and by telephone. These services include:

- *Copies of Transcripts.* The IRS works with the Small Business Administration (SBA) at FEMA sites to provide account transcripts to taxpayers seeking SBA loans.
- *Tax Return Copy Requests.* The IRS may waive fees for disaster victims requesting copies of their prior tax returns.
- *Disaster Kits.* These kits contain information and forms to help taxpayers determine and file casualty loss claims.

[19] IRM 25.16.3 Exhibit 2 (Jun. 1, 2003).

[20] IRS Disaster Relief Declarations and IRS Disaster Assistance Program. *See* http://www.irs.gov/newsroom/article/0,,id=98936,00.html.

- *Return Preparation.* The 2006 Field Assistance Program Letter removed many earlier income-based restrictions on return preparation and other help by TACs, and extended these services to the hurricane victims of the Gulf Coast for 2006. The IRS later made these changes permanent and applicable to future disaster victims.

- *Delinquent Return Preparation.* To qualify for some federal benefits, taxpayers must provide their last two or three years of income tax filings. Taxpayers who have not filed these returns may need help preparing past year returns to qualify for SBA loans and other benefits.[21] The IRS generally offers limited delinquent return preparation at TAC offices. Since Katrina, the IRS has permanently changed its procedure and now exempts taxpayers impacted by a declared disaster from income limitation restrictions for preparing delinquent returns.[22]

- *Stakeholder Partnerships.* The IRS may set up stakeholder partnerships with professional organizations, such as practitioner and industry groups, to provide help that is beyond IRS capacities. An example is the partnership with the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, several Low Income Taxpayer Clinics, and other organizations to assist victims of Hurricanes Rita, Katrina, and Wilma.

ANALYSIS

The IRS's Initial Disaster Response

The IRS has not set criteria for classifying disasters or established a response plan based on the disaster's size or characteristics. In our analysis of how the IRS reacted to disasters, we classified the IRS response into four categories: Traumatic National Event, Major Catastrophic Disaster, Major Disaster, and Presidentially Declared Disaster Without Individual Relief Offered by FEMA. The following is a brief discussion of each:

1) *Traumatic National Event.* The IRS convenes its Disaster Relief Council (DRC)[23] in case of a traumatic national event.[24] The DRC has convened only twice, once after the September 11 attacks and again after Hurricane Katrina. The group reacts to disasters by deciding issues as events occur. The IRS has no established criteria to trigger action by this high-level group, nor does it commit the lessons learned and experience gained to its institutional memory to plan for future events.

[21] Small Business Administration, *Home and Personal Property Disaster Loans*, available at http://www.sba.gov/disaster_recov/loaninfo/property.html.

[22] IRM 21.3.4.10.10.1

[23] Also referred to as Disaster Tax Administration Policy Group (DTAPG).

[24] IRM 25.16.3.1, Disaster Assistance and Emergency Relief - National Disaster Assistance Coordinator (NDAC) (Jun. 1, 2003).

2) *Major Catastrophic Disaster.* A Major Catastrophic Disaster is one in which FEMA has offered individual assistance and the IRS has automatically suspended enforcement and other activities (known internally as O Freeze or Disaster Freeze). These disasters have no DRC involvement. The National Disaster Coordinator is in charge of the agency's response. For 2003, the IRS used the automatic relief mechanism for two events that affected three states.[25] In 2004 and 2005, the IRS used the automatic relief mechanism in three disasters involving six states.[26]

3) *Major Disaster.* A Major Disaster is one in which FEMA has offered individual assistance but the IRS does not automatically suspend tax filing, payment, and enforcement activities for the affected area. In this type of disaster, the affected taxpayers must "self-identify" to the IRS. Thirty-nine disasters fit this class in 2003, 41 in 2004, and 14 in 2005.[27]

4) *Presidentially Declared Disaster Without Individual Relief Offered by FEMA.* The IRS offers no special relief for victims of this group of disasters. The IRS could invoke relief for affected taxpayers, but in practice, the IRS has rarely offered any relief provisions.[28]

TABLE 1.14.2, DISASTER DECLARATIONS, CALENDAR YEAR 2005[29]

Event Type	FEMA Determined Qualified For Individual Assistance		
	Yes	No	Grand Total
Hurricanes	8	3	11
Severe Storm		1	1
Storm/Flood/Mud -Landslide	5	19	24
Tornado	3		3
Tropical Cyclone	1		1
Tropical Storm		1	1
Winter Storm/Flood	2	5	7
Grand Total	**19**	**29**	**48**

Note: Systemic -O Freeze authorized seven times from three events Hurricanes Katrina, Wilma and Rita.

[25] IRS News Releases IR-2003-112 (Sept. 24, 2003) and IR-2003-126 (Oct. 28, 2003). In 2003, the IRS provided automatic relief to victims of Hurricane Isabel (NC and VA) and the California Wildfires. *See* http://www.irs.gov/newsroom/article/0,,id=98936,00.html.

[26] IRS News Releases IR-2004-108 (Aug. 16, 2004), IR-204-115 (Sept. 10, 2004), IR-2004-118 (Sept. 22, 2004), IR-2005-016 (Jul. 15, 2005), IR-2005-084 (Aug. 30, 2005), and IR-2005-110 (Sept. 26, 2005). In 2004, the IRS provided automatic relief to victims of Hurricane Ivan (AL, FL, LA, and MS), Hurricane Francis (FL), and Hurricane Charley (FL). In 2005, the IRS provided automatic relief to victims of Hurricane Katrina (AL, LA, and MS), Hurricane Rita (LA and TX), and Hurricane Dennis (FL). *See* http://www.irs.gov/newsroom/article/0,,id=98936,00.html.

[27] IRS Disaster Relief Declarations. *See* http://www.irs.gov/newsroom/article/0,,id=98936,00.html.

[28] *See* IRC §§ 6081 and 6161. The IRS may provide relief to taxpayers affected by natural disasters by extending the deadline to file certain tax returns and pay certain taxes.

[29] FEMA, *2005 Federal Disaster Declarations*, available at http://www.fema.gov/news/disasters.fema?year=2005.

The IRS's method of reacting to disasters as they happen is not the most effective strategy. To improve its response to these events, the IRS needs a dedicated cross-organizational group that reviews lessons learned, modifies guidance, and develops and conducts training internally and with stakeholders. Such a group should include representatives from all IRS business units, including TAS and should function as a standing, ongoing task force. This group's primary responsibility would be to work with FEMA and the Department of Homeland Security to identify the types of potential disasters, and develop models and plans to respond quickly and effectively in the event of a major disaster or terrorist attack.

IRS State Disaster Coordinators

In all but the most serious disasters, the IRS's State Disaster Coordinators provide recommendations to the National Disaster Coordinator about what relief the IRS will offer, if any. We are concerned about the lack of guidance given to the state coordinators before they conduct the assessments. There are no specific disaster assessment criteria, nor even a requirement that the coordinator visit the disaster area. The ability to assess a disaster and the resources available to the state coordinators to respond vary from location to location.

The IRS has not established specific expectations for its operating divisions and functions to provide staff and other support to the State Disaster Coordinator. Again, this lack of clear direction may lead to inconsistent responses. The Stakeholder Liaison Area Manager coordinates IRS staffing at FEMA sites from a cadre of trained volunteers and others, but available cadres differ from site to site, and volunteers may themselves be disaster victims, leaving the manager short-staffed. The IRS has no templates for staffing at FEMA sites or setting up and training cadre volunteers. We believe the IRS should form a Standing Committee on Disasters (SCOD) to plan, coordinate, and implement all facets of disaster planning and relief.

The Automatic Disaster Relief Decision (O Freeze)

The disaster relief freeze condition (the "O Freeze") suspends all action on a taxpayer's account for the relief period. The freeze may be set automatically by IRS computers by using affected zip codes or input manually by employees on a case-by-case basis (when taxpayers identify themselves as disaster victims). However, because the IRS does not provide criteria for applying the automatic disaster relief freeze, similarly situated taxpayers may be treated inconsistently. In 2005, only areas affected by Hurricanes Katrina, Rita, and Dennis received automatic relief treatment, and even then it did not cover all the counties in the Presidentially declared areas.[30]

[30] IRS, *Disaster Declaration #1606*, available at *Around the Nation* http://www.irs.gov/newsroom/article/0,,id=98936,00.html.

In zip codes for victims of Hurricanes Katrina and Rita, the IRS decided to systemically place disaster freezes on the accounts of affected taxpayers.[31] Taxpayers not in an automatically frozen area may identify themselves as victims in several ways (e.g., by calling the IRS, or writing the disaster identification on their tax returns). According to the Treasury Inspector General for Tax Administration (TIGTA), the systemically generated indicators were 99.9 percent accurate and effective.[32] On the other hand, TIGTA found that when disaster relief indicators were input manually for taxpayers who self-identified, the IRS had a 68 percent error rate.[33] These errors can cause taxpayers to receive incorrect bills for interest and penalties even when the taxpayers were covered by a granted relief provision. Even when on accounts with properly placed disaster relief indicators, problems can occur when there is no pre-planning or execution. For example, disaster freezes started expiring for many Hurricane Katrina affected taxpayers on approximately October 9, 2006. The IRS failed to anticipate that the freeze release would trigger the automatic issuance of nearly 25,000 Federal Payment Levy Program (FPLP) levies. Had the IRS run through a scenario, set up a comprehensive plan, or learned from previous disasters, it could have expected these levies and dealt with them.[34]

In examining the IRS's procedures, we found disparate treatment of taxpayers who self-identified by making a notation on their tax return. The IRS processing centers only restricted penalty assessments for these taxpayers.[35] Taxpayers in identical circumstances who self-identified by telephone or whose accounts were identified systemically by the IRS received better treatment than those who self-identified by notating their tax return. For these taxpayers, the IRS restricted penalty assessments, restricted interest assessments, and suspended collection and examination activity during the relief period.[36]

The IRS's problems with properly identifying and providing relief for disaster victims who self-identify are not new. In April 2000, the Local Taxpayer Advocate (LTA) in Dallas, Texas, identified the same issues after a tornado in Fort Worth.[37] In the six intervening years, the IRS has not been able to resolve these problems.

[31] IRS, *Disaster Declaration #1610* –Zip Codes, available at http://www.irs.gov/newsroom/article/0,,id=98936,00.html. Not all of Hurricane Rita's Presidentially declared disaster counties were included in the IRS's systemic disaster relief. The most notable exception was Harris County, TX (which includes Houston).

[32] Treasury Inspector General For Tax Administration, Ref. No. 2006-40-109, *Taxpayers Residing in the Hurricanes Katrina and Rita Disaster Areas Were Accurately Identified for Tax Relief* (Jul. 31, 2006).

[33] *Id.*

[34] Email from Director Stakeholder Liaison, Small Business/Self Employed, October 20, 2006. The IRS says only 30 of the 25,000 attached, but the fact so few attached is simply lucky.

[35] IRM 3.11.3.7.1.7 *Natural Disaster Emergency Relief Program* (Jan. 1, 2006).

[36] IRC § 7508A and *Disaster Assistance for the State of Louisiana (FEMA 1603-DR)* August 30, 2005, *See* http://www.irs.gov/newsroom/article/0,,id=98936,00.html.

[37] TAS, Systemic Advocacy Management System - Project P0000437, *Disaster Relief Processing Errors.*

A newspaper article recently reported that the IRS was not properly processing requests for relief by self-identified disaster victims in Missouri and again in Montana.[38] TIGTA has reported that even when taxpayers properly self-identified themselves to the IRS, the IRS did not accurately identify these taxpayers affected by Hurricanes Katrina and Rita to grant them the extended relief period.[39]

Tax Law Complexity (Post Disaster Filing)

Although many types of relief provided by governments, charities, and individuals are not taxable, disaster victims may still have many complex tax issues. Much of this complexity involves the receipt of insurance proceeds that are greater than the taxpayer's "adjusted basis" in the destroyed or damaged property.[40] In the days and weeks following a disaster, victims must assemble, locate, or newly obtain documents such as birth certificates, drivers' licenses, Social Security cards, property records, and insurance policies in order to file insurance claims and apply for aid.

An analysis of all possible tax consequences of a disaster is beyond the scope of this discussion.[41] Disaster victims may receive various types of payments from governments, charities, individuals, insurance companies and so on. The victim will have to determine whether the payments received are taxable. Taxpayers who suffer damage to their homes or personal property are required to complete a complex analysis of their records, including reconstruction of lost or damaged records. They must determine their basis in the property and compare that to the property's fair market value and replacement cost to determine whether they have a loss or a gain. Once taxpayers calculate gains and losses, they face many complicated tax decisions, which are contingent on other choices the taxpayers make about replacing or repairing their property. Taxpayers reimbursed by insurance for more than the cost of their property may find they have a potentially taxable capital gain. Their gains may be taxable now, they may be deferred, or they may be fully free from tax. The disaster victim is faced with daunting choices that may be costly if made incorrectly. Other disaster victims will incur casualty losses. Taxpayers in a Presidentially declared disaster area have the option of claiming their loss on the preceding tax year or the current year. Normally, these losses are reduced by ten percent of

[38] Kevin Coleman, *IRS Relief a Disaster for Some*, Columbia Daily Tribune June 1, 2006. *See also* TAS, Systemic Advocacy Management System - Project P0025302, *Penalty and Interest Assessed on Returns with Disaster Designations.*

[39] Treasury Inspector General For Tax Administration, Ref. No. 2006-40-109, *Taxpayers Residing in the Hurricanes Katrina and Rita Disaster Areas Were Accurately Identified for Tax Relief* 4 (Jul. 31, 2006).

[40] *See* IRC § 1033. Basis is generally the amount of a taxpayer's investment in a property. For tax purposes, the taxpayer uses his or her basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale or exchange of the property. The basis of property is usually its cost.

[41] *See* Francine J. Lipman, *Anatomy of a Disaster Under the Internal Revenue Code*, Florida Tax Review 2005, Volume 6, Number 10. This article provides a comprehensive analysis of the application of the Internal revenue Code to a hypothetical taxpayer who was a victim of a disaster.

the taxpayer's adjusted gross income plus $100.00.[42] Again, disaster victims must make decisions that may be costly if they are poorly informed.

Post Disaster Execution of Relief Provisions and Processing of Disaster Claims

Immediately after a disaster, the IRS's response focuses on information distribution at FEMA Recovery Centers and similar sites. At this beginning stage of recovery, most taxpayers are not yet able to focus on their tax matters. Later in the recovery cycle, after obtaining necessities, determining losses, receiving reimbursements, and securing loans, taxpayers start dealing with their taxes and the IRS. Unfortunately, at this point, the IRS's once abundant assistance and presence may have disappeared from the disaster area. Taxpayers needing help must now contact the IRS by telephone or go to a Taxpayer Assistance Center. The loss of IRS support, which was so visible and available at FEMA sites immediately following a disaster, often triggers taxpayer confusion and unnecessary delays.

Taxpayers trying to comply with their obligations but who need help often contact TAS for assistance. The Taxpayer Advocate Management Information System (TAMIS) database shows that TAS has received taxpayer cases involving many disaster related issues. These cases include the following:

- Replacing lost records;
- Help in preparing and filing disaster loss tax claims;
- Resolving delays in processing claims including related examinations;
- Correcting problems with payments returned from electronic transfer programs; and
- The proper processing of Form 8914, *Exemption Amount for Taxpayers Housing Individuals Displaced by Hurricane Katrina.*

Three of the high volume issues involved lost records, examining claims and installment agreements.

Lost Records

After Hurricane Katrina, the IRS released guidance on lost or destroyed documents that might not be immediately replaced. This release included guidelines for an oral disclosure authentication process for taxpayers who were left without government identification, so they could obtain their tax records.[43] Additional guidance covered taxpayers who were unable to get Social Security numbers for their children before the 2005 filing deadlines. Although the IRS promptly addressed these situations, it could have anticipated them and had procedures in place. The initial lack of guidance caused

[42] IRC §§ 165(h)(1) & (2).

[43] IRS, Disaster Assistance Self-Study - Record Reconstruction, *available at* http://www.irs.gov/businesses/small/article/0,,id=147164,00.html (Sept. 2006).

taxpayer and preparer delays and confusion about how to file their tax returns. Standing procedures, incorporated into the Internal Revenue Manual (IRM), will result in better informed IRS employees and stakeholders, and will allow for training of IRS employees and stakeholders outside the "crunch" time of the actual disaster.

Examination Criteria

When taxpayers file returns claiming disaster losses, the IRS may select the claims for examination before processing the returns and paying refunds. TAS becomes involved because of delays in examining disaster claims. The IRS has been slow to adjust its criteria for returns it wants to audit to reflect the total uninsured losses on the Gulf Coast.

In examinations where the claimed disaster loss exceeds a certain threshold, the IRM requires "expert analysis."[44] This requirement involves obtaining an IRS engineering report to verify the value of the damaged or destroyed property. The process is time-consuming and of questionable benefit in an area damaged as severely as the region struck by Hurricane Katrina. TAS has worked with the Examination function to ease this requirement and raise the threshold.

Direct Deposit Installment Agreements (DDIA)

A taxpayer in a disaster area who is paying a tax liability through an installment agreement with the IRS may stop making payments during the relief period. However, if the taxpayer has set up a Direct Debit Installment Agreement (which automatically takes the payment from his bank account) he or she must call and ask the IRS to stop the DDIA. TAS has worked cases that involve delays in obtaining these releases, which may result in the IRS taking additional payments from the taxpayer's bank account and applying them to the IRS balance.

CONCLUSION

Disasters are an unfortunate but inescapable part of life, striking almost every state and yielding an average of more than 50 Presidential declarations annually in recent years.[45] FEMA data shows over 2.5 million people in every state and Puerto Rico registered with FEMA for Individual Assistance relief from Hurricanes Katrina and Rita.[46]

The IRS responded to Katrina, Rita and Wilma by giving out over 400,000 *Disaster Kits*, providing over 150,000 account transcripts and preparing 934 tax returns in TAC offices.[47] After Katrina, the IRS convened a Disaster Relief Council of high-level executives, charged with making policy and resource decisions. The IRS deserves the praise it

[44] IRM 4.8.8.10.1, Technical Support (Exam) - Miscellaneous Responsibilities (Oct. 2003).

[45] FEMA, *Declared Disasters by State*, available at http://www.fema.gov/news/disaster_totals_annual.fema.

[46] FEMA, *Hurricane Katrina and Hurricane Rita*, available at http://www.fema.gov/hazard/hurricane/2005katrina/index.shtm, and http://www.fema.gov/news/newsrelease.fema?id=29987, and http://www.fema.gov/news/newsrelease.fema?id=30941.

[47] SB/SE Response to TAS Information Request (Jun. 21, 2006).

has received for its Katrina response effort. However, its success is more attributable to the outstanding efforts of its employee "first responders" than its planning and strategy execution.

The IRS must institutionalize the many lessons learned from responding to September 11 and the Gulf Coast hurricanes of 2005, as well as many smaller disasters. The IRS must use these lessons to develop comprehensive plans for different types and sizes of disasters. It needs practice scenarios, better training, and expanded and better support for taxpayers trying to file disaster related returns. All these objectives and more call out for a permanent high-level servicewide group to change IRS strategies from reactive to proactive.

IRS COMMENTS

The IRS strongly disagrees with the National Taxpayer Advocate's observations that the IRS's disaster response and recovery efforts deserve to be called one of the Most Serious Problems facing taxpayers. Dealing with disasters is not an exact science. Each one is different in scope, nature, and geographic location. A degree of flexibility in the decision making process, with respect to the granting of administrative tax relief, is crucial to assisting victims of a disaster. However, the IRS does have sound criteria and established policies and procedures in place for responding to disasters.

The Gulf Coast hurricanes of 2005 resulted in an unparalleled need for coordination between IRS operating divisions and external partners to provide disaster assistance to taxpayers in the impacted areas. In the GAO Report on Catastrophic Disasters, GAO-06-618, the Comptroller General recognized the IRS among a few agencies for its "flexibility and adaptability" in responding to Katrina's challenges. Specifically, GAO recognized the IRS for the assignment of 5,000 employees to augment the FEMA hurricane registration efforts, the establishment of a dedicated toll-free disaster hotline, the distribution of over 291,000 disaster kits (through February 2006), and the creation of a special section on the IRS internet site.

TIGTA and GAO have conducted a total of 10 audits involving our response to the disasters with very few findings. In addition, the Director, Communications, Liaison and Disclosure, who has overall stewardship for the Disaster Assistance and Emergency Relief Program, commissioned an internal review of the current disaster policies and procedures to identify lessons learned and recommend formalized procedures and policies for future use.

Pursuant to that direction, the Disaster Assistance Review Team (DART) completed a comprehensive program review and issued a report in May 2006. The DART report already raised many of the issues noted in the NTA's report and outlined many recommendations and program enhancements that are currently in process, including a complete revision of the IRS Disaster IRM Section 25.16.

The IRS Disaster Tax Administration Policy Group (DTAPG), a cross-functional team of senior officials responsible for directing IRS policy in disaster response efforts, reviewed and approved the DART report. The Taxpayer Advocate Service (TAS) representative to the DTAPG did not raise concerns during this program review or the many DTAPG policy meetings conducted since the hurricanes. On several occasions, the TAS representative expressly stated there had not been any increase in inventory or contacts as a result of our response to the unprecedented level of disasters.

The IRS has used its administrative authority to reduce taxpayer burden by granting broad relief for impacted taxpayers. In almost all cases, the IRS suspended taxpayer correspondence and prevented compliance activities from occurring. The IRS made every possible effort to help taxpayers in their financial recovery from the devastating storms. The National Taxpayer Advocate's report states that the IRS generated nearly 25,000 Federal Payment Levies erroneously. However, less that 30 of these levies actually attached to an account and, in each instance, the IRS reversed actions to ensure that taxpayers were not adversely affected.

In an agency first, the IRS secured agreements with seven tax professional organizations to jointly provide assistance to taxpayers at local disaster recovery centers. These agreements outlined careful guidance for disaster coordinators and several of these organizations went beyond expectations, accepting referrals for free tax return preparation for low income taxpayers needing to report unreimbursed casualty losses as a result of the Hurricane disaster. In addition, the Wage and Investment Division permanently removed income-based restrictions on preparing delinquent returns at the Tax Assistance Centers for taxpayers directly impacted by disasters.

In another program improvement initiative, the IRS is creating a new Master File freeze code to ensure that all taxpayers located in a Presidentially declared disaster area receive filing and payment relief without having to self-identify.

In 2005, the IRS granted tax relief in 20 Presidentially declared disaster areas. For Katrina victims, filing and payment deadlines were postponed until October 16, 2006 for the most severely affected areas in Louisiana, Mississippi, and Alabama. In addition, the IRS assisted over 175,000 taxpayers at the FEMA Disaster Recovery Centers, responded to over 100,000 telephone calls made to the toll-free Disaster Hotline, and expedited over 1.3 million tax return transcripts to the U.S. Small Business Administration Office of Disaster Assistance for taxpayers who applied for federal disaster loans.

Finally, the IRS initiated many administrative tax relief measures including increasing the standard mileage rate for the final months of 2005, implementing an expedited review and approval process for new organizations seeking tax exempt status in order to provide relief to victims of Hurricane Katrina, allowing retirement plan participants affected by the disaster to use streamlined loan procedures, liberalizing hardship distribution rules for certain retirement plans, and many other similar types of administrative tax relief.

TAXPAYER ADVOCATE SERVICE COMMENTS

It is surprising that the IRS does not recognize its lack of a disaster response strategy as a Most Serious Problem. In this report, we have complimented the IRS on its reaction to Hurricane Katrina and the other Gulf Coast hurricanes of 2005. Frontline managers and employees responded extraordinarily. To anyone watching a television set, it was obvious the number of victims needing help in New Orleans and Mississippi far exceeded the number affected by prior disasters. The IRS's primary response was convening the Disaster Tax Administration Policy Group. The Taxpayer Advocate Service (TAS) was part of this group and is proud of its participation. TAS did in fact raise many of the issues discussed in this report with the group, while contributing to timely solutions as events unfolded. Again, this group reacted well to events as they surfaced; but that does not mean the IRS could not have done better. The U.S House of Representatives and the Senate apparently believed taxpayers deserved better, having passed legislation to establish a permanent IRS Disaster Response Group.[48] This high-level cross-organizational group would develop strategies, plans, and models, and work with other governmental agencies developing disaster responses.

The IRS and the National Taxpayer Advocate share common ground on issues raised in this report and by the IRS's Disaster Assistance Review Team. We differ on how to fix these deficiencies. For example, the IRS's new IRM draft still fails to set standards for evaluating and classifying disasters, or templates for responding to different types of disasters; nor does it create procedures for deciding what relief to offer disaster victims. The IRS response discusses a new Master File freeze code, stating, "…all taxpayers located in a Presidentially declared disaster area receive filing and payment relief without having to self-identify."

The National Taxpayer Advocate welcomes the decision to grant filing and payment relief (penalty and interest) to all taxpayers in a Presidentially declared disaster area. We expect the IRS to incorporate this commitment into its new manual.

This commitment to grant filing and payment relief to all taxpayers in a Presidentially declared disaster area takes a first step towards addressing a key concern. We believe disaster victims in similar circumstances deserve similar relief, which, under current IRS policy and procedures, is not always the case. A resident who lost his home in a hurricane and another who lost his home to a tornado should expect the same treatment. From January 1 through November 30, 2006, the President declared 48 major disasters. FEMA offered Individual Assistance in 24 of these disasters. [49] The IRS did not implement automatic relief for any disaster in 2006.[50] The IRS disbanded the DTAPG after 9/11. Had the group continued the work it began in 2001, the IRS would be better

[48] Tax Administration Good Government Act, H.R. 1528, 108th Cong. (2004). The Senate version of the Tax Administration Good Government Act, S. 882, was incorporated into H.R. 1528 with an amendment. H.R. 1528 was passed by Senate on May 19, 2004, by unanimous consent.

[49] FEMA, 2006 Federal Disaster Declarations, available at http://www.fema.goc/news/disasters.fema?year=2006.

[50] IRS Disaster Relief Declarations. *See* http://www.irs.gov/newsroom/article/o,,id=98936,00.html.

prepared for devastating hurricane disasters in 2005. Once engaged, the IRS reacted by taking actions, making plans and issuing guidance. Many of these decisions and actions should be part of a strategic plan. Had the IRS developed such a plan *before* the 2005 hurricanes struck, the thrust of our analysis today would be considering whether the IRS's tactics met its strategic goals, instead of discussing the effectiveness of the IRS's crisis management.

RECOMMENDATIONS

1) Establish a permanent disaster response team in the national office of the Internal Revenue Service. The team should be composed of employees who, besides their regular responsibilities, shall assist taxpayers in clarifying and resolving federal tax matters associated with or resulting from any Presidentially declared disaster. The disaster response team would include personnel from the Office of the Taxpayer Advocate, and others from the IRS's national office with expertise in individual, corporate, small business tax matters, including Counsel, Chief Information Officer, Agency Wide Shared Services, Communications and Liaison and so on. The team shall operate in coordination with the Secretary of the Treasury, the Directors of the Federal Emergency Management Agency and the Department of Homeland Security.

We believe that once it is formed, the permanent disaster response team should address these issues:

- Develop methodology to evaluate and classify disasters based on characteristics relevant to an effective response effort. This methodology would include criteria for any "on the ground" evaluation by the State Disaster Coordinator or other personnel charged with making an on-site assessment. Develop a plan for coordinating the disaster classification with templates of planned response strategies including staffing and services offered at FEMA and other recovery sites.
- Set up Service Level Agreements with IRS business units and functional divisions specifying their disaster support commitments.
- Establish specific criteria for using automatic disaster relief (O Freeze).
- Change the processing procedures of IRM 3.11.3.7.1.7 to ensure that taxpayers who self-identify by notating their tax returns get the same treatment as those identified by the IRS or who self-identify by telephone.
- Adopt the safe harbor valuation rules detailed in Revenue Procedure 2006-032 for personal use residential real property.
- At technical employee Continuing Professional Education, provide technical disaster tax law training to all employees to provide the IRS with a core of "first responder" tax specialists to deploy in case of a disaster.

- Coordinate with other agencies to identify most likely disasters and likely areas to experience disasters, and to develop specific models and strategies for response to the future disasters.

PROBLEM

TOPIC #15 CONCERNS WITH THE IRS OFFICE OF APPEALS

RESPONSIBLE OFFICIAL

Sarah Hall Ingram, Chief Appeals

DEFINITION OF PROBLEM

In the 2003, 2004, and 2005 Annual Reports to Congress, the National Taxpayer Advocate identified issues related to the IRS Office of Appeals (Appeals) as one of the most serious problems facing taxpayers for each of these years. Appeals has not adequately responded to concerns raised and discussed in these prior annual reports, and these same issues remain problematic:

- Despite Appeals' implementation of its campus strategy and other measures to eliminate inventory delays, taxpayers and their representatives continue to complain that it takes an unreasonable time to complete the Appeals process;
- Taxpayers and practitioners are still dissatisfied with Appeals' independence; and
- Under the present structure, taxpayers must often choose between waiting a long time to obtain a hearing with an Appeals officer locally or accepting an alternative, remote hearing with an Appeals officer who does not understand local issues.

Appeals inventory and processing delays can harm unrepresented (pro se) as well as represented taxpayers, leading to an increase in defaulted cases or incorrect results.

ANALYSIS OF PROBLEM

Background

Ever since Congress established the Treasury Department in 1789, the federal government has provided an administrative appeal process to taxpayers who do not agree with proposed tax assessments.[1] The mission of the present-day IRS Office of Appeals is to resolve tax controversies without litigation, on a basis that is fair and impartial to both the government and the taxpayer, in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the IRS.[2] To achieve this mission, Appeals must maintain independence from the IRS compliance functions in fact and appearance, and afford all taxpayers reasonable and equal access to the Appeals process. If taxpayers perceive that Appeals does not provide a fair, timely, and independent forum for resolving tax controversies, they will bypass Appeals and proceed directly to litigation or simply give up and accept the determinations of the IRS. Low income or unrepresented taxpayers may take the latter course of action by default.[3]

[1] Act of Congress Establishing the Department of the Treasury, September 2, 1789, Chapter XII, Section 5.

[2] IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 2.

[3] *See* National Taxpayer Advocate 2004 Annual Report to Congress 264.

In the IRS Restructuring and Reform Act of 1998 (RRA 1998), Congress required the IRS to "ensure an independent appeals function within the [IRS], including the prohibition . . . of *ex parte* communications between appeals officers and other [IRS] employees to the extent that such communications appear to compromise the independence of the appeals officers."[4]

The Appeals process is essential for both taxpayers and the IRS. For Appeals to fulfill its congressional mandate, taxpayers must have confidence that their cases will be handled fairly and timely. Taxpayers must also have access to a competent and trained Appeals officer who understands fully the taxpayer's case, including any applicable issues related to the taxpayer's business or locality, while his or her case is being considered.

The "Modernized" Office of Appeals

In fiscal year 2004, Appeals implemented the Campus Specialization Initiative (CSI) and moved certain cases from the local field offices to IRS campuses. Appeals goal for this initiative is to "re-engineer our processes to reduce the length of the appeals process."[5] To reduce cycle time, Appeals plans to:

- Automate more of its campus function to work correspondence cases in any of its campus locations;
- Use the breakthrough approach to further streamline the traditional process;[6]
- Actively promote the use of early intervention and alternative dispute resolution to resolve tax matters before they come to Appeals;
- Pursue the development of additional innovative approaches to reducing case cycle time;
- Tailor the way Appeals interacts with taxpayers to the most efficient means for resolving the matter; and
- Actively promote the advantages of resolving appeals cases via teleconference or correspondence so they remain the preferred choice of taxpayers, while continuing to advise taxpayers of the availability of face-to-face conferences."[7]

Appeals plans to measure its success in accomplishing these goals through:

- Appeals Quality Measurement System (AQMS);
- Customer Satisfaction Survey results; and

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[4] Pub. L. No. 105-206 Sec. 1001(a)(4). *Ex parte* communication is any communication about disputed issues between Appeals and another IRS function without the participation of the taxpayer or the taxpayer's representative. Rev. Proc. 2000-43, 2000-2 C.B. 404.

[5] IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 4.

[6] The breakthrough approach is Appeals method of developing new programs and processes.

[7] IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 4.

- Average Cycle Time.[8]

Appeals Inventory and Cycle Time

Appeals tracks inventory and cycle time to determine the effect of workstreams (type of case) and days required to work cases. In fiscal year 2004, Appeals started to reduce its inventory by closing more cases than it received. Appeals' critical measure is the ratio of resolutions to receipts. As of August 2006, Appeals reported closing 106 cases for every 100 receipts.[9] Field closures (a ratio of 114 to 100) in fiscal year 2006 were much higher than campus closures (93 to 100).[10] An analysis of closed cases indicates that Appeals has improved cycle time in some workstreams, but times in others have risen or remained essentially constant.

In measuring cycle time for its Business Performance Review (BPR),[11] Appeals includes the days beginning when Appeals receives the case and ending when Appeals closes the case through its processing section. Cycle time measurements include days spent in the Appeals processing section, which provides technical support for controlling and processing all Appeals and IRS Office of Chief Counsel tax cases. This unit is the final processing point in the Appeals office and performs the full range of interim and closure processing actions, including adjustments, assessments, manual refunds, and abatements for all types of tax cases.[12]

An analysis of the Appeals life cycle[13] as compared to cycle time reported in the BPR shows significant delays by IRS operating divisions in sending cases to Appeals. For some types of cases, transfer and processing time can add nearly a year – or more – to reported Appeals cycle time. The time can certainly matter to the taxpayer if he or she is waiting for a refund. Further, if the reversal of an Earned Income Tax Credit (EITC) assessment is not restored in a timely manner, the IRS may automatically freeze the taxpayer's EITC for a later tax year.[14]

Appeals' ability to manage its inventory is critical to fostering compliance and projecting a fair and impartial presence in the IRS. Inventory delays create a myriad of related issues such as amended return filings, multiple calls, taxpayer uncertainty, additional interest charges, impact on future years, Taxpayer Advocate Service (TAS) referrals, and

[8] IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 5.

[9] Appeals response to TAS research request, Sept. 15, 2006.

[10] *Id.*

[11] The BPR is part of the balanced measures system mandated by the IRS Reform and Restructuring Act of 1998, Pub. L. No. 105-206. This system measures performance in customer satisfaction, employee satisfaction, and business results.

[12] IRM 8.20.1.3 (Sept. 25, 2006).

[13] The Appeals life cycle covers the time from a taxpayer's initial request for an appeal to the date of final closure through any operating division's processing section.

[14] The law now requires the IRS, if it denies EITC as a result of deficiency procedures, to also deny the credit for subsequent years unless the taxpayer provides evidence of eligibility. IRM 21.5.10 (Oct. 1, 2006).

most importantly, the loss of confidence in the Appeals function. Although Appeals has implemented strategies to address workload issues, TAS has noted only minimal improvement. For the past several years, Appeals has sought to reduce cycle time by "getting the right work to the right employee at the right time to get to the right decision."[15] However, the cycle time numbers show that this strategy did not improve cycle time in any significant way.

TABLE 1.15.1, APPEALS LIFE CYCLE (REQUEST APPEAL TO DATE CLOSED ON AIMS[16]) COMPARED TO APPEALS CYCLE TIME (APPEALS RECEIVED TO DATE CLOSED TO APPEALS PROCESSING SECTION).

Work Stream	FY 2006 Average Cycle Time[17]	Appeals Average Life Cycle[18]	Average Days Difference
Collection Due Process	247	262	15
Offers in Compromise	234	429	195
Innocent Spouse	356	859	503
Penalty Appeals	121	405	284
Coordinated Industry Cases	786	993	207
Industry Cases	541	682	141
Examination	352	508	156

Appeals Quality Measurement System (AQMS)

Appeals developed AQMS to provide statistically valid data on case quality,[19] which the system defines by specific quality standards, attributes and reason codes. To obtain the

15 IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 2.

16 Audit Information Management System provides inventory and activity controls of active Examination cases.

17 IRS Office of Appeals, *Commissioner's Monthly Report* (Apr. 2006).

18 IRS Office of Appeals, *Diagnostics and Balanced Appeals Measures Report System for ACDS Process Measures Cycle Time for (National) Cases by Categories,* FY 2006 Cumulative through Apr. 30, 2006.

19 Appeals Quality Measurement System, *Reviewer's Guide for Cases Selected for Review after 10/1/2005* 15-16 (Dec. 20, 2005).

AQMS measures, Appeals' quality staff performs statistical closed case reviews and measures eight standards:[20]

- Standard 1: Taxpayer Service and Rights
- Standard 2: Quality of Decision
- Standard 3: Accuracy of Computations
- Standard 4: Appeals Case Memo
- Standard 5: Time Span & Time Applied
- Standard 6: Procedural Compliance
- Standard 7: TCS Computations
- Standard 8: Appeals Interest and Assessment

Appeals' quality measurement staff reviews a representative number of cases from each Appeals area, scoring them based on compliance with the standards and related attributes so that the maximum score per case is 100. If all eight standards apply to a given case, each standard contributes 12.5 percent to the overall score. According to AQMS reports for fiscal years 2003-2005, Appeals consistently scored low on timeliness (Standard 5).[21]

In fiscal year 2006, Appeals revised its scoring methodology to create "a more equitable approach" to computing the score.[22] This new approach involved adding Standards 7 and 8 to measure the processing function of Appeals once a case was resolved. A

[20] Appeals Quality Measurement System, *Reviewer's Guide for Cases Selected for Review after 10/1/2005 15-16* (Dec. 20, 2005).
Quality standards defined:
- Taxpayer Service and Rights – measures whether Appeals communicated with the Taxpayers in an appropriate, professional manner, addressed their needs and respected their rights.
- Quality of Decision – measures whether the Appeals settlement is supported by a well-reasoned analysis of facts and law.
- Accuracy of Computations – measures the accuracy of the tax and penalty computations prepared by the AOs, ATCLs, etc. who do their own computations and whether correct closing information was provided for the computation of interest.
- Appeals Case memo – measures whether the Appeals Case Memorandum adequately explains and documents the rationale and merits of each settlement or unagreed disposition.
- Time Span and Time Applied – measures the timeliness of actions taken by the AO/SO/ATCL during the time span required to complete the case, and the use of time relative to the complexity of the issues.
- Procedural Compliance – measures whether important procedural aspects of the case were performed.
- Tax Computation Specialist Computations – measures the accuracy of the tax and penalty computations prepared by the TCS, whether correct closing information was provided for the computation of interest and whether the TCS time span and time applied were appropriate.
- Appeals Interest and Assessment – measures the accuracy of the interest computations, whether computational and assessment/abatement procedures were followed, the accuracy and timeliness of assessments/abatements and whether the Tax Examiner and Tax Specialist time spans and time applied were appropriate.

[21] Appeals Quality Measurement System Results Report for cases reviewed in FY 2005, Executive Summary 2 (Aug. 4, 2006).

[22] Appeals Quality Measurement System, *Reviewer's Guide for Cases Selected for Review after 10/1/2005* 1 (Dec. 20, 2005).

comparison of the "old" and "new" systems reveals that the overall average rating changed very little.[23]

AQMS management recommended Appeals increase its "Organizational Commitment to Improving Timeliness:"

> AQMS believes that Appeals needs to make a much stronger organizational commitment to improving the timeliness and effectiveness of case actions. For example, reviewers have noted a wide disparity of accomplishment of timely actions among individual employees, groups and areas. There are, apparently a number of employees who, in spite of workload and inventory concerns, etc., continue to perform their case activity in a timely and effective manner. It would benefit the Appeals organization to identify these high performers and seek from them the keys to taking timely actions on cases when faced with high inventories or excessive workloads. [24]

To improve timeliness, reduce taxpayer burden, and reach performance goals, AQMS strongly recommended that Appeals establish a mentor program for Appeals officers to obtain advice in resolving timeliness issues. Appeals must focus on timeliness of actions rather than cycle time to improve quality and customer satisfaction.[25] Instead of implementing this recommendation, Appeals continues to pursue its campus centralization and "right work/right employee/right time" strategies to reduce inventories.

Customer Satisfaction Survey Results

Appeals works with an independent consulting group to conduct annual customer satisfaction research as part of the IRS-wide initiative to improve taxpayer satisfaction. Ratings are based on a scale of 1 to 5, with 1 Very Dissatisfied and 5 Very Satisfied. For Appeals, the survey categories with the lowest customer satisfaction ratings are "Length of Appeals Process" and "Time to Hear from Appeals."[26]

In the survey covering April through September 2005, 56 percent of Appeals customers were satisfied with the service they received (*i.e.*, the overall satisfaction rating was a 4 or 5 on a 5-point scale), while 26 percent were dissatisfied (the overall satisfaction rating was a 1 or 2).[27] Eighteen percent of Appeals customers were neither satisfied nor dissatisfied (a rating of 3). Some sample customer comments from the survey include:[28]

23 Appeals Quality Measurement System Third Quarter 2006 Update (Mar. 31, 2006).

24 AQMS, *Appeals (All Areas) Results, For Cases Reviewed in FY 2004* A-17 (Aug. 2, 2005).

25 The Taxpayer Advocate Service emphasizes timeliness of actions to improve cycle time on cases. This policy has reduced TAS's overall cycle time without measuring cycle time directly.

26 IRS Customer Satisfaction Survey, *Appeals National Report Covering April through September 2005, with Fiscal Year 2005 Results*, Satisfaction Ratings 21 (Feb. 2006).

27 *Id.* at 5.

28 *Id.* at 8.

- "It took Appeals two years to resolve my case."
- "I never received a call back from the Appeals agent. My case has been in their office for two years, and it appears that nobody is working on it."
- "The amount of time that it took to complete my case was very long and made me very anxious."
- "The Appeals Officer had a very heavy workload which prevented him from settling our case quickly."
- "The length of time it took to get an answer was too long. We were never sure what the next step was because we never received a clear explanation of what to do."
- "The time it took to resolve our case was excessive. We were kept in limbo too long."

This last issue – that taxpayers are left in limbo – is a very important point. The process keeps taxpayers on hold, potentially with respect to large dollar amounts or recurring transactions with impact on future years.

Appeals attributes the low overall customer satisfaction rating to the increased number of *pro se* (unrepresented) taxpayers.[29] Taxpayers generally expect the Appeals process to take much less time than it actually requires. Appeals maintains that this is especially true for *pro se* taxpayers who may not be familiar with the process.[30] If this is true, because more taxpayers are representing themselves, Appeals should ensure that *pro se* taxpayers understand their rights and the expected length of the Appeals process rather than using these taxpayers as an excuse for low customer satisfaction ratings.

Based on the survey results, the Pacific Consulting Group recommended Appeals shorten the time it takes customers to complete the process. The length of the Appeals process is the top improvement priority for all Appeals customers.[31]

Campus Centralization

In an attempt to reduce cycle time and save resources by more efficiently working its "less complex" cases, Appeals centralized certain workstreams at IRS campuses in 2003 and 2004. The National Taxpayer Advocate raised questions about this initiative in her 2005 Annual Report to Congress and still holds many of the same concerns.[32]

[29] IRS Customer Satisfaction Survey, *Appeals National Report Covering April through September 2005, with Fiscal Year 2005 Results*, Report Summary 6 (Feb. 2006).

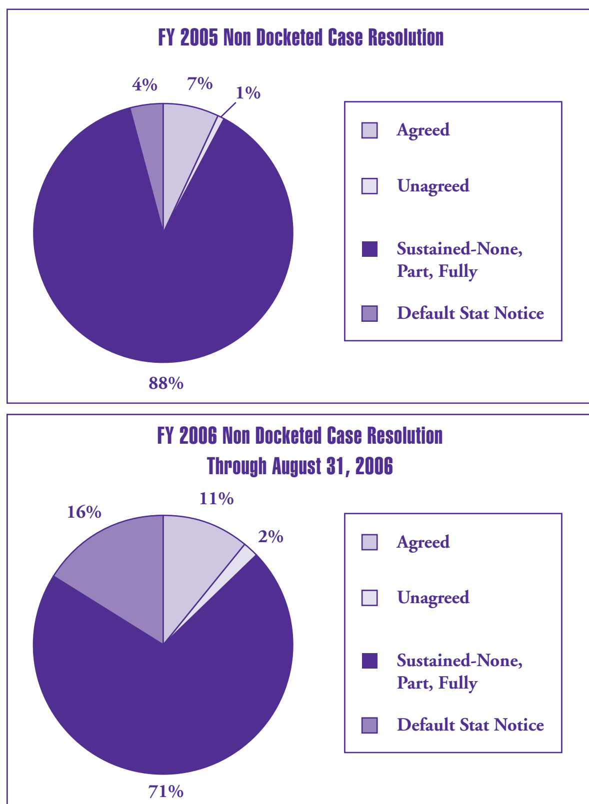
[30] *Id.* Appeals has not provided empirical evidence to support this statement.

[31] IRS Customer Satisfaction Survey, *Appeals National Report Covering April through September 2005, with Fiscal Year 2005 Results,* Report Summary 6 (Feb. 2006).

[32] National Taxpayer Advocate 2005 Annual Report to Congress 136-161.

An analysis of campus inventory dispositions reveals that the percentage of total dispositions attributable to defaults rose sharply, from four percent to 12 percent, from FY 2005 to FY 2006 (through August 31, 2006).[33]

CHART 1.15.2, CAMPUS INVENTORY RESOLUTION[34]



Reduced Face-to-face and Local Appeals Office Interaction

Some taxpayers prefer to meet with Appeals officers face-to-face or deal with an officer who is familiar with local circumstances. The initial Appeals letter mentions face-to-face conferences but campus Appeals emphasizes telephone or correspondence contacts to expedite the process.[35]

Appeals has indicated that it will not grant every request for a transfer to a local office. The Appeals response in the 2005 Annual Report to Congress stated that "Management evaluation of the request is required to ensure the taxpayer is not raising issues such as

[33] IRM 8.20.7.25 (Jan. 31, 2002). Default cases arise when a taxpayer fails to petition the U.S. Tax Court within the allotted 90 days after the IRS issues a statutory notice of deficiency. The proposed deficiency is then assessed.

[34] Appeals Centralized Database System.

[35] IRS Letter 4141(C)(G) (Aug. 2006).

the constitutionality of the tax system or using the request as part of a scheme to avoid or delay the resolution of the case."[36]

In fact, IRS campus procedures do not address denied transfer requests due to constitutionality claims. Rather, the procedures direct campus employees to telephone taxpayers who request an area office interview and "provide assurance that the issue can be resolved at the Campus." If unable to contact the taxpayer by telephone, IRS employees are directed to issue a letter to the taxpayer and refile the case for the remaining suspense period. Only if the taxpayer insists on an interview at an area office will the request be granted.[37]

From October 1, 2005 through May 31, 2006, Appeals transferred 8,445 cases from campuses to field offices.[38] These cases involved essentially equal numbers of represented and *pro se* taxpayers. Appeals does not track instances where requests are made and denied.

Protecting Taxpayer Rights

In its most recent strategic plan, Appeals lists taxpayer awareness of the appeal process and taxpayer rights, especially for *pro se* taxpayers, as key to improving taxpayer service and facilitating participation in the tax system by all sectors of the public. Appeals commits to "vigorously champion a taxpayer's right to a fair and impartial appeal, independent of outside influences," and to "expand our efforts to increase awareness of the appeals process through a wide range of products and communication methods, with an emphasis on reaching *pro se* taxpayers."[39] While we commend this goal, it is not clear exactly how Appeals intends to implement this strategy.

In one recent TAS case, the taxpayer requested a face-to-face conference with Appeals regarding a denied offer in compromise (OIC). Due to extraordinary local news coverage of a company that impacted the OIC issues, and at the recommendation of the IRS unit rejecting the compromise, the taxpayer sought a local conference. Appeals denied the request because there were apparently no Appeals officers in the local IRS office serving that state. TAS intervened and arranged a face-to-face meeting between the taxpayer and an Appeals officer from a neighboring state. It is unclear how many other taxpayers may have faced similar situations and simply accepted telephonic hearings.

Appeals' concerns with staffing and inventory balancing should not trump the taxpayer's need to raise issues in the setting most conducive to securing the correct resolution. Appeals must make clear in all taxpayer correspondence that taxpayers can resolve audit issues face-to-face as well as by telephone from a local area office.

[36] National Taxpayer Advocate 2005 Annual Report to Congress 158.

[37] IRM 4.19.1.4.14 (Jan. 1, 2006).

[38] Appeals response to research request (June 6, 2006). The data includes only regular transfers-not transfers due to workload balancing.

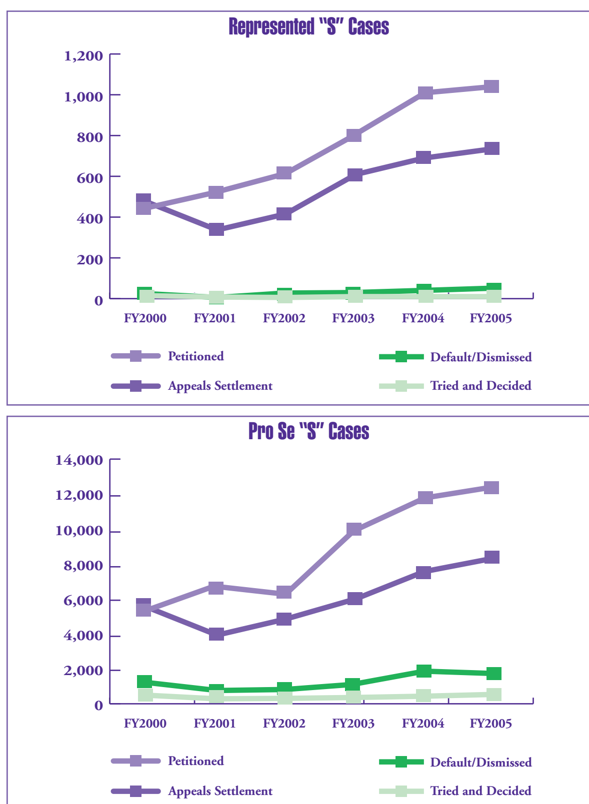
[39] IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 3.

Docketed "S" Cases

A small or "S" case is a Tax Court case with a deficiency of $50,000 or less.[40] Taxpayers may elect to have their cases considered under the United States Tax Court's simplified small "S" tax case procedure. Trials in "S" cases generally are less formal and result in a speedier disposition.[41]

Petitioned "S" cases for *pro se* and represented taxpayers increased by an annual average of 20 percent and 19 percent, respectively, from fiscal year 2000 through fiscal year 2005.[42] Based on historical data on "S" cases from fiscal years 2000 to 2005, the default/dismissal rate is almost three times higher for *pro se* cases than cases where taxpayers had a representative.[43] This may indicate that *pro se* taxpayers are not as familiar with the process as those with representation, and fail to properly submit technical documents and narratives.

CHARTS 1.15.3 AND 1.15.4, COMPARISON OF DOCKETED "S" CASES OVER TIME[44]



40 IRC § 7463(a).

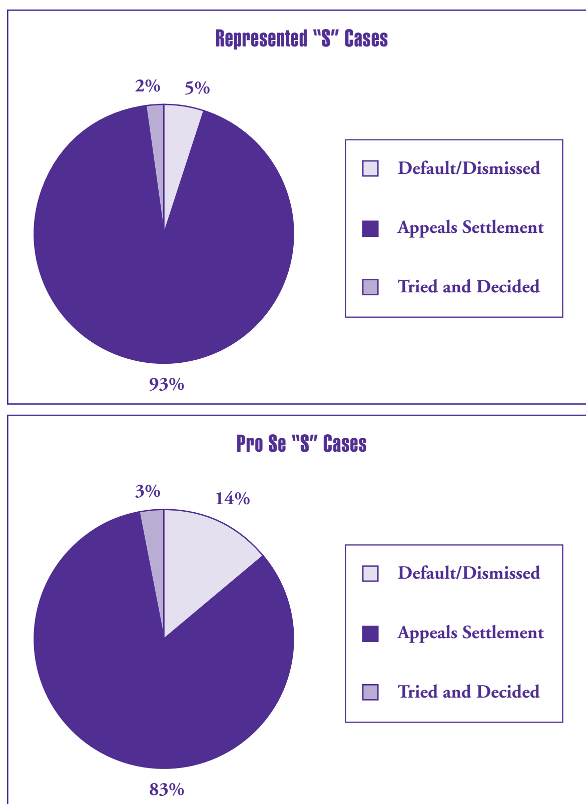
41 *See* www.ustaxcourt.gov/forms/Petition_Kit.pdf

42 Data derived from Counsel Automated Tracking System TL-708A.

43 *Id.*

44 *Id.*

CHARTS 1.15.5 AND 1.15.6, RESOLUTION OF DOCKETED "S" CASES FROM FISCAL YEAR 2000 TO FISCAL YEAR 2005[45]



The United States Tax Court recently proposed an amendment to its Rules of Practice and Procedure to require the IRS to file answers in all "S" cases, effective for petitions filed after November 27, 2006. The discussion of the proposal cited a lack of pretrial communication between the parties as a reason for the amendment. Further, the court believes an earlier exchange of information may reveal issues with precedential value that lead to discontinuance of small tax case proceedings.[46] This change highlights the need for taxpayers and counsel to engage in dialogue to understand and potentially resolve issues prior to the court date. This is especially important to the campus appeals process, as most "S" cases originate from campus correspondence examinations.[47]

Appeals Staffing

While Appeals receipts continue to grow, field staffing statistics show significant declines in the number of Appeals officers and settlement officers.

45 Data derived from Counsel Automated Tracking System TL-708D, E and F.

46 U.S. Tax Court Notice of Proposed Amendment to Rule 173 (Sep.12, 2006).

47 IRS Office of Appeals, *Breakthrough Performance Plan, Small Docketed Cases ("S" Cases)* (Jun. 18, 2004).

TABLE 1.15.7, APPEALS FIELD STAFFING[48]

Job Title	Employees Oct. 1, 2005	Employees Sept. 30, 2006	Gain (Loss)
Tax Computation Specialists	94	91	(3)
Appeals Officers	742	714	(28)
Settlement Officers	216	236	20
Tax Specialists	4	4	0
Account Resolution Specialists	28	25	(3)
Case Processors	22	22	0
Tax Examiners	239	208	(31)
Other	185	218	33
TOTAL	**1,530**	**1,518**	**(12)**

TABLE 1.15.8, APPEALS CAMPUS STAFFING[49]

Job Title[50]	Employees Oct. 1, 2005	Employees Sept. 30, 2006	Gain (Loss)
Appeals Officers	80	98	18
Settlement Officers	63	74	11
Tax Specialists	31	23	(8)
Account Resolution Specialists	24	25	1
Case Processors	12	7	(5)
Tax Examiners	75	73	(2)
Other	35	20	(15)
TOTAL	**320**	**320**	**0**

Although Appeals' overall staffing decreased by less than one percent in FY 2006, campus appeals officer staffing increased by 22.5 percent while the number of field appeals officers declined by 3.8 percent. Appeals projects a 10.7 percent attrition rate for fiscal year 2007 and plans to hire 80 field Appeals officers to replace the projected 86 losses in field offices.[51] In addition, the fiscal year 2007 attrition rate for tax computation specialists is expected to reach nearly 20 percent with no hiring anticipated.[52] The loss of employees in this position will negatively impact processing time in the Appeals life cycle.

48 Appeals research request (Sept. 15, 2006) and Employee Service Record Report (ESRR) for pay period ending October 1, 2005.

49 Appeals research request (Sept. 15, 2006).

50 *Appeals Officers* are responsible for handling issues and cases generated by various compliance functions in campuses and the field and for arriving at the final dispositions and to approve the final settlements of the cases. *Settlement Officers* are responsible for resolving collection cases generated and referred to Appeals by various compliance components in campuses and the field. *Tax Specialists* are responsible for resolving tax issues that are generated and referred to Appeals by various campus compliance and accounts management components. *Case Screeners* review new receipts, determine initial case processing, and prepare the administrative file for transfer or reassignment. *Case Processors* provide administrative and clerical support in processing and closing cases. *Tax Examiners* are responsible for reviewing cases, processing adjustments, computing internal interest and simple restricted interest cases, and closing pipeline and special processing cases.

51 Appeals response to research request (Jun. 14, 2006).

52 *Id.*

The knowledge and experience of seasoned Appeals officers and support staff cannot be replaced overnight. Appeals' challenge is to recruit, train, and mentor employees in an environment of continuous change. This situation also presents opportunities for Appeals management to implement new practices and procedures.

Alternative Dispute Resolution (ADR)

Alternative Dispute Resolution describes a broad range of nontraditional methods for resolving disputes. Mediation is one form of ADR used extensively in the federal and private sectors to resolve disputes such as Equal Employment Opportunity complaints and collective bargaining disputes. Mediation is a voluntary process that employs a trained mediator to help opposing parties reach a mutually agreeable solution. Mediation is widely considered an effective alternative to litigation and is less costly to impacted parties.[53]

The Administrative Dispute Resolution Act of 1996 directed each federal agency to adopt a policy that addresses ADR.[54] A 1998 presidential memorandum directed heads of executive departments to "promote greater use of mediation, arbitration, early neutral evaluation, agency ombudsmen, and other alternative dispute resolution techniques."[55]

The Federal Mediation and Conciliation Service (FMCS) is the U.S. government agency responsible for mediating collective bargaining agreements.[56] Federal disputes are increasingly resolved through ADR to reduce cost to both the claimant and the government.[57] Appeals Policy Statement P-8-1 (approved 11-4-98) reaffirms the dispute resolution process as a necessary alternative to litigation. The IRS Appeals office administers both Fast Track mediation[58] and Fast Track settlement[59] to expedite case resolution. Both programs offer an opportunity for the taxpayer (or representative) to engage in dialogue about the protested issue with the examination team and Appeals.

The IRS implemented a Fast Track Dispute Resolution Pilot Program in the Large and Midsize Business (LMSB) operating division.[60] This program demonstrated that IRS can successfully use ADR techniques to promote issue resolution and decrease the time from

[53] Federal Alternative Dispute Resolution Council, Inc., at http://www.fadrc.com/History.htm (2004).

[54] Pub. L. No. 104-320 (amending Pub. L. No. 101-552 and Pub. L. No. 102-354) Sec. 1.

[55] Presidential Memorandum, *Interagency Committees on Use of Alternate Means of Dispute Resolution and Negotiated Rulemaking* (May 1, 1998).

[56] A collective bargaining agreement literally means bargaining between and/or among representatives of collectivities (thus involving internal as well as external bargaining); but by custom the expression refers to bargaining between labor organizations and employers.

[57] Federal Mediation and Conciliation Service at http://www.fmcs.gov/internet/itemDetail.asp?categoryID=39&itemID=19768 (Nov. 16, 2005).

[58] Fast Track mediation employs a trained Appeals Officer mediator. Although all parties discuss issues involved in the disagreement, the Appeals Officer does not have settlement authority.

[59] Fast Track settlement employs a trained Appeals Officer with settlement authority.

[60] Notice 2001-67, 2001-2 C.B. 544.

tax return filing to ultimate resolution. Revenue Procedure 2003-40 made Fast Track Dispute Resolution a permanent program for LMSB taxpayers.

In July 2006, Appeals announced an agreement with the Small Business/Self-Employed division (SB/SE) to implement a Fast Track Settlement process. Previously, only Appeals mediation was available to individual taxpayers and small businesses. In IRS Announcement 2006-61, Section 2, cases with specified criteria are excluded from Appeals Fast Track Settlement consideration. Collection Due Process, offer in compromise, and Trust Fund Recovery cases are presently excluded but may be added later. Campus cases are not eligible for Fast Track Settlement due to the lack of a manager's closing conference.[61] This rule effectively eliminates the right to alternative dispute resolution procedures for many low income and middle income taxpayers.

Appeals' use of settlement and mediation alternatives is increasing at a much lower rate than in the federal sector as a whole. For example, in fiscal year 2005, Appeals receipts for unagreed examination cases totaled 99,245.[62] Only 167 of these cases were referred for fast track mediation or settlement.[63] This is an area of opportunity for Appeals to utilize resources more efficiently and reduce cycle time.[64]

Appeals added new questions regarding the ADR program to its FY 2005 customer satisfaction survey. Only three large and midsize business taxpayers that the IRS surveyed used ADR so the results are not statistically representative. Customers who did not use the ADR program were asked a series of questions concerning the value of the ADR program. Forty-eight percent of these customers reported that ADR options were not explained to them during the audit.[65] Taxpayers who did have the ADR options explained to them offered a number of reasons why they did not use the program:

- "We only had one issue, so there was no need to use it."
- "Our case was very simple, so there was no reason to use it."
- "We were able to come to a mutual agreement without having to use ADR."[66]

The survey responses indicate that taxpayers do not fully understand the alternative dispute resolution options available in Appeals, or the advantages of participating in the mediation or settlement process.

[61] General Appeals Fast Track Mediation Technical and Procedural Guidelines, (Feb. 23, 2005).

[62] Appeals response to research request (Sept. 13, 2006).

[63] *Id.*

[64] During an October 23, 2006 tax controversy conference sponsored by the UCLA Extension in Los Angeles, IRS Appeals Chief Sarah Hall Ingram praised the fast-track program and addressed the significant decrease in program cases from fiscal year 2004 to fiscal year 2005. Ms. Ingram cited benefits of reduced processing times and high resolution rates when using the Fast Track settlement program.

[65] The sample margin was plus or minus 12.7 percent at the 95 percent confidence level.

[66] IRS Customer Satisfaction Survey, *Appeals National Report Covering April through September 2005, with Fiscal Year 2005 Results* 37 (Feb. 2006).

Appeals Independence

In the 2004 Annual Report to Congress, the National Taxpayer Advocate noted that public perception of Appeals as an arm of the compliance function persists. The IRS Restructuring and Reform Act of 1998 (RRA 98) mandated that

> "The Commissioner of Internal Revenue shall develop and implement a plan to reorganize the Internal Revenue Service. The plan shall ensure an independent appeals function within the Internal Revenue Service, including the prohibition in the plan of *ex parte* communications between appeals officers and other Internal Revenue Service employees to the extent that such communications appear to compromise the independence of the Appeals officers."[67]

Recent correspondence from the public and court opinions support the notion that Appeals independence is still questionable. For example, Tax Executives Institute (TEI) is a professional organization whose members are primarily tax professionals of large corporations. A January 17, 2006 letter from TEI President Michael P. Boyle to IRS Commissioner Mark W. Everson questioned Appeals' independence. Mr. Boyle challenged the implications of Announcement 2005-80, which was designed to promote settlement of a tax shelter issue. The announcement asserts that "eligible persons who forgo resolving eligible transactions under this settlement initiative…should not expect to receive a better offer than that offered under this settlement initiative."[68] Mr. Boyle wrote "Regrettably, Announcement 2005-80 threatens to fundamentally change the balance between Examination, Appeals, and taxpayers and to deprive taxpayers of a right conferred by Congress."[69]

In *Moore v. Commissioner*,[70] the U.S. Tax Court remanded an individual's case to an IRS Appeals office because before issuing an adverse collection due process determination, the appeals officer received prohibited *ex parte* communication from IRS compliance employees who had been involved in the taxpayer's collection process. The court held that the IRS conducted *ex parte* communications that were covered by the prohibition and ordered the case remanded to Appeals for a remedy to avoid prejudice to the taxpayer.

In *Drake v. Commissioner*,[71] the Tax Court held that *ex parte* communications between the IRS insolvency unit advisor and an Appeals settlement officer may have damaged the taxpayer's credibility in future administrative proceedings. The case was remanded to Appeals for a new hearing with an independent Appeals officer.

[67] Pub. L. No. 105-206 § 1001(a)(4).

[68] Announcement 2005-80. 2005-46 I.R.B. 1.

[69] Tax Executives Institute, *TEI Encourages IRS to reaffirm Independence of Appeals* (Jan. 17, 2006).

[70] *Moore v. Comm'r*, T.C. Memo. 2006-171.

[71] *Drake v. Comm'r*, 125 T.C. 201.

The American Bar Association (ABA) Tax Section recently surveyed its members about the IRS Appeals process in an effort to give the IRS honest, constructive feedback. The survey was designed to measure

1. The satisfaction of ABA Tax Section members with the overall IRS Appeals process, and
2. The current perception regarding whether the Appeals Division conducts its activities independently of the examination, collection, and enforcement functions of the IRS.[72]

Although the survey results are not final at the time of this writing, the responses to questions about campus centralization, use of alternative dispute resolution strategies, and Appeals independence will produce a picture of the Appeals function from the perspective of an important external stakeholder.

CONCLUSION

Taxpayers who find themselves in a tax controversy with IRS should view Appeals as an objective, informed third party. If taxpayers sense that Appeals is merely another arm of IRS enforcement, they may well bypass the Appeals process in favor of litigation or possibly noncompliance. The National Taxpayer Advocate remains concerned that if Appeals is perceived as a mere extension of IRS enforcement, it will begin to fail its historical mission.

IRS COMMENTS

At the heart of the National Taxpayer Advocate's Report to Congress is her continuing strong support for the Appeals organization. The IRS agrees that the Appeals function is vital to good tax administration. However, we are not convinced that the issues described by the National Taxpayer Advocate rise to the level of a "most serious problem."

The issues raised in this year's report are nearly identical to those raised in prior reports and without any level of detail or documentation to support the findings. One particular case, selected examples from the customer satisfaction survey and two court cases, are not persuasive when a greater weight of evidence indicates to the contrary.

The National Taxpayer Advocate's report finds that the IRS has not adequately responded to the prior concerns raised in her reports. We disagree and believe that the IRS's strategic plan shows that it promotes and supports an independent Appeals function knowledgeable of its mission and ready and able to deliver fair and impartial case resolution services.

[72] American Bar Association Section of Taxation, *A Survey of Satisfaction and Experience with the IRS Appeals Office* (Aug. 2006).

Cycle Time

The IRS agrees that cycle time is an important issue. Appeals has indeed found this one aspect of its performance measures the most resistant to improvement. In part, this is because Appeals has devoted significant attention to repositioning itself through its specialization and early intervention strategies and by improving efficiencies, and has not solely focused on cycle time. However, Appeals has identified cycle time as its major emphasis to improve customer service for FY 07.

Appeals has worked with each Operating Division in an effort to reduce the amount of time it takes to move a case into Appeals. We agree that this is an important part of case consideration from the taxpayers' perspective and it cannot be overlooked.

In FY 2005, it took an average of 69 days to get a case into Appeals. In FY 2006, this was reduced to 67 days. We continue to work with each Operating Divisions to analyze the cause for delay in each workstream and provide feedback for improvement.

TABLE 1.15.9, P1 TIME – FROM TP REQUEST FOR APPEAL TO TIME THE CASE IS RECEIVED IN APPEALS

	CDP	CIC	Exam	IC	INNSP	OIC	PENAP	Other	Overall
FY 05	60	88	86	93	58	38	87	106	69
FY 06	57	96	80	90	48	47	70	117	67

AQMS and Customer Satisfaction Data

The IRS agrees that the Appeals Quality Measurement System (AQMS) and customer satisfaction survey results are important measures. Both are measures Appeals wants to strengthen.

Regarding the customer satisfaction survey data, we agree that *pro se* taxpayers' rights need to be protected. We believe the Appeals initiatives in this area actively support such protections.

Campus Centralization Efforts

The National Taxpayer Advocate continues to assert that field consideration and the right to a "face to face" conference is a panacea for curing all problems. The IRS disagrees with the National Taxpayer Advocate's assumptions. However, we do agree that tracking such requests may help to add meaningful data to the discussion. We have initiated programming enhancements so that we will have the capability to capture this data.

We do not understand the National Taxpayer Advocate's discussion of Campus Examination employee's procedures as part of an MSP regarding Appeals. She does, however, clarify in a footnote that this was a Campus Exam procedure and that it will be deleted in January 2007 in the new updated IRM Part 4.

S Docketed Case Consideration

The IRS does not agree with inclusion of this specific issue in an MSP discussion about Appeals. Petitioned/Default rates are a discussion that relate to the Compliance programs that generate the case, not Appeals. However, the IRS agrees that this is an area it needs to explore cross-functionally. Appeals has a “feedback loop” process in place to assist Compliance in improving in this area.

We are uncertain as to the meaning of the discussion on data regarding *pro se* versus represented cases but agree that the IRS should make every effort to explain the process and invite taxpayers to be active participants.

Campus/ Field Staffing

As the IRS has stated previously, campus versus field hiring is a planned strategy. We believe Appeals campus operations provide the same quality case resolution services as the field operations. This is supported by AQMS and customer satisfaction survey data. However, our conclusion is the opposite of the National Taxpayer Advocate’s –campus centralization is a healthy initiative supporting organization efficiency and provides, when coupled with a strong Appeals field presence, a fair and impartial case resolution forum.

It is an organizational concern for Appeals and for TAS that its employees be knowledgeable and experienced. We agree with the National Taxpayer Advocate’s identification of “…Appeals’ challenge is to recruit, train, and mentor employees in an environment of continuous change.” As evidenced by the Appeals strategic plan, these are identified goals.

ADR

Alternative Dispute Resolution techniques are still in their infancy. We are pleased that the National Taxpayer Advocate discussed them. They need as much communication and support, particularly with the practitioner community, as we can obtain.

Appeals Independence

As stated at the beginning, the IRS is confident that Appeals is providing fair and impartial case resolution services. We see nothing in this report which provides any convincing evidence to the contrary. In fact, we think a careful examination of court proceedings would show quite the contrary - taxpayers’ positions are exceptionally well attended to by Appeals. In addition, TIGTA conducted an audit and issued a report in September 2005 concluding that Appeals is an independent dispute resolution organization.

PROBLEMS

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is disappointed in Appeals' dismissive response to her concerns about the operation of the Office of Appeals. While we do not expect the IRS to agree with all of our observations and comments, rarely does the IRS dismiss our well-supported discussion, and rarer still does the IRS do so without any supporting data or references itself. To merely say that there are no problems does not make it so.

Appeals Cycle Time

The National Taxpayer Advocate commends Appeals for its identification of cycle time as a major emphasis for improving customer service in fiscal year 2007. Continued emphasis on timeliness of actions in Appeals and working with the operating divisions to reduce the overall life cycle of a case promotes taxpayer confidence in the Appeals function.

Customer satisfaction survey data serves as a barometer for taxpayer confidence in Appeals. It is a snapshot of taxpayer attitudes about the Appeals process and serves as a reminder that taxpayers demand and deserve our attention when tax disputes arise. Customers that report lengthy delays and lack of communication deserve better treatment. The dissatisfaction rate and individual taxpayer comments indicate frustration with the Appeals process. To ensure that taxpayers have confidence in the Appeals function, Appeals must take customer satisfaction survey comments to heart and improve timeliness of responses and actions.

Campus Centralization

Appeals mischaracterizes the National Taxpayer Advocate's position with respect to Appeals' Campus Centralization initiative. The National Taxpayer Advocate does not maintain that a face-to-face conference "is a panacea for curing all problems." In fact, our discussion about the campus initiative highlighted the need, in specific cases, for a *local* conference, with a *local* Appeals officer, not necessarily a face-to-face conference. In some cases – and certainly not all – taxpayers believe their cases will be better understood by an Appeals Officer in the community, particularly when the underlying examination was conducted by a remote correspondence unit. Face-to-face conferences are particularly important to taxpayers with functional or language literacy challenges.

In short, we are not denying that "campus versus field" is a "planned strategy" on the part of Appeals and the IRS. We are saying that it is a controversial strategy, and one that involves great risk at the taxpayer's expense. It requires extensive training and oversight. It also requires a willingness on the part of Appeals to recognize that some taxpayers will be harmed by being channeled to remote Appeals conferences and that alternate approaches must be available to help these taxpayers. The data cited in our report – that defaults in campus appeals inventory increased by 12 percent between FY 2005 and FY 2006 – indicate that something is wrong with Appeals' current

approach. Rather than denying the existence of the problem, Appeals should be analyzing the causes of the increased default rate.

The National Taxpayer Advocate commends Appeals, however, for initiating programming enhancements that will capture data on taxpayer requests for transfers to local offices. Tracking transfers and analyzing reasons for requests as well as reasons for denial will reveal patterns among issues or taxpayer groups. Appeals must get behind the numbers and develop a strategy that minimizes taxpayer burden while preserving taxpayer rights.

Small Tax Court Case Resolution

The National Taxpayer Advocate is puzzled by Appeals' failure to acknowledge the role it plays in the resolution of Tax Court cases, and S cases in particular. Most *pro se* taxpayers have not availed themselves of an Appeals conference before filing a petition in Tax Court. Under Chief Counsel's own guidance,[73] petitioners who did not have an Appeals conference prior to the issuance of the Notice of Deficiency are referred to Appeals to attempt settlement. At a recent conference of Low Income Taxpayer Clinic (LITC) representatives, many of whom have entered into agreements with the Tax Court to notify *pro se* petitioners about the availability of representation by LITCs, there was unanimous concern that the handling of these appeals in remote campuses harmed low income taxpayers.[74] Many expressed the view that taxpayers equate Campus Appeals with Campus Exam, whose results the taxpayer is disputing. We believe the data cited in our report about default rates demonstrates the importance to *pro se* petitioners of an independent Appeals function, and that any compromise of that independence – in appearance or in fact – harms those taxpayers specifically and tax administration generally.

Moreover, a discussion of petitioned "S" cases primarily emanating from campus correspondence examinations is relevant to the National Taxpayer Advocate's concerns about *pro se* taxpayers and their understanding of the appeals process. A study of docketed "S" case dispositions by issue and type of petitioner is necessary to determine why taxpayers do not resolve issues in Appeals or whether taxpayers simply fail to follow IRS procedures that enable them to reach Appeals. Appeals should seek the answers to questions such as:

- Why are "S" case petitions increasing by an annual average of 19-20 percent? Are these taxpayers bypassing Appeals or are they not reaching agreement at the Appeals level?

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[73] IRS Delegation Order No 60 (Rev. 7) (May 5, 1994).

[74] Taxpayer Advocate Service FY 2007 Annual Low Income Taxpayer Clinic Conference, held December 4 through 7, 2006, in New Orleans, Louisiana. At least one representative of each of the 150 clinics awarded funding under IRC § 7526 for the 2007 grant cycle attended the conference.

- Why is the default/dismissal rate almost three times higher for *pro se* cases than cases where taxpayers are represented? Are these taxpayers in the Appeals process but give up on the system?

The answers to these questions will produce a clearer picture of IRS roadblocks that prevent taxpayers from timely and accurately resolving their tax disputes. We urge Appeals to take responsibility for researching the underlying reasons why so many "S" case taxpayers default or have their cases dismissed by the United States Tax Court, and we offer our assistance in conducting that research. TAS also welcomes the opportunity to participate in a cross-functional effort to improve this process upon completion of the research.

Appeals Independence

Appeals independence is called into question based on public perception as well as documented cases of prohibited *ex parte* communication. The National Taxpayer Advocate is closely monitoring the results of the American Bar Association's survey of its members about the IRS Appeals process. Survey feedback will summarize perceptions of Appeals independence by stakeholders with significant interaction with Appeals.

In addition to documented *ex parte* communication, one need look no further for evidence of the erosion of Appeals' independence than recently-announced new procedures that link Appeals with the examination function.[75] These procedures, which operate after Appeals and the taxpayer are unable to reach agreement casts doubt on Appeals ability to remain objective. They also diminish the role of Appeals as an independent function, and place it as a mere stepping stone for additional IRS enforcement review.

Specifically, the new procedures provide that, where Appeals and the taxpayer cannot agree on a resolution in cases involving a listed transaction that are not docketed in the Tax Court, "the Office of Appeals will close out its consideration, notify the taxpayer, and send the case to the appropriate Operating Division for further handling." According to the notice, it is the operating division that will decide whether the case needs "further development." If the operating division so determines, the IRS will proceed with further case development. If the division determines further development is not necessary, it is the division that issues the Notice of Deficiency.

The IRS's rationale for implementing these extraordinary procedures is that it "wants to ensure that it has fully developed the limited number of unagreed cases that involve listed transactions . . . before it sends a statutory notice of deficiency . . . to the taxpayer." Leaving aside the IRS's astonishing admission that it deliberately sends forth to Appeals inadequately developed cases, the National Taxpayer Advocate believes that

[75] IRS, *Appeals Closing Cases Involving Unsettled Listed Transactions*, Announcement 2006-100 (Dec. 5, 2006).

these procedures impairs both the effectiveness of the Appeals process as well as the perception of Appeals' independence.

Whereas taxpayers heretofore knew that Appeals was the final step in the administrative process after the IRS examination function completed its development of a case, Appeals will now become an *interim* step in the IRS examination process. If issues remain unagreed, the examination function will get another bite at the apple. In both reality and perception, this change will erode the attractiveness of Appeals and make it more likely that taxpayers will choose to avoid the Appeals process and litigate. And that, in turn, will undermine Appeals' role and cause a needless waste of resources for both taxpayers and the government. The IRS's demurral that "Nothing else has changed in Appeals,"[76] does not mask the fact that in order to go after listed transactions the IRS has undermined longstanding tax administration principles. It is the IRS enforcement function that will make the decision in these cases, not the independent Office of Appeals. As a former IRS Chief Counsel put it, "it is the first time in the history of the tax code that the tools of tax administration 'have themselves been turned into a kind of threat.'"[77] Bad facts not only make bad law, they make bad tax administration.

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to protect the independence of Appeals and enable it to better fulfill its mission:

- Research what *pro se* taxpayers expect of the Appeals process, then determine whether their expectations are unrealistic or Appeals is failing its mission.
- Insert information on locations of Low-Income Taxpayer Clinics in all Appeals campus initial contact letters.
- Establish a mentor program to reduce cycle time.
- Look at "timeliness" quality standards as opposed to time span or cycle time measures.
- Train Appeals and Examination employees to use ADR processes and promote their use throughout IRS compliance functions.
- Expand Fast Track Mediation to the campus Appeals function. Offer campus examination taxpayers Fast Track Mediation and transfer the case to a local office if the taxpayer agrees to mediation.
- Analyze campus case results and results on cases transferred to Appeals field offices. Are there more defaults on campus cases? Is there a better resolution for taxpayers at field offices? Is there more time on field cases? What is the cycle time

[76] IRS Officials Defend New Approach to Appeals and Penalties, Tax Notes (Dec. 15, 2006) (quoting Diane Ryan, director of technical services for Appeals).

[77] *Id.*

on campus versus field cases? Why do more *pro se* taxpayers default on "S" cases? Is the default rate higher in campus than in field cases, and if so, why? What are the characteristics of cases in which taxpayers request to be transferred from campus to field offices? Appeals is missing an opportunity to research the impact of its processes and develop proactive solutions.

- Conduct a survey of *pro se* taxpayers in Tax Court "S" cases to determine what their needs, expectations, concerns, misconceptions, and reservations are with respect to Appeals' role in Tax Court case resolution.
- Explore moving the Office of Appeals from the Commissioner of Internal Revenue to the Secretary of the Treasury, to better protect its independence from further compromise by the IRS's enforcement focus.[78]

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[78] A 1987 IRS document summarized Appeals' history:

> A 1952 reorganization established the structure of the Appeals organization along the lines we see today [*i.e.*, 1987]. Prior to the 1952 reorganization, the Appeals function (Technical Staff) reported directly to the Commissioner through the Head of the Technical Staff. The reorganization brought about the establishment of a system of regional administration of districts under Regional Commissioners of Internal Revenue. However, to maintain the independent status of Appeals and preserve the principle of separating the Audit and Appeals operations, the Appeals function was carved out and placed under the office of the Assistant Regional Commissioner (Appellate), who had final settlement authority. In 1982, the Chief Counsel was delegated line supervisory authority over Appeals by the Commissioner. The transfer of Appeals to Chief Counsel facilitates the flow of information and assistance between appeals officers and counsel attorneys. *See* IRS Document 7225, "History of Appeals" (Nov. 1987).

In 1995, the IRS moved the reporting structure of the Office of Appeals from Chief Counsel back to the Commissioner and Regional Commissioners. See IRS Appeals to be Under Commissioner in Chief Counsel Reorganization, 95 TNT 117-4, June 16, 1995; Linda B. Burke, TEI Says IRS Appeals Function Should Report to Deputy Commissioner, Not Chief Counsel, 95-TNT 108-89, June 5, 1995 ("The current structure of Appeals, reflecting the 1982 decision to shift Appeals to the Chief Counsel's "side of the house," has contributed to a perceived diminution in Appeals' independence. Given Counsel's role as the adviser to Examination personnel, it is hardly surprising that taxpayers are less than sanguine about Appeals' reporting to Counsel. Indeed, anecdotal evidence suggests that Counsel has generally become more involved in the management and oversight of Appeals' workload and that this involvement has affected Appeals' attitude toward settlement").

In 1998, Congress enacted legislation to "ensure an independent appeals function within the [IRS]". Pub. L. No. 105-206 § 1001(a)(4). For examples of congressional concerns with Appeals independence, see 144 Cong. Rec. S4182 (1998) ("One of the main concerns we've listened to throughout our oversight initiative – a theme that repeated itself over and over again – was that the taxpayers who get caught in the IRS hall of mirrors have no place to turn that is truly independent and structured to represent their concerns. With this legislation, we require the agency to establish an independent Office of Appeals – one that may not be influenced by tax collection employees and auditors") and 144 Cong. Rec. S7639 (1998) ("the bill mandates that the Commissioner's restructuring of the IRS include an independent appeals function. This appeals unit is intended to provide a place for taxpayers to turn when they disagree with the determination of front-line employees. A truly independent appeals unit will assure that someone takes a fresh look at taxpayers' cases, rather than merely rubber-stamping the earlier determination").

PROBLEM

TOPIC #16 CORRESPONDENCE EXAMINATION

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

DEFINITION OF THE PROBLEM

The IRS examination functions support the IRS mission by maintaining an enforcement presence and promoting correct reporting by taxpayers. While many complex tax issues necessitate face-to-face interviews or field examinations, the IRS can often conduct the less complicated examinations by correspondence. This process is most effective for tax returns with questionable items that the IRS can directly verify with records the taxpayer can easily submit by mail.[1]

There are several problems associated with the IRS correspondence examination program. These include:

- Identifying appropriate inventory for correspondence examination;
- Inadequate communication with taxpayers;
- Inappropriate use of a combination letter that both shortens the amount of time the taxpayer has to respond to the exam function and prematurely triggers the right to an administrative appeal;
- Inconsistency among examiners in the verification required to substantiate a deduction; and
- Cycle time measures that exacerbate problems and create rework.

The correspondence examination process was designed to expedite resolution of issues in a fair and impartial manner. Significant procedural impediments have led to disparate treatment of taxpayers, ineffective communication with taxpayers, premature audit closures, and increased taxpayer burden.

ANALYSIS OF THE PROBLEM

Background

The primary purpose of correspondence examinations is to effectively utilize examination resources to promote voluntary compliance.[2] The Wage and Investment (W&I) division's Examination Operations and Small Business Self-Employed (SB/SE) division's Campus Examination units share ownership of the correspondence examination process in IRS campuses.[3]

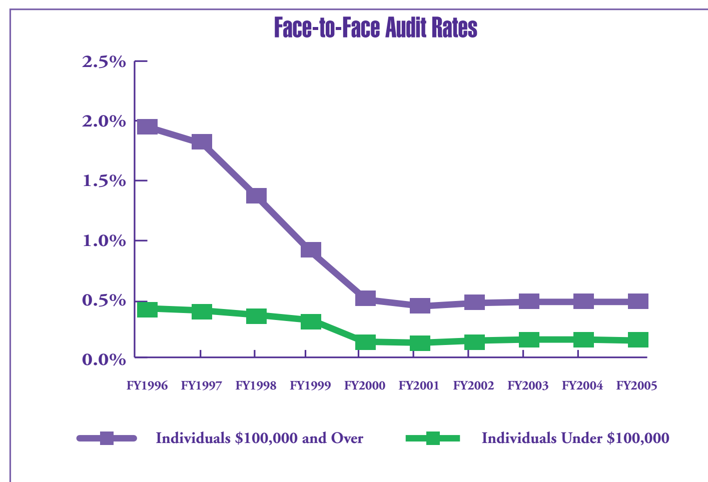
[1] IRM 4.19.1.2.3(6) (Jan. 1, 2006).

[2] IRM 4.19.1.1 (Jan. 1, 2006).

[3] *Id.*

During fiscal year (FY) 2005, the IRS examined 1,215,308 individual income tax returns, with 84 percent of those examinations conducted by correspondence.[4] Correspondence examinations accounted for 88 percent of the FY 2005 examinations of individuals with incomes under $100,000 and 67 percent of those with incomes of $100,000 or more.[5] While face-to-face examinations rose by 25 percent from FY 2002 through FY 2005, correspondence examinations increased by 170 percent over the same period.[6]

TABLE 1.16.1, FACE-TO-FACE AUDIT RATES[7]



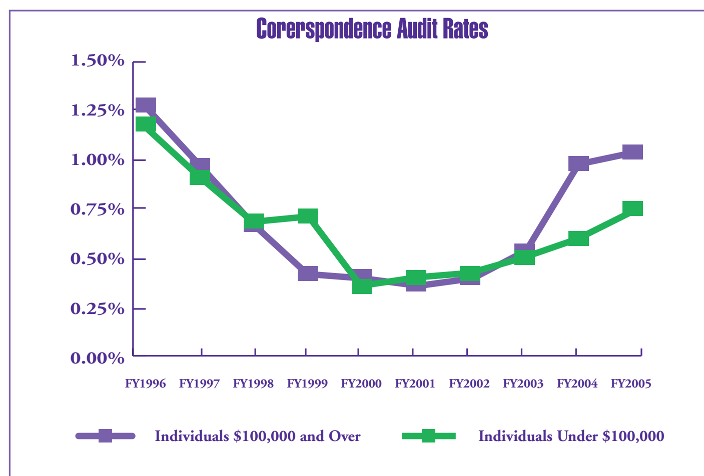
[4] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, T*rends in Compliance Activities Through Fiscal Year 2005* 8 (Mar. 27, 2006).

[5] *Id.*

[6] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* 2 (Jul. 25, 2006).

[7] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, T*rends in Compliance Activities Through Fiscal Year 2005* 8 (Mar. 27, 2006); *see also* IRS Data Book Spreadsheet (Mar. 2006).

TABLE 1.16.2, CORRESPONDENCE AUDIT RATES[8]



In correspondence examinations, the IRS sends an initial contact letter informing the taxpayer that his or her return is under examination, then a 30-day letter accompanied by a report detailing any tax adjustment attributable to examined issues, and finally a Statutory Notice of Deficiency if the taxpayer does not agree to, or otherwise resolve, the proposed adjustment.[9] Each phase of the process has timeframes established by internal policy. If the taxpayer does not respond within a prescribed time for action, the case moves to the next phase through an automated batch process.[10]

Identifying Appropriate Inventory for Correspondence Examinations

The IRS utilizes internal database information to identify audit issues such as the Earned Income Tax Credit (EITC). The exam functions may select a return for correspondence audit if all the questioned items are susceptible to direct verification from records that the taxpayer could easily provide by mail, and a review of the return clearly indicates the taxpayer can effectively communicate with the IRS in writing.[11]

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[8] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* (Mar. 2006); *see also* IRS Data Book Spreadsheet. The significant drop in correspondence audits between 1996 and 1997 may be due to Congress authorizing the IRS to use Math Error Authority for specific dependency, EITC, and child tax credit issues. Once the IRS had authority, it didn't have to use deficiency procedures to assess tax so the results are excluded from correspondence audit rates. For a more detailed discussion of the IRS's math and clerical error authority *see* National Taxpayer Advocate 2002 Annual Report to Congress 25-31 and 185-197.

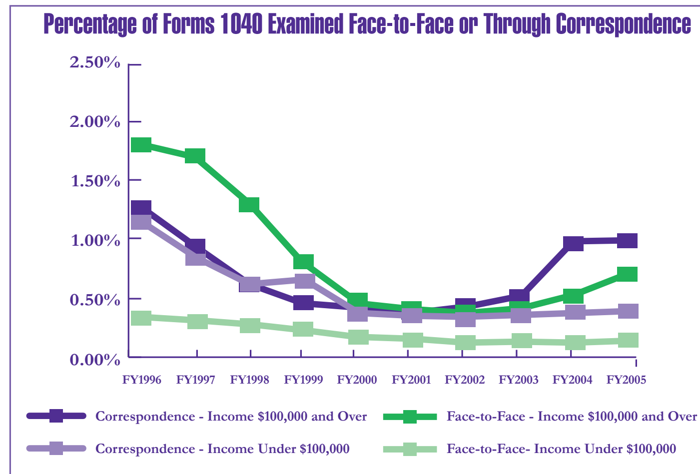
[9] IRC § 6212. If the IRS proposes changes to a tax liability and the taxpayer does not respond or cannot reach an agreement with the IRS, the IRS issues a statutory notice of deficiency. The notice of deficiency allows the taxpayer 90 days to petition the U.S. Tax Court and outlines the procedures to follow. If the taxpayer does not petition the Tax Court, the IRS assesses the tax and gives notice and demand to the taxpayer for the amount due.

[10] IRS Wage and Investment Division, *Correspondence Examination Automation Support, Concept of Operations* 6 (Jul. 16, 2004).

[11] IRM 4.1.5.9.1(4) (Oct. 1, 2001).

Correspondence examinations rely heavily on information reporting. While correspondence examiners may request certain documents to identify unreported income, the revenue agents and tax compliance officers who conduct field and office examinations, respectively, use more sophisticated indirect methods. Unlike correspondence examiners, revenue agents are trained to use a "dynamic" examination strategy and change the focus of the examination in response to new information. This approach allows agents to find unreported income that the IRS could not locate in a correspondence examination of limited scope.[12] There are indications that the IRS is using correspondence examinations to accomplish work that is better reserved for interviews or field audits. As depicted in the following chart, since fiscal year 2000, high income taxpayers filing individual income tax returns are increasingly examined by correspondence.

CHART 1.16.3, PERCENTAGE OF FORMS 1040 EXAMINED FACE-TO-FACE OR THROUGH CORRESPONDENCE[13]



Correspondence examinations have expanded to include strategies for dealing with nonfilers, projects involving return preparers, and high income taxpayers. However, the complexity of a case should dictate the audit method. Conducting a correspondence examination that fails to identify adjustments attributable to a complex issue only serves to reinforce the noncompliance, not deter it.

A 2006 report by the Treasury Inspector General for Tax Administration (TIGTA) found the IRS either abated or did not collect 86 percent of the audit assessments on high

[12] *The Tax Gap: Hearing Before the Subcomm. on Federal Financial Management, Government Information, and International Security, Senate Comm. On Homeland Security and Governmental Affairs*, 109th Cong., 2nd Sess (Oct. 26, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

[13] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities* 33 (Mar. 2006).

income taxpayers, almost two years after the assessments.[14] In addition, of the $2.1 billion assessed on high-income taxpayers through correspondence examination in FY 2004, $1.4 billion (66 percent) was attributable to taxpayers who did not respond to the examiner.[15]

The increase in correspondence examinations of taxpayers with Schedule C businesses rose to about 30 percent of all high-income taxpayer Schedule C examinations from FY 2002 through FY 2004, and 54 percent of all high-income taxpayer Schedule C examinations in fiscal year 2005.[16] Given the potential for unreported income in Schedule C business activities and the lack of third-party information reporting, it would appear that the IRS should conduct most of these examinations face-to-face. Recent reports on the makeup of the tax gap support this notion, indicating that well over half ($109 billion) of the individual underreporting gap came from understated net business income – underreported receipts and overstated expenses.[17]

Communication with Taxpayers

In 2004, the Taxpayer Advocate Service conducted a study of audit reconsideration cases where taxpayers had claimed the EITC. The findings suggested that the manner in which the IRS communicates with taxpayers may significantly affect the outcome of the audit process.[18] Considering that more than 40 million adults, or approximately 21 percent of the adult population of the United States, have less than a high school education, the lack of telephone or face-to-face individual contact can negatively impact these taxpayers.[19]

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[14] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* 2 (Jul. 25, 2006).

[15] For a related discussion of non-responders, see Most Serious Problem, *Taxpayer No Response Rates, infra.*

[16] Treasury Inspector General for Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* 2 (Jul. 25, 2006).

[17] IRS, *Business Income and the Tax Gap*, at http://www.irs.gov/newsroom/article/0,,id=158618,00.html (Jun. 2006).

[18] National Taxpayer Advocate 2004 Annual Report to Congress vol. 2 at i. The National Taxpayer Advocate's Earned Income Tax Credit (EITC) Audit Reconsideration Study included a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002 and January 31, 2003. Ultimately, 679 cases (340 IRS Examination and 339 TAS) were analyzed in detail. The study found 70 percent of the EITC audit reconsideration cases came to TAS for assistance because the taxpayer had not heard from IRS concerning his or her original audit or audit reconsideration request. For the 339 TAS cases, employees made 293 follow-up contact phone calls with the taxpayers and sent 436 follow-up letters. In contrast, of the 340 IRS Examination cases, tax examiners made only six follow-up contact phone calls to taxpayers and sent only 173 follow-up letters during the initial audit process. The likelihood of a taxpayer receiving additional EITC increased with the number of phone calls made by the TAS employees. Overall, of taxpayers who went through the audit reconsideration process and received no phone calls, only 38 percent were awarded EITC. This percentage increased to 67 percent for taxpayers who received three or more calls.

[19] Beth Lasater and Barbara Elliott, RTI International Center for Research in Education, *Profiles of the Adult Education Target Population*, Information from the 2000 Census 1-9 (Revised Dec. 2005). That is, they have not completed a high school diploma or equivalent. Adults who have completed four or fewer years of secondary schooling constitute 11.3 percent of the target population, or 2.4 percent of the total adult population.

A separate IRS study of the EITC raised questions about how the IRS conducts correspondence examinations and its reluctance to contact taxpayers by telephone. Two of the areas identified as barriers related to IRS correspondence and contacting the IRS.[20]

Toll Free Access

Internal Revenue Code (IRC) § 7602 authorizes the IRS to examine books and records and take testimony. Oral testimony can produce information not available on any document as well as corroborate return information. To provide oral testimony, however, the taxpayer first has to get through to the IRS. In January 2006, W&I instituted Intelligent Call Management on its toll-free phones to improve the quality of correspondence examinations.[21] This service provides more immediate assistance to the taxpayer by providing a better level of service on unassigned cases and reduces the need for the taxpayer to call several times to seek assistance. In May 2006, the IRS further expanded this service to the taxpayer by introducing new programming for extension-routed calls. This programming allows extension routed calls to roll over to the next available examiner if the assigned examiner is not available. The number of calls answered by a live assistor rose from 14.9 percent in FY 2005 to 39.8 percent in FY 2006.[22]

We applaud the IRS's efforts to improve customer service. However, some taxpayers still cannot reach the IRS employees who are familiar with their cases. In one TAS case, a taxpayer received a correspondence examination letter with an examiner's name and contact telephone number. The taxpayer and examiner were located in Nevada and the non-toll-free telephone number was listed in Ohio. The taxpayer was frustrated with the process and lack of responsiveness and contacted TAS for assistance.[23]

Taxpayers must feel confident that the individual whose name appears on IRS correspondence will answer their questions, review their documentation, and guide them through the process. As noted in the National Taxpayer Advocate's 2005 Annual Report to Congress, "This allows the taxpayer to develop a relationship with the caseworker and may encourage the taxpayer to respond to calls and requests for information."[24]

Unassociated Mail

In a 2005 TAS focus group, tax practitioners frequently commented that the IRS would request additional information prior to reviewing all relevant case information, and before associating the information the taxpayer had already sent in with the taxpayer's

[20] National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, at 10.

[21] IRS Wage and Investment Division research request response (Sept. 26, 2006).

[22] IRS Wage and Investment Division research request response (Nov. 22, 2006). The Wage and Investment Division Reporting Compliance Correspondence Examination Phone Initiative was recognized by the National Taxpayer Advocate with a National Taxpayer Advocate Team Award for 2006.

[23] Taxpayer Advocate Service Management Information System (TAMIS).

[24] National Taxpayer Advocate 2005 Annual Report to Congress 115.

case.[25] The tax practitioners noted that these circumstances often led to an inefficient, challenging, and frustrating exam process. A number of practitioners mentioned having to send documentation by certified mail in order to have a receipt. Some said the sheer volume of documentation requested is often overwhelming, which makes it difficult to fax responses back to the IRS.[26]

Taxpayers and their representatives continue to express concern over the IRS's failure to acknowledge receipt of correspondence. One representative wrote, "I am becoming increasingly concerned about the difficulty of getting an acknowledgment of my response to the IRS prior to the end of the 30 day period stated in notices…. Please provide a procedure in which taxpayer or practitioner responses are quickly acknowledged as being received. Provide a contact point for taxpayers or practitioners to call if no response is received by the promised date. Allow a quick means, through e-services or elsewhere, for a practitioner to acknowledge receipt of the notice and obtain 2-3 weeks of additional time."[27]

Improved communication could help resolve many difficulties with documentation, non-responsive taxpayers, and audit reconsiderations. Every year, IRS campuses receive millions of taxpayer letters and responses, which clerks sort, route, classify, associate, and control for response by Customer Service Representatives (CSRs) or Tax Examiners (TEs). Taxpayers frequently make multiple contacts in writing or by phone on the same issue, and CSRs and TEs at one location do not have access to incoming correspondence at another location. The IRS's move to computer scanning of taxpayer documents to create electronic images should minimize these problems, reduce response time, and improve case quality by automating manual processes that cause errors.[28] This promising process, called the Correspondence Imaging System (CIS), provides online access to images of taxpayer correspondence so assistors can readily resolve phone and written inquiries. However, the IRS presently uses this system only for amended returns.[29]

Personal Contacts

Increased telephone contact helps taxpayers better understand what supporting documentation is needed to satisfy questionable deductions or credits, and affords taxpayers an opportunity to provide oral testimony and pose questions about the audit process and their rights. IRS examiners must learn to differentiate between various types of targeted communication and find the one that works best in given circumstances.

25 National Taxpayer Advocate, *Findings from Correspondence Examination Focus Groups, IRS Tax Forums* (Jun. – Sept. 2005), ii.

26 *Id.*

27 Systemic Advocacy Management System (SAMS) (Aug. 2006).

28 IRS Wage and Investment Division Executive Steering Committee Presentation (Mar. 1, 2002).

29 IRS Wage and Investment Division research request response (Sept. 1, 2006).

The IRS needs to improve communication during the correspondence examination process. For example, the IRS mails customer satisfaction surveys each month to a sample of taxpayers it has audited through correspondence. The customer dissatisfaction rate (*i.e.*, the taxpayer rated satisfaction as either a "1" or "2" on a 5 point scale) for taxpayers examined by correspondence was 37 percent in fiscal year 2006 and 40 percent in FY 2005.[30] The priority for improvement among these dissatisfied customers is fairness of treatment by the IRS.[31] The surveys indicate that taxpayers increasingly perceive the correspondence examination process as confusing and unfair.

The National Taxpayer Advocate voiced her concern over the IRS's lack of effective communication methods in her 2007 Objectives Report to Congress.

> We remain concerned, however, about the Service's continued bias away from human interaction and toward self-service, both in the taxpayer service and enforcement environments. While self-service and communication through correspondence may make sense and be adequate for many taxpayers, many other taxpayers will not be able to comply unless they receive individualized assistance from a knowledgeable IRS employee either in person or by telephone.[32]

The "Combo" Letter and Shortened Turnaround

In calendar year 1998, the IRS implemented a new process to reduce the length of correspondence examinations (*i.e.*, cycle time). The IRS combined the initial contact letter and an official examination report (explaining the taxpayer's appeal rights) into one mailing (the "combo" letter). This system gave the taxpayer a very compressed timeframe to gather information and respond before the IRS issued a statutory notice of deficiency. If the taxpayer was confused by the combo letter, or otherwise failed to secure and submit necessary documentation within the allotted 30 days, he or she lost the opportunity to request a meeting with IRS Appeals. Many taxpayers did not realize that the 30-day appeal opportunity period was running while they were providing documentation on the issue to a tax examiner.

In fiscal year 2004, the compliance examination functions entered into an agreement with the National Taxpayer Advocate not to use the combo letter for EITC audits.[33] This has not deterred the IRS from using the combo letter for other discretionary work. The IRS agreed, in concept, that the combo letter should be reserved for simple issues, such as the penalty for premature withdrawal from an Individual Retirement Account (IRA) and self-employment tax on non-employee compensation payments. However,

[30] Wage and Investment Division correspondence examination response (Nov. 22, 2006). While the difference in customer dissatisfaction rates between fiscal year 2005 and fiscal year 2006 is not statistically significant, the fact that more than a third of all respondents are dissatisfied is disturbing.

[31] Wage and Investment Division correspondence examination research request (Sept. 26, 2006).

[32] National Taxpayer Advocate 2007 Objectives Report to Congress vii.

[33] National Taxpayer Advocate 2003 Annual Report to Congress 87-98.

the current list of projects clearly indicates that audits of more complex matters such as tip income and alimony are initiated with the combo letter.[34] SB/SE also agreed to study the impact of not using the combo letter for other issues. To date, TAS is unaware of any such study.

Even as the IRS continues to use the combo letter, employees do not consistently follow letter procedures. In 20 percent of the cases sampled during a TIGTA review, audits began with letters proposing tax changes rather than the standard audit initiation letters.[35] This approach further reduces the time taxpayers have to respond to IRS inquiries, since audit initiation letters indicate the IRS will wait 30 days for taxpayers to submit substantiation before proposing any changes to a tax return. Unless the IRS follows letter procedures consistently, it risks contributing to taxpayers' perceptions that they are not treated fairly.[36] The National Taxpayer Advocate has repeatedly addressed the need to eliminate combination letters to safeguard taxpayer rights.[37]

Verification Inconsistencies

Taxpayers and their representatives cite problems with inconsistencies in the acceptance of documentation for correspondence examination issues.[38] The two main problems are inconsistency as to which documents the IRS will accept (a document is accepted in one campus, but not in another) and inflexibility in accepting proof (failure to accept alternative types of documentation when the taxpayer cannot provide the standard documentation).[39] These problems are especially burdensome for low income taxpayers examined for EITC. IRS requirements for acceptable documentation are typically limited to receipts for expenditures, which are not readily accessible by these taxpayers.

In 2004, the IRS tested the use of an EITC certification form offering three options for certifying child residency, a significant cause of EITC disallowance. These options were:

- Records from school, utility bills, health care provider;
- Statement or letter from school, utility company. health care provider; or
- Affidavit of third party with record of or personal knowledge of residency.

34 Wage and Investment Division correspondence examination research request (Sept. 26, 2006).

35 Treasury Inspector General for Tax Administration, Ref. No. 2000-10-066, *The Internal Revenue Service Can Improve the Treatment of Taxpayers During Service Center Audits* ii (Apr. 2000).

36 *Id.*

37 National Taxpayer Advocate Fiscal Year 2003 Objectives Report to Congress 7; National Taxpayer Advocate 2003 Annual Report to Congress 87-98; National Taxpayer Advocate Fiscal Year 2004 Objectives Report to Congress 11; National Taxpayer Advocate 2004 Annual Report to Congress, at v; National Taxpayer Advocate 2005 Annual Report to Congress 119; National Taxpayer Advocate Fiscal Year 2006 Objectives Report to Congress 33.

38 National Taxpayer Advocate, *Findings from Correspondence Examination Focus Groups, IRS Tax Forums* (Jan. 2006).

39 General Accounting Office, GAO-02-449, *Opportunities To Make Recertification Program Less Confusing and More Consistent* 21 (Apr. 2002).

Taxpayers were encouraged to use one of the options in lieu of the standard documentation requested. The study marked the first time affidavits were routinely used for tax administration purposes.[40] Taxpayers in the test were able to prove they met the qualifying child residency requirement by submitting a third party affidavit. The affidavit guides the taxpayer through the process of meeting the child residency test for EITC, and eliminates the need for multiple contacts by correspondence. The results showed that affidavits had the highest acceptance rate[41] and provided a reliable way to substantiate the taxpayers' qualification for EITC.[42] The test suggests alternative documentation is effective in resolving audit issues and meets the IRS's goals of maximizing EITC participation while minimizing erroneous claims.[43]

The National Taxpayer Advocate urges the IRS to use the affidavit form developed for the EITC certification study in all EITC correspondence examinations. In addition, IRS must incorporate the lessons learned from the study into routine practice. Alternative methods are effective for resolving tax issues and should be pursued. The balance between service and enforcement can be achieved by examiners using sound judgment when analyzing all documentation provided by taxpayers.

In addition to improving consistency of acceptable documentation for correspondence examinations, the IRS should continue focusing on the clarity of requests for documentation. We commend the IRS for improvements to Form 886-H, Explanation of Items (request for supporting documentation), used in correspondence examinations. The IRS redesigned the forms in response to feedback from taxpayers who found the old forms confusing.[44] This improvement should serve as a model for partnering with taxpayers and representatives to enhance the quality of examinations.

Cycle Time Measures Exacerbate Problems and Create Rework

Even though correspondence examinations require minimal resources, some IRS measures, including cycle time and total returns examined, can inadvertently encourage employees to close audits prematurely. For example, correspondence cases for claims are to be resolved within 30 days of receipt, with a goal of maintaining cases in inventory less than 45 days 95 percent of the time.[45] These are unrealistic timeframes for producing records supporting complex cases such as high income nonfilers and issues such as alimony. Taxpayers who prepare their own returns may be overwhelmed by the

[40] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 17 (Oct. 2005).

[41] The overall acceptance rate of documents was 64 percent. Affidavits had the highest acceptance rate of 82 percent, followed by letters with an acceptance rate of 55 percent, and records with a rate of 48 percent. IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 33 (Oct. 2005).

[42] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 33 (Oct. 2005).

[43] *Id.* at 2.

[44] *Hearing Before the Subcomm. on Regulatory Affairs, House Comm. on Government Reform. Paperwork Burden Reduction*, 109th Cong. 1st Sess. (May 25, 2005) (testimony of Mark Everson, Commissioner of Internal Revenue).

[45] Wage and Investment Division *Correspondence Imaging System Organizational transition Plan 1* (Aug. 6, 2002).

level of documentation needed to support a deduction or credit and simply agree to a disallowance or fail to respond to IRS communication. Taxpayers who speak English as a second language, are disabled, or cannot afford to hire paid preparers may fall by the wayside in a process that offers little personal contact.[46]

IRS procedures and measures can encourage unresponsive taxpayers as well as premature closures. For example, assume a taxpayer provides documentation to support expenses questioned on a return and also claims that he or she has additional expenses not previously claimed. If the taxpayer does not produce the source documents for additional expenses with the response to the classified issues, the examiner is directed to send a closing letter to the taxpayer.[47] The examiner inserts a special paragraph to advise the taxpayer that he or she can use Form 1040X, Amended U.S. Individual Income Tax Return, to reduce the income indicated as overstated on the original return. Thus, instead of waiting a reasonable time to secure additional information from the taxpayer and resolve the case, the IRS encourages another cycle of examination through the audit reconsideration or claim process.

Audit Reconsiderations

IRC § 6404(a) grants the IRS the discretionary authority to abate any unpaid tax determined to be excessive. Under this authority, the IRS affords taxpayers an opportunity to present information not previously considered during an examination. An audit reconsideration is the process the IRS uses to reevaluate audit results when additional tax was assessed and remains unpaid.[48] If a taxpayer disagrees with an audit assessment, he or she may request reconsideration and provide new information.

A central reconsideration unit screens incoming correspondence requesting an audit reconsideration. Screeners are to reject any case that closed from a correspondence unit where taxpayer correspondence was received and not worked before the case was closed. If the correspondence could change the audit determination, the IRS returns these requests to the original correspondence exam unit to consider.[49]

Taxpayers are sometimes unable to produce requested documentation within IRS timeframes for a correspondence examination and request a reconsideration once they gather the documents. For example, the correspondence exam procedures for dependency exemptions require the examiner to verify information from the taxpayer to prove he or she meets the support test. That information includes receipts for food, clothing, upkeep of the home, medical and dental bills, schooling, recreation, and personal

[46] *See* Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Language and Cultural Barriers to Tax Compliance* and Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities, infra.*

[47] IRM 4.19.3.20.7.1 (Sept. 1, 2006).

[48] IRM 4.13.1.1 (Oct. 1, 2006).

[49] IRM 4.13.3.2 (Oct. 1, 2006).

items.[50] Taxpayers cannot usually secure records such as these and return them to the IRS within 30 days. Alternatives to this requirement include:

- Use of the Bureau of Labor Statistics Consumer Expenditures Survey data for specific family size and income levels;[51]
- An interview with an examiner to provide oral testimony; and
- A targeted issue support worksheet based on taxpayer records and estimates.[52]

Although the reconsideration process consumes additional time reviewing documentation from taxpayers after an examination closed, it still ensures that taxpayers receive an opportunity to resolve tax matters.

Taxpayer Rights

The IRS encourages resolution of cases in campus operations whenever possible. For example, if a taxpayer requests an Appeals conference in a local office, the campus examiner is directed to phone the taxpayer to assure him or her that the issue can be resolved at the campus. If unable to contact the taxpayer by phone, the examiner is directed to issue Letter 1654, which acknowledges the request for a transfer but encourages the taxpayer to work with the campus to resolve the matter. Only if the taxpayer insists on an interview at a local office is the transfer granted.[53] The National Taxpayer Advocate is concerned that the IRS directs its employees to call taxpayers to persuade them not to pursue their rights to a local appeals hearing, but does not direct its employees to call taxpayers to discuss the merit of their cases.

A TAS case provides insight to why taxpayers eventually lose confidence in the system. The taxpayer requested a face-to-face meeting due to the difficulties and expense of copying and mailing all documents needed to prove medical expenses. The examiner refused to transfer the case. The taxpayer was dealing with family issues related to his illness and stated he did not have time to fight the assessment so he agreed to the proposed deficiency. This was an elderly taxpayer who the TAS case advocate believed had legitimate medical expenses, but who gave up under the weight of the burden placed on him by the IRS.[54]

[50] IRM 4.19.1.5.3.8 (Jan. 1, 2006).

[51] IRM 4.10.4.6.1.3. The Consumer Expenditure Survey (CE) program consists of two surveys collected for the Bureau of Labor Statistics by the Census Bureau – the quarterly Interview survey and the Diary survey – that provide information on the buying habits of American consumers, including data on their expenditures, income, and consumer unit (families and single consumers) characteristics.

[52] The Appeals function utilizes a worksheet to secure support information from taxpayers prior to a conference. The worksheet lists basic household expenses and asks the taxpayer to indicate how much of each estimated expense was paid personally or by others.

[53] IRM 4.19.1.4.14 (Jan. 1, 2006).

[54] Taxpayer Advocate Management Information System (TAMIS).

In another TAS case, the case advocate secured the taxpayer's case file from the examining campus and found the taxpayer had submitted documentation multiple times. The IRS ultimately accepted the return as filed. The examiner had all necessary information and either did not look at it or did not associate it with the case in a timely manner.

Taxpayers with limited English proficiency or who are disabled often fall prey to miscommunication.[55] These taxpayers may need a face-to-face meeting to fully detail requirements for issues such as filing status and dependency exemptions. Correspondence examiners do not have specialized training to address the needs of these taxpayers.

IRS COMMENTS

The IRS does not agree with the National Taxpayer Advocate's assessment of the Correspondence Examination program.

- Issues selected for correspondence examination are generally simple and subject to third-party verification;
- Current procedures provide adequate opportunities for taxpayers to respond or to contact IRS employees;
- Use of the combination (combo) letter shortens the length of these audits, thereby minimizing a source of taxpayer dissatisfaction. Combo letters do not infringe upon taxpayers' ability to appeal the examination or to petition the Tax Court;
- We have procedures in place to ensure examination consistency;
- We do not have sufficient data to warrant more widespread use of affidavits in lieu of standard audit documentation;
- There are very clearly established timeframes for these examinations that do not encourage or require our employees to close them prematurely; and
- It is not appropriate for the IRS to use Bureau of Labor Statistics or other similar data to allow a tax benefit when IRS has specific third-party data to indicate the taxpayer is not entitled to that benefit.

Identifying Appropriate Inventory

For many years, the IRS has relied on a range of techniques to verify certain items on tax returns. Each of these techniques is appropriate for particular returns or types of potential errors. Correspondence examinations are an effective and efficient means of checking income and deductions. Correspondence examinations are generally verification audits and do not require sophisticated tax law interpretation or an in depth inspection of the taxpayer's books and records. In Wage and Investment (W&I), most

[55] For a related discussion of taxpayers with language barriers or disabilities, see Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities, infra/supra* and Most Serious Problem, *Limited English Proficient (LEP) Taxpayers; Language and Cultural Barriers To Tax Compliance, infra.*

audits are related to exemption issues, such as the earned income tax credit (EITC), child tax credit, or simple Schedule A issues. A minimal amount of verification is required to substantiate the deduction or credit.

Conducting audits through correspondence examination also provides flexibility to the taxpayer and decreases taxpayer burden. Since most taxpayers work during normal IRS field hours, a face-to-face audit would require the taxpayer to take time off from work. A correspondence audit allows taxpayers the flexibility of preparing for the audit on their own time. If the taxpayer requests a face-to-face audit, and we deem the request appropriate, we will transfer the case to the field. However, if the issues are simple, we retain the latitude to deny taxpayer transfer requests to ensure the best use of our limited field examination resources and to prevent taxpayer "shopping."

The complexity of the tax issue is considered prior to determining if an examination can be conducted in the correspondence environment. Although we are increasing audits on high income taxpayers, the issues we are using to select returns for audit are not more complex and generally focus on one or two issues, such as alimony or the alternative minimum tax.

The National Taxpayer Advocate states that correspondence examinations have expanded to include non-filer returns and preparer projects. For non-filers, we have a wealth of internal information available, such as Forms 1099 and W-2, to establish income and deductions. Our preparer projects generally address large Schedule A items or credits which can be easily substantiated by a limited number of documents.

Case selection criteria for correspondence examinations are the result of years of research, development, and refinement. Sophisticated filtering and selection criteria are reassessed yearly and appropriate changes are made to improve cases selected for examination. The methodology is mostly rule-based with matching capabilities to third-party data such as the Federal Case Registry, KIDLINK, and information returns data. This allows us to limit our focus to a small number of issues having a high likelihood of error.

Communication with Taxpayers

The IRS has taken several steps to improve communication with taxpayers. The Internal Revenue Manual (IRM) requires tax examiners to attempt to contact the taxpayer by telephone when additional information is needed if the taxpayer provides a number. Our letters also inform taxpayers about the option to call toll-free at any time during the audit process if they require personal contact to resolve or clarify an issue. Correspondence Examination has also implemented Universal Call Routing that provides toll-free assistance in both English and Spanish. All Correspondence Examination telephone assistors are trained to resolve general and specific case related questions for all Correspondence Examination audit-related programs. A database was developed which contains information on all Correspondence Examination project codes, IRM links, and frequently asked questions with corresponding answers. This provides the

telephone assistors with readily available information to respond to taxpayer questions on a myriad of issues. A Telephone Assistance Guide was also provided to all telephone assistors. As a result, it is not necessary for a taxpayer to speak with the individual tax examiner assigned to their case when they call. Universal Call Routing allows an employee to assist the taxpayer regardless of their geographic location and includes the capability for the employee to view current and past case history. This allows taxpayers a much greater opportunity to contact the IRS about their case, while significantly increasing efficiency in conducting these examinations. In addition, Universal Call Routing has resulted in a significant increase in the telephone level of service (LOS) afforded taxpayers. Our LOS, 69 percent in FY 2005 and 78 percent in FY 2006, has risen to 83 percent through the first month of FY 2007.

Currently, IRS uses the Correspondence Imaging System (CIS) in Accounts Management for mail not specific to Examination. Other modernization priorities prevented IRS from expanding this system to handle Compliance mail. Currently, Examination uses the Correspondence Examination Automated System (CEAS), which does not interface with CIS. However, Collection, Automated Underreporter, and Examination are working on requirements for a new system, Image Delivery for Correspondence, currently planned for delivery in January 2010. This new imaging system will interface with other compliance systems, including CEAS.

In order to track and timely process incoming mail, we date stamp and route it to the correct area to be associated with the case file. The IRM requires that we update the Audit Information Management System (the automated system used by Examination to control and document all case-related actions) to reflect the mail received date within five days of receipt. Although acknowledgement letters are not generated on initial receipt of correspondence, if the taxpayer calls the IRS, any employee can access the Integrated Data Retrieval System and inform the taxpayer if the IRS received mail related to their case. The first interim letter to the taxpayer is issued within 30 days of the correspondence received date (CRD). A subsequent interim letter, if necessary is sent within 70 days of the CRD if the issue remains unresolved. A third interim letter is mailed in the event the issue is not resolved within 115 days.

The "Combo" Letter

As part of an agreement with the NTA, EITC Examination agreed to add an additional 30-day letter to all Proof of Concept (POC) cases. This test was to determine if the IRS could get a higher response rate on POC EITC cases. A research report titled *Evaluation of Effect of Letter 3826 on Response Rate*, dated August 26, 2005, indicated the additional letter did not increase the response rate. The no-response rate actually increased by four percent. In other words, taxpayers who were given additional time to reply did not make use of the additional time, while the extra letter added 30 days to the average cycle time.

Examination cycle time, the time it takes the IRS to complete an examination, has consistently been a source of taxpayer dissatisfaction with the audit process. To address this concern, the IRS adopted the "combo letter" for certain kinds of examinations.

We believe the combo letter is appropriate when the IRS has third-party information available to indicate a taxpayer is not entitled to a particular tax benefit. As with premature withdrawals from Individual Retirement Accounts or assessments of unreported self-employment tax, the IRS has third-party information available for many other examination issues, such as duplicate dependents and tip income. In alimony cases, we compare the amount deducted and the amount of income reported by the two related parties. Third-party data from the Social Security Administration, the Federal Case Registry, and KIDLINK are used on issues that involve the child care, child tax, and education credits. Documentation requirements for taxpayers in such cases are not complex, taxpayers that respond timely do not lose their appeal rights, and use of the combo letter reduces the time needed for these examinations by 30 days.

Taxpayers that have appropriate documentation often respond within 30 days. Once a response is received, the IRS stops the audit process until an examiner has an opportunity to evaluate the documentation. The National Taxpayer Advocate indicates that cases move directly to a statutory notice of deficiency in an automated batch process. This is true if the taxpayer does not respond. However, although it is more efficient, not all cases go through the batch process. In W&I, much of the non-EITC related Correspondence Examination work does not involve the batch process. In the Small Business/Self-Employed Division, only two Correspondence Examination programs utilize batch processing. In either instance, the taxpayer has the same amount of time to respond whether a case is initiated through batch processing or not. In addition, if a taxpayer responds, the case is taken out of batch processing while we address any correspondence or issues raised by the taxpayer. Cases that are part of a preparer project or are identified by the Criminal Investigation Division generally have a low response rate because the taxpayers often have no documentation to support their claims. This low response rate is not a reflection of taxpayer confusion; rather, it indicates they cannot substantiate items or deductions.

Verification Consistency

The IRS has made several changes to ensure taxpayer documentation is evaluated correctly, consistently, and fairly. Within the last year, we implemented a decision support tool that is used for the EITC, filing status, dependent credits, and certain itemized deductions. We also revised IRM 4.19.14.4(1) to emphasize the use of judgment in reviewing the facts and circumstances involved with each issue to determine if the taxpayer's documentation establishes that the tax paid is substantially correct. To ensure our employees follow IRM requirements, we perform operational reviews in each campus. Additionally, we conduct closed case reviews on an on-going basis.

Use of Affidavits

The National Taxpayer Advocate's report states that the IRS should use affidavits to allow taxpayers to claim the EITC. While affidavits appear to offer some promise as a way to reduce the burden on eligible taxpayers, our limited scale proof of concept testing did not replicate real world conditions. As a result, many of the potential risks associated with the use of affidavits could not be evaluated. Taxpayers and tax preparers – who completed well over 70 percent of the returns in the study – were unfamiliar with the form or its use. The IRS was not able to ascertain whether widespread use of such affidavits could contribute to intentional erroneous EITC claims because of the ease with which affidavits can be created and submitted.

To prevent the use of false affidavits to verify eligibility criteria, the IRS would need a comprehensive approach to identifying and preventing abuse. At this point, we do not have sufficient information to do this or to understand the costs associated with such a program. Nor do we have data to evaluate the deterrent effect such verification efforts might have on potentially eligible taxpayers. Finally, such a program has the potential to shift current Correspondence Examination resources from direct examination casework to third-party verification activities – a change that may not be warranted or cost effective.

Cycle Time Measures

We do not agree that cycle time measures encourage employees to close examinations prematurely. Correspondence Examination has very clear timeframes for the taxpayer to respond to the IRS and to allow them to either appeal the audit or petition the Tax Court. The taxpayer receives an Initial Contact Letter with a 30-day suspense period, a 30-day letter with a 30-day suspense period, and a 90-day letter.

As previously noted, correspondence examinations target income, credit, or deduction issues that are readily verifiable by the IRS through third-party information. These issues generally do not involve complex issues or the need for taxpayers to produce sophisticated business or tax documentation. Taxpayers that maintain appropriate documentation to establish the income or expense claimed on their return have adequate time to respond to correspondence examination letters.

Use of Bureau or Labor Statistics Data

The IRS does not endorse use of Bureau of Labor Statistics (BLS) Consumer Expenditures Survey data for specific family size and income levels to allow certain deductions. The BLS is a sophisticated tool more suited for use by Field Examination when developing income or expenses using an indirect method. In a normal correspondence examination, the IRS has third-party information that indicates a taxpayer is not entitled to a claimed tax benefit. IRS acceptance of BLS statistical norms to allow such claims is not warranted in these circumstances.

In summary, the IRS correspondence examinations properly target issues that are not appropriate for face-to-face field examinations. Procedures and systems are available to support access to IRS employees trained and capable of addressing taxpayer questions or issues. Use of the combo letter reduces taxpayer burden by reducing the time needed for these audits while preserving taxpayer rights. Procedures are in place to ensure and verify consistent treatment of examination issues. The IRS does not have sufficient data to warrant use of affidavits to resolve audit issues. IRS cycle time measures ensure prompt and consistent actions on correspondence examination cases. Finally, it is not appropriate for the IRS to allow deductions or credits based on statistical norms when third-party data specifically indicates a taxpayer is not entitled to a deduction or credit.

TAXPAYER ADVOCATE SERVICE COMMENTS

Inventory Selection

The National Taxpayer Advocate agrees with IRS that correspondence examinations can be an effective and efficient means of auditing tax returns for **narrowly defined issues**. The IRS states that correspondence examinations target income, credit, or deduction issues that the IRS can readily verify through third-party information. In addition, the IRS maintains these audits generally do not involve complex issues or require taxpayers to produce sophisticated business or tax documentation. While this should be the case for all correspondence examination cases, the National Taxpayer Advocate found the IRS selected for correspondence examination complex issues that require substantial verification or sophisticated tax law knowledge. One example of this situation is alimony.[56]

The National Taxpayer Advocate disagrees with the IRS's classification of alimony as a simple issue that can be substantiated through correspondence examination. Campus procedures for the examination of alimony are extensive.[57] Documentation must include the legal instrument that orders the payment of alimony with all amendments and proof of payment in the form of copies of cancelled checks, money orders, or proof of direct deposit; or court receipts or statements from state or county agencies to which payments were made. Documentation may also include a copy of a deed to verify home ownership for mortgage, real estate taxes and home insurance payments, receipts for living expenses, education and medical expenses.[58] The correspondence examiner must be familiar with legal terminology to interpret the legal instrument.[59] It is clear that alimony requires more than a minimal amount of verification to

[56] Alimony issues typically arise because of discrepancies between the amount deducted as alimony by the payer and the amount reported as income by the payee(s).

[57] IRM 4.19.1.6.21 (Oct. 1, 2004).

[58] IRM 4.19.1.6.21.5 (Oct. 1, 2004).

[59] IRM 4.19.1.6.21.6 (Oct. 1, 2004).

substantiate a deduction, as well as knowledge of legal and tax issues beyond the scope of training provided to a correspondence examiner.

The National Taxpayer Advocate also questions the IRS's characterization of Alternative Minimum Tax (AMT) as simple. Leaving aside the complex computational issues that even the IRS gets incorrect, the AMT involves such technically complex issues as incentive stock options, intangible drilling expenses, and capital gain calculations. Congress, the National Taxpayer Advocate, and the President's Commission on Tax Reform have all labeled AMT a complex provision.[60]

The IRS expansion of correspondence audits to non-filer cases is risky. If the IRS audits these taxpayers based solely on information returns such as Form 1099-MISC, Miscellaneous Income, and W-2, Wage and Tax Statement, it offers non-filers an opportunity to resolve tax liabilities based only on income reported to the IRS. Income from cash transactions or other sources go undetected when the IRS fails to conduct a face-to-face interview and a review of taxpayer records. Instead of promoting voluntary compliance by conducting a thorough examination, the IRS condones unreported income and encourages future noncompliance.

The "Combo Letter"

The IRS adopted the "Combo Letter" in response to taxpayer dissatisfaction with the length of the examination process. While resolving issues timely is a worthy goal, the combo letter works against taxpayers by reducing the time many taxpayers need to produce documentation for examined issues. The "Combo Letter" is not appropriate for cases involving alimony or any other issue that requires factual development or a review of records. The IRS claims that preparer project cases or cases identified by the Criminal Investigation Division have a low response rate because taxpayers have no documentation to support their claims. The National Taxpayer Advocate sees no empirical evidence to support this claim. On the contrary, these taxpayers may require additional time to produce records or consult with legal or professional advisors.[61]

The IRS states that the "Combo Letter" does not impact taxpayer appeal rights. Due to the shortened time for a response and request to appeal, taxpayer rights are certainly affected. Many taxpayers, particularly low income or limited English proficiency (LEP) taxpayers, may need assistance to respond to tax issues. They may be unaware that the opportunity period for an appeal is running while they seek assistance in documenting the issue for a tax examiner. The IRS study cited in the report did not test taxpayer *comprehension* of the "Combo Letter". In addition, the study only included taxpayers

[60] The President's Advisory Panel on Tax Reform, Final Report 3 (Nov. 1, 2005).

[61] For additional discussion of IRS Criminal Investigation Division cases, see National Taxpayer Advocate 2005 Annual Report to Congress vol. 2. The TAS Criminal Investigation Refund Freeze Study of a statistically representative number of Questionable Refund Cases (QRP) revealed that over 80 percent of taxpayers got full or partial refunds and 53 percent of taxpayers received full relief.

who did not previously respond to the IRS in the EITC Qualifying Child Residency Certification Study. Accordingly, the test cases were compared to pre-certification cases where the lack of a response or an incomplete response was already an issue.

The National Taxpayer Advocate urges the IRS to reconsider its use of the "Combo Letter." Shortening the length of an audit and decreasing the percentage of dissatisfied customers should not trump the need to determine the best approach to examining issues while protecting taxpayer rights.

Verification Inconsistencies

TAS focus group reports cited problems with inconsistencies in the acceptance of documentation for correspondence examination issues.[62] The IRS asserts that it has implemented several changes to ensure that taxpayer documentation is evaluated correctly, consistently, and fairly. The National Taxpayer Advocate applauds these changes and urges the IRS to continue emphasizing use of judgment in reviewing the facts and circumstances of each issue to determine if taxpayer documentation establishes tax per return as substantially correct.

The IRS does not endorse use of Bureau of Labor Statistics (BLS) Consumer Expenditures Survey data as a source of information to allow certain deductions during the correspondence audit process. The National Taxpayer Advocate is perplexed by this statement, given that the IRS uses BLS data for field audits that warrant indirect methods and in the collection context to determine a taxpayer's ability to pay a delinquent debt. Why not use BLS data for low income taxpayers who have a difficult time pulling records together?

Use of Affidavits

The certification requirement in the EITC Qualifying Child Study included proof of qualifying child residency in the form of records, a letter on official letterhead, or a third-party affidavit. The study found that the traditional methods used to verify eligibility (*i.e.* records and statements) were not as reliable as affidavits, yet the IRS dismisses the opportunity to pursue this concept.[63]

The IRS reported that the use of affidavits to certify EITC eligibility offers some promise as a way to reduce taxpayer burden, but warned that its limited scale "proof of concept" testing did not replicate real world conditions. The National Taxpayer Advocate disputes this notion. Findings from the EITC Qualifying Child Residency Certification Study were based on extensive data collection from EITC claimants.[64] A

62 National Taxpayer Advocate, *Findings From Correspondence Examination Focus Groups, IRS Tax Forums* (Jan. 2006).

63 IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 33 (Oct. 2005).

64 *Id.* at i.

private consulting firm, along with the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA), favorably reviewed the IRS study design.[65]

The study results suggest alternative documentation is effective in resolving audit issues and meets the IRS's goals of maximizing EITC participation while minimizing erroneous claims.[66] The IRS statement that taxpayers and tax preparers in the study were unfamiliar with the form or its use is true; however every tax law change has the propensity to require the use of a new form. Taxpayers accept these changes as a matter of course and adapt to the change. Complacency stifles progress; the challenge to IRS is to integrate the new form or method of doing business into its process when it clearly promotes voluntary compliance.

Service to Taxpayers

Despite our differing perspectives on the correspondence examination process, the National Taxpayer Advocate is pleased with the IRS's steps to improve communication with taxpayers. Universal Call Routing is revolutionizing the correspondence examination process by enabling telephone assistors to service taxpayers regardless of geographic location or case assignment. The increased level of service is a significant move in the right direction. However, the IRS's ability to sustain or enhance growth depends on staffing. Telephone assistors who serve a dual role as correspondence examiners may be assigned cases that reduce telephone communication with taxpayers as well as the overall level of service. The IRS must balance service and enforcement priorities to maximize compliance, minimize taxpayer burden, and protect taxpayer rights.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- List a telephone number on all correspondence examination letters for the taxpayer to call if he or she needs the letter reissued in Spanish.
- For visually impaired and blind taxpayers, make correspondence examination letters available in a format that is readable and understandable (e.g., in Braille). Place a hold on the taxpayer's account while waiting for the accommodating notice. Create a process to allow the taxpayer to request that all further correspondence between the taxpayer and the IRS be communicated in the requested accommodating format.
- Extend the response time to 45 days in the initial stage of correspondence. Conduct research to determine if using a 30 or 45 day letter or two separate letters

[65] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* i (Oct. 2005).

[66] *Id.* at 2.

PROBLEMS

(one at 30 days and a follow-up letter 15 days later) makes a difference in taxpayer response times.

- Provide specific examples of documentation needed to resolve the issue
- Develop fill-in forms like the EITC certification form to the greatest extent possible.
- Acknowledge receipt of correspondence from taxpayers, regardless of whether the information is sufficient to resolve the issue(s).
- Attempt to reach taxpayers by telephone in all no response cases. Conduct additional address research, including internet and external databases, not just the U.S. Postal Service.
- Evaluate the correspondence examination process to determine why taxpayers have difficulty understanding what documentation is needed.
- Eliminate the use of "Combo Letters" in all but the simplest tax cases (*i.e.*, cases with issues that can readily be resolved in one taxpayer contact by a single source document or brief explanation).
- Develop and implement performance measures to;
  1. reduce the volume of unassociated mail;
  2. reduce the premature closure of audits; and
  3. consider the time it takes to resolve an audit reconsideration in the cycle time computation.
- Establish a better system of correspondence control so responses can be timely associated with case files.
- Make sure taxpayers know that the time is running for petitioning the U.S. Tax Court even if additional information is submitted for consideration.
- Train examiners in the appropriate use of oral testimony.
- Include information on the Low Income Taxpayer Clinic program in the initial correspondence letter.

PROBLEM

TOPIC #17 IRS IMPLEMENTATION OF MATH ERROR AUTHORITY IMPAIRS TAXPAYER RIGHTS

RESPONSIBLE OFFICIAL

Richard J. Morgante, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

Taxpayers who are summarily assessed additional tax via a "math error" notice may not be afforded the same rights as those who are assessed additional tax through normal IRS deficiency procedures. Math error authority allows the IRS to summarily assess tax *before* a taxpayer has the opportunity to challenge the assessment in the U.S. Tax Court.

Because math error assessments are not subject to judicial review before the tax is paid or collected, the Internal Revenue Code only allows the IRS to use these assessments in specific, narrow circumstances. The IRS has, however, issued math error notices in cases that go beyond these specific narrow circumstances, thus exceeding its limited statutory authority. Even in instances where the IRS has the authority to issue math error assessments, the corresponding math error notices do not adequately explain the error that gave rise to the math error assessment, or the actions required to contest the assessment. When the IRS summarily assesses taxes without authority and issues confusing math error summary assessment notices, taxpayers' rights are impaired.

ANALYSIS OF PROBLEM

What is a math error assessment?

Internal Revenue Code § 6213(b) authorizes the IRS to assess an addition to tax, without issuing a notice of deficiency, where the adjustment is the result of a mathematical or clerical error on the tax return as defined in IRC § 6213(g). This summary assessment authority allows the IRS to assess and collect the additional tax and provides the taxpayer no initial opportunity for review in the Tax Court. A taxpayer receiving a math error assessment may only go to Tax Court if he or she contests the assessment within 60 days *after* the assessment has been made.[1] The IRS issued more than 2.5 million math error notices resulting in deficiencies in calendar year 2005.[2]

The IRS is authorized to make math error assessments *only* in the following circumstances:

- An error in addition, subtraction, multiplication, or division shown on any return (IRC § 6213(g)(2)(A));

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1 IRC § 6213(b)(2).

2 The IRS issued 975,581 math error balance due notices to individuals and 1,557,608 math error balance due notices to businesses during 2005. Individual balance due math error notices are defined as notices CP11, CP11A, and CP711. Business balance due math error notices are defined as notices CP101, CP102, CP103, CP104, CP105, CP107, CP132, CP801, and CP802. IRS Office of the Notice Gatekeeper, *Calendar Year 2005 Total Volumes*.

- An incorrect use of any table provided by the IRS with respect to any return if other information in the return makes the incorrect use apparent (IRC § 6213(g)(2)(B));
- An entry on a return of an item which is inconsistent with another entry of the same or different item on that return (IRC § 6213(g)(2)(C));
- An omission of information which is required to be supplied on the return to substantiate an entry on that return (IRC § 6213(g)(2)(D));
- An entry on a return of a deduction or credit in an amount which exceeds the statutory limit for that deduction or credit, if that limit is expressed as a specific monetary amount or as a percentage, ratio, or fraction, and if the component items of that limit appear on the return (IRC § 6213(g)(2)(E));
- A correct Taxpayer Identification Number (TIN) not provided on the return as required for:
  - the Earned Income Tax Credit (EITC)[3] (IRC § 6213(g)(2)(F)),
  - the child and dependent care credit[4] (IRC § 6213(g)(2)(H)),
  - the personal or dependent exemption[5] (IRC § 6213(g)(2)(H)),
  - the child tax credit[6] (IRC § 6213(g)(2)(I)), and
  - the Hope and Lifetime Learning credits[7] (IRC § 6213(g)(2)(J));
- A return claiming an EITC for net earnings from self-employment, where the self-employment tax imposed by IRC § 1401 on those net earnings has not been paid (IRC § 6213(g)(2)(G));
- An omission of information required for recertification of eligibility for the Earned Income Tax Credit (IRC § 6213(g)(2)(K));
- An entry on the return of a TIN required for the EITC, the child credit, and the child and dependent care credit, when information associated with that TIN indicates the child does not meet the age eligibility requirements for those credits (IRC § 6213(g)(2)(L)); and
- An entry on the return of a claim for the EITC where the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of that child (IRC § 6213(g)(2)(M)).

[3] IRC § 32.

[4] IRC § 21.

[5] IRC § 151.

[6] IRC § 24(e).

[7] IRC § 25A (g)(1).

These specific circumstances encompass the entire universe of IRS math error assessment authority. The IRS is authorized to summarily assess taxes in these circumstances, and these circumstances only.[8]

How are math error assessments different from general IRS assessments?

General Deficiency Procedures

Under general IRS deficiency procedures, when the IRS examines a tax return and identifies an error that results in an understatement of tax, the IRS notifies the taxpayer of the proposed deficiency.[9] When the taxpayer does not agree with the assessment, the IRS sends the taxpayer a report that describes the return items to be adjusted, the tax (if any) reported on the original return, and the correct tax according to the IRS.[10] The taxpayer has 30 days to accept the proposed adjustments or request an appeal with the IRS Office of Appeals.[11]

If the taxpayer does not respond to the initial notice or does not prevail in the Appeals conference, the IRS will issue the taxpayer a statutory notice of deficiency (SNOD).[12] The SNOD sets forth the proposed deficiency and informs the taxpayer that he or she has 90 days (from the date of the notice) to file a petition in the Tax Court to challenge the proposed deficiency.[13] During this 90-day period, and until the Tax Court's decision is final, the IRS generally may not proceed with assessment and collection procedures against the taxpayer with respect to the subject tax.[14] If the taxpayer does not timely file a petition with the Tax Court, the IRS will assess the proposed deficiency.[15]

In general, the Tax Court is the only judicial forum where a taxpayer can challenge a tax liability before paying the liability in full.[16] A statutory notice of deficiency, however, is required before a taxpayer can litigate a tax dispute in the Tax Court. For this reason,

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[8] For additional discussion of the IRS's math and clerical error authority, see National Taxpayer Advocate 2002 Annual Report to Congress 25-31 and 185-197.

[9] A "deficiency" is the amount by which the tax exceeds "the excess of (1) the sum of (A) the amount shown as the tax by the taxpayer upon his return … plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over (2) the amount of rebates … made." IRC § 6211(a).

[10] IRM 4.10.8.11 (Aug. 11, 2006).

[11] IRM 4.10.8.11.9 (Aug. 11, 2006).

[12] IRC § 6212(a).

[13] IRC § 6213(a). If a SNOD is addressed to a taxpayer outside the United States, the taxpayer has 150 days to file a petition in Tax Court. *Id.*

[14] IRC § 6213(a).

[15] *Id.*

[16] IRC § 6512(a).

a statutory notice is often called the "ticket" to Tax Court, without which the taxpayer does not have the right to legally challenge a tax liability in that court.[17]

Summary Assessment Procedures

The IRS does not have to follow its standard deficiency procedures, however, when it makes a summary assessment of tax under math error authority. The IRS must only notify the taxpayer that the assessment has been made and provide an explanation of the error.[18] This "math error" notice is not considered a statutory notice of deficiency and thus does not allow a taxpayer to petition the Tax Court.[19]

Internal Revenue Code § 6213(b)(2) provides, however, that a taxpayer receiving a math error notice has 60 days from the date of the notice to request that the IRS abate the tax. The IRS cannot begin to collect the tax until the taxpayer has agreed to the tax or the 60-day period has ended. If the taxpayer requests that the tax be abated, the IRS must then use the general deficiency procedures under IRC § 6212 if it believes that the additional tax is in fact due.[20]

The taxpayer is not required to explain a request for the abatement of a summary assessment. Instead, the Code requires the IRS to "abate the assessment" "upon receipt of a request."[21] Unless a taxpayer requests abatement of a math error assessment, however, he or she cannot challenge the assessment through IRS deficiency procedures or petition the Tax Court. Thus, the abatement request is the only procedure available to a taxpayer receiving a math error adjustment for protesting the tax liability without first paying the tax in full.[22]

How did the IRS get the authority to issue math error assessments?

Congress first authorized the IRS to make math error assessments in the Revenue Act of 1926, which denied the taxpayer the right to appeal to the Board of Tax Appeals where a

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[17] Taxpayers who cannot challenge a tax liability in Tax Court may still have the opportunity to challenge the liability in the United States district court or the United States Court of Federal Claims. These courts have jurisdiction over suits for federal tax refunds. 28 U.S.C. § 1346(a)(1). Unlike in the Tax Court, in order to receive judicial review of a tax liability in one of the refund forums, a taxpayer must first pay the disputed income tax in full and then file a claim for refund with the IRS. *See Flora v. United States*, 362 U.S. 145 (1960) (United States District Court has no jurisdiction of a suit for refund of income tax payments that did not discharge the entire amount of assessment); I.R.C. § 7422(a). If the disputed tax is a divisible tax (such as employment or excise tax), the taxpayer need only pay the amount of tax attributable to a single transaction or event (for example, employment taxes for one employee for one quarter) in order to file suit in one of the courts with jurisdiction over federal tax refund suits. *See Flora v. United* States, 362 U.S. at 171, n. 37 and 175; *Fidelity Bank, N.A. v. United* States, 616 F.2d 1181 (10th Cir. 1980) (employment taxes); *United States v. Papandon,* 331 F.3d 52 (2d Cir. 2003) (excise taxes). In these suits, the government generally counterclaims for the balance of the amount of tax in dispute.

[18] IRC § 6213(b)(1).

[19] *Id.*

[20] IRC § 6213(b)(2)(A).

[21] *Id.*

[22] *Id.*

deficiency was based on a mathematical error, and authorized the IRS to make an assessment and collect the tax due as a result of that error.[23]

In 1976, Congress expanded the IRS's summary assessment authority to include clerical as well as mathematical errors. The Tax Reform Act of 1976 defined for the first time "mathematical or clerical error," which encompassed the first five instances of mathematical or clerical error in the present law listed above.[24] From 1996 through 2001, Congress added the remaining five permissible uses of math error authority to the Code.[25]

When Congress first defined "mathematical or clerical error" in 1976 legislation, it was concerned that the IRS might use its summary assessment authority in ways that would undermine taxpayer rights. Before the 1976 Act was passed, the IRS had been interpreting the term "mathematical error" "to include several types of error which are broader in nature than literal errors of arithmetic." Court opinions, on the other hand, had generally "limited the scope of the term 'mathematical error' to arithmetic errors involving numbers which are themselves correct."[26]

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[23] Revenue Act of 1926, enacting IRC § 274(f). *See* H. Rep. 69-1, 10-11. The Board of Tax Appeals was the predecessor to the United States Tax Court.

[24] A mathematical or clerical error was defined as: (1) an error in addition, subtraction, multiplication, or division shown on any return; (2) an incorrect use of any table provided by the IRS with respect to any return if other information in the return makes the incorrect use apparent; (3) an entry on a return of an item which is inconsistent with another entry of the same or different item on that return; (4) an omission of information which is required to be supplied on the return to substantiate an entry on that return; and (5) an entry on a return of a deduction or credit in an amount which exceeds the statutory limit for that deduction or credit, if that limit is expressed as a specific monetary amount or as a percentage, ratio, or fraction, and if the component items of that limit appear on the return. IRC § 6213(g)(2)(A-E).

[25] *See* The Small Business Job Protection Act of 1996, P.L. No. 104-188, section 1615(c) (authorizing the use of summary assessment procedures where a taxpayer fails to supply a taxpayer identification number (TIN) for a dependent); The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, P.L. No. 104-193, section 451(c) (authorizing the use of math error procedures where a required TIN was not supplied with respect to the EITC; and where a taxpayer, receiving the EITC on the basis of self-employment income, did not pay self-employment tax on that income); P.L. No. 105-34, sections 1085(a) and 101(d)(2) (authorizing math error assessments for omitted TINs for purposes of the Hope and Lifetime Learning Credits and the Child Tax Credit); The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. No. 107-16, section 303(g) (authorizing summary assessment procedures where data from the Federal Case Registry of Child Support Orders (FCR) indicates that a taxpayer is the noncustodial parent of a qualifying child). Although authorized to do so, the IRS does not currently use math error procedures to make summary assessments in the latter instance. For a detailed discussion of the legislative history of math error authority expansion from 1996-2001, see National Taxpayer Advocate, 2002 Annual Report to Congress, 185-197 (recommending that the definition of mathematical and clerical error be limited to: (1) inconsistent items in which the inconsistency is determined from the face of the return, (2) omitted items, including schedules, that are required to be included with the return, and (3) items reported on the return that are numerical or quantitative and which can be verified by a government entity that issues or calculates such information; and recommending repeal of IRC § 6213(g)(2)(M), which authorizes math error summary assessments for an entry on a return with respect to a qualifying child for the EITC, where a taxpayer has been identified as the non-custodial parent of that child by the FCR.)

[26] H. Rep. 94-658, 289; S. Rep. 94-938, 374. "The [IRS] position is that mathematical error includes the following: errors in arithmetic (such as 2+2=5); errors in transferring amounts correctly calculated on a schedule, form, or another page of Form 1040 to either page 1 or 2 of Form 1040; missing schedules, inconsistent entries and computations (such as cases where total exemptions claimed do not agree with the total used in computing the tax); and errors where the entry exceeds a statutory numerical or percentage limitation (such as a standard deduction claimed in excess of the maximum allowed by the Code)."

Because of this definitional discrepancy, the IRS requested that Congress statutorily expand math error authority on efficiency grounds. The IRS argued "that the deficiency notice procedure is significantly more costly than the mathematical error procedure" and that it (the IRS) "properly uses this procedure in categories of cases where most taxpayers do not dispute the [IRS's] conclusions."[27]

While mindful of these efficiency issues, Congress did not want to authorize the IRS to use summary assessment procedures where it "*may have* erred in its determination."[28] Congress attempted to balance these considerations by both expanding the IRS's math error assessment authority, but also "[providing] greater protection for taxpayers who wish to contest [IRS] summary assessments in mathematical error cases by restricting the [IRS's] powers in such cases," and "[clarifying] the kinds of cases in which the [IRS] could use its *restricted* summary assessment authority."[29] IRC § 6213(b) incorporates these taxpayer protections by requiring the IRS to:

- Explain the asserted error to the taxpayer;
- Abate the assessment if the taxpayer requests such abatement within 60 days of the date of the notice; and
- Abstain from collecting on the assessment until the taxpayer has agreed to the assessment or has allowed his or her time for objecting to the assessment to expire.[30]

To help ensure that the IRS did not exceed its summary assessment authority in the name of administrative convenience, Congress took the unusual step of providing specific examples in the committee reports that illustrate the correct application of math error authority. For instance, where there are inconsistencies on a return, summary assessment procedures are allowed only in "those cases where it is apparent which of the inconsistent entries is correct and which is incorrect."[31] The reports discussed two examples, one in which a math error assessment is permitted and the other where it is not.

- In the first example, a taxpayer listed six dependents on the face of the return and entered the number "6" as the total number of exemptions. However, on the second page of the return, the taxpayer entered a dollar amount for the personal and dependent exemptions that was equal to a multiple of "7." The committees stated that the IRS may treat this as a math error and correct the exemption amount to the multiple of "6." However, the committees further stated they expected the IRS "will so phrase its notification to the taxpayer as to include questions designed

[27] H. Rep. 94-658, 289; S. Rep. 94-938, 375.

[28] H. Rep. 94-658, 289; S. Rep. 94-938, 375 (emphasis added).

[29] *Id.*.

[30] *Id.* at 375.

[31] H. Rep. 94-658, 291; S. Rep. 94-938, 376.

to show whether the taxpayer is indeed entitled to the greater number of exemptions."[32]

- In the second example, a taxpayer listed three names as dependents but entered "4" in the box for the total number of dependents. The committees stated that it is not clear from the face of the return whether the taxpayer inadvertently omitted a dependent's name from the face of the return or simply added incorrectly. Here, the committees believed that "the summary assessment procedure is not to be used where it is not clear which of the inconsistent entries is the correct one."[33]

The committee reports from the 1976 Act also direct the IRS to clearly explain math and clerical error summary assessments to affected taxpayers. The committee reports explain that the IRS is to send math and clerical error notices with detailed, itemized, line-by-line explanations of such errors. The reports also instruct the IRS to word its math and clerical error notices in such a way as to *encourage* taxpayers to respond with information to correct errors resulting in erroneous adjustments.[34]

The specific examples and instructions in the committee reports indicate that Congress was concerned that the IRS might (1) use its summary assessment procedures beyond their limited scope in an attempt to facilitate administrative convenience and (2) fail to adequately explain the errors resulting in summary assessments and how taxpayers could question or challenge such assessments.

How does the IRS make summary assessments and issue math error notices?

The IRS mails a math error notice to a taxpayer when it identifies a mathematical or clerical error on a tax return. The notice describes why the IRS changed one or more lines on the return and instructs the taxpayer that no action is required if he or she agrees with the change, but to call or write the IRS within 60 days if the taxpayer disagrees with the change.[35] If the taxpayer disagrees with the change and contacts the IRS, the taxpayer's "protest" of the change is classified as either substantiated or unsubstantiated.

Substantiated Protests

A substantiated protest occurs when the taxpayer provides supporting information (oral or written) to indicate that the math or clerical error is erroneous.[36] An unsubstantiated protest occurs when the taxpayer does not provide supporting information to show that the IRS erred in determining the math or clerical error[37] When the taxpayer contacts the IRS with a substantiated protest, the IRS will reverse the error and adjust the

[32] H. Rep. 94-658, 291; S. Rep. 94-938, 377.

[33] *Id.*

[34] H. Rep. 94-658, 288-293; S. Rep. 94-938 374-378.

[35] *See* IRM 3.14.1-8–3.14.1-14 (Jul. 1, 2006).

[36] IRM 21.5.4.4.4 (Oct. 1, 2005).

[37] IRM 21.5.4.4.5 (Oct. 1, 2006).

taxpayer's account (including releasing any withheld refunds).[38] The IRS will reverse math errors in substantiated protest cases even if the taxpayer does not contact the IRS within 60 days.[39]

Unsubstantiated Protests

When a taxpayer contacts the IRS with an unsubstantiated protest, the IRS's actions depend on whether the contact takes place before or after the 60 day period has expired. If a taxpayer makes an unsubstantiated protest within 60 days of the date of the math error notice, the IRS customer service representative (CSR) is to:

- Explain the taxpayer's abatement rights and the consequences of abatement (*i.e.*, the case may be referred to Examination and any applicable refund may be held);
- Ask whether the taxpayer wishes to request an abatement; and
- If the taxpayer does request an abatement (and this request may be made orally), the CSR is to restore the original figures on the taxpayer's return (*i.e.*, abate the assessment), place a hold on the taxpayer's account (including a hold on any applicable refunds), and refer the case to Examination – which must make any assessment pursuant to general deficiency procedures.[40]

When a taxpayer contacts the IRS with an unsubstantiated protest after 60 days from the date of the math error notice, the taxpayer cannot challenge the summary assessment through normal deficiency procedures and has lost the opportunity to challenge the assessment in Tax Court.[41] If the taxpayer still wishes to challenge the liability, he or she must pay any tax due and file a claim for refund.[42] Once the taxpayer pays the tax (or if the IRS has already collected the tax by reducing the taxpayer's refund), the taxpayer can challenge a denied refund claim through IRS Appeals.[43] Refund claims not settled in Appeals can be litigated in the United States district courts or the United States Court of Federal Claims.[44]

Table 1.17.1 summarizes the IRS's math error notice processing procedures.

[38] IRM 21.5.4.4.3 (Oct. 1, 2006).

[39] *Id.*

[40] IRM 21.5.4.4.5 (Oct. 1, 2006).

[41] IRC § 6213(b); IRM 21.5.4.4.3 (Oct. 1, 2006).

[42] 28 U.S.C. § 1346(a)(1); IRC § 7422(a); IRM 21.5.4.4.3 (Oct. 1, 2006). The IRS may, at its own discretion, consider a taxpayer's claim without requiring the taxpayer to pay the tax in full, but the IRS is not required to do this.

[43] IRM 21.5.4.4.3 (Oct. 1, 2006); IRM 21.5.3.4 (Oct. 1, 2006).

[44] 28 U.S.C. § 1346(a)(1).

TABLE 1.17.1, MATH ERROR NOTICE PROCESSING

Taxpayer Contacts the IRS within 60 Days

If	and	and	Then
Taxpayer agrees with change			No action required
Taxpayer disagrees with change	Provides substantiation		Math error is reversed
Taxpayer disagrees with change	Does not provide substantiation (or provides insufficient or inadequate substantiation)	A tax balance is due	The assessment is abated, the account is referred to Exam, and deficiency procedures are instituted
Taxpayer disagrees with change	Does not provide substantiation (or provides insufficient or inadequate substantiation)	The taxpayer's refund has been reduced (*i.e.*, the IRS has already collected the tax)	The assessment is abated, the refund is held, and the account is referred to Exam

Taxpayer Contacts the IRS After 60 Days

If	and	and	Then
Taxpayer agrees with change			No action required
Taxpayer disagrees with change	Provides substantiation		Math error is reversed
Taxpayer disagrees with change	Does not provide substantiation (or provides insufficient or inadequate substantiation)	A tax balance is due	Taxpayer must pay the tax liability and file a claim for refund
Taxpayer disagrees with change	Does not provide substantiation (or provides insufficient or inadequate substantiation)	The taxpayer's refund has been reduced (*i.e.*, the IRS has already collected the tax)	Taxpayer's "claim" for amount of reduced refund is denied. Taxpayer must challenge the denied claim through IRS Appeals

Math Error Notice Volume

From 2003 to 2005, the IRS issued, on average, more than 7.2 million math error notices to individual and business taxpayers each calendar year.[45] An average of 2.8 million notices per year resulted in taxpayers being assessed a balance due.[46] Thus, millions of taxpayers annually are unable to challenge IRS assessments through normal deficiency procedures and in Tax Court unless they proactively request, within 60 days, that the tax summarily assessed on a math error notice be abated.

[45] This figure includes math error notices that resulted in a changed refund, even balance, or a balance due. Individual filer notices are defined as CP10, CP10A, CP11, CP11A, CP12, CP12A, CP12E, CP13, CP13A, CP16, CP711, CP712, and CP713. Business filer notices are defined as CP101, CP102, CP103, CP104, CP105, CP106, CP107, CP111, CP112, CP113, CP114, CP115, CP116, CP117, CP123, CP124, CP125, CP126, CP127, CP131, CP132, CP133, CP268, CP801, CP802, CP811, and CP812.

[46] The IRS sends notices where the adjustment is over a *de minimus* amount. IRS Office of the Notice Gatekeeper, *Annual Master File Notice Volume by CP# and Center report*. Individual filer balance due math error notices are defined as CP11, CP11A, and CP711. Business filer balance due math error notices are defined as CP101, CP102, CP103, CP104, CP105, CP107, CP132, CP801, and CP802.

TABLE 1.17.2, NUMBER OF BALANCE DUE MATH ERROR NOTICES BY CALENDAR YEAR[47]

Calendar Year	Individual Filers Receiving Notice	Business Filers Receiving Notice	Total Balance Due Notices
2003	1,249,907	1,612,091	2,861,998
2004	1,339,884	1,568,714	2,908,598
2005	975,581	1,557,608	2,533,189

The inability to challenge an IRS assessment through normal deficiency procedures and in the Tax Court can be a problem for any taxpayer who faces a deficiency because of a math error assessment. This problem is particularly challenging for low income taxpayers, however, because these taxpayers are generally not in a position to pay their taxes in full, as required to challenge an assessment under IRS refund and litigation procedures and in Tax Court. Table 1.17.3 below shows taxpayers earning less than $40,000 annually receive 49 percent of individual math error notices (based on tax year 2004 data).

TABLE 1.17.3, DISTRIBUTION OF INDIVIDUAL TAXPAYERS RECEVING A BALANCE DUE MATH ERROR NOTICE BY ADJUSTED GROSS INCOME, TY2004[48]

Adjusted Gross Income	Notices	Percentage
Under $20,000	240,370	24.8%
$20,000 - $39,999	235,533	24.3%
$40,000 and over	492,270	50.9%
Total Balance Due Math Error Notices	**968,173**	**100.0%**

Has the IRS used its summary assessment authority inappropriately?

The Code authorizes the IRS to use summary math error assessment authority in lieu of normal deficiency procedures in the thirteen instances enumerated in section 6312(g), and in those instances only. Generally, the IRS uses its summary assessment authority properly, but the Taxpayer Advocate Service (TAS) is aware of instances where the IRS has exceeded its limited statutory authority.

[47] IRS Office of the Notice Gatekeeper, *Annual Master File Notice Volume by CP# and Center report.* Changes in the tax law can cause a change in the number of math errors. For example, the Jobs Growth Relief Act of 2003 increased the child tax credit from $600 to $1,000 per child and instructed the IRS to advance payment of the increased portion. Pub. L. No. 108-27 § 101. The IRS mailed a check for $400 per eligible child to taxpayers where prior year data allowed the IRS to reasonably predict eligibility. Taxpayers who received the check were to subtract $400 per child from the amount of credit claimed on the return, and taxpayers who did not receive a check could claim the full $1,000 per child. IRS Instructions for Form 1040, 2003 Tax Year. The IRS created a new error code related to the advance child credit (Taxpayer notice code 547, IRM 3.12.3 (Jan. 1, 2004), and this new error accounted for 2.6 million math errors (both reduced refund and balance due) for the 2003 tax year. *Individual Master File data*, Tax Year 2003. Taxpayers would have received these notices in calendar 2004.

[48] IRS, *Individual Master File, Tax Year 2004.* Errors on tax year 2004 returns will, in most cases, result in a math error notice issued in calendar year 2005.

Disallowed Business Expenses

In July 2006, TAS challenged the IRS's use of math error authority to deny expense deductions to non-resident alien students.[49] IRC § 871(c) allows foreign students meeting certain criteria to claim certain expenses as business deductions from scholarship income. However, the IRS summarily denied these deductions to hundreds[50] of eligible taxpayers using math error procedures.[51] Determining the legitimacy of a business expense deduction is not one of the circumstances enumerated in IRC § 6213(g) for which a math error assessment is allowed. Thus, the IRS exceeded its statutory authority by summarily assessing additional tax for these denied § 871(c) deductions.

Three hundred eighty six impacted taxpayers sought TAS assistance. After TAS intervened, the IRS reversed the assessments and agreed to stop using math error authority for assessments attributable to denied IRC § 871(c) deductions and to revise the Internal Revenue Manual to reflect this change. It is unknown, however, how many taxpayers received math error assessments for denied IRC § 871(c) deductions but did not come to TAS for help. And even those who received TAS assistance waited up to 19 months to receive their full refunds.[52]

Other TAS Examples

TAS is also aware of other examples where IRS mistakes in the math error process harmed taxpayers. The IRS used its math or clerical error authority to summarily assess taxes in the following cases:

- A family experienced an immediate financial hardship when the IRS disallowed the EITC because the IRS had incorrectly entered all the taxpayer's income as interest instead of wages.[53]
- An 82-year old retiree sought TAS assistance when his refund was delayed for three months because his pension income was entered by the IRS as wages.[54]
- The IRS processed the Form 1040 of a U.S. citizen living abroad as a Form 1040NR (non-resident). The taxpayer received a letter requesting information about his citizenship as well as a math error notice denying an exemption for

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49 Systemic Advocacy Management System project (2006). The cases involved tax year 2004.

50 IRS systems do not allow us to identify taxpayers who may have received a math error notice due to this specific tax issue. However, there were 1,338 Form 1040NR (Non-resident) tax year 2004 returns filed that had a Schedule A attached and a math error. Subtracting the 386 known cases, there could be as many as 952 other taxpayers who were denied their refund. IRS, *Individual Master File Tax Year 2004*.

51 Other related code sections are 8 USCS § 1101(a)(15)(F),(J),(M),(Q) which provides that international students are treated as nonimmigrant aliens, and IRC § 1441(b) which provides for the treatment of a scholarship as income. The employee business expenses being questioned were claimed on IRS Form 2106, *Employee Business Expense* (2005).

52 The refunds were released in October and November 2006.

53 Taxpayer Advocate Management Information System (TAMIS) (2006).

54 *Id.*

a deceased dependent (this was incorrect). With TAS assistance, the taxpayer received his refund plus an interest payment of $138.00.[55]

- The IRS summarily assessed a business taxpayer additional tax despite the taxpayer's explanation (which was included with the return) as to why tax was not owed. The taxpayer then contacted the IRS within 60 days of the math error notice to protest the assessment, but the IRS did not abate the tax. The IRS did send the case to the Examination function for review, but did not issue a statutory notice of deficiency to the taxpayer. Instead, the IRS told the taxpayer to pay the disputed tax and file a claim for refund. The IRS actions in this case are in direct violation of IRC § 6213(b).[56]

These cases are only a few examples of math error assessment problems the Taxpayer Advocate Service dealt with in fiscal year 2006.

Clarity of IRS math error notices

When the IRS identifies a computational or clerical error on a tax return, it must notify the taxpayer of the error.[57] Because taxpayers must proactively challenge a math error assessment within 60 days to use general IRS deficiency procedures and to challenge the assessment in the Tax Court, math error notices must clearly explain the nature of the assessment, how a taxpayer can challenge the assessment, and the time period for making a challenge.

In recent years, the IRS has made its math error notices more clear by listing applicable math errors by tax return line item,[58] and specifically explaining what a taxpayer must

[55] Taxpayer Advocate Management Information System (TAMIS) (2005).

[56] Taxpayer Advocate Management information System (TAMIS) (2006). TAS was actively working this case at the time this report was published.

[57] IRC § 6213(b).

[58] Beginning in 2005, the IRS implemented a past National Taxpayer Advocate recommendation that math error explanations include a line number reference. *See* National Taxpayer Advocate 2002 Annual Report to Congress 30. Examples:
- We lowered the total income on Line 22 of your Form 1040 because income was included that is not taxable. Welfare payments, Workmen's Compensation, etc., are not taxable income. (Taxpayer Notice code 113).
- We changed the amount of capital gain or loss on Line 14 of your Form 1040. There was an error in the transfer of the amount from Line 18b(2) of your Form 4797, Sales of Business Property, to Line 14 of your Form 1040. (Taxpayer Notice code 123). *Wage and Investment Division Response*, June 2006.

do to challenge the summary assessment.[59] However, further improvements are needed to ensure that notices meet congressional standards.

Congressional Intent Regarding Math Error Notice Clarity

The committee reports to the Tax Reform Act of 1976 indicate Congress expected the IRS to clearly explain the nature of math error assessments to taxpayers.[60] In fact, the reports explain that Congress expected the IRS to send summary assessment notices that show detailed, itemized, line-by-line explanations of math or clerical errors, and that encourage taxpayers to contact the IRS with questions about the notice and with the information necessary to correct applicable errors.[61] The committee reports provided an example of a single taxpayer who identified himself as "married filing separately," but used the tax table for single taxpayers to compute the tax shown on his return. The committees noted that a summary assessment would be appropriate to correct this error (incorrect use of a table), but the committees also emphasized the importance of clearly explaining the assessment to the taxpayer and wording the notice to encourage the taxpayer to contact the IRS with the correct information:

> It is expected that the notification to the taxpayer will indicate that the taxpayer used the single person's rate schedule, that the taxpayer checked line 3 on the Form 1040, that such a taxpayer should have used the married persons filing separately schedule, and the notification should show the amount of the difference in tax (indicating the amount from the married persons filing separately schedule minus the amount from the single persons schedule).
>
> The notice to the taxpayer is also to inquire whether the taxpayer is in fact married and is to inquire as to such other information which might enable the taxpayer to determine whether he or she might be eligible for a more favorable tax status even though married.[62]

An actual taxpayer in this situation today would receive a math error notice from the IRS with the following explanation:

[59] The IRS added revised appeal rights language to the major math error notices in January 2006. The revised language states:

> Should you contact us about your account and we cannot reach an agreement about the change we made to your account, you have the right to ask us to reverse the change. In response to your request, we will forward your case to our examination function for an additional review. This action will give you formal appeal rights, including the right to appeal our decision in court.
>
> Our examination function will contact you once they've received your request – usually within five to six weeks. At that time, you will receive a complete explanation of our examination process and of your rights.
>
> **Remember –** You need to contact us within 60 days from the date of this letter to request an examination of your return and to retain your right to appeal our decision. We will consider any information you send us, regardless of the 60-day period, but you can only request an examination and keep your right to appeal our decision within that period.

[60] H. Rep. 94-658, at 290-291 and S. Rep. 94-938, at 376-377.

[61] H. Rep. 94-658, 288-293; S. Rep. 94-938, 374-378.

[62] H. Rep. 94-658, at 290-291 and S. Rep. 94-938, at 376-377.

> We changed your filing status. We refigured your tax using the married filing separately filing status based on the information on your tax return.[63]

The current IRS explanation does not meet the standard set forth in the committee reports. It does not indicate the tax rate schedule the taxpayer used or the filing status checked, nor does it inquire about the taxpayer's marital status or provide information that allows the taxpayer to determine if the IRS computed his or her tax based on the most favorable rate schedule.

We reviewed the language used for 231 math errors,[64] and found only nine instances where the language provided additional guidance that may help the taxpayer achieve a more beneficial tax situation.[65] These nine types of math errors together accounted for less than one percent of all math errors on tax year 2004 individual returns.[66] In other words, 99 percent of the notices going to individual taxpayers still do not contain the type of information that the Congress anticipated when it initially defined "math or clerical error."

Abatement Request Procedures

IRS math error assessment notices could also better explain what a taxpayer must do to challenge a summary assessment, when this challenge must be made, and the consequences of failing to challenge the assessment in a timely manner. Current math error notices explain:

> You need to contact us within 60 days from the date of this letter to request an examination of your return and to retain your right to appeal our decision. We will consider any information you send us, regardless of the 60-day period, but you can only request an examination and keep your right to appeal our decision within that period.

IRC § 6213(b) provides that taxpayers who fail to request the abatement of a summary assessment within 60 days of the date of the math error notice will not receive a statutory notice of deficiency and will thus lose the opportunity to contest the assessment in Tax Court – and effectively lose the opportunity to challenge the tax liability without first paying the tax. Because both the proactive abatement request and deadline by which this request must be made are critical, the IRS could be more specific about these

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63 IRM 3.12.3-2 (Jan. 1, 2006).

64 Taxpayer notice codes in the ranges 101–299, 502-696, 604-748. IRM 3.12.3-2 (Jan. 1, 2006).

65 The nine instances were taxpayer notice codes 109, 120, 129, 132, 133, 166, 167, 193, and 257. IRM 3.12.3-2 Taxpayer Notice Codes (Jan. 1, 2006). The explanation for notice code 109 says:
> We changed your filing status. We refigured your tax using the married filing separately filing status because you can't claim your spouse as an exemption when using single or head of household filing status. Note: You may file Form 1040X, Amended U.S. Individual Income Tax Return, claiming the married filing jointly filing status for a more favorable tax rate. Both you and your spouse must sign Form 1040X.

66 The occurrences of taxpayer notice codes 109, 120, 129, 132, 133, 166, 167, 193, and 257 totaled 3,289 in TY2004. Total math errors equaled 4.1 million. *Individual Master File, Tax Year 2004.*

items on math error notices. One model of specificity is the IRS's own statutory notice of deficiency. When the IRS issues a SNOD, the header includes the text:

> "Last Day to File a Petition With the United States Tax Court: [date]"[67]

Summary assessment notices should be at least as clear as SNODs, because the taxpayer will lose the ability to challenge the summary assessment in Tax Court without proactively requesting an abatement. Including a specific "last day to contact the IRS" date would also help taxpayers avoid any confusion about when the 60-day period begins to run, or if it includes weekends and holidays.

Reconciliation Table

Math error notices contain a reconciliation table that is intended to show the effect of the math error on the taxpayer's tax liability. This table, however, shows only the "bottom line" impact of the error and does little to help the taxpayer understand the changes the IRS has made.

For example, assume a taxpayer made two mistakes on his Form 1040: (1) a computational error summing up two Forms W-2, Employee's Wage And Tax Statement,[68] to arrive at total wages, and (2) an error copying total itemized deductions from the Schedule A to the tax return. The taxpayer would receive a math error notice that contains the following language and table describing these errors:

> We changed the total income on Line 22 to include all the forms W-2, W-2g, etc., that were attached to your tax return because there was an error in the total income reported.
>
> We changed the amount claimed as total itemized deductions on Line 40 of your Form 1040 because there was an error on Schedule A, Itemized Deductions. The error was in the:
>
> - Computation of total itemized deductions on Line 28 of Schedule A and/or
> - Transfer of that amount to Line 40 of your Form 1040.[69]

[67] IRS Letter 531 Notice of Deficiency, (Rev. 4-2006).

[68] Form W-2 is issued by an employer and contains the wages earned and tax withheld during a calendar year.

[69] Taxpayer Notice Codes 114 and 187, Wage & Investment Division Response (Jun. 2006).

TABLE 1.17.3, RECONCILIATION TABLE FROM BALANCE DUE MATH ERROR NOTICE[70]

2005 Tax Return Form 1040 as of [date]

Line Item On Your Return	Your Figures	IRS Figures
Adjusted Gross Income	$54,333.00	$55,333.00
Taxable Income	$34,215.00	$35,935.00
Total Tax	$5,221.00	$5,646.00
Total Payments		$5,300.00-
Amount of Underpaid Tax		$5,346.00
Penalties (computed below, if applicable)		$.00
Interest computed through [date] (computed below)		$.00
Total amount owed		$346.00
Minus: Total of all payment you made that are not included in the Total Payments amount shown above	(Enter amount)	
Amount You Owe after subtracting above payments	(Enter amount)	

This table presents a summary of the IRS changes only. It does not show the specific line item that the IRS adjusted, as Congress directed in 1976.

The IRS could improve taxpayers' understanding of the changes made to the tax return by enhancing the table. The following table is an example of what this might look like. This three-column format is similar to what the IRS requires taxpayers to provide when they file an amended tax return.[71]

[70] CP11 – Math Error with a Balance Due of $5 or More, IRM 3.14.1-9 Exhibit, (Jul. 1, 2006). The table contains hypothetical figures.

[71] Form 1040X, *Amended U.S. Individual Income Tax Return* (Rev. November 2005). Taxpayers are required to provide any schedule or form relating to the change, for example, a Schedule A if the taxpayer was amending the tax return to itemize deductions. In addition, the taxpayer completes the Form 1040X and must provide three columns of data for the original amount, the net change, and the correct amount. *Instructions for Form 1040X, Amended U.S. Individual Income Tax Return* (Rev. November 2005).

TABLE 1.17.4, PROPOSED RECONCILIATION TABLE FOR A BALANCE DUE MATH ERROR NOTICE

Line Item On Your Return	Your Figures	Net Change	IRS Figures
Wages, salaries, tips, etc. (Line 7)	$54,111.00	$1,000.00	$55,111.00
Adjusted Gross Income (Line 37)	$54,333.00	$1,000.00	$55,333.00
Itemized Deductions (Line 40)	$16,918.00	-$720.00	$16,198.00
Taxable Income (Line 43)	$34,215.00	$1,720.00	$35,935.00
Total Tax (Line 63)	$5,221.00	$425.00	$5,646.00
Total Payments (Line 71)	$5,300.00	0.00	$5,300.00
Amount of Underpaid Tax	($79.00)	$425.00	$346.00
Penalties (computed below, if applicable)			$.00
Interest computed through [date] (computed below)			$.00
Total amount owed			$346.00
Minus: Total of all payment you made that are not included in the Total Payments amount shown above		(Enter amount)	
Amount You Owe after subtracting above payments		(Enter amount)	

This table contains several improvements to the IRS form currently in use:

- The table shows the tax form lines changed by the IRS and provides the taxpayer with "before and after" figures. Including these lines is especially important when there is more than one error or a single error has a ripple effect on other figures.[72]
- Line number references have been added to assist the taxpayer when he or she refers back to a copy of the tax return.
- A third column has been added showing the net difference in the relevant line items as a result of the IRS's changes. In this example, the table shows that the increase in taxable income is due to a $1,000 increase in wages and a $720 reduction in itemized deductions.

CONCLUSION

The IRS faces an enormous challenge each year in processing tens of millions of returns and ensuring that they are complete and accurate. To accommodate that challenge, Congress has authorized the IRS to use summary assessment authority in specified cases of math and clerical errors. This authority allows the tax system to work efficiently when the IRS uses the authority as permitted and adequately explains summary assessments to taxpayers and informs them how to question or challenge a summary assessment. However, when the IRS misuses this authority or does not clearly explain these assessments, the tax system becomes less efficient because taxpayer rights are compromised and the IRS must use resources to handle increased taxpayer questions and problems.

[72] In the hypothetical example presented, the taxpayer made a computation error when he summed the wages from two Forms W-2. Depending on the income level of the taxpayer, such an error could impact his ability to claim the EITC or to itemize deductions.

IRS COMMENTS

We do not agree that the IRS math error authority impairs taxpayer rights. The IRS makes every effort to exercise the math error authority granted by the Internal Revenue Code (Code) in strict compliance with the provisions of the law. The National Taxpayer Advocate's report correctly indicates that the IRS made an error in applying this authority to deny certain expense deductions of non-resident alien students. When the Taxpayer Advocate Service (TAS) brought this to our attention, we immediately changed our procedures. The report does not provide sufficient detail to allow us to respond to the other four examples that are included to suggest IRS uses its math error authority beyond what is permitted by the law. However, each of these examples appears to involve an employee mistake as opposed to a systemic or procedural error in the application of the law. We also acknowledge the need to improve math error notices. Three years ago, a multi-functional team that includes the TAS was established to do just that. The team's efforts have already resulted in several enhancements that improve the clarity of these notices and additional improvements are planned.

Each year, the IRS processes millions of individual income tax returns. Errors and omissions on these returns as well as clerical processing errors are an inherent element of returns processing. It is in this vein that Congress granted the IRS authority in § 6213(b) of the Code to assess an addition to tax without issuing a notice of deficiency. This authority is limited to mathematical and clerical errors defined in § 6213(g).

When a math error assessment is made, the taxpayer is notified by mail. This notification advises the taxpayer that an error was identified on his or her income tax return, the action taken by the IRS, and provides the actions that need to be taken if the taxpayer agrees or disagrees within a 60-day time period. This notice also advises the taxpayer he or she must contact the IRS within the 60-day period to protect his or her right to petition the Tax Court. During this protected 60-day period, the taxpayer's account is frozen by the IRS to prevent collection actions.

If the taxpayer agrees with the math error change, generally no further action is necessary unless the change results in a balance due. If the taxpayer disagrees and notifies the IRS within the sixty day period, he or she may either contact the IRS by phone or in writing and provide the substantiation necessary to reverse the assessment in whole or in part or he or she may request an abatement of the assessment without providing any substantiation. The IRS must honor this abatement request. In accordance with the law, these unsubstantiated requests are referred to the Examination function for issuance of a statutory notice of deficiency.

It is important to note the math error procedures authorized by the Code serve as an alternative to deficiency procedures in the limited mathematical or clerical error circumstances provided for in the law. Math error authority is not a method for the IRS to accelerate or initiate collection actions and it does not eliminate any taxpayer rights provided for by the Code.

We agree that the IRS incorrectly used math error procedures to deny certain expense deductions to non-resident alien students. The unallowable item hold process should have been used by IRS to work these questionable expense deductions. This issue affected a limited number of taxpayers and IRS immediately ceased use of math error authority in these cases in July 2006, when the issue was raised by TAS.

The National Taxpayer Advocate cites four other examples that suggest improper use of math error authority by the IRS. We have not been afforded an opportunity to review the specific facts in each of these examples. However, these four cases do not appear to involve systemic application of math error authority beyond what is permitted in the Code. Rather, they seem to involve mistakes by the employees working each case. Regardless, the IRS would welcome more detailed information that will allow us to research and respond to the specific circumstances involved in these four examples. More importantly, with additional information, we will be able to determine if they indicate systemic problems or a need for procedural changes.

We agree that math error notices can be improved. The Tax Reform Act of 1976 requires the IRS to clearly explain math errors identified during original processing and the recourse available to taxpayers to challenge these assessments. Over the last three years, the IRS has made great strides in improving the clarity of all math error notices. The IRS formed the Notice Improvement Initiative Team (NPIIT) comprised of cross-functional representatives from Submission Processing, Accounts Management, Field Assistance, and TAS. The overall goal of NPIIT was to improve the notice process by:

- Modifying the Taxpayer Notice Codes (TPNCs) to use clear, concise, and reader-focused, return-line (Form 1040 series) specific, non-accusatory language. TPNCs are the descriptive narratives used in the body of math error notices to identify and explain the error(s).
- Reducing the number of TPNCs to promote their ease of use by IRS and to reduce errors in selecting the correct TPNCs.
- Establishing a proper sequence for the TPNCs when multiple math errors are present so they match the flow of the return.

The IRS also initiated a new procedure requiring functional Subject Matter Experts and Single Point of Contact employees (people designated in each function to coordinate all notice issues) to jointly review revised notices during the Systems Acceptance Testing process. This will further ensure the accuracy and consistency of these notices.

As a result of these efforts, each TPNC now provides both a descriptive explanation identifying the specific error on the return, and the action taken by IRS to correct the error. All math error notices were revised to include more detailed information on the steps needed for taxpayers to challenge these assessments. In January 2006, appeal rights language was added to a number of the Computer Paragraph (CP) notices (notices that involve selection of optional computer generated standard paragraphs) and the team

will partner with the Office of Chief Counsel to review the appeal rights sections in all other math error notices. In addition, to further clarify the time requirements for challenging math error assessments, by 2009 we expect to have computer programming that will allow the addition of a paragraph with a variable date field. This will enable us to include the specific date for the last day a taxpayer can challenge the assessment.

TAXPAYER ADVOCATE SERVICE COMMENTS

By definition, math error assessment authority does not give taxpayers the rights they would otherwise have under general IRS assessment procedures. IRC § 6213(a) provides for certain restrictions on IRS assessments (no collection on the assessment from the time the taxpayer is allowed to petition the Tax Court until the Tax Court's decision is final) and § 6213(b) – the math error assessment provision – provides for "exceptions to [these] restrictions on assessments." While Congress granted the IRS the authority to issue math error assessments, it also recognized that math error authority would limit taxpayer rights, and it clearly directed the IRS to use the authority appropriately and provide clear math error assessment notices to taxpayers. The National Taxpayer Advocate believes the IRS, while having made significant improvements to the math error notice process, still has some work ahead so that it is administering its math error assessment authority in the way Congress intended.

TAS recognizes and commends the IRS's efforts to quickly stop using math error authority to deny expense deductions to non-resident alien students. TAS also acknowledges that many math error assessment problems may be the result of IRS employee errors rather than faulty processing procedures. TAS believes, however, that when IRS employees erroneously use math error assessment authority, a systemic problem is present. The examples TAS cites suggest that there is not a complete understanding at all levels within the IRS of the strict limitations Congress has placed on the implementation of math error authority. IRS employees who handle math error assessments and notices must understand more than the mere mechanics of notice processing. These employees must also understand how math error assessments differ from general IRS assessments, that math error assessments statutorily limit taxpayer rights, and that math error authority is to be used in the limited circumstances enumerated in the Code, and in those limited circumstances *only*.

Our concern about math error authority implementation goes beyond denying expense deductions to nonresident students (although the example does highlight the concerns raised in this and prior Annual Reports to Congress).[73] Any misuse of statutory authority is a matter of concern, whether it affects a large number of taxpayers or a "limited" number as the IRS suggested.

[73] *See* National Taxpayer Advocate 2001 Annual Report to Congress 33-34, National Taxpayer Advocate 2002 Annual Report to Congress 25-31, National Taxpayer Advocate 2003 Annual Report to Congress 113-121.

As with all examples of TAS casework cited in this report, the cases are just that – examples. We know about the 386 taxpayers affected by the inappropriate use of math error authority because they came to TAS for assistance. The actual number of taxpayers affected is likely larger, and the rest of these taxpayers, who did not seek our assistance, will never receive the refunds to which they were entitled.

The other examples where taxpayers received math error notices that resulted from IRS processing mistakes emphasize the importance of carefully wording notices so they clearly explain to taxpayers their rights and what they need to do if they disagree with the change made by the IRS. In recent years, the IRS has improved the clarity of these notices by adding line specific references to errors and more detailed information about appeal rights. Yet, these improvements are incremental in light of the congressional intent for math error notices. As noted in our analysis, *99 percent of the notices going to individual taxpayers still do not contain the type of information that the Congress anticipated when it defined "math or clerical error" in 1976.*[74]

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS take the following steps to improve its administration of math error authority:

- Math error notices should specify the exact nature of an error so the taxpayer understands clearly what must be corrected to reverse the change to the tax return. For example, if a Social Security number on the return is not valid, the explanation on the notice should identify which taxpayer or claimed dependent is associated with the suspect number.
- Math error notices should clearly state the date by which taxpayers must contact the IRS to retain the right to petition the Tax Court. We encourage the IRS to investigate options for implementing this improvement in advance of the current 2009 target date.
- The IRS should revise the reconciliation table on math error notices to include the individual line items that were in error, and show the net difference in line items as a result of IRS changes to the return. The line items shown in the table should also include the line number of the tax return.
- The IRS should enhance its math error notice employee training to include an overview of the legislative basis for math error authority in training materials for employees involved in math error processing. The training should cover: (1) the differences between a math error assessment and a general assessment; (2) the congressional intent behind the IRS's math error assessment authority (including examples from the legislative history showing what constitutes a math error and

[74] We also note that while the IRS quickly agreed to stop using math error authority in these nonresident student cases, it took up to four months to release the disputed portion of the refunds, resulting in these taxpayers waiting up to 19 months after filing their tax returns to receive their rightful refund.

what does not); (3) the specific limited allowable uses of math error authority enumerated in IRC § 6213(g); and (4) the statutory requirement to abate a math error assessment at the taxpayer's request.

- The quality review process for math error notices should be improved by adding a determination that math error authority was applied appropriately. Currently, the quality review process focuses only on processing (for example, determining whether a math error notice contains the correct computer-generated paragraph for the identified return error).

PROBLEM TOPIC #18 LIMITED ENGLISH PROFICIENT (LEP) TAXPAYERS: LANGUAGE AND CULTURAL BARRIERS TO TAX COMPLIANCE

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Division

DEFINITION OF PROBLEM

The IRS provides limited pre-filing, filing, and post-filing assistance to taxpayers who have low literacy levels or for whom English is a second language, which can result in increased hardships, taxpayer burden, and noncompliance among this fast-growing group. Limited English Proficiency (LEP) taxpayers experience difficulties in dealing with the IRS and present unique challenges for tax administrators, including:

- Language and cultural barriers amplify the complexity of tax laws and IRS procedures;
- Language barriers hinder LEP taxpayers in filing returns, limiting their ability to meet tax obligations or obtain tax benefits to which they are entitled;
- Language barriers may also cause taxpayers to turn to tax preparers who are not competent or not scrupulous; and
- If they do file returns, LEP taxpayers may find post-filing notices, letters, and audit notifications difficult to understand when the communication from the IRS is in a language other than a taxpayer's primary language.

Further, some LEP taxpayers come from cultures where citizens do not trust the tax system or government in general. This sentiment affects their interactions with the IRS and other government agencies. Establishing and maintaining trust between the IRS and the LEP community is an important step in bringing LEP taxpayers into the system and keeping them there.

ANALYSIS OF PROBLEM

The U.S. LEP Population and the LEP Taxpayer Population

According to the U.S. Census Bureau's 2005 American Community Survey, nearly 52 million people, or 19 percent of the total population age five and over, reported speaking a language other than English at home.[1] Of those 52 million, approximately 23 million[2] reported speaking English less than "very well" and are considered to be

1 U.S. Census Bureau, *2005 American Community Survey*, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

2 U.S. Census Bureau, *2005 American Community Survey*, Table S1601, Language Spoken at Home.

linguistically isolated and to have limited English proficiency.[3] In 2003, 11 million adults, or five percent of the U.S. population, were considered non-literate in English.[4]

Spanish is the most common language other than English, with 32 million speakers. Almost half of all Spanish speakers, approximately 15 million, reported they spoke English less than "very well." After English, the five languages most often spoken at home in the United States are Spanish, Chinese, French, Tagalog, and Vietnamese.[5]

TABLE 1.18.1, TOP TEN LANGUAGES OTHER THAN ENGLISH SPOKEN AT HOME IN 2005[6]

Language spoken at home	Number of Speakers	Number who speak English less than "very well"	Percentage who speak English less than "very well"
Spanish	32,184,293	15,396,674	48 %
Chinese	2,300,467	1,263,972	55 %
French	1,383,432	308,453	22 %
Tagalog	1,376,632	453,666	33 %
Vietnamese	1,142,328	707,372	62 %
German	1,120,256	217,499	19 %
Korean	983,954	581,711	59 %
Russian	812,404	415,347	51 %
Italian	802,436	224,053	28 %
Arabic	686,986	245,685	36 %

Between 1990 and 2000, the number of Spanish speakers grew by about 62 percent, Vietnamese speakers almost doubled, and Russian speakers nearly tripled.[7] The LEP population is expected to continue to increase along with the immigrant population. The Census Bureau projects the Hispanic population alone will rise to almost 48 million by 2010 and exceed 102 million by 2050.[8]

Immigrants and LEP individuals make up a large and growing segment of the U.S. labor force, which will potentially interact with the IRS or seek information about tax obligations. In 2005, foreign-born workers comprised almost 15 percent of the overall work

[3] U.S. Census Bureau, *Summary File 3, 2000 Census of Population and Housing, Technical Determination* B-32 (March 2005). Reports vary in the use of census numbers when defining LEP taxpayers. Although some reports use the number of persons who self-identify as speaking English "not well" or "not at all" as LEP individuals, the Census Bureau defines a linguistically isolated household as one in which no person 14 years old or older is able to speak English "very well." Due to the highly technical nature of tax law and IRS procedures, this report will follow the Census Bureau's interpretation of a linguistic isolated household and consider those who speak English less than "very well" as having limited English proficiency (LEP).

[4] National Center for Education Statistics, *National Assessment of Adult Literacy; A First Look at the Literacy of America's Adults in the 21st Century* 4 (Dec. 2005).

[5] *Id.*

[6] U.S. Census Bureau, 2005 *American Community Survey*, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

[7] U.S. Census Bureau, *Census 2000 Brief, Language Use and English-Speaking Ability: 2000* 3 (Oct. 2003).

[8] U.S. Census Bureau, *US Interim Projections by Age, Sex, Race and Hispanic Origin,* Table 1a (March 2004).

force. Hispanics accounted for about 49 percent of these workers while Asians made up another 22 percent.[9] As the number of immigrant workers increases, so does the number of those who are self-employed. Immigrant self-employment increased from 10.9 percent of the total self-employed population in 1994 to 14.7 percent in 2003.[10] One estimate projects that immigrants will generate all of the net growth in the nation's labor force in the next 20 years.[11]

The IRS Demographic Assessment

The IRS's demographic assessment uses census figures where LEP individuals are identified as speaking English "not well" or "not at all."[12] Using this definition, the IRS put the LEP population in 2003 at 12.3 million.[13] For the reasons stated below, we believe this stratification inaccurately reflects the LEP population because it omits 9.8 million individuals who identified themselves as speaking English "well" in 2003.[14]

The 2000 census data on ability to speak English represents the person's own perception about his or her ability. Respondents were not instructed how to interpret the response categories: "Very well," "Well," "Not well," and "Not at all."[15] Further, this question only covers the ability to speak English, not reading skills or reading comprehension. Because of the highly legal and technical nature of the Internal Revenue Code and IRS processes, we believe it is accurate to add those persons who identified themselves as speaking English "well" to the LEP category.

The Treasury Inspector General for Tax Administration (TIGTA) agrees that individuals who speak English "well" should be considered part of the LEP population, stating that this group was included in its reports because TIGTA wanted to show "…the maximum number of LEP persons who could benefit from having documents translated into non-English languages."[16] In addition, the census defines a "linguistically isolated" household as one in which no person 14 years old or older is able to speak English "Very well." In 2000, the Census Bureau listed 4.4 million households encompassing 11.9 million people as linguistically isolated. This is nearly 52 percent higher than

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[9] U.S. Department of Labor, *Labor Force Characteristics of Foreign-Born Workers Summary* (April 2006).

[10] Small Business Administration, *Self-Employment Business Ownership Rates in the United States: 1979 -2003* (Dec. 2004).

[11] National Conference of State Legislatures, *Immigrants in the Workforce: Some Fast Facts* (Aug. 2005).

[12] IRS, *Multilingual Initiative Customer Base Report FY 2006* 9 (Feb. 2006).

[13] *Id.*

[14] U.S. Census Bureau, 2003 *American Community Survey*, Custom Table, PCT020 Nativity by Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

[15] U.S. Census Bureau, *Summary File 3, 2000 Census of Population and Housing, Technical Determination* B-32 (March 2005).

[16] Treasury Inspector General for Tax Administration, Ref. No. 2003-40-163, *Limited English Proficient Taxpayers Need Improved Written Products to Help Them Understand and Comply With Tax Laws* 6 (Aug. 2003).

the 2.9 million households and almost 55 percent higher than the 7.7 million people described as linguistically isolated in 1990.[17]

Barriers to LEP Taxpayer Compliance and Obtaining Assistance for LEP Taxpayers

Language Barriers

To meet the needs of an expanding LEP population, the IRS must train its workforce and provide the necessary tools to assist these taxpayers in meeting tax obligations and obtaining benefits. This assistance must go beyond the basic information in brochures and publications. It must reach taxpayers throughout the "life" of a tax return, including post-filing requests for information as well as the examination and collection processes. While the IRS has increased the number of products (including notices, forms, and brochures) and services available to LEP taxpayers, improvements are still needed.

Although some translated notices are available, the IRS does not attempt to determine the taxpayer's spoken language at the outset of his or her interaction with the IRS. As a result, in FY 2005 only 0.6 percent of all computer-generated letters sent to taxpayers were in Spanish.[18] Receiving correspondence in a language that the taxpayer cannot understand may delay or prevent a response. By waiting until later in the examination or collection process to determine the taxpayer's language preference, the IRS may be sending the taxpayer crucial initial notices that he or she cannot understand. This failure to communicate could result in missed deadlines, hardships, and diminished taxpayer rights. Statutory notices of deficiency, for example, require responses within specified timeframes. Taxpayers who disagree with the deficiencies, but cannot fully understand the notice because of limited English proficiency, may not meet the timeframes. They would then face the extra burden of having to pay the tax first and file a claim before the issue can be taken to court.[19]

Cultural Barriers

Limited English Proficient taxpayers may face significant barriers in learning about IRS services and tax obligations because of beliefs and perceptions brought from their native countries. Many of these taxpayers come from countries where the governments and tax systems are rife with corruption and fraud. Some taxpayers have never participated in a tax system at all before coming to the United States. Misunderstanding and mistrust of the IRS can lead LEP taxpayers to fail to seek out and use IRS services, not respond to IRS communications, or simply disappear from the tax system and become part of

[17] U.S. Census Bureau, *Census 2000 Brief, Language Use and English-Speaking Ability: 2000* 10 (Oct. 2003).

[18] IRS Office of the Notice Gatekeeper, Integrated Data Retrieval System (IDRS) Cumulative Notice Volume, FY 2005. The Notice Gatekeeper records all IRS letters generated through the IDRS system. The IRS sent 16,225,293 C-letters (IDRS generated letters based on standard letter templates) in FY 2005 and of this total, only 98,407 were in Spanish. *See* Most Serious Problem, *Correspondence Delays, supra.*

[19] IRC § 6213. The notice of deficiency starts the 90-day (or 150 days if the notice is addressed to a person outside the United States) statutory period within which the taxpayer can petition the United States Tax Court for a redetermination of the deficiency without first having to pay the proposed increase in tax.

the underground economy. A study prepared for the IRS found frustration with the IRS and the U.S. tax system among parts of the Hispanic population, including small business owners, because there is little information or understanding of the benefits of paying taxes and many believe "the wealthy" receive unfair advantages within the system.[20] The study also found certain segments of the Hispanic community believe the IRS shares information with U.S Citizenship and Immigration Services (USCIS).[21] It is important for the IRS to reach out to these immigrants with targeted messages that build trust within the LEP communities and reverse these negative perceptions. To accomplish this, the IRS must tailor outreach and communications to fit each LEP community.

These impressions and beliefs about the U.S. tax system can quickly spread throughout the immigrant population. Immigrants often gravitate to particular regions and metropolitan areas, where they gather and create communities of family, friends, churches, shops, and community centers, all of which provide a network of familiarity and help them adapt to life in the United States.[22] For example, surveys have shown that Hispanics may hold diverse views, values, and beliefs, yet they share a range of attitudes and experiences that set them apart from the non-Hispanic community.[23] Research indicates that most Hispanic taxpayers would not seek information from the IRS directly, but would turn to their tax preparers because they trusted the preparers and felt they were more familiar with their "personal histories."[24]

Taxpayers in LEP communities are often targeted by preparers who prepare inaccurate and even fraudulent returns. Many of these preparers remain open only through April 15, then close their doors, leaving taxpayers without follow-up assistance when they need it. Because these taxpayers place so much trust in their preparers, the taxpayers often know very little about how the returns were prepared and cannot explain some of the items listed. Somali and Bosnian immigrants recently have been targets of unscrupulous preparers who allegedly used inflated or fictitious deductions in these LEP taxpayers' returns.[25] One such preparer in the Midwest targeted recent immigrants from various African countries, including Somalia. The U.S. Department of Justice (DOJ)

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[20] GlobalHue, *Qualitative Hispanic Market Research* 9 (May 2003).

[21] GlobalHue, *Hispanic LEP Taxpayer Research Quantitative Report* 67 (Jun. 2003).

[22] IRS Wage and Investment Research Group 2, Project 2-04-16-2-043E, *Hispanic Language/Ethnic Islands Data and Their Implication on Tax Administration* 9 (Nov. 2004).

[23] Robert Suro, ET AL., 2002 National Survey of Latinos, Pew Hispanic Center/Kaiser Family Foundation 6 (Dec. 2002).

[24] GlobalHue, *Qualitative Hispanic Market Research* 11 (May 2003).

[25] Press Release, Department of Justice, Federal Judge Shuts Down Second Tax Preparer Who Targeted Bosnian Immigrants in Bogus Tax-Refund Scheme (March 2, 2006). Press Release, Department of Justice, Federal Court Bars Second Minnesota Man From Preparing Tax Returns For Others (Mar. 10, 2006).

asserts he prepared more than 3,300 returns since 2002, causing an estimated loss of over $8 million to the U.S. Treasury.[26]

Downstream Effects of Language and Cultural Barriers

Failure to provide necessary customer service at the beginning of the tax filing process can often lead to increased contact with taxpayers further downstream. As Senator Max Baucus, the Ranking Member of the Senate Committee on Finance, recently stated, "Taxpayer service gives taxpayers the opportunity to get their tax obligations right the first time, so expensive enforcement action is unnecessary."[27] While all taxpayers are vulnerable to the effects of reduced or nonexistent customer service, LEP taxpayers have a greater chance of surfacing in the compliance arena because of their limited sources of tax information and limited knowledge of the tax system. Since the IRS does not capture data on the preferred language of taxpayers, it is impossible to determine how many or what percentage of LEP individuals receive post-filing notices or end in tax controversies.

However, recent Department of Justice injunctions against tax preparers who targeted immigrants offer insight into how these taxpayers end up further downstream in the tax compliance process.[28] A Minnesota preparer, who prepared fraudulent returns for Somali and other African immigrants, sent taxpayers scrambling for help once they discovered their returns were under investigation. The IRS expended resources from its Criminal Investigation and Examination functions to audit the returns and the Office of Appeals worked cases not settled in Examination. Some taxpayers eventually turned to the U.S. Tax Court in hopes of resolving their disputes. Because these immigrants had little or no knowledge of the U.S. tax system, they sought help from Low Income Taxpayer Clinics (LITC) and the Local Taxpayer Advocate's (LTA) office.[29] After hearing about these problems in the community, Taxpayer Advocate Service employees visited local community organizations and educated these taxpayers about applicable tax laws and the information needed for their audits. One LITC alone, Mid-Minnesota Legal Assistance, represented 104 taxpayers with problems associated with this preparer.[30]

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[26] Press Release, Department of Justice, Federal Court Bars Second Minnesota Man From Preparing Tax Returns For Others (March 10, 2006). Press Release, Department of Justice, Justice Department Asks Federal Court to Bar Minnesota Man from Preparing Tax Returns for Others (Feb. 7, 2006).

[27] Letter from Sen. Max Baucus, Ranking Member, Senate Committee on Finance, to Sens. Christopher Bond and Patty Murray, Chairman and Ranking Member, Senate Appropriations Subcommittee on Transportation, the Treasury, the Judiciary, and Housing and Urban Development (Jun. 16, 2006), available at http://www.senate.gov/~finance/press/Bpress/2005press/prb061906.pdf.

[28] Press Release, Department of Justice, Federal Judge Shuts Down Second Tax Preparer Who Targeted Bosnian Immigrants in Bogus Tax-Refund Scheme (March 2, 2006). Press Release, Department of Justice, Federal Court Bars Second Minnesota Man From Preparing Tax Returns For Others (Mar. 10, 2006).

[29] At least 41 of these cases were worked by the Minnesota Local Taxpayer Advocate's office. The TAS case receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS) for cases in organization code 041 received on or after 10/01/2004 and having SOMAL in the local use field, or with a Primary Core Issue Code (PCIC) between 610 -640 (Examination Issues) and a search for Somali names, or with a PCIC of 950 (Criminal Investigation) and a search for Somali names.

[30] Telephone Interview with Director, Mid-Minnesota Legal Assistance (Oct. 18, 2006).

According to the LITC Director, the clinics represented these taxpayers in Examination, Appeals, Collection, and filed petitions in Tax Court. In some cases, the LITC represented the taxpayer throughout the entire process. Even though these taxpayers knew little of the tax system or how their taxes were prepared, some found these tax issues worked against them when they applied for U.S. citizenship.[31]

These cases illustrate that the consequences of failing to provide customer service for LEP taxpayers extend beyond taxes and the IRS. These taxpayers, who may have been drawn to unscrupulous preparers because they could not obtain LEP services from the IRS, must now attempt to resolve their issues with even fewer IRS resources available in their primary languages at the tax controversy stage.[32]

IRS Response to These Barriers: IRS Multilingual Initiative

On August 11, 2000, President Clinton signed Executive Order 13166, *Improving access to Services for Persons with Limited English Proficiency*.[33] The order directed all federal agencies to "… develop and implement a system by which LEP persons can meaningfully access those services consistent with, and without unduly burdening, the fundamental mission of the agency." In response, the IRS created the Multilingual (MLI) Strategy Office to provide executive oversight of the agency-wide multilingual strategy.[34]

The IRS had previously established the Multilingual Initiative to comply with the IRS Reform and Restructuring Act of 1998 (RRA 98), which required the IRS to establish Spanish telephone help lines and prompted the IRS to create an External Civil Rights Unit (ECRU) to investigate alleged violations of Title VI of the Civil Rights act of 1964.[35] To stress the IRS's commitment to assisting non-English speaking taxpayers in meeting their responsibilities, the Commissioner issued a Multilingual Policy Statement on October 18, 1999, solidifying the IRS's commitment to provide its workforce with the tools to serve a diverse population.[36]

In the past few years, the IRS has made progress in expanding services to the LEP community, specifically Spanish-speaking taxpayers. In addition to creating a Spanish language website translating over 240 documents into Spanish,[37] other LEP services include:

- Some notices generated in Spanish at the taxpayers' request;

[31] *Id.*

[32] IRS, *Multilingual Initiative Customer Base Report FY 2006* 102, 109 (Feb. 2006). Over-the-phone (OPI) interpreter assistance is only listed as being offered at Taxpayer Assistance Centers and is not offered as a service to customers using the IRS's toll-free phone lines.

[33] Exec. Order No. 13166, 65 Fed. Reg. 50121 (Aug. 11, 2000).

[34] IRS, *Multilingual Initiative Customer Base Report FY 2006* 12 (Feb. 2006).

[35] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685.

[36] IRS Policy Statement, P-6-41 (Oct. 18, 1999).

[37] IRS, *Multilingual Initiative Customer Base Report FY 2006* 60 (Feb. 2006).

- Toll-free phone assistance at six call sites around the country;
- Customer service kiosks in 38 locations; and
- Over-the-phone interpreters (OPI) at all Taxpayer Assistance Centers.[38]

The IRS has completed Phase II of the LEP Needs Assessment[39] aimed at identifying LEP taxpayers and assessing current products and services both internally and with feedback from external stakeholders.[40] While it is too soon to determine how the IRS will use this research, it does show the IRS is attempting to understand the demographics of the LEP population and identify opportunities for improvement. We applaud this effort. The question remains, however, whether the IRS will have the necessary resources to implement the resulting recommendations.

IRS Response to Barriers: Language Assistance Policy

The IRS identified only Spanish as a "regularly encountered"[41] language in the recent demographic assessment by the MLI Strategy Office.[42] As such, the IRS adopted the following Language Assistance Policy:[43]

- For Spanish-speaking customers, the IRS will offer oral language assistance comprised of various options and written language assistance (document translations), including the translation of "Vital Documents;"
- For areas heavily populated with non-English speaking taxpayers who speak languages other than Spanish, the IRS will offer limited oral language assistance but no written assistance; and

38 IRS, *Multilingual Initiative Customer Base Report FY 2006* 60 (Feb. 2006).

39 *Id.* at 158. External stakeholder source information includes Low Income Taxpayer Clinic (LITC) Director and LEP Customer Surveys, Tax Practitioner Surveys, EITC Grassroots LEP Participant Survey, LEP Random Digit Dialing Telephone Survey, and SEPC, Field Assistance, ACS and Accounts Management Customer Satisfaction Surveys.

40 IRS, *Multilingual Initiative Customer Base Report FY 2006* 12-13 (Feb. 2006)

41 Department of Justice Guidance to Federal Financial Assistance Recipients Regarding Title VI Prohibition Against National Origin Discrimination Affecting Limited English Proficient Persons, 67 Fed. Reg. 117 (June 18, 2002). This guidance provides no specific definition of "regularly encountered" individuals, but rather provides four factors agencies should use when assessing how to provide meaningful access to programs and services. The four factors include: (1) The number or proportion of LEP persons eligible to be served or likely to be encountered by the program or grantee; (2) the frequency with which LEP individuals come in contact with the program; (3) the nature and importance of the program, activity, or service provided by the program to people's lives; and (4) the resources available to the grantee/recipient and costs. However, the guidance cautions agencies that the flexibility given in addressing the needs of the LEP populations served "does not diminish, and should not be used to minimize, the obligation that those needs be addressed."

42 IRS, *Multilingual Initiative Customer Base Report FY 2006* 20 (Feb. 2006). *See also* Memorandum from Mark Matthews, Deputy Comm'r for Services and Enforcement to Divisional Commissioners (Oct. 24, 2005).

43 Memorandum from Mark Matthews, Deputy Comm'r for Services and Enforcement to Divisional Commissioners (Oct. 24, 2005).

- For languages not designated as "regularly encountered," the IRS may provide assistance to community volunteers or limited over-the-phone interpreter services within resource constraints. The IRS will not offer written language assistance.

Written Communication

Executive Order 13166 requires all federal agencies to develop and implement a system by which LEP individuals can meaningfully access services without unduly burdening the fundamental mission of the agency.[44] Per the Executive Order, the Department of Justice issued guidance and provided a framework for federal agencies to carry out this mission, including determining what documents should be considered for translation.[45] Using this guidance, the IRS has designated 108 documents as "vital."[46] The IRS defines vital documents as either "required by law or critical to the receipt of a federal benefit or service."[47] The IRS plans to translate these vital documents only into Spanish, its sole designated "regularly encountered" language. This policy, which precludes the translation of vital documents into any language but Spanish, leaves millions of LEP taxpayers struggling to understand their tax obligations and navigate the tax controversy process. For example, the IRS offers no written language assistance or translated notices to approximately 1.3 million people who speak Chinese and identify themselves as speaking English less than "very well."[48] The IRS recognizes the Asian population as the second fastest growing LEP population segment in the U.S., yet does not include any Asian languages in its translation policy.[49]

The IRS has translated a limited number of documents into other languages, mostly for education and outreach purposes.[50] Individuals who speak languages other than English or Spanish must look outside the IRS for help in translating forms, notices, and letters, many which directly impact taxpayer rights. Expecting LEP taxpayers to find their own translators to interpret forms, notices, and publications places a burden upon these taxpayers. Further, not being aware of the complexity or importance of IRS forms and notices, these LEP taxpayers may seek help from others, such as their school-age children, who only have limited English skills or who cannot comprehend and translate complex IRS issues.

[44] Exec. Order No. 13166, 65 Fed. Reg. 50121 (Aug. 11, 2000).

[45] Department of Justice Guidance to Federal Financial Assistance Recipients Regarding Title VI Prohibition Against National Origin Discrimination Affecting Limited English Proficient Persons, 67 Fed. Reg. 117 (Jun. 18, 2002).

[46] IRS, *Multilingual Initiative Customer Base Report FY 2006* 70 (Feb. 2006). Form 2688, which is listed as a vital document for translation, is now obsolete and superseded by Form 4868.

[47] *Id.*

[48] U.S. Census Bureau, *2005 American Community Survey*, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

[49] IRS, *Multilingual Initiative Customer Base Report FY 2006* 19 (Feb. 2006).

[50] *Id.* at 70.

The IRS has translated over 240 documents into Spanish.[51] While this figure includes 87 of the 108 "vital" documents, the IRS has yet to translate several other "vital" documents that are essential to the examination or collection process and the protection of taxpayer rights.[52]

TABLE 1.18.2, SAMPLE OF VITAL DOCUMENTS NOT CURRENTLY TRANSLATED INTO SPANISH[53]

Document Title	Product Type	Product Number	Legislative Requirement
Notice of Deficiency[54]	Letter	531(DO) 531(SC)	IRC 6212/6155/6303
CP 2000 – AUR Notice of Proposed Tax Changes[55]	Notice	CP 2000	IRC 6212
Notice of Intent to Levy and Notice of Your Right to a Hearing[56]	Notice	CP-90	IRC 6331/6320
LT 11 Notice of Intent to Levy[57]	Notice	LT 11	IRC 6330/6331

As noted earlier, the IRS defines "vital documents" as those that are "required by law or critical to the receipt of a federal benefit or service."[58] Following this definition without consideration for IRS-specific rights may lead the IRS to omit documents for translation that impact taxpayer rights or provide taxpayer protections. It is clear from the list

[51] IRS, *Multilingual Initiative Customer Base Report FY 2006* 19 (Feb. 2006).

[52] *Id.* The IRS designated these documents as vital but has not yet translated them. In lieu of translating Notice CP-90, the IRS added a statement informing the taxpayer where (telephone number) he or she can obtain assistance in Spanish.

[53] IRS, *Multilingual Initiative Customer Base Report FY 2006* 71-77 (Feb. 2006).

[54] The statutory notice of deficiency is required by IRC § 6212 when the IRS determines there is a deficiency, which is generally the excess of the amount the IRS contends is the correct tax over the amount the taxpayer showed on the return. Meeting prescribed timeframes is important because per IRC § 6213 the taxpayer has 90 days from the date of the letter to file a petition in Tax Court challenging the proposed tax deficiency (or 150 days if addressed to a person who resides outside the United States). Failing to meet these statutory guidelines would require the taxpayer to first pay the tax and file a claim for a refund before litigating the issue.

[55] CP 2000 is a notice that informs the taxpayer of a proposed change to tax liability because of income that is not identifiable or apparently not fully reported on the return. It may also include credits and deductions that appear overstated. If the taxpayer's response does not resolve the issue, there is no response, or the notice is undeliverable, a Statutory Notice under IRC § 6212 will be issued. The taxpayer would then fall under the prescribed timeframes for IRC § 6213.

[56] This notice informs taxpayer that IRS intends to issue a levy against any federal payments due the taxpayer, such as SSA benefits or OPM retirement benefits, because the taxpayer still has a balance due on his or her tax account. If the taxpayer does not agree with the proposed action, the taxpayer has the right to file a Collection Due Process (CDP) hearing request. The request for a CDP hearing must be filed within 30 days of the notice for full CDP rights.

[57] This notice, as required under IRC §§ 6330 and 6331, informs a taxpayer that the IRS intends to levy on his or her property or rights to property 30 days after the date of the letter unless the taxpayer pays, makes arrangements to pay, or files for a CDP hearing, if available. Examples of property include bank accounts, wages, commissions, business assets, cars and other income and assets.

[58] IRS, *Multilingual Initiative Customer Base Report FY 2006* 70 (Feb. 2006).

above that the IRS has adopted a narrow view of the term "federal benefit or service." Fundamental statutory taxpayer rights, such as the right to be heard in Tax Court or have a Collection Due Process (CDP) hearing, are indeed "fundamental benefits or services." Thus, the IRS's current translation policy does not comply with Executive Order 13166.

Telephone, Automated, and Face-to-Face Assistance

The IRS has attempted to remove some of the barriers that LEP taxpayers face by offering several bilingual services, including telephone assistance, self-service kiosks,[59] web sites, and face-to-face contacts.[60] However, the overwhelming majority of this assistance is in Spanish; for example, telephone assistance is only available in English and Spanish.[61] The IRS offers a Spanish language website[62] and self-service kiosks that assist taxpayers in English and Spanish, but does not offer these services in any other language.[63]

All Taxpayer Assistance Centers (TACs) provide over-the-phone interpreter service (OPI) in over 144 languages.[64] Undocumented immigrants and other taxpayers without government issued identification, however, have difficultly entering TACs in government buildings and therefore have limited access to this service. In 2004, out of 41,446 calls interpreted in 52 languages, 96 percent of the (OPI) contacts were in Spanish.[65] Not only does this statistic indicate a greater need for Spanish language assistance, it also may indicate a lack of awareness, outreach, or access for this service to the non-Spanish speaking LEP population, in light of U.S. population demographics.

IRS Response to Barriers: Outreach, Education, and Volunteer Services

Stakeholder Liaison and SPEC

The IRS's Wage and Investment (W&I) division provides outreach and education to taxpayers through its Stakeholder, Partnership, Education and Communication (SPEC) function. The Small Business/Self-Employed (SE/SE) division provides similar services through the Stakeholder Liaison in its Communication, Liaison, and Disclosure (CLD) organization.[66]

59 Email from Deputy Director, Field Assistance, W&I (Oct. 2, 2006). The IRS is in the process of phasing out the limited-use self-service kiosks currently in use.

60 IRS, *Multilingual Initiative Customer Base Report FY 2006* 69 (Feb. 2006).

61 *Id.* at 102.

62 Available at http://www.irs.gov/Espanol.

63 IRS, *Multilingual Initiative Customer Base Report FY 2006* 108 (Feb. 2006). The IRS does operate a kiosk at one location that assists taxpayers in Chinese, Vietnamese, and Korean in addition to English and Spanish.

64 *Id.* at 102, 109 (Feb. 2006). Over-the-phone (OPI) interpreter assistance is only listed as being offered at Taxpayer Assistance Centers and is not offered as a service to customers using the IRS's toll-free phone lines.

65 *Id.* at 111-112.

66 For a further discussion of SB/SE education and outreach, see Most Serious Problem, *Small Business Outreach, supra.*

The IRS offers only seven multilingual products to small businesses. All seven are translated into Spanish; two are translated into Mandarin Chinese and one into Korean.[67] SPEC has 17 products to assist in outreach to individual LEP taxpayers. All are translated into Spanish, but only one, Publication 4269, the I Speak Language Identification Card, is translated into any other language.[68] Although we suspect that more LEP outreach actually occurs, the internal assessment of these organizations by the IRS's MLI Strategy Office reports no other activities to educate or assist the LEP taxpayer population.[69] In an environment where the number of individual and business LEP taxpayers is increasing, the IRS should be making a concerted effort to reach these taxpayers at the beginning of the tax process to avoid costly compliance efforts downstream.

Low Income Taxpayer Clinics (LITC)

The Low Income Taxpayer Clinic (LITC) program, administered by the Office of The Taxpayer Advocate, provides matching IRS grants to organizations that provide representation to low income taxpayers involved in a controversy with the IRS or that offer outreach and education on tax rights and responsibilities to English as a second language and LEP taxpayers.[70] These clinics are an important resource to LEP taxpayers struggling to understand their tax obligations or navigate the controversy process. The LITCs help level the playing field for LEP taxpayers who might otherwise be unable to understand IRS notices, forms, and processes. [71] In calendar year 2006, 129 of the 150 LITCs offered assistance to LEP taxpayers in 47 different languages.[72]

Volunteer Income Tax Assistance (VITA)

The Volunteer Income Tax Assistance (VITA) Program, which the IRS administers, provides free tax return preparation and electronic filing (e-filing) to underserved groups of individual taxpayers, including low income, elderly, disabled, and LEP taxpayers.[73] These taxpayers are frequently involved in complex family situations that make it difficult to correctly understand and apply the tax law.[74] The IRS has focused on expanding VITA through increased recruitment of social service, nonprofit, corporate, financial,

67 IRS, *Multilingual Initiative Customer Base Report FY 2006* 113-114 (Feb. 2006).

68 Information received from IRS *Policy Analyst, Customer Assistance, Relationships, and Education, W&I (Nov. 7,* 2006). The I Speak Language Identification card, translated into 38 languages, is used at VITA sites to allow LEP taxpayers to point to the language they speak so volunteers can find the best method of assistance.

69 IRS, *Multilingual Initiative Customer Base Report FY 2006* 113-114 (Feb. 2006).

70 IRC § 7526.

71 *Taxpayer Advocate Report and Low Income Tax Clinics, Hearing Before the Subcomm. on Oversight of the Comm. on Ways and Means*, 107th Cong. 1st Sess. (July 12, 2001) (statement of Leslie Book, Assistant Professor of Law and Director, Federal Tax Clinic, Villanova University School of Law,).

72 IRS Pub. 4134, *Low Income Taxpayer Clinic List* (March 2006).

73 IRS, *Free Tax Return Preparation for You by Volunteers*, *at* http://www.irs.gov/individuals/article/0,,id=107626,00.html (last visited Oct. 19, 2006).

74 Treasury Inspector General for Tax Administration, Ref. No. 2006-40-004, *Significant Improvements Have Been Made in the Oversight of the Volunteer Income Tax Assistance Program, but Continued Effort Is Needed to Ensure the Accuracy of Services Provided* 7 (Nov.2005).

educational, and government organizations (partners) to provide greater assistance to the LEP community.[75] In FY 2005, over 14,000 VITA and Tax Counseling for the Elderly (TCE) sites prepared over 2.1 million tax returns.[76] Many VITA sites serving the LEP population are run by trusted individuals who have ties to that community. This partnership helps establish trust between these taxpayers and the IRS, thus encouraging continued voluntary compliance.

LEP Best Practices: What is Possible?

The Social Security Administration (SSA) has implemented a comprehensive LEP program that is impressive in its scope and shows it is possible for a government agency to address the needs of the LEP population. The SSA collects written and spoken language preference for individuals who apply for:

- Retirement, Survivors and Disability Insurance;
- Supplemental Security Income; and
- Social Security numbers.[77]

This primary data, captured directly from individuals contacting the SSA, allows the agency to determine precisely where LEP assistance is needed most. It also streamlines contacts by allowing SSA employees to identify language preference during the initial contact and arrange for interpreters at the outset. The SSA also conducts LEP focus group testing and has an online comment and suggestion system to respond to the public's concerns.[78]

Based on overall workload comparison, the IRS would seem to have the potential for contact with a larger number of LEP individuals as shown in the following table.

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[75] Treasury Inspector General for Tax Administration, Ref. No. 2006-40-004, *Significant Improvements Have Been Made in the Oversight of the Volunteer Income Tax Assistance Program, but Continued Effort Is Needed to Ensure the Accuracy of Services Provided* 2 (Nov.2005).

[76] IRS Statistics of Income, *Internal Revenue Service Taxpayer Assistance and Education Programs for Individual Taxpayers, by Type of Assistance Program, Fiscal Year 2005*, Table 23.

[77] SSA, *Social Security Administration's Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP), at* http://www.ssa.gov/multilanguage/LEPPlan2.htm (Sept. 2004).

[78] *Id.*

TABLE 1.18.3, FY 2003 SOCIAL SECURITY ADMINISTRATION AND IRS WORKLOAD COMPARISON

	Total Claims Processed (SSA) or Tax Returns Received (IRS)	Total Toll-Free Calls Handled
Social Security Administration	16,402,361[79]	54,800,000[80]
Internal Revenue Service	222,271,428[81]	88,509,631[82]

Since the SSA captures language preference data directly from its customers, it can accurately report foreign language preference and project future demand. In FY 2003, the SSA reported 13,258 individuals preferred to conduct business in Vietnamese when discussing their Social Security insurance claims.[83] The IRS does not collect language preference data from taxpayers but instead uses census data to project potential LEP taxpayers. This data shows over 707,000 individuals who speak Vietnamese identify themselves as speaking English less than "very well."[84] A conservative estimate that half of these individuals are in the work force and have a tax filing requirement leaves the IRS with more than 300,000 potential contacts from taxpayers that speak this language. The SSA has 40 brochures and publications translated into Vietnamese.[85] In its FY 2006 Multilingual Initiative Customer Base Report, the IRS lists no forms, notices, letters, or publications translated to Vietnamese.[86]

[79] SSA, *Social Security Administration's Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP), at* http://www.ssa.gov/multilanguage/LEPPlan2.htm (Sept. 2004). Total claims processed include Retirement and Survivors insurance claims, SSI Aged insurance claims, Initial Disability insurance claims, and Social Security number requests.

[80] SSA, *Social Security Administration's Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP), at* http://www.ssa.gov/multilanguage/LEPPlan2.htm (Sept. 2004).

[81] IRS Data Book, *Number of Returns filed, by Type of Return and State, Fiscal Year 2003*, Table 3.

[82] IRS Statistics of Income, *Internal Revenue Service Taxpayer Assistance and Education Programs, by Type of Assistance Program, Fiscal Year 2003*, Table 23.

[83] SSA, *Social Security Administration's Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP), at* http://www.ssa.gov/multilanguage/LEPPlan2.htm (Sept. 2004). This figure does not include requests for Social Security numbers.

[84] U.S. Census Bureau, 2005 *American Community Survey*, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

[85] SSA, *Social Security Information in Other Languages, at* http://www.ssa.gov/multilanguage/ (last visited June 22, 2006).

[86] IRS, *Multilingual Initiative Customer Base Report FY 2006* 69-70 (Feb. 2006). This report does state a limited number of education and outreach documents are available in Vietnamese, but does not list the specific document number or type. However, Publication 1546, The Taxpayer Advocate Service of the IRS - How to Get Help With Unresolved Tax Problems, is available in Vietnamese (as well as English, Spanish, Chinese, Korean, and Russian).

The SSA not only has a separate web site for Spanish speakers,[87] but also a link from its main web site to a "Multilanguage Gateway"[88] that offers help in 14 other languages.[89] The SSA has publications translated into 15 languages other than English. Although the number of publications differs depending on the language, over 25 publications are available in most of the 15 languages.[90]

The Social Security Administration also offers free interpretation services both in person and by phone.[91] This service is available throughout the duration of an individual's business with the agency. If an issue cannot be handled or completed over the phone, the SSA will make an appointment for the individual at a local office and arrange for an interpreter to be there. The agency actively promotes the interpreter service on its Multilanguage Gateway web site and distributes "interpreter service policy" posters to all Social Security field offices. The poster contains the Social Security interpreter policy translated into 19 languages and alerts the LEP community that this service is available.[92]

In addition to offering interpretation services, the SSA has carried out an aggressive hiring initiative aimed at achieving the right mix of employee language skills to serve the LEP population. For instance, in FY 2003 almost one-third of all newly hired SSA employees were bilingual.[93] In its approach to providing public information and increased access to agency services across a broad spectrum of the LEP population, the SSA seems to recognize the value of educating, improving access, and building public confidence among this often overlooked demographic group.

IRS COMMENTS

The IRS does not agree that there is a lack of service for Limited English Proficient (LEP) taxpayers. The IRS provides an extraordinary number of services in Spanish that are on a par with those offered by any other agency in government. In addition, IRS-sponsored volunteer services are available to LEP taxpayers in many languages other than Spanish. Finally, the IRS has adopted a strategic approach to further expand these services to the LEP communities most in need.

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87 Available at http://www.ssa.gov/espanol/.

88 Available at http://www.ssa.gov/multilanguage/.

89 SSA, *Social Security Information in Other Languages, at* http://www.ssa.gov/multilanguage/ (last visited June 22, 2006). The 14 languages other than Spanish include Arabic, Armenian, Chinese, Farsi, French, Greek, Haitian-Creole, Italian, Korean, Polish, Portuguese, Russian, Tagalog, and Vietnamese.

90 SSA, *Social Security Information in Other Languages, at* http://www.ssa.gov/multilanguage/ (last visited June 22, 2006). The two languages with the fewest publications available are Greek (6) and Arabic (5).

91 SSA, *If You Need an Interpreter, at* http://www.ssa.gov/multilanguage/langlist1.htm (last visited June 22, 2006).

92 *Id.*

93 SSA, *Social Security Administration's Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP), at* http://www.ssa.gov/multilanguage/LEPPlan2.htm (Sept. 2004).

Current services for LEP taxpayers encompass a wide array of telephone, correspondence, volunteer, small business, Internet, forms and publications, walk-in, and initial contact assistance.

In FY 2006, IRS assistors answered 2.3 million toll-free calls in Spanish. An additional 1.1 million calls were resolved through our Spanish-language automated telephone response systems. These services are provided from six telephone call sites (Austin, Dallas, Denver, Fresno, Jacksonville, and Puerto Rico) employing over 700 Spanish-speaking employees. Enterprise Queue, a sophisticated call routing technology, was rolled out in 2006 that enables the IRS to more efficiently route a Spanish-speaking caller to the first available Spanish-speaking IRS assistor anywhere in the country. By 2009, we project that fully ten percent of the IRS's total telephone workforce will be bilingual. These figures, both in terms of the number of employees and number of calls answered, compare very favorably with the Spanish-language telephone services offered by the Social Security Administration.

TeleTax, the IRS's toll-free automated telephone service, is available in English and Spanish 24 hours a day, seven days a week. TeleTax provides helpful pre-recorded tax messages on 145 topics. These messages are also available on the web in Spanish on IRS.gov/espanol. They cover many topics including who must file, highlights of tax changes, education credits, Individual Retirement Accounts, Earned Income Tax Credit, what to do if you can't pay your tax. TeleTax can also help Spanish-speaking callers check the status of their tax refunds.

As noted in our response to the Most Serious Taxpayer Problem on Correspondence Delays, although the IRS receives very few pieces of correspondence written in Spanish, each IRS functional area has staff trained and skilled to process Spanish correspondence. Taxpayers that write to the IRS in Spanish receive a response from the IRS in Spanish.

There are currently 275 IRS-sponsored community coalitions and numerous Volunteer Income Tax Assistance and Tax Counseling for the Elderly partners that provide outreach and free volunteer tax services for individual taxpayers in languages other than English. These partners offer a variety of tax related products and services in over 25 languages including press releases, tax fact sheets, radio broadcasts, articles in community newspapers, television broadcasts, EITC toolkits, flyers, marketing products, and free tax return preparation. The languages include Albanian, Arabic, Bengali, Cantonese, Chinese, Chukese, Creole, German, Hindi, Hmong, Ilocano, Japanese, Korean, Native Alaskan, Mandarin, Polish, Russian, Samoan, Spanish, Tagalog, Turkish, Ukrainian, Urdu, Vietnamese, and others.

The IRS also hosts Hispanic Small Business Forums for the Spanish-speaking business community. To date, nine Forums have been held in California, South Carolina, New Jersey, New York, and Florida. The IRS also has 19 Spanish-language publications dedicated to tax issues affecting small businesses.

The IRS's world-class website includes a Spanish-language webpage (http://www.irs.gov/espanol) which is only one click away from the IRS.gov homepage. The Spanish landing page has recently been revised and for 2007 will include new, direct links to online tools (EITC Assistant, Free File, Where's my Refund, and the Withholding Calculator) and to topical information such as split refunds, disaster assistance, and IRS news releases. Web content available in Spanish mirrors IRS.gov and includes forms and publications, information for self-employed and small business owners, warnings about tax scams that victimize taxpayers, information on the EITC and other credits, links to other useful websites, and much more.

The IRS currently has over 250 LEP tax-related products in its Forms, Publications, and Products repository. In addition to Spanish, Publication 850, English/Non-English Glossary of Words and Phrases Used in Publications Issued by the IRS is scheduled for release this year in Chinese, Vietnamese and Korean. Publications 179, 547(SP), 596(SP), 579(SP) and 584(SP) are all products that benefit Spanish-speaking taxpayers in need of assistance with IRS filing instructions and procedures. For example, Publication 579(SP) is a partial Spanish translation of Publication 17, Your Federal Income Tax, which is slated for full translation in the future.

An Over-the-Phone-Interpreter (OPI) service is available at IRS Taxpayer Assistance Centers (TAC) across the nation. This system offers interpreter service in 144 languages for TAC walk-in customers.

We are also making a concerted effort to reach LEP taxpayers at the beginning of the examination and collection process. Once a taxpayer notifies the IRS that he or she speaks Spanish, every effort is made to communicate with him or her in Spanish. Spanish-speaking examination and collection employees are available to answer taxpayer calls. Several vital Correspondence Examination letters are available in or include information in Spanish. Several Collection letters have an information block that advises taxpayers if they need assistance in Spanish they can call a toll free number. And, for designated zip codes and areas in Puerto Rico, virtually all letters are translated to Spanish.

With regard to the National Taxpayer Advocate's comments on the Notice of Deficiency, the Office of Chief Counsel issued an opinion on March 3, 2006, that states there is no statutory or regulatory requirement for the IRS to provide taxpayers with a Spanish translation of the Letter 531 (Notice of Deficiency). Nonetheless, the translation of Letter 531 is under active consideration by the Multilingual Initiative Executive Council. Further, a Spanish version of the comparable Letter 3219 (Notice of Deficiency 90 Day Letter) was created in April 2000 for use by our Correspondence Examination and Automated Underreporter functions. When a taxpayer notifies the IRS that he or she speaks Spanish and a notice of deficiency is required, the Spanish version of Letter 3219 is issued.

Through its Multilingual Initiative Strategy Office, the IRS assesses language needs, develops policies, monitors delivery of products and services, and cross-functionally trains its multilingual staff. As a foundation for this initiative the IRS published a Multilingual Policy signed by Commissioner Rossotti in October 1999. The MLI Strategy Office is responsible for implementing this policy for the IRS, as well as meeting the requirements of Executive Order 13166, Improving Services for Persons with Limited English Proficiency (LEP), signed by the President in October 2000. In 2003, a continual process to obtain direct LEP taxpayer and stakeholder feedback was implemented. Through this formal LEP Needs Assessment Process, the IRS has conducted extensive research and worked with external stakeholders to gain a better understanding of language assistance needs. Based on this research, in October 2005, the Deputy Commissioner for Services and Enforcement issued the IRS Language Assistance Policy. This policy provides the foundation for our current multi-tiered strategy that focuses on delivery of LEP products and services to the largest customer base, which is Spanish, and provides a strategy for expanding services in other languages.

Research shows that Spanish speakers continue to be the overwhelming majority representing 73 percent of the total LEP population. This is an approximately 20 percent increase over 2000 census data. The next highest language priorities are Chinese, Vietnamese, Korean, and Russian, which combined represent 11 percent of the LEP population. As noted below, the IRS has plans to target the needs of these groups. The remaining 16 percent of the LEP population is comprised of over 100 other language groups. These LEP taxpayers are currently provided services through OPI systems located in our TACs and through the local community education and outreach efforts outlined above.

Research from the LEP Needs Assessment was also used to develop the IRS Multilingual Initiative Strategic Plan. The FY 2006 – 2007 plan prioritized five improvement projects:

- Increasing LITC in isolated ethnic communities;
- Expanding communications in isolated ethnic communities;
- Expanding the Espanol website;
- Developing an integrated communications plan to disseminate basic tax information; and
- Developing a basic tax information DVD.

In furtherance of these Servicewide initiatives, the 2007-2008 Wage & Investment Strategy and Program Plan includes Operational Priorities to improve the quality, delivery, and accessibility of LEP products and services, including:

- Laying the foundation for translating forms and publications into the other IRS-priority languages (Chinese, Korean, Vietnamese, and Russian);
- Expanding the availability of tax products in Spanish and the other IRS-priority languages through the Virtual Translation Office;

- Increasing the accessibility of OPI interpreter services at our TACs;
- Using research to pinpoint specific isolated LEP community locations and targeting local education, outreach and communication messages for these groups; and
- Expanding and enhancing electronic options.

The Small Business/Self Employed Division has initiated similar efforts in support of the Multilingual Initiative Strategic Plan by establishing the SB/SE MLI Advisory Team. This team will manage and advance multilingual initiatives in SB/SE through a research-based assessment of SB/SE LEP taxpayer needs and, in concert with the MLI Strategy Office, explore options for meeting those needs.

Also noteworthy is the IRS's effort to comply with Presidential Executive Order 13166 by establishing the Virtual Translation Office (VTO) in April 2006. The VTO will increase the quality and quantity of written tax information for LEP taxpayers and the preparers, volunteers and others that assist them. The VTO also serves as a central focal point that produces, reviews, and manages official IRS translations and elevates and standardizes translation consistency across the IRS. In conformance with the IRS Language Assistance Policy, these efforts will focus initially on Spanish language translations and then target the other strategic priority Chinese, Korean, Vietnamese and Russian languages.

The National Taxpayer Advocate's assertion that the needs of non-Spanish speaking LEP taxpayers are being neglected fails to recognize the much greater need for Spanish assistance. Data included in the National Taxpayer Advocate's own analysis reveal that fully 96 percent of current OPI interpreter service users choose Spanish, even though this system supports over 140 other languages. While we do not dispute the need to expand non-English services offered for Asian and other non-Hispanic populations, IRS efforts in this area are subject to the same budget constraints as any other IRS program. We have chosen to focus primarily on Spanish, where the most taxpayers can benefit, while laying the strategic groundwork for expanding these services to other priority languages.

In summary, the IRS currently delivers a robust variety of telephone, correspondence, volunteer, small business, Internet, forms and publications, walk-in, and initial contact services in Spanish and supports a large number of local volunteer groups in providing outreach, education and tax assistance in over 25 additional languages. We have an office totally dedicated to assessing the needs of LEP taxpayers and to developing fiscally prudent strategies to meet those needs. A new Virtual Translation Office is in place. In addition, current plans call for expanding Spanish-language services for the LEP population most in need and targeting future initiatives in Chinese, Vietnamese, Korean and Russian.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes and commends the IRS for the services it offers Limited English Proficiency (LEP) individuals who speak Spanish. The Spanish-language web site, including the revisions for 2007, is an impressive and important tool for reaching out to the Spanish-speaking community. We also recognize the IRS's achievements in partnering with volunteer organizations and in translating numerous notices into Spanish.

Despite these impressive efforts, the National Taxpayer Advocate finds it unacceptable that the statutory notice of deficiency is still not translated into Spanish. Regardless of the lack of a statutory or regulatory requirement for the translation, the significance of this notice for taxpayer rights and due process cannot be understated. The notice of deficiency provides the taxpayer with a 90 day window to petition the United States Tax Court to protest a deficiency in tax before it is assessed and before it is paid.[94] Understanding the importance of this notice, the Multilingual Initiative Executive Council should take immediate steps to translate this notice into Spanish and seriously consider translation into other languages as well.

Additionally, The National Taxpayer Advocate agrees with the Chief Counsel's response to the IRS dated March 3, 2006, stating there is no statutory or regulatory authority requiring to provide a Spanish translation of Letter 531 Statutory Notice of Deficiency. However, the National Taxpayer Advocate believes this sentence from Chief Counsel's response was taken out of context by the IRS. In fact, when the Chief Counsel response is read in its entirety, it supports the National Taxpayer Advocate's recommendation that Letter 531 be translated into Spanish. After stating that there is no statutory or regulatory authority requiring the IRS to provide Letter 531 in Spanish, the response goes on to state that it is IRS policy to assist taxpayers in understanding their tax rights and responsibilities, regardless of what their primary language may be, and in response to this policy, the MLI Executive Council determined that the statutory notice of deficiency would be translated into Spanish, in its entirely, as it is essential that a taxpayer be able to read the adjustment shown on the notice. Therefore, when Chief Counsel's response is read in its entirety, it is clear that it is consistent with the National Taxpayer Advocate's recommendation.

The National Taxpayer Advocate remains concerned that the IRS does not recognize the importance of determining a taxpayer's language preference at the outset of his or her interaction with the IRS, before he or she moves further into the tax controversy process. The number of IRS notices and letters translated into other languages is irrelevant if the

[94] The statutory notice of deficiency is required by IRC § 6212 when the IRS determines there is a deficiency, which is generally the excess of the amount the IRS contends is the correct tax over the amount the taxpayer showed on the return. Meeting prescribed timeframes is important because per IRC § 6213 the taxpayer has 90 days from the date of the letter to file a petition in Tax Court challenging the proposed tax deficiency (or 150 days if addressed to a person who resides outside the United States). Failing to meet these statutory guidelines would require the taxpayer to first pay the tax and file a claim for a refund before litigating the issue.

IRS never sends these notices to the taxpayers who would benefit from the translation. The IRS should allow a taxpayer to specify a language preference on his or her tax return that would be posted to the taxpayer's account during processing. This indicator would prompt all subsequent letters and notices to be mailed in Spanish and in other languages as the translations become available. In addition, the language preference question should be asked again in the first examination and collection notice. This approach would enhance the IRS's ability to tailor future interaction with the Examination and Collection functions and allow them to coordinate contacts with bilingual employees.

The National Taxpayer Advocate acknowledges the importance of partnering with volunteer and community organizations, but the IRS should not allow such groups to become substitutes for basic IRS customer service and outreach. While these organizations provide a valuable service, they also have geographic limitations and cannot reach every LEP taxpayer needing assistance. Expecting LEP taxpayers to locate and use volunteer and community-based organizations for the simplest of tasks solely based on limited English proficiency places an increased burden on these taxpayers.

In its response, the IRS states the National Taxpayer Advocate fails to recognize the much greater need for Spanish assistance and cites our analysis that 96 percent of current over-the-phone interpreter service (OPI) users are Spanish speaking. The National Taxpayer Advocate does recognize that Spanish speakers represent the largest segment of the LEP taxpayer population. However, we disagree with the IRS's interpretation of our analysis. We stated that this statistic indicates a greater need for Spanish language assistance, but also pointed out that it may signify a lack of awareness or access to this service among the non-Spanish speaking LEP population, or a lack of IRS outreach to this population. If the only awareness and outreach of this service to the LEP community is delivered in Spanish, then the results are not unexpected. Increasing awareness of the service to other non-Spanish speaking LEP language groups would likely increase its usage in other languages. Moreover, the IRS has not explained why this interpreter service is only available in Taxpayer Assistance Centers (TAC) and is not available to customers using the toll-free telephone line, where it would benefit a larger segment of the LEP population. If this decision is largely resource driven, then the IRS should vigorously make its case – which is compelling – to Congress. The National Taxpayer Advocate will lend her support to such an initiative.

RECOMMENDATIONS

To ensure that taxpayers with low literacy levels, or for whom English is a second language, receive the necessary information to meet their tax obligations, we recommend the IRS do the following:

- Research and test whether educating taxpayers about the availability of the over-the-phone interpreter service (OPI) would increase its usage as well as increase requests for interpreters in other languages;

- Expand over-the-phone interpreter service to include the toll-free sites and post-filing compliance functions, and expand outreach and awareness to the LEP community about this service;
- Clarify that the definition of a "vital" document includes any document that impacts taxpayer rights, provides taxpayer protection, or proposes to assess a tax or levy on taxpayer property;
- Increase the number of "regularly encountered" languages to mirror other government agencies of similar size and customer base, such as the Social Security Administration, and translate all vital documents into these languages; and
- Develop a process to determine the language spoken by taxpayers at the outset of their interaction with the IRS to ensure effective communications occur throughout the "life" of a tax return.[95]

[95] The National Taxpayer Advocate previously made this recommendation in the 2002 Report to Congress. *See* National Taxpayer Advocate 2002 Report to Congress 93.

PROBLEM

TOPIC #19 TAXPAYER "NO RESPONSE" RATES

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Deborah Nolan, Commissioner, Large and Mid-Size Business Division

Steven Miller, Commissioner, Tax Exempt and Government Entities Division

DEFINITION OF PROBLEM

The IRS relies almost exclusively on standardized paper correspondence to communicate with taxpayers. In many instances, taxpayers do not respond to IRS notices or requests for information, with downstream consequences for both the IRS and the taxpayer. The IRS could potentially avoid some of these downstream effects by attempting other methods of making meaningful contact with taxpayers, thereby encouraging them to respond.

ANALYSIS OF PROBLEM

The Problem of No Response

The problem of no response occurs among all types of taxpayers – individuals, businesses, and tax-exempt organizations – and at all income levels. While most of the IRS's attention to the problem has focused on examinations, particularly in the Earned Income Tax Credit (EITC) arena (which this discussion will cover), the problem extends far beyond audits.[1]

While the IRS experiences numerous problems with taxpayers who do not respond, similar problems exist for practitioners. In focus group discussions and surveys conducted with practitioners and Low Income Taxpayer Clinics (LITCs), respondents indicated they experience problems with taxpayers who respond to their requests in an untimely manner or not at all.[2] However, each group has come up with different ways of addressing the problem.

What is a "No Response?"

When the IRS sends a taxpayer a notice or other correspondence, a number of outcomes are possible:

- The taxpayer receives the notice and responds to the IRS;

[1] For a discussion of the effect of IRS failure to make personal contact in routine collection cases involving low income taxpayers, see Most Serious Problem, *Collection Issues of Low Income Taxpayers, supra*.

[2] Taxpayer Advocate Service, *Communicating With Taxpayers Focus Group* (draft report); responses received through informal survey of Low Income Taxpayer Clinics (LITCs). The Low Income Taxpayer Clinic (LITC) Program is a grant program under IRC § 7526 in which qualified organizations receive matching federal grants to represent low income taxpayers in controversies before the IRS or provide tax outreach and education to English as a second language (ESL) taxpayers.

- The taxpayer receives the notice and does not respond to the IRS;
- The taxpayer receives the notice and partially responds to the IRS; or
- The notice is undeliverable.

A "no response" is an instance where the IRS sends a taxpayer a notice and the taxpayer receives it but does not respond. This situation is different from a partial response, in which the taxpayer attempts to respond but does not respond fully. This partial response is also considered a "default with correspondence."[3] A notice that is undeliverable is one that is mailed to the taxpayer but cannot be delivered because the taxpayer's address is incorrect.[4]

The Magnitude of the No Response Problem

The IRS does not know the magnitude of the no response problem. The IRS does not generally track the number of taxpayers that do not respond to notices, how many taxpayers try to respond, or how many notices are undelivered.[5] The one group of taxpayers whose response rates the IRS does track, and has attempted to improve, is the EITC population.

EITC Correspondence Examinations

The IRS's Revenue Protection Strategy (RPS) guides the processing of most tax returns selected for EITC examination by correspondence.[6] The IRS sends the taxpayer a series of letters with information requests, and the case continues through an automated batch process.[7] The exam begins with an initial contact letter explaining the audit process and the issues under examination, and requesting documentation specific to these issues.[8]

If the taxpayer does not respond within the given period, the IRS issues a second letter, commonly referred to as the 30-day letter, which includes an examination report showing

[3] For a discussion of "default with correspondence," see notes 28 -30, *infra* and accompanying text.

[4] The definition of "undeliverable" is provided for purposes of this discussion. The IRM does not contain a definition of the term "undeliverable."

[5] Response received to OD research request states that the IRS does not track this information.

[6] IRM 25.12.1.5, *Revenue Protection Strategy* (Dec. 1, 2000). The revenue protection strategy is a program developed to focus on problematic tax returns and is built on a four-pronged approach to address the returns: Understanding, Prevention, Detection, and Enforcement.

[7] IRM 4.19.1.12, *Batch Processing Overview* (Oct. 1, 2004). Batch processing is an IRS-developed, multi-functional software application that fully automates the initiation, aging, and closing of certain EITC and non-EITC cases. Using the batch system, the correspondence exam unit can process specified cases with minimal to no involvement by a tax examiner until a taxpayer reply is received.

[8] A correspondence examination (audit) is handled through written correspondence (rather than a face-to-face meeting), normally can be completed in a few hours, is limited in scope to a few issues and does not include a review of detailed account records. *See* Most Serious Problem, *Correspondence Examination, supra.*

the tax liability resulting from the adjusted issues.[9] The taxpayer has the opportunity to send documentation to the IRS to verify the issues, agree with the exam report, or appeal the tax by returning a form included with the 30-day letter. If the taxpayer does not respond to the 30-day letter, the IRS issues a statutory notice of deficiency (SNOD) also known as the 90-day letter. The taxpayer has 90 days from the date of this notice to petition the United States Tax Court.[10]

If the taxpayer does not respond to a notice of deficiency, the IRS will close the case and assess the taxpayer's account for the tax, interest, and any penalties. Because the batch processing system automatically moves cases through creation, statutory notice, and closing unless the IRS receives a taxpayer response, the taxpayer's failure to respond to any of the IRS's letters leads to the correspondence examination closing with no involvement from an IRS examiner.[11]

In tax year 2003, approximately 22 million taxpayers claimed the EITC.[12] In fiscal year 2005, the IRS closed nearly 534,000 EITC correspondence exams.[13] Table 1.19.1 shows the outcomes of these cases. Of the EITC correspondence exam cases closed in 2005, over 60 percent closed as the result of some form of no reply.[14]

[9] The IRS generally gives a taxpayer 30 days to respond to the initial letter. If the taxpayer sends documentation, and the IRS review determines it is inadequate, the taxpayer receives another letter requesting additional information. If the IRS receives documentation from a taxpayer but is unable to review it timely, the IRS generally sends an interim letter acknowledging receipt and giving a reply date. IRM 4.19.1.4.9, *Taxpayer Replies* (Apr.25, 2005). If a reply is thirty days old or older, then an acknowledgement letter is sent advising taxpayer that a reply was received and an answer will be issued within thirty days. IRM 4.19.1.4.10, *Monitoring Overage Replies* (Jan. 1, 2001). When possible, all correspondence should be addressed before a statutory notice of deficiency is issued to a taxpayer. If the assessment statute expiration date is close to expiring, the IRS may not address all taxpayer correspondence before issuing a statutory notice of deficiency. IRC §§ 6501, 6503; IRM 25.6.23.8 (Feb. 1, 2006).

[10] IRC § 6213.

[11] IRM 4.19.1.12 (Apr. 7, 2005). These cases are referred to as no-reply or no response cases.

[12] For TY 2003, EITC claims totaled approximately $39 billion. EITC Program Office, *EITC Fact Sheet*.

[13] AIMS Closed Case Database (Correspondence audit defined by using Employee Group Codes for Campuses, Disposal Codes, and Technique Codes 2, 6, or 7).

[14] In fiscal year 2005, 61.2 percent of cases closed as no response (35.9 percent), undeliverable (6 percent), or default with correspondence (19.3 percent). As discussed earlier, a default with correspondence is a situation in which the taxpayer attempts to respond to an IRS notice but does not respond fully.

PROBLEMS

TABLE 1.19.1, FY 2005 EITC CORRESPONDENCE EXAMS BY TYPE OF CLOSURE[15]

Type of Closure	Number of Cases	Percentage of Total
No Response[16]	191,712	**35.9%**
Undeliverable[17]	31,951	**6%**
No Change without Adjustment[18]	98,184	**18.4%**
No Change with Adjustment[19]	19,718	**3.7%**
Agreed[20]	76,370	**14.3%**
Appealed/Petitioned[21]	4,146	**0.8%**
Default with correspondence[22]	103,007	**19.3%**
Other[23]	8,747	**1.6%**
Total	**533,835**	**100%**

Is a "No Response" Really a No Response?

In FY 2005, the IRS closed approximately 40 percent of EITC correspondence exams as a "no response" or "undeliverable," indicating the taxpayer did not respond to the exam notice.[24] In 2004, the Wage and Investment division (W&I) research unit conducted an EITC Pre-Refund Audit Non-Response Survey to determine reasons for the high non-response rate.[25] The survey involved employees and volunteer representatives who came in direct contact with EITC taxpayers when they sought assistance.[26] The results suggest that most taxpayers categorized as non-responsive did try to make contact with the IRS.[27] According to the results of the survey, 87 percent of taxpayers attempted some form of contact, with 68 percent of taxpayers mailing or faxing the requested documents. Only 13 percent of taxpayers made no efforts to respond. The survey results

[15] AIMS Closed Case Database (Correspondence audit defined by using Employee Group Codes for Campuses, Disposal Codes, and Technique Codes 2, 6, or 7).

[16] Disposal Code 10 and Technique Codes 6 & 7.

[17] Disposal Code 13.

[18] Disposal Code 2.

[19] Disposal Code 1.

[20] Disposal Codes 3, 4 & 9.

[21] Disposal Codes 7 & 11.

[22] Disposal Code 10 and Technique Code 2. Default with correspondence is a situation in which the taxpayer attempts to respond to an IRS notice but does not respond fully.

[23] Disposal Codes 8 & 12.

[24] AIMS Closed Case Database.

[25] W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-2-021E (Mar. 2004).

[26] The individuals surveyed included IRS employees from TAS and Appeals, and Low Income Taxpayer Clinic (LITC) representatives. Taxpayers themselves were not surveyed; rather, the survey collected information from taxpayer representatives about taxpayers' actions.

[27] W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-2-021E 6 (Mar. 2004).

indicate the IRS is failing to accurately handle taxpayers' attempts to engage in the audit process, thereby affecting taxpayers' ability to prove their EITC claims.

Some cases that the IRS categorizes as "no response" do not actually represent a taxpayer's failure to respond. An additional 19.3 percent of EITC correspondence audits close as "default with correspondence," indicating that the taxpayer tried to engage in the audit process but ultimately left the system.[28] This is a slight increase over FY 2004 numbers.[29] IRS research shows that in many of these instances, the taxpayer has unsuccessfully attempted to contact the IRS or has not received the IRS notice.[30]

Failure to Receive Correspondence

The EITC Qualifying Child Residency Certification Study (hereinafter referred to as "certification study") conducted for tax year 2004, looked into the problem of taxpayers who do not receive IRS correspondence.[31] Approximately six percent of the letters the IRS issued as part of the 2004 certification study were returned as undeliverable.[32] In a follow-up telephone survey of a random sample of taxpayers in the certification study, almost half of the taxpayers could not be reached.[33] Approximately seven percent of those surveyed indicated they had lived at their current addresses for less than six months. The highly mobile nature of the EITC population suggests that failure to receive correspondence may be one reason why some taxpayers do not respond to the IRS.

Although the IRS has not conducted related research in areas other than the EITC, it is likely that similar problems are present in other IRS programs. Given the large number of cases the IRS closes because the taxpayer failed to respond, provided an incomplete reply, or did not receive the notice, it is important to understand why the taxpayer did not respond or respond completely, and the impact of these closures on both the IRS and the taxpayer.

[28] AIMS Closed Case Database W&I and SB/SE.

[29] In FY 2004, 15.7 percent of EITC correspondence audits closed as "default with correspondence." AIMS Closed Case Database.

[30] W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-2-021E (Mar. 2004).

[31] The IRS conducted the first certification study from December 2003 through April 2004 for tax year 2003. The IRS conducted a second certification study from December 2004 through April 2005 for tax year 2004, with some modifications from the 2003 test. The 2004 certification study looked at a random sample of 25,000 EITC claimants for whom the IRS could not establish qualifying child residency eligibility through available data. The 25,000 taxpayers in the test group were compared with a similarly sized control group with characteristics similar to the test group. The study sought to determine the impact of a residency certification requirement on: the amount of EITC claimed including the amount of erroneous claims; the number of children claimed; taxpayer participation in the EITC; taxpayer burden; and the amount of erroneous claims that were prevented from being paid to ineligible taxpayers. IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005*, 4-5 (Oct. 2005).

[32] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 23 (Oct. 2005).

[33] *Id.* at 7 & 23.

Why Don't Taxpayers Respond to the IRS?

To improve the taxpayer response rate, it is important to understand why taxpayers do not respond to the IRS. However, the IRS has conducted only limited research into the reasons for non-responses. The available information on the issue is mainly anecdotal but does shed some light on taxpayer behavior.

EITC Audit Reconsideration Study

The Taxpayer Advocate Service (TAS) EITC Audit Reconsideration Study, released in December 2004, focused on identifying ways to improve the accuracy and effectiveness of EITC audit reconsiderations and the overall EITC correspondence exam process, including minimizing burden to taxpayers.[34] In the cases examined, taxpayers cited documentation difficulties as a reason for the audit reconsideration in 45 percent of the cases and communication challenges as a cause in 42 percent of the cases.[35] With regard to communication challenges, the taxpayers' reason for not responding or responding late to the IRS notice could not be determined in 74 percent of these cases.[36] The reasons identified for the no response or late response in the remaining cases include:

- Taxpayer did not understand the notice;
- Taxpayer lost documents; and
- Difficulty or delay in obtaining documents.[37]

EITC Audit Barriers Study

The Taxpayer Advocate Service initiated a project and is now working jointly with the EITC Program Office and W&I Research to identify the most significant barriers that taxpayers encounter during the EITC correspondence examination process. The research team has completed the first phase of its research, consisting of focus group interviews with LITC representatives who have assisted taxpayers undergoing EITC correspondence exams.[38] The team used the results of the interviews to design a survey, which was sent to a representative sample of taxpayers who recently experienced EITC correspondence audits to quantify the impact these barriers have on taxpayers. The study should help TAS and the IRS identify areas of improvement for the audit process.

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[34] For a detailed discussion of the study and its results, see National Taxpayer Advocate 2004 Annual Report to Congress vol. 2. Audit reconsideration is an IRS process available to a taxpayer who meets certain eligibility criteria when the taxpayer disagrees with an IRS assessment made during an audit or disagrees with an Automated Substitute for Return (ASFR) the IRS created when the taxpayer did not file his or her own return.

[35] National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, at 19.

[36] *Id.* at 21.

[37] *Id.* at 22.

[38] Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005). For this study, eight LITC attorneys were interviewed about barriers EITC taxpayers face because of an examination of their tax return. The specific LITC sites were selected based on the number of EITC filers in the area, geographic location, and the proximity of an LITC.

While the study is still underway, initial results from the focus groups suggest that the IRS's reliance on correspondence causes problems for many EITC taxpayers. Specifically, the focus groups indicated taxpayers sometimes cannot understand many of the IRS letters they receive.[39] Also, some EITC taxpayers are more comfortable visiting an IRS walk-in site than calling or writing the IRS to resolve a problem. This preference stems in part from language barriers and trust issues experienced by some low income taxpayers.[40] This research, although still preliminary, illustrates the IRS's need to reevaluate the way it interacts with taxpayers to help them better understand their tax obligations in an examination context, and avoid downstream problems for both taxpayers and the IRS.

Practitioners – First Hand Experience with No Response

Because practitioners suffer from the same problem of unresponsive taxpayers as the IRS, their interaction with taxpayers can shed some light on why taxpayers do not respond and how to increase responses.[41]

According to practitioners, taxpayers' reasons for failing to reply to IRS requests are almost as complex as the tax code itself. A taxpayer may become intimidated or overwhelmed by the tax process. Many taxpayers do not understand their rights and remedies, which leads them to just ignore the issue.[42] This may be particularly true of taxpayers who cannot pay what the IRS indicates they owe and are not aware that alternatives such as offers in compromise or installment agreements can help them resolve their liabilities.[43]

Some taxpayers may realize they took incorrect positions on their returns, accept the results, and not respond to the IRS.[44] Others may choose not to respond because they do not understand what the IRS is asking for or cannot provide the type of information requested. Still others may be suspicious or fearful of the government in general. Some taxpayers may never get the notice simply because they have moved and left no forwarding address, or the forwarding address has expired.[45]

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[39] Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005).

[40] *Id.* Practitioners explained that some like to look someone in the eyes to gauge whether to trust someone or how much trust to place in the answer provided.

[41] *Id.*

[42] Janet Spragens and Nancy Abramowitz, *Low Income Taxpayers and the Modernized IRS: A View From the Trenches*, 2005 TNT 113-38 (June 14, 2005).

[43] Taxpayer Advocate Service, *Communicating With Taxpayers Focus Group* (draft report); responses received through interviews with LITC attorneys.

[44] Leslie Book, *EITC Noncompliance: What We Don't Know Can Hurt Them*, 203 TNT 121-27 (June 24, 2003).

[45] Taxpayer Advocate Service, *Communicating With Taxpayers Focus Group* (draft report); responses received through interviews with LITC attorneys.

Low Income Taxpayers

The transient nature of the low income population means that many of these taxpayers do not receive IRS notices or requests for information.[46] Taxpayers who do receive IRS correspondence may be confused about what information the IRS is requesting because of language and literacy issues or a lack of clarity in the notices.[47]

For low income taxpayers in particular, even if they want to respond to an IRS request for information, they have difficulty providing the necessary documents. Many taxpayers do not keep adequate records and may be embarrassed or afraid to admit they do not have the information. This can be an especially difficult problem for taxpayers who are self-employed.

Low income taxpayers also have particular difficulty gathering records for the IRS even if they want or are able to respond to IRS requests for information. Many of these taxpayers do not use standard financial institutions and are thus unable to provide copies of bank or credit card statements. Much of the information is more than a few months old and in the hands of someone other than the taxpayer (such as a school or doctor's office), making it difficult and time consuming for taxpayers to obtain. If a taxpayer moves often, which is common among the low income population, the necessary school, medical, and other records may not reflect his or her correct address.[48] These circumstances make it difficult for the taxpayer to provide the IRS with the information needed to support a claim.

Many practitioners have indicated that even if their clients have no problems obtaining documents, serious life issues such as financial, health, work, and family concerns often take priority over responding to the IRS.[49]

Does a No Response Mean a Taxpayer is Not Eligible for Relief?

The TAS EITC Audit Reconsideration Study empirically demonstrates that 43 percent of taxpayers who sought reconsideration of correspondence examinations that disallowed the EITC in whole or in part received additional EITC as a result of the audit

[46] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 23 (Oct. 2005) (discussing highly mobile nature of EITC population).

[47] For a more detailed discussion, see Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities, infra* and Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Multilingual and Cultural Barriers, supra*.

[48] Taxpayer Advocate Service, *Communicating with Taxpayers Focus Group* (draft report); responses received through interviews with LITC attorneys.

[49] *Id.*

reconsideration.[50] Where the taxpayer received additional EITC, he or she received, on average, 96 percent of the EITC amount claimed on the original return.[51] Moreover, when TAS employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC increased significantly in direct proportion to the number of phone calls made by the TAS employee.[52]

The EITC Audit Reconsideration Study found that taxpayers who do not respond to notices are typically no less entitled to prevail in an audit than taxpayers who respond timely. The results of the study demonstrate that IRS failure to address the no response rate harms taxpayers.

The Costs of No Response

The problem of no response creates downstream costs for both the IRS and the taxpayer.[53] If a taxpayer fails to respond to an initial notice and later contacts the IRS, the IRS must engage in a significant amount of rework. Failure to resolve a taxpayer case at the outset may result in the taxpayer requesting audit reconsideration, contacting TAS, calling the IRS toll-free number, or visiting a Taxpayer Assistance Center when the IRS attempts to collect money the taxpayer claims he or she does not owe. This later contact by the taxpayer results in two or more IRS employees who must touch the taxpayer's case instead of one employee resolving the case at the time of the initial notice.

Failure to respond may cost a taxpayer additional time and money in other ways as well. Some taxpayers who need assistance may receive it free from TAS or an LITC, but others may have to pay preparers to resolve their cases. Those who choose to not seek assistance and fail to respond can lose certain appeal rights.[54] The loss of the ability to

[50] *See* National Taxpayer Advocate 2004 Annual Report to Congress Vol. II, at 29. For the EITC Audit Reconsideration Study, the team reviewed a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002 and January 31, 2003. Ultimately, 679 cases (340 Examination and 339 TAS) had mostly complete data and were analyzed in detail for this study. Analyses segmented data by Examination and TAS involvement, in addition to summarizing the total dataset. *See* National Taxpayer Advocate 2004 Annual Report to Congress, Vol. II, at 9.

[51] *See* National Taxpayer Advocate 2004 Annual Report to Congress Vol. II, at 29.

[52] *Id.* at 35-37.

[53] Downstream costs refer to additional activity "downstream" that results when an initial action (*i.e.*, processing a tax return, resolving a tax dispute, answering a tax law question, or conducting an audit) is not conducted correctly or to the satisfaction of the taxpayer. This additional activity, which may cost the IRS and the taxpayer both time and money, would not have occurred if the initial action operated correctly and effectively. Examples of downstream costs include a tax dispute that goes to Appeals because the dispute could not be resolved during regular processing, a case that comes to TAS because it was not resolved during routine processing, or an original audit that results in an audit reconsideration.

[54] A taxpayer has 90 days from the mailing of a notice of deficiency (150 days if the taxpayer is located outside of the IRS) to file a petition with the Tax Court. Failure to timely file a petition will prevent the court from having jurisdiction over the taxpayer's case. IRC § 6213. The 90 day time period is critical because the Tax Court is a taxpayer's only opportunity to contest the tax in court without first paying the amount of the liability. If a taxpayer is unable to have his or her case heard in Tax Court, his or her only other option is to pay the amount of the liability and file a claim for refund. IRC § 7422.

take a case to the IRS Office of Appeals or the U.S. Tax Court is one of the most severe downstream costs to the taxpayer resulting from his or her failure to respond to the IRS.

In some cases, a failure to respond may ultimately cause a taxpayer to fall out of the tax system entirely. If a problem in one year goes unresolved, the taxpayer may be afraid to file returns in future years or become overwhelmed by their outstanding tax issue.[55] This fear may cause the taxpayer to drop out of the tax system, which leads to further problems for both the IRS and the taxpayer. The IRS could avoid some of these additional costs and ease taxpayer burden by working to improve the taxpayer response rate.

IRS Efforts to Improve the Taxpayer Response Rate

While the IRS must improve how it deals with taxpayers, the IRS has successfully altered some of its processes to increase the response rate. In particular, the IRS has significantly changed the EITC examination process in the areas of communication, correspondence, and case assignments.

Communication

The IRS has made a concerted effort to improve its communication with taxpayers. Most importantly, the IRS realizes live contact with taxpayers not only improves the exam process, but also encourages taxpayers to respond to requests for documentation. The focus on improving communications has resulted in the IRS encouraging examiners to contact taxpayers to explain what information is needed to complete their examination *before* sending them a letter.[56]

In January 2006, W&I began using Intelligent Call Management (ICM) on its toll-free phone lines.[57] ICM is designed to improve the quality of correspondence examinations and provide a better level of service by directing incoming calls to the first available assistor at any of the W&I call sites.[58] In May 2006, the IRS further expanded the use of ICM by introducing similar programming to calls in which the taxpayer dials the extension for a particular examiner.[59] The new programming allows calls placed to a specific extension to be directed to the next available examiner if the assigned examiner is not available. ICM will also direct calls from Spanish-speaking taxpayers to bilingual employees, and should ensure that all calls are handled more efficiently.

[55] Taxpayer Advocate Service, *Communicating With Taxpayers Focus Group* (draft report); responses received through interviews with LITC attorneys. One practitioner notes that the clients who have the most difficulty when the IRS asks for information are nonfilers. Explaining further, the practitioner noted that if someone hasn't filed taxes in a while, the person is afraid and doesn't know how to resolve the problem.

[56] IRS Wage and Investment Division, Response to Research Request (Nov. 17, 2006); IRM 4.19.1.4.9.

[57] IRS Wage and Investment Division, Response to Research Request (Sept. 26, 2006).

[58] *Id. See also* IRM 1.4.19.3 (Jun. 1, 2006).

[59] IRS Wage and Investment Division, Response to Research Request (Sept. 26, 2006).

While the IRS has seen an increase in the number of correspondence examination calls answered by a live assistor in FY 2006, ICM only solves part of the problem.[60] The system helps ensure that taxpayers who *choose to call* the IRS receive prompt assistance. However, ICM does not *increase the likelihood* that a taxpayer will call the IRS or the IRS will call the taxpayer. To increase the likelihood that a taxpayer will call the IRS or that the IRS will call the taxpayer, the IRS must make additional changes. The TAS EITC Audit Reconsideration study demonstrates that the IRS and the taxpayer receive better results – in terms of both time and money – if the IRS calls the taxpayer instead of sitting back and waiting for the taxpayer to call.

Correspondence

The IRS has also improved the correspondence it sends to taxpayers during the EITC exam process. Beginning in fiscal year 2005, the IRS eliminated the combination letter for EITC examinations.[61] Previously, the IRS sent one letter that simultaneously denied the credit claimed on the tax return, asked the taxpayer to substantiate the EITC, and triggered the opportunity for the taxpayer to take his or her case to Appeals.[62] This combination letter was very confusing for many EITC taxpayers. Now, taxpayers subject to an EITC correspondence exam receive two separate notices. The first notice informs the taxpayer that his or her EITC claim is under examination and requests information to substantiate the claim. If the taxpayer fails to respond to the first notice or provides insufficient information, he or she receives a second letter, known as the 30-day letter. This letter sets forth any proposed adjustments to the return and gives the taxpayer the opportunity to appeal the IRS's decision.

In conjunction with eliminating the combination letter in EITC examinations, the IRS created Publication 3498-A, The Examination Process (Examinations By Mail). This new publication outlines the correspondence exam process and provides a "tear off" form the taxpayer can use to request an appeal of an IRS decision.

Case Assignments

The IRS has made additional changes that affect not only examinations but all W&I casework. In early 2007, W&I will provide W&I and SB/SE Examination employees with a "universal view" of any taxpayer case.[63] For processing year 2007, W&I and SB/SE Campus Examination employees will be able to identify specific items needed to

[60] The number of correspondence examination calls answered by a live assistor rose from 48.7 percent in FY 2005 to 62.5 percent in FY 2006. IRS Wage and Investment Division, Response to Research Request (Sept. 26, 2006).

[61] National Taxpayer Advocate 2003 Annual Report to Congress 87-98. The IRS still uses the combination letter for other discretionary work. For a detailed discussion of the current use of the combination letter, see Most Serious Problem, *Correspondence Examination*, *supra*.

[62] For a detailed discussion of the combination letter, see National Taxpayer Advocate 2003 Annual Report to Congress 87-98.

[63] Universal access will be available for all cases except those with prior correspondence or cases that are currently assigned. IRS Wage and Investment Division, Response to Research Request (Nov. 14, 2006).

resolve a taxpayer's case, and provide this information to the taxpayer.[64] This system will allow taxpayers to more easily receive assistance and may eliminate some of the frustration they experience when they call the IRS but cannot obtain help or are bounced around from one employee to another.

Recommendations for Improving the Response Rate

Despite this progress, there is still significant room for improvement in the way the IRS communicates with all taxpayers, not just those claiming EITC. The first step is for the IRS to understand the magnitude of the problem of no response. As noted previously, the IRS does not keep adequate records on the response rate of various notices or requests for information. The IRS does not track the number of notices for which taxpayers do not respond, respond only in part, or are returned as undeliverable. Until the IRS captures this information, it is impossible to understand the extent to which its notices go unread or unanswered.

Once additional data is available on the no response rate, the IRS should develop a targeted strategy aimed at increasing the response rate, including studies or surveys to find out why some taxpayers do not respond. The study should not be limited to the audit process and should look at all aspects of IRS activities involving communication with taxpayers and all types of taxpayers – individual, business, tax-exempt, etc. Moreover, we believe the IRS should develop a strategic goal of lessening the percentage of taxpayers who do not respond to notices or requests for information.

Communication

The IRS still needs to improve its communication with taxpayers. The IRS should encourage its employees to call taxpayers to follow up on issues instead of simply sending them a letter. The IRS could expand the use of the predictive dialer, currently in limited use by the collection functions, and attempt to contact taxpayers instead of sitting back and waiting for taxpayers to call.[65] Personal contact may help alleviate some of the confusion and fears associated with dealing with the IRS, and encourage taxpayers to respond to IRS requests. TAS procedures require that when a case advocate needs additional information from a taxpayer or representative, the advocate must make two attempts to obtain the information or documents.[66] This is not to say that IRS examiners should phone taxpayers in every examination. The IRS should train its examiners

[64] IRS Wage and Investment Division, Response to Research Request (Nov. 14, 2006). A processing year is the year in which a tax return is processed by the IRS.

[65] A predictive dialer system automatically calls individuals and transfers the call and account information to an assistor if the individual answers the phone. Darren Waggoner, *Not Your Father's Call Center*, 8 Coll. & Credit. Risk, September 2003, 46; *see also* Treasury Inspector General for Tax Administration, *Budget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers*, Reference No. 2003-30-132, 1, footnote 1, (June 2003). For a discussion of IRS use of the predictive dialer, see 2004 Annual Report to Congress 234.

[66] IRM 13.1.7.10.3.17 (Apr. 1, 2003). The second follow-up attempt must be made in writing and must provide the consequences of a no response or partial response.

to identify instances in which calling the taxpayer will help clarify an issue or obtain a response. This type of targeted communication with taxpayers will ultimately save time and money.

The IRS can also increase its outreach and education efforts to encourage taxpayers to respond to the IRS. The 2006 certification test attempted to increase the response rate among taxpayers eligible to claim the EITC as well as those receiving certification notices.[67] One of the messages for qualifying taxpayers was "reply to any IRS correspondence about your EITC to get the credit you deserve."[68] While the results of the 2006 certification test are still unclear, the IRS did try to encourage taxpayers to respond to IRS notices, and explored working with community groups to communicate this information to taxpayers.

Outside of the EITC, the IRS could design an outreach campaign aimed at explaining the consequences of not responding to letters and notices and encouraging taxpayers to open them. By informing taxpayers about the consequences of ignoring IRS notices, the IRS may help some taxpayers understand the need to open IRS notices and respond.

Correspondence

While the elimination of the combination letter for EITC was an important first step, the IRS still uses the letter in other discretionary work that is much more complex than the letter was initially intended for.[69] To improve the quality of IRS correspondence and safeguard taxpayer rights, the IRS should stop sending the combination letter once and for all.

Further, the IRS can continue to simplify and improve its correspondence in several ways. Much correspondence is written in boilerplate language that is not targeted to the taxpayer's specific situation and can be confusing. The IRS should attempt to draft correspondence that specifies exactly what is happening in a taxpayer's case and what he or she must do to resolve the issue. Notices should explain to the taxpayer exactly what issues are being examined. Any requests for information should be limited only to those issues under examination and explain why the IRS is requesting specific information, with examples when possible. The IRS should also include forms the taxpayer can fill in to provide the requested information. One possibility would be for the IRS to adopt the residency form with the option to use an affidavit, as used in the 2004 certification study for purposes of EITC examinations.[70] If previous documentation was

[67] The 2006 certification test was conducted from December 2005 through April 2006 for tax year 2006.

[68] Wage and Investment SPEC Communications and Marketing, *W&I Communication Strategy – Earned Income Tax Credit (EITC) FY 2006*, 2 (Jan. 24, 2006).

[69] IRS Wage and Investment Division, Response to Research Request (Sept. 26, 2006); Most Serious Problem, *Correspondence Examination, supra*.

[70] For a discussion of the affidavit used in the 2004 certification study, see notes *infra* 78 - 79 and accompanying text.

insufficient, follow-up correspondence should explain exactly why the documentation was not enough to support the taxpayer's case and what more is needed.

Language barriers create problems for many taxpayers who do not understand the IRS notices they receive.[71] While many IRS notices are available in both English and Spanish, the IRS should make efforts to print them in other languages as well. The IRS could also help overcome language barriers by allowing taxpayers to specify (possibly on their tax returns) the language in which they want to receive correspondence. Taxpayers could choose in which language they would like to receive IRS correspondence. This approach may prevent taxpayers from ignoring correspondence because they are unable to read it.

Disabled taxpayers face similar barriers.[72] Taxpayers can receive a notice in Braille if they call and request it from the IRS Alternative Media Center, but the IRS does not widely publicize this service and has no clear procedures for placing a hold on the taxpayer's account while waiting for the accommodating notice.[73] Further, there is no way for a taxpayer to request that the IRS send all future correspondence in Braille. The IRS should consider putting language – in Braille – on envelopes indicating that they contain important IRS correspondence, and providing a telephone number to call for more information.

When requesting documentation, the IRS should consider providing taxpayers an adequate sized self-addressed stamped envelope to return the information.[74] Additionally, the IRS should inform taxpayers (and their authorized representatives) that use of the envelope speeds processing and ensures the documentation reaches the right department. Many LITCs have adopted this approach with their own clients, and it has proven successful in encouraging taxpayers to follow up with the requested documentation.

The IRS can also make further efforts to locate updated addresses for taxpayers whose notices are returned as undeliverable. Currently, the IRS uses a software database to locate updated taxpayer information in limited instances.[75] The IRS should also consider conducting basic Internet research to find addresses and ensure taxpayers receive their notices.

[71] *See* Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Multilingual and Cultural Barriers, supra.*

[72] *See* Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities, infra.*

[73] IRM 21.3.6.4.1 (Oct. 1, 2006); IRM 21.3.6.4.2 (Oct. 1, 2006).

[74] SB/SE Research, *TEC Practitioner Focus Group Interviews, 2004*, 6-7 (Jan. 2005).

[75] CNNMoney.com, *ChoicePoint to Work for the "Taxman"* (June 28, 2005) *available at* http://money.cnn.com/2005/06/28/news/economy/choicepoint_its/index.htm.

Documentation

As discussed previously, many taxpayers are unable to meet the IRS requirements for acceptable documentation.[76] This can cause taxpayers to become discouraged and simply ignore the IRS request entirely. As part of the 2004 certification study, the IRS piloted the use of affidavits to allow taxpayers to prove they met the qualifying child residency requirement.[77] The study results indicate that the affidavit was the most effective and accurate means of proving eligibility and taxpayers preferred using the affidavit to providing documents, records, or letters.[78] Given the effectiveness of the affidavit, and taxpayers' willingness to use the new form, we believe the IRS should expand use of the affidavit to all EITC examinations. Allowing all EITC taxpayers subject to a correspondence exam to submit affidavits to substantiate their claims for qualifying child can help resolve exams early. This approach may also encourage increased participation by taxpayers if they know they are capable of sending the IRS the requested information.

IRS COMMENTS

The IRS recognizes that problems result for taxpayers when they do not respond to IRS notices and letters requesting information concerning their federal tax liabilities. The IRS has taken significant steps to improve response rates, specifically in our Correspondence Examination program.

Communications

To improve our ability to reach taxpayers, the IRS uses a software database to locate and update taxpayer information on undeliverable mail. Address updates are received weekly from the United States Postal Service via the National Change of Address (NCOA) program, which maintains the most current taxpayer mailing address.

To refine the information available on no response rates, in January 2007 IRS will add a new technique code to AIMS (the automated systems used to control and track examinations) to indicate if the taxpayer called for information or orally agreed to the assessment but did not send any correspondence. This information will enable the IRS to better determine the actual no response rate by tracking data for taxpayers who reply by telephone but do not send in correspondence.

[76] The problems with documentation are also discussed in TAS's recent EITC Audit Reconsideration study. National Taxpayer Advocate 2004 Annual Report to Congress Vol. 2. Documentation difficulties or deficiencies with the original audit were the cause of audit reconsideration in 45 percent of the cases examined during the period of July 1, 2002 through January 31, 2003.

[77] The 2004 certification study marked the first time IRS examination routinely used affidavits for tax administration purposes. IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005*, 8 (Oct. 2005).

[78] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005*, 33 (Oct. 2005). The 2004 certification study was the first time the IRS used the affidavit. Because the affidavit was new, taxpayers may have been very cautious when filling it out, which may have affected the accuracy rate. For a complete discussion of the use of the affidavit during the 2004 certification study, see IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* (Oct. 2005).

In 2006, the IRS also implemented two new telephone enhancements to give taxpayers flexibility when responding to the IRS. Universal Call Routing provides toll-free assistance in both English and Spanish. All Correspondence Examination telephone assistors are trained to resolve general and specific case related questions for all Correspondence Examination audit-related programs. Universal Call Routing allows an employee to assist the taxpayer regardless of their geographic location and includes the capability for the employee to view current and past case history. This allows taxpayers a much greater opportunity to contact the IRS about their case, while significantly increasing efficiency in conducting these examinations. Universal Call Routing has resulted in a significant increase in the telephone level of service (LOS) afforded taxpayers. Our LOS, 69 percent in FY 2005 and 78 percent in FY 2006, has risen to 83 percent through the first month of FY 2007. In addition, Extension Call Routing enables tax examiners (TEs) to put their specific extension number on all of their assigned cases, thereby allowing callers to reach their assigned TE. If the call is not answered live by the assigned TE, instead of just going to voice mail the call is routed to an available TE who can assist the taxpayer with any question concerning their case.

To improve the effectiveness of examination telephone operations, IRS established two new performance measure targets in the Wage and Investment (W&I) Strategy and Program Plan for FY2007 - FY2008. Correspondence Examination Level of Service measures the percentage of examination initial contact calls answered by TEs. Correspondence Exam Customer Accuracy (Telephones) measures the accuracy of the resolution of correspondence examination telephone calls. These performance goals will help us ensure the quality of taxpayers' experience when contacting the IRS by telephone regarding their correspondence examination.

To further ensure contact with the taxpayer, Correspondence Examination requires TEs to call the taxpayer when additional information is needed to resolve the case. This guidance is provided in IRM 4.19.1.4.1.9. TEs are instructed to call the taxpayer "if the taxpayer's telephone number is available, to request additional information needed instead of sending a letter." The IRM also states, "telephone contact should also be attempted, if warranted, after issuance of Notice of Deficiency if less than 15 days until default and information submitted is not sufficient to make a change."

Correspondence

Examination cycle time, the time it takes the IRS to complete an examination, has consistently been a source of taxpayer dissatisfaction with the audit process. To reduce cycle time, the IRS adopted the "combo letter" for certain kinds of examinations.

As discussed in more detail in our response to the Correspondence Examination section of the National Taxpayer Advocate's report, we believe the combo letter is appropriate when the IRS has third-party information available to indicate a taxpayer is not entitled to a particular tax benefit. Documentation requirements for taxpayers in such cases are

not complex, taxpayers that respond timely do not lose their appeal rights, and use of the combo letter reduces the time needed for these examinations by 30 days.

In an effort to improve the rate of taxpayer responses, as well as to enhance the overall quality of communications, the IRS has revised the following notices and publications:

- Form 8862, Information to Claim Earned Income Credit After Disallowance, used by the taxpayer to recertify, was revised, resulting in a decrease to the time needed to complete the form by 50 percent.
- Computer Paragraph (CP) 27, EIC Potential for Taxpayer without Qualifying Children, is generated for any taxpayer potentially eligible for EITC without a qualifying child even when a recertification indicator is on Masterfile. The IRS also reprogrammed its systems not to reject electronically filed Forms 1040 or 1040A that claim EITC without qualifying children, when the recertification indicator is present and Form 8862 is not attached.
- CP74, You've Successfully Re-Certified for EIC, was recently developed to inform taxpayers that they have been recertified for EITC. The recertification indicator is now automatically released when the taxpayer verifies their EITC. This allows the taxpayer's refund to generate timely the following year.
- CP79, Taxpayer Inquiry, Earned Income Credit Eligibility Requirement, sent to the taxpayer to explain the recertification process, was revised using taxpayer feedback.
- CP79A, Earned Income Credit Two Year Ban, was revised to display the next year a taxpayer would be eligible to claim the EITC again.
- Publication 596, Earned Income Credit, contains a new chapter on information concerning recertification and the recertification process. This chapter was added to assist the taxpayer in determining if and when the Form 8862 is required. The EITC web page on IRS.gov links to the new recertification chapter and also includes links to Form 8862 and letters CP79 and CP79A.
- Forms 886-H Series, Supporting Documents for Taxpayers Claiming: EIC on the Basis of a Qualifying Child(ren), Dependency Exemptions or Head of Household Filing Status, was revised to properly address changes in the tax law as a result of the Uniform Definition of a Qualifying Child. A team that includes members of the Taxpayer Advocate Service (TAS), W&I Compliance, Small Business/Self Employed (SB/SE) Compliance, Single Point of Contact, and the EITC Office are working to further improve the clarity of these forms so that the taxpayer will clearly understand what they should send in, when, and why.
- Publication 3498A, The Examination Process, is being revised to enhance the language to adequately address premature Appeals concerns. Analysts working on the revision team include members from TAS, W&I Compliance, SB/SE Compliance, Appeals and the EITC Office.

- Other Notices - In September 2006, the IRS updated several publications in English and Spanish to promote awareness of the EIC refund eligibility: Publication 962 and 962E (Spanish); Publication 4194 English/Spanish and Publication 3211M. Each publication included the new "I take credit campaign" message. Additionally, in 2006, the IRS delivered several messages in its W&I Communication Strategy to encourage taxpayers to respond to EITC related notices.

In order to overcome language barriers for Limited English Proficient (LEP) taxpayers, the National Taxpayer Advocate suggests the very costly initiative of adding a "language indicator" on all tax forms. This would require significant training, computer programming, and data entry to update taxpayers' files. In addition to being very costly, there is insufficient evidence such a change would actually improve the response rate. Issues related to LEP taxpayers are addressed in more detail in our response to the Language and Cultural Barriers section of the National Taxpayer Advocate's report.

The IRS has procedures in place to accommodate visually impaired taxpayers. IRM 21.3.1.5, Request for Copy of Notice in an Alternative Media Format, provides procedures for TEs to place a hold on the taxpayer's account until a notice can be sent in Braille. A more detailed discussion of this issue is contained in our response to the Reasonable Accommodations section of the National Taxpayer Advocate's report.

Notices and letters generated by Correspondence Examination TEs explain to taxpayers what items are disallowed and what additional information is needed to support the disallowed item. A self-addressed stamped envelope is not included with notices and letters as this is extremely costly to the government. Additionally, the IRS encourages taxpayers to call its toll-free assistance lines to resolve their tax issues. As noted above, the IRS enhanced AIMS to document telephone contacts, improved its examination telephone system, and established performance goals to ensure access and accuracy for taxpayers that choose to respond by telephone.

Documentation

The National Taxpayer Advocate suggests that onerous documentation requests by the IRS cause taxpayers to give up and ignore an IRS notice or letter entirely. To remedy this problem, the use of affidavits is suggested for all EITC examinations in lieu of traditional documentation. As addressed in more detail in our response to the Correspondence Examination section of the National Taxpayer Advocate's report, previous testing of affidavits to establish EITC qualifying child residency requirements did not replicate the "real world" conditions under which affidavits might be used. Although affidavits appear to offer some promise as a way to improve response rates, they may generate additional erroneous claims that the IRS would have to examine. Further, to prevent use of false affidavits the IRS would need a comprehensive approach to identifying and preventing their abuse. Thus, while data from the EITC certification tests indicates some potential usefulness for affidavits, the data is insufficient to warrant use of similar affidavits for all EITC examinations.

Even though we do not have sufficient data to support acceptance of affidavits, in some cases we do allow our TEs to accept alternative documents when standard documentation is unavailable. For example, we worked closely with the Tax Exempt and Government Entities Division to determine acceptable documentation for the Native American population since traditional documentation is often not available.

In summary, the IRS has taken significant steps to improve taxpayer response rates:

- We utilize the NCOA program to obtain the best and most current taxpayer mailing address.
- We improved our AIMS system to better measure the no-response rate.
- We enhanced our telephone system and implemented new performance measures to improve the taxpayer's experience when responding by phone.
- We require our TEs to initiate telephone contact when additional information is needed or 15 days prior to default when a Statutory Notice of Deficiency has been issued.
- We use the combo letter to reduce taxpayer burden by reducing cycle time.
- We improved the clarity of several notices and publications and have procedures in place to accommodate visually impaired taxpayers.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS for recognizing the problems that arise when a taxpayer does not respond to an IRS notice or letter. We are also pleased that the IRS has taken steps to improve response rates, particularly in the Correspondence Examination program. Requiring examiners to call taxpayers when the IRS needs additional information to resolve their cases is an important step in ensuring that taxpayers do not simply fall through the cracks of the examination process.

We are encouraged by the improvements to AIMS, which will more accurately capture whether a taxpayer contacts the IRS in regards to a notice. This will help the IRS to develop a more precise view of how many taxpayers do not respond. However, we believe there is room for additional improvement. The first step is to understand the magnitude of the problem of no response and develop a targeted strategy aimed at increasing the response rate. We look forward to working with the IRS in its efforts to improve taxpayer response rates.

As noted previously, we are pleased by the recent telephone enhancements that allow the IRS to better respond to taxpayer calls without having to transfer taxpayers or send them to voicemail. The new performance measures for correspondence examination calls will also help improve the quality of a taxpayer's experience when he or she contacts the IRS for assistance.

While these changes improve service for those taxpayers who do call the IRS for assistance, they still do not increase the likelihood that taxpayers *will call* the IRS when they receive a notice or letter. To increase the likelihood that a taxpayer will contact the IRS, the IRS should increase its outreach and education efforts to encourage taxpayers to respond to correspondence.

We are disappointed that the IRS continues to use the combination letter in certain types of examinations. The combo letter gives taxpayers conflicting instructions – simultaneously telling them to communicate with exam while also telling them to fill out a request for an appeals conference if they do not agree with the result. It should come as no surprise that taxpayers do not respond to such conflicting instructions. We are concerned that the IRS's refusal to eliminate the combo letter is driven, in part, by an attempt to minimize the number of appeals conferences in order to reduce costs and accelerate assessments. Even if that is not the intention, it is clearly the effect and it serves to undermine a taxpayer's *meaningful* right to an administrative appeal. We believe eliminating the "combo" letter is important to improving both the quality of IRS correspondence and taxpayer rights, and we will continue to work for the elimination of the combination letter.[79]

We are pleased that the IRS is reviewing notices and publications in an effort to enhance the overall quality of its communications with taxpayers. Here too, however, there is still room for improvement, particularly when the IRS communicates with taxpayers who may face additional barriers in their interaction with the IRS. Limited English Proficiency (LEP), visually impaired, and low income taxpayers may have greater difficulty in responding to IRS requests. Although some of our suggestions for improving the response rate among these taxpayers may mean additional costs, they may also help eliminate downstream costs to both the taxpayer and the IRS.

Taxpayers who are unable to meet IRS requests for documentation may become discouraged and ignore the IRS request. For this reason, and to improve the resolution of IRS examinations, we believe the IRS should expand the use of the affidavit to all EITC examinations. Based on the EITC certification study, the IRS should also test the effectiveness of other methods of proof to determine which are most accurate and best suited for meeting IRS and taxpayer needs. The IRS can continue to gather data regarding the use of affidavits while expanding their use to all EITC examinations in the near future.

RECOMMENDATIONS

To improve the taxpayer response rate and help reduce downstream costs for both taxpayers and the IRS, we recommend that the IRS do the following:

[79] *See* Most Serious Problem, *Correspondence Examination, supra.*

- Accurately track the no response rate to IRS notices and letters in order to understand the magnitude of the problem of no response.
- Develop a targeted strategy aimed at increasing the taxpayer response rate, including studies or surveys to find out why some taxpayers do not respond.
- Increase outreach and education efforts to encourage taxpayers to respond to the IRS, including:
  - Examining the 2006 EITC certification test in which one message to qualifying taxpayers was "reply to any IRS correspondence about your EITC to get the credit you deserve";[80]
  - Design an outreach campaign aimed at explaining the consequences of not responding to notices and letters and encouraging taxpayers to open mail from the IRS.
- Continue to review IRS correspondence and publications to ensure that taxpayers understand what the IRS is requesting.
- Consider changes to communication that would assist LEP, disabled, and low income taxpayers, such as:
  - Allow taxpayers to specify in what language they want to receive communication from the IRS;
  - Put language in Braille on envelopes indicating that the letter contains important IRS correspondence and providing a telephone number to call for more information; and
  - Include a self-addressed stamped envelope with letters requesting information from a taxpayer.
- Expand use of the residency affidavit to all EITC examinations while continuing to monitor its effectiveness relative to other forms of documentation.

[80] Wage and Investment SPEC Communications and Marketing, *W&I Communication Strategy – Earned Income Tax Credit (EITC) FY 2006* 2 (Jan. 24, 2006)

PROBLEMS

PROBLEM

TOPIC #20 REASONABLE ACCOMMODATIONS FOR TAXPAYERS WITH DISABILITIES

RESPONSIBLE OFFICIALS

Kevin M. Brown, Deputy Commissioner, Services and Enforcement
Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division
Richard J. Morgante, Commissioner, Wage and Investment Division
Deborah M. Nolan, Commissioner, Large and Mid-Size Business Division
Steven T. Miller, Commissioner, Tax Exempt and Government Entities
Sarah Hall Ingram, Chief, Appeals
Nancy J. Jardini, Chief, Criminal Investigation
Donald L. Korb, Chief Counsel

DEFINITION OF PROBLEM

Taxpayers with disabilities often find themselves attempting to navigate and comply with a complex tax system that was not designed to provide equal access. Taxpayers who are blind, deaf, or have other disabilities encounter numerous barriers unique to these groups. These barriers can discourage taxpayers with a disability from complying with their tax responsibilities, or from initiating any contact with the IRS.

Disabilities impact all areas of our society – people of every economic background, age, race, and creed. The U.S. Census Bureau reports 51.2 million people, representing 18 percent of the population, as having some type of disability[1] and of this group 32.5 million, or 12 percent of the population, have severe disabilities.[2] The elderly community has the highest rate of disabled individuals when compared with other age groups: 72 percent of people age 80 and over have some type of disability.[3] Most likely, this number will increase as the population continues to age.[4] These statistics demonstrate how important it is for the IRS to provide accommodating services to taxpayers with disabilities.

Disabled taxpayers generally encounter three major barriers when attempting to comply with and navigate the tax system. These barriers are:

- **Communication Barriers:** Individuals with a disability often use different skills to communicate effectively. They may require a translator, materials in an alternative format, or materials that can be accessed with assistive technology. The type of accommodation a taxpayer needs to communicate effectively will vary according to the taxpayer's disability.

1 U.S Census Bureau, *Question and Answer Center*, at http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html.

2 *Id.*

3 *Id.*

4 CDC, *Public Health and Aging: Trends in Aging – United States and Worldwide*, at http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5206a2.htm. Between 2000 and 2030, the number of U.S citizens 80 years of age or older is expected to increase from 9.3 million to 19.5 million.

- **Education and Outreach to the Disabled Community:** The IRS needs to increase its efforts to educate taxpayers with disabilities about the helpful services available to them, when and whether to file a tax return, and other issues such as tax deductions or credits. Moreover, the Small Business/Self-Employed(SB/SE) Operating Division should reach out to disabled taxpayers who are attempting to set up a small business. SB/SE also needs to improve its outreach to owners of small businesses about tax incentives available for complying with The Americans with Disabilities Act.[5]
- **Problems with Deductions and Credits:** Taxpayers with disabilities may be eligible for a variety of tax deductions and credits, but these provisions of the tax code are often complex and confusing to the most sophisticated tax professionals, let alone a lay person who may face obstacles in obtaining IRS resources. Further, due to the complexity of the tax system, small business owners may have difficulty understanding when they can take deductions and credits for expenses incurred as a result of complying with The Americans with Disabilities Act.[6]

ANALYSIS OF THE PROBLEM

Background: Persons with Disabilities in the U.S.

Persons with disabilities are the largest protected class in the United States. This group is diverse in age, race, and economic standing.

- 51.2 million Americans, 18 percent of the population, have some level of disability;
- 32.5 million Americans, or 12 percent of the population, have severe disabilities;
- 10.7 million Americans age six and older need daily assistance with one or more activities of life, such as taking a bath or using the telephone;
- 1.8 million Americans age 15 and older report being unable to see;
- 2.6 million Americans age 15 or older report some difficulty having their speech understood by others; and
- 14.3 million Americans have limitations on their cognitive function, or an emotional or mental illness.[7]

The median income for Americans who have a non-severe disability is $22,000, compared to $25,000 for those who do not have a disability. Twenty-six percent of Americans with a severe disability fall below the poverty line, compared with 11 percent of those with a non-severe disability and six percent with no disability. Thirty–three percent of Americans between the ages of 25 and 64 who have non-severe disabilities, and 22 percent of those with severe disabilities have graduated from college, compared to

[5] 42 U.S.C. §§ 12101 et seq (1990); PL 101-336 (Jul. 26, 1990). *See also* Most Serious Problem, *Small Business Outreach, supra.*

[6] 42 U.S.C. §§ 12101 et seq (1990); PL 101-336 (Jul. 26, 1990).

[7] U.S Census Bureau, *Question and Answer Center*, at http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html.

the 43 percent who do not have disabilities and have graduated from college. Thirty-six percent of Americans between the ages of 15 and 64 with a severe disability have a computer and 29 percent use the Internet at home, compared with 61 percent of Americans who do not have a disability and have a computer and 51 percent who use the Internet at home. Finally, 2.6 million veterans receive compensation for service related disabilities.[8] Clearly, persons with disabilities constitute a large and diverse segment of the U.S. population.

Communication Issues

Visually Impaired and Blind Taxpayers

There are 1.8 million people aged 15 or older who report being unable to see. Many of these individuals utilize large print, audio, Braille, adaptive technology, adaptive equipment, and other devices to communicate in a sighted world.[9] The IRS provides forms and publications in PDF and HTML formats,[10] which may be compatible with assistive technology.[11] However, not all IRS documents are compatible with assistive technology, and this gap impedes or impairs taxpayers' ability to read these documents.[12] The IRS has also established the Alternative Media Center (AMC), which will provide forms, publications, and even notices in a variety of formats that are usable for the visually impaired or blind taxpayer.[13] However, many taxpayers are unaware of these services, because they are not well publicized and can be difficult for taxpayers to find.[14] Visually impaired and blind taxpayers may also have difficulty reading IRS correspondence sent directly to them, and may be burdened by their inability to immediately read the notice or even realize they have received an IRS notice.

Forms and Publications in Accommodating Formats

Although the IRS has taken steps to provide forms and publications in alternative formats, the IRS is not taking steps to make people aware of this service. Because the AMC produces 555 forms in PDF talking format, and 345 forms and publications in

[8] U.S Census Bureau, *Question and Answer Center*, at http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html.

[9] American Federation of the Blind, Computer Use, at http://www.afb.org/Section.asp?SectionID=15&DocumentID=1367#comp (last visited Sept, 11 2006). Just over 1.5 million people with limited vision use computers and 196,000 of the 1.5 million have severe vision limitations.

[10] IRS, *Accessible IRS Tax Products*, at http://www.irs.gov/formspubs/article/0,,id=96151,00.html.

[11] Freedom Scientific, at http://www.freedomscientific.com/ (last visited Sept. 12, 2006). This company sells screen reading programs (JAWS) and screen magnification programs (Magic) for the blind and visually impaired.

[12] *See, e.g.*, IRS Instructions for Form 5884, *Work Opportunity Credit*, (1981). This is an example of an old form that has not been redesigned to comply with Section 508.

[13] IRM 21.3.6.4.1 (Oct. 1, 2006); and IRM 21.3.6.4.2 (Oct. 1, 2006).

[14] IRS, *Accessible IRS Tax Products*, at http://www.irs.gov/formspubs/article/0,,id=96151,00.html. How to request forms, publications, or notices in Braille or other alternative formats is not advertised on the IRS's accessibility website.

text only files and Braille ready format,[15] taxpayers can request any form, publication, notice, or bill in Braille or an alternative format.[16] However, the IRS does not advertise this service anywhere on its website or the AMC website, or address the service in publications.[17] With virtually no advertising, this service is difficult to locate and is significantly under-utilized.[18] The IRS should promote this service on its accessibility website and require it to be mentioned on every IRS form, publication, and notice.

Correspondence

IRS correspondence also creates a unique challenge for visually impaired and blind taxpayers. For instance, many visually impaired and blind taxpayers hire sighted individuals to help them sort their mail but those with low incomes may not be able to afford daily assistance and may hire someone weekly or even more irregularly, or may rely on unscheduled volunteers or family members for assistance. This lag time between when the taxpayer receives the notice and the time he or she can identify and understand it may place a burden on the taxpayer.

Some IRS notices come with a relatively short turnaround time, and taxpayers who are visually impaired or blind may experience a burden trying to respond timely. For instance, taxpayers must respond to a CP 2000 notice within 30 days of receiving it. This timeframe could create a burden for the visually impaired or blind taxpayer since the taxpayer may not realize he has received a notice until his reader reviews the correspondence. Failure to respond to notices can result in serious consequences for the taxpayer; therefore, it is imperative that the notice be available in a format the taxpayer can read and understand. As noted previously, taxpayers can receive a notice in Braille if they call and request it from the AMC, but again, this service is not widely publi-

[15] Text only files are electronic files that contain only a basic character set of letters, numbers and punctuation. Text files do not display fonts, images, icons or any other graphical information. These files can be opened and edited in any text-editing program such as Microsoft Word, WordPerfect, WordPad and Notepad. Braille Ready Format (.brf) files are text-only files which have been formatted specifically for embossing. Embossing, which produces a raised image on paper by striking the other side, is the most commonly used method for producing Braille. These files can be sent directly to any personal or commercial Braille embosser using the DOS print command or through Braille translation software.

[16] IRM 21.3.6.4.1 (Oct. 1, 2006); and IRM 21.3.6.4.2 (Oct. 1, 2006).

[17] IRS, Pub. 907, *Tax Highlights for Persons with Disabilities* (2005); IRM 21.3.6.4.1 (Oct. 1, 2006); IRM 21.3.6.4.2 (Oct. 1, 2006); IRS *Tax Topics 102, Tax Assistance for Individuals with Disabilities and the Hearing Impaired*, (2005), and IRS, Tele Tax 105 *Public Libraries – Tax Information Tapes and Reproducible Tax Forms* 1-800-829-4477. The IRS has inconsistent information on how to request forms, publications, notices, and bills in alternative formats. For example, IRM 21.3.6.4.1 (Oct. 1, 2006), tells the IRS employee to order the material in an accommodating format through the desktop integration system, which is the correct process. The TeleTax topic actually gives the taxpayer incorrect information on how to request a Braille or large print publication or form: "Braille materials for the visually impaired are available at any of the 142 regional libraries in conjunction with the national library service for the blind and physically handicapped. To locate your nearest library write to the National Library Service for the Blind and Physically Handicapped, Library of Congress at 1291 Taylor Street, NW, Washington, D.C. 20542." Not only is the information inconsistent, but it is very difficult to find. In fact, it is not even advertised on the Alternative Media Center website.

[18] Systemic Advocacy Management Information System (SAMS). A blind taxpayer submitted an issue on SAMS saying IRS employees could not provide information on how to obtain tax bills in Braille.

cized.[19] Also, the IRS does not have a process that allows the taxpayer to request that all further correspondence be sent in the accommodating format.

Technology and Section 508 Compliance Issues

Congress enacted § 508 of the Rehabilitation Act in an effort to eliminate barriers in information technology.[20] This legislation requires federal agencies to make all electronic materials available to people with disabilities.[21] The impact of not having information technology available to federal employees and the general public can be detrimental to effective government and individual rights. For instance, it can be a barrier to obtaining and utilizing necessary information quickly and easily.

Section 508 requires the IRS, as well as all other federal agencies and departments, to make electronic and information technology equally accessible to federal employees and all members of the public. Thus, people with disabilities must have use of and access to electronic and information technology that is comparable to the use and access enjoyed by people who do not have a disability.[22]

This legislation has a significant impact on the visually impaired and blind community since these individuals rely heavily on assistive technology to use computers and access information.[23] The development of this assistive technology has opened a whole new world for disabled individuals. If documents are designed correctly, the visually impaired and blind can access them on the Internet easily and quickly, whereas many of these materials were previously available only in print and were difficult to access in an accommodating format. However, with new technology, different challenges occur. Websites must be designed in a manner that is compatible with the screen reader, screen magnification, or other assistive technology programs. If sites and documents are not

[19] IRM 21.3.6.4.1 (Oct. 1, 2006); and IRM 21.3.6.4.2 (Oct. 1, 2006).

[20] 29 U.S.C. 794d, as amended by the Workforce Investment Act of 1998 (Pub. L. No. 105-220, (Aug. 7, 1998).

[21] 29 U.S.C. 794d, as amended by the Workforce Investment Act of 1998 (Pub. L. No. 105-220, (Aug. 7, 1998), provides

> (a) REQUIREMENTS FOR FEDERAL DEPARTMENTS AND AGENCIES.– (1) ACCESSIBILITY.– (A) DEVELOPMENT, PROCUREMENT, MAINTENANCE, OR USE OF ELECTRONIC AND INFORMATION TECHNOLOGY.–When developing, procuring, maintaining, or using electronic and information technology, each Federal department or agency, including the United States Postal Service, shall ensure, unless an undue burden would be imposed on the department or agency, that the electronic and information technology allows, regardless of the type of medium of the technology– (i) individuals with disabilities who are Federal employees to have access to and use of information and data that is comparable to the access to and use of the information and data by Federal employees who are not individuals with disabilities; and (ii) individuals with disabilities who are members of the public seeking information or services from a Federal department or agency to have access to and use of information and data that is comparable to the access to and use of the information and data by such members of the public who are not individuals with disabilities.

[22] 29 U.S.C. 794d, as amended by the Workforce Investment Act of 1998, (Pub. L. No. 105-220, (Aug. 7, 1998).

[23] American Federation of the Blind, *Computer Use*, at http://www.afb.org/Section.asp?SectionID=15&DocumentID=1367#comp. Just over 1.5 million people with limited vision use the Internet and 196,000 of the 1.5 million have severe vision limitations.

properly designed, the user will either have difficulty navigating the site or program, or will be unable to access the site entirely.

The IRS has made significant strides in developing § 508 compliant websites, but it can still make improvements. It is unclear how many IRS sites fail to comply with § 508 because the IRS does not track this information. Many older IRS sites have not been redesigned. Moreover, it is not realistic or cost effective to redesign and update these old inaccessible websites. However, publicizing the procedure for taxpayers to request forms and publications in accommodating formats would provide another way to obtain usable documents.

We were unable to identify any formal procedures for taxpayers to comment on the difficulties they may have when attempting to navigate and use the IRS's website. Even though the IRS's accessibility webpage contains a comment section, it does not ask for specific comments on § 508 compliance issues.[24] Further, even if taxpayers make comments, the IRS has no formal procedures for determining if they have merit, or implementing steps to address issues that do have merit. Such a mechanism is an essential element of full compliance with § 508, because otherwise the IRS will have difficulty knowing if taxpayers encounter barriers when navigating and using the IRS website.

In addition to improving the number of § 508 compliant documents, the IRS could make a number of adjustments that would make its external website more accommodating to disabled taxpayers.[25] For example, the IRS could offer several options that would allow the taxpayer to manipulate the site to meet his or her individual needs, such as fonts, color, and speech option. Developing a website that provides these accommodations may help prevent or resolve these problems and ultimately save the IRS money and resources.

Moreover, not only should the IRS improve the accessibility of its websites, but it should also be conscientious about writing § 508 requirements into contracts with private companies, since private firms are otherwise not required to be § 508 compliant. It is true that the IRS may not be in violation of § 508 by entering into an agreement with a company that does not have an accessible website, such as the e-file sites that

[24] IRS, *Alternative Media Center*, http://www.irs.gov/help/page/0,,id=13148,00.html.

[25] National Institutes Of Health, *Elderly* at http://nihseniorhealth.gov/.

participate in the Free File program.[26] Even if this is within the letter of the law, however, is it really within the spirit of the law? Moreover, is the IRS promoting good public policy by *not* requiring its contractors to provide equal access to all taxpayers? The IRS should make a business decision to contract only with private companies that will guarantee equal access. If private companies cannot provide services with equal access, the IRS should provide the service (or access) itself – maintaining the sound principle that all taxpayers are entitled to equal access to IRS services.

Barriers Facing Deaf and Hard-of-Hearing Taxpayers

Deaf and hard-of-hearing taxpayers also face unique challenges when attempting to communicate effectively. For example, many of these taxpayers use American Sign Language (ASL) as their primary language.[27] Communicating with people by using other methods – such as writing notes – can be difficult and confusing, and lead to misunderstanding between the taxpayer and the hearing person. Also, a deaf or hard-of-hearing taxpayer who uses ASL as a primary language may have difficulty understanding printed material since it is not in his or her primary language.[28]

American Sign Language as a Primary Language

The most significant barrier deaf and hard-of-hearing taxpayers experience when attempting to navigate and utilize the tax system is communicating with the IRS. For example, when a deaf person enters a Taxpayer Assistance Center (TAC), and the taxpayer only speaks ASL, the taxpayer and IRS assister may have to communicate by passing notes to one another. This approach can lead to confusion since the taxpayer's primary language is ASL and it may be difficult for him or her to understand what the IRS employee is communicating.[29] The IRS could provide an ASL video relay service in its TACs to

[26] The IRS entered into a three-year agreement prior to the 2003 filing season with a consortium of tax preparation software companies known collectively as the "Free File Alliance." The agreement had a three-year term that ended last year, and in October 2005, the IRS and the Free File Alliance agreed to extend the contract for four years with some modifications. The initial agreement required the Free File companies, in the aggregate, to make free electronic preparation and filing available to a minimum of at least 60 percent of all taxpayers and the 2005 agreement prevents Free File companies, in the aggregate, from making free services available to more than 70 percent of all taxpayers. Free On-Line Electronic Tax Filing Agreement entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2002), available at www.irs.gov/efile/article/0,,id=103626,00.html; Free On-Line Electronic Tax Filing Agreement Amendment entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2005), available at www.irs.gov/pub/irs-efile/free_file_agreement.pdf.

[27] Rosenberg Amy (1999) *Writing Sign Languages*. Masters Thesis, University of Kansas at http://www.signwriting.org/forums/research/rese013.html (last visited Nov. 16, 2006). The National Association of the Deaf reports that there are 28 million people who report having some hearing impairment; two million of them are deaf, meaning they cannot hear speech; and 300,000 people who consider themselves culturally "Deaf," which means they consider American Sign Language their primary language and live in a Deaf community.

[28] National Association of the Deaf, at http://www.nad.org/site/pp.asp?c=foINKQMBF&b=99566.

[29] Hoffmeister, R. J., De Villiers, P. A., Engen, E., & Topol, D. (1997). *English Reading Achievement and ASL Skills in Deaf Students*. Proceedings of the Annual Boston University Conference on Language Development, 21(1), 307-318; Nover, S. M., Christensen, K. M., & Cheng, L. R. L. (1998).Development of ASL and English Competence for Learners Who Are Deaf. Topics in Language Disorders, 18(4), 61-72; and Prinz, P. M. & Strong, M. (1998). ASL Proficiency and English Literacy within a Bilingual Deaf Education Model of Instruction Topics in Language Disorders, 18(4), 47-60.

assist with communication and translate between the deaf or hard-of-hearing taxpayers and IRS employees.[30] Unfortunately, no TAC has this technology available.

The language barrier also extends to IRS forms and publications. Again, deaf individuals who use ASL as their primary language often have difficulty understanding written materials since they are not in their primary language. To minimize this barrier, the IRS could provide answers to some of the most frequently asked tax questions in ASL and post them on its website as a streaming video.

Education and Outreach to Taxpayers with Disabilities

Helpful Services

The IRS does offer some services to taxpayers with disabilities, such as the AMC.[31] However, the IRS must do more to inform taxpayers about these services as well as improve its outreach to this group of taxpayers and educate them about the tax laws and tax administration.

The IRS should expand its accessibility website to include information on tax deductions and credits for disabled taxpayers and how to request IRS materials in an alternative format. Centralizing all this information in one location, with links to other appropriate sites, is more logical than scattering it throughout the IRS site. Such information can be difficult for all taxpayers to find, but the search may be even more difficult and frustrating for those with disabilities.

In addition to providing information on the Internet, the IRS should maintain and improve accessibility to its TACs and toll-free telephone number. Many taxpayers with a disability do not have access to the internet or assistive technology because of its cost, and they prefer personal contact with the IRS.[32] Also, it is essential that all IRS employees – especially employees at TACs and those staffing the toll-free number – are trained on IRS services for taxpayers with disabilities, so they can make appropriate referrals.

When To File

Taxpayers with a disability, when interviewed in focus groups, expressed confusion about when to file a tax return, and how filing a return would impact social security benefits.[33] This confusion indicates that the IRS needs to increase its outreach to this group.

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[30] National Center on Accessibility Information Technology in Education at http://www.washington.edu/accessit/articles?111.

> "The Video Relay Service (VRS) is similar to the [Telephone Relay Service] (TRS), but a relay operator provides translation between spoken word and American Sign Language (ASL), rather than spoken word and text. The hearing user communicates by voice, the non-hearing user communicates by video using ASL, and the relay operator serves as a liaison, communicating by voice to the hearing party and by video using ASL to the non-hearing party. VRS is an important alternative to the original TRS, since many individuals with hearing impairments prefer ASL as their primary method of communication."

[31] IRS, *Accessible IRS Tax Products*, at http://www.irs.gov/formspubs/article/0,,id=96151,00.html.

[32] IRS, *TAB II Draft Report on Taxpayers with Disabilities: A Focus Group Project* (Jun. 13, 2006).

[33] *Id.*

Publication 907, Tax Highlights for Persons with Disabilities, briefly addresses the issue of Supplemental Security Income (SSI) payments but offers no information on how filing a return may or may not impact a taxpayer's SSI.[34] At a minimum, the IRS should include a reference in Publication 907 on where to obtain more information, such as a Social Security Administration website or toll-free number.

Tax Deductions and Tax Credits

Tax deductions and credits can be helpful to millions of disabled taxpayers, their caretakers, or businesses owners who comply with the ADA's accessibility standards by making their facilities accommodating. The IRS has not conducted research to identify the specific needs of this population, nor has it developed or implemented a campaign to educate taxpayers with disabilities. There is one exception: the Stakeholder Partnership Education and Communication (SPEC) organization in the Wage and Investment (W&I) division has set an example for the IRS by developing a disability toolkit. This toolkit is designed to educate SPEC's community-based partners, such as Goodwill Industries, who have direct contact with the disabled community, and provide guidance on how to establish work groups within the community, that will assist disabled taxpayers with tax preparation, financial literacy, and asset building. Currently, this toolkit is only available internally, but SPEC intends to make it available to the public. SPEC has also created a page on its internal (IRS intranet) website devoted entirely to disability issues, with information on outreach and education.[35]

Taxpayers with Disabilities and Their Caretakers

Several tax deductions and tax credits have been designed to assist disabled taxpayers and their caretakers. Unfortunately, the IRS has conducted little outreach to inform and explain these deductions and credits to taxpayers.

- **Medical Expenses:** Taxpayers can take certain medical and dental deductions for themselves, their spouses, and dependants. This deduction is limited to expenses that total more than 7.5 percent of the Adjusted Gross Income (AGI).[36]
- **Impairment Related Work Expenses:** This deduction applies to individuals with a physical or mental disability that functionally limits employment or substantially limits one or more major life activities.[37] Taxpayers eligible for this deduction are not subject to the two percent AGI threshold for work-related expenses that applies

[34] IRS, Pub 907, *Tax Highlights for Taxpayers with Disabilities* (2005). "Social security benefits do not include SSI payments, which are not taxable. Do not include these payments in your income." Supplemental Security Income home page available at http://www.socialsecurity.gov/notices/supplemental-security-income/ (last visited on Nov 3. 2006). Supplemental Security Income (SSI) is a federal supplemental income program designed to assist the aged, blind, and disabled person who has little or no income. This program provides money for basic human needs, such as food, clothing, and shelter.

[35] IRS, *Wage and Investment Insider*, http://win.web.irs.gov/spec/SPEC_disability.htm.

[36] IRC § 212.

[37] IRC § 67(d).

to other taxpayers.[38] However, this deduction can only be used if the taxpayer itemizes deductions rather than taking the standard deduction.

- **Child and Dependent Care Credit:** The taxpayer can take this credit if he or she pays a person to provide care to a dependant under the age of 13, a dependent who is over the age of 13 but unable to care for him or herself, or a spouse who is unable to care for him or herself. This credit is up to 35 percent of the taxpayer's dependent care expenses, with a maximum of $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals.[39]
- **Credit for the Elderly or Disabled:** A taxpayer can claim this tax credit if he or she is age 65 or older, or is permanently unable to work and receives disability.[40]

Small Business and Self-Employed Taxpayers

Congress has created two major incentives for business owners to make their businesses accommodating to disabled customers and employees. The Disability Access Credit[41] and the deduction for removing barriers for the disabled and elderly[42] were designed to alleviate some of the financial burden businesses may experience when complying with the Americans with Disabilities Act.[43] These incentives are available in the following circumstances:

- **Disability Access Credit:** Small businesses can use this tax credit for expenses incurred by complying with the ADA, which may include architectural adaptations, equipment acquisitions, and services such as sign language interpreters.[44] This tax credit can be claimed up to 50 percent of the first $10,000 eligible expenses that exceed $250.
- **Deduction for Removing Barriers for the Disabled and Elderly:** This deduction allows a business of any size to deduct expenses, up to $15,000 per year, associated with the removal of architectural or transportation barriers in connection with a trade or business that comply with applicable accessibility standards.[45]

These incentives are useful for encouraging and supporting businesses to be more accessible to the disabled and elderly consumer. However, SB/SE has done very little to educate taxpayers about these incentives. SB/SE's website contains only one

[38] IRC §§ 67(a) and 67(b)(6).

[39] IRC § 21.

[40] IRC § 22.

[41] IRC § 44.

[42] IRC § 190.

[43] 42 U.S.C. §§ 12101 et seq (1990); PL 101-336 (Jul. 26, 1990).

[44] IRC § 44.

[45] IRC § 190.

brief discussion of these issues.[46] The discussion is unclear and does not provide any examples of which expenses would qualify for these incentives.[47] In addition, the information is difficult to locate. Again, it would make more sense to consolidate these materials on a designated disability website. SB/SE's lack of outreach may be a factor in the low number of taxpayers who actually apply for these incentives.[48]

Moreover, SB/SE has conducted even less outreach and education for small businesses owners and self-employed individuals who have a disability. It is important that the IRS becomes more active in outreach to taxpayers with a disability because some professionals believe that being self-employed or owning their own small businesses is an increasing trend in the disability community.[49] One of the most significant barriers facing disabled individuals who are attempting to start their own business is the inaccessibility of business materials.[50] Thus, the IRS should ensure that it is not a barrier to disabled individuals entering business, but is instead a resource for these entrepreneurs. To help accomplish this goal, the IRS should have a small business and self-employment section on its accessibility webpage.

Problems With Deductions and Credits

Not only has the IRS done a poor job of educating disabled taxpayers about these deductions and credits, but many of them are complex and difficult for taxpayers to understand. This process is even more difficult for persons with disabilities because of the lack of accommodating resources and poor communication from the IRS.

Disability Access Credit

One of the most beneficial tax credits for small businesses is the Disability Access Credit (DAC).[51] This credit was created to help eliminate some of the cost of providing accommodations for employees. The credit applies to businesses that have 30 or fewer

[46] IRS, *Know the Rules Regarding Tax Incentives for Improving Accessibility for the Disabled*, at http://www.irs.gov/businesses/small/article/0,,id=113382,00.html.

[47] *Id.*

[48] General Accounting Office, GAO 03-39, *Business Tax Incentives* (Dec. 2002). Although the GAO report does not directly connect the low numbers of eligible businesses who claim the Disability Access Credit, Deduction for Removing Barriers for the Disabled and Elderly, and Work Opportunity Credit to lack of outreach and education, it strongly recommends that federal agencies, including the IRS, increase its outreach and education efforts.

> Academic disability researchers, businesses, disability groups, and other interested parties we interviewed proposed various options to increase the awareness and usage of the incentives, including (1) expanding and improving federal outreach through better coordination and clarification of incentive requirements; (2) increasing the maximum amount allowed to be claimed; and (3) expanding eligibility to cover more workers with disabilities, businesses, and types of accommodation.

[49] Department of Labor, *Business Ownership - Cornerstone of the American Dream*, at http://www.dol.gov/odep/pubs/business/business.htm.

[50] *Id.*

[51] IRC § 44.

full-time employees, or have less than one million dollars in gross yearly proceeds.[52] The business is allowed a credit in the amount of half of the cost of the access expenditure for the first $10,000 eligible expenses that exceed $250. Thus, the maximum allowable credit would be $5,000.[53] Although this credit is very beneficial for businesses, only a small proportion of corporations and individuals with affiliations with business claim this useful credit.[54]

Unclear IRS guidelines may be one reason that few businesses claim this credit. For example, there is some concern that businesses with fewer than 15 employees cannot take this credit, because its intent is to alleviate the financial burden the ADA places on businesses,[55] and the ADA only applies to businesses with 15 or more employees.[56] The IRS should clarify its position on this issue, or taxpayers may be discouraged from taking the credit for fear of taking it incorrectly.[57]

The lack of IRS guidance concerning what type of equipment and devices are eligible for the DAC make it difficult for businesses to determine when they can take the DAC. The IRS has provided some guidance on other types of expenditures that qualify for the DAC, such as removing architectural barriers that prevent a business from being accessible, hiring interpreters, and providing qualified readers and taped text for blind and visually impaired employees. However, there are no such examples on what types of equipment and devices would qualify for this credit. The only guidance the IRS has provided on this issue includes the following: businesses must show that the devices were reasonable and necessary for the effective treatment of communication with people with disabilities.[58] This vague IRS determination of what type of devices and equipment are eligible for the DAC[59] does not seem to be supported by the statute and legislative history.[60] Moreover, this interpretation contradicts the General Accounting Office (GAO, now the Government Accountability Office) report, which suggests a broader application of these tax incentives.[61]

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[52] *Id.*

[53] *Id.*

[54] General Accounting Office, GAO 03-39, Business Tax Incentives (Dec. 2002).

[55] IRS, Form 8826, *Disability Access Credit*, (2005); *see also* 136 Cong. Rec. E2679-02 (1990).

[56] 42 U.S.C.A § 12111(5)(A).

[57] General Accounting Office, GAO 03-39, *Business Tax Incentives* 25 (Dec. 2002). "IRS guidelines do not clearly state whether a business that is not required by title I of the ADA to accommodate an employee can use the credit for these expenditures."

[58] IRC § 44 and IRS, Form 8826, *Disability Access Credit* (2005).

[59] Technical Advice Memorandum, TAM 200031001, 2000 WL 33120112, IRS TAM (Aug 4, 2000).

[60] IRC § 44; *see also* 136 Cong. Rec. E2679-02 (1990).

[61] General Accounting Office, GAO 03-39, *Business Tax Incentives* 25, 27 (Dec. 2002).

Impairment-Related Work Expenses

The Impairment-Related Work Expense deduction applies to taxpayers who have a physical or mental disability that functionally limits their employment or substantially limits one or more life activities, such as performing a manual task, including walking, speaking, breathing, learning, and working.[62] Determining what expenses are eligible for this deduction can be complicated and difficult. For instance, Publication 907, Tax Highlights for Persons with Disabilities, only provides one example of when this deduction would be allowable.[63] This publication refers the taxpayer to Publication 529, Miscellaneous Deductions, for more detailed information on the deduction.[64] The information provided in Publication 529, however, is equally brief and provides the taxpayer with the same example as Publication 907. Moreover, the one publication that does provide another example, Publication 17, Your Federal Income Tax (For Individuals),[65] is not referenced in either Publication 907 or 529.

Searching IRS publications in an effort to comply with the tax code can be burdensome for any taxpayer, but this burden is even more significant for a taxpayer with a disability. Therefore, the IRS should revise Publication 907 to include references to all relevant publications on the issues addressed. In addition, the IRS should include more examples in Publication 907 so the taxpayer can have a clearer understanding of what deductions are included in Impairment Related Work Expenses.

IRS COMMENTS

The IRS acknowledges the growing need for services for taxpayers with disabilities. The barriers listed in the National Taxpayer Advocate's report are important and the IRS has already taken numerous actions to address them. Through our use of the Teletypewriter and Telecommunications Device for the Deaf (TTY/TDD), the IRS Alternative Media Center (AMC), and outreach and education efforts, the IRS has made significant strides in serving the needs of the disabled community.

Access to IRS Assistance, Forms, and Publications

Hearing impaired callers who use TTY/TDD may choose a relay service to receive telephone assistance. Information on this service is provided in the Form 1040 instructions; Publication 17, Your Federal Income Tax; on the IRS website, http://www.irs.gov; and many other IRS publications. The IRS maintains dedicated toll-free telephone lines for this purpose. Hearing impaired taxpayers may call and

- Order tax forms and publications;

[62] IRC § 67(d). *See also* Key Legislative Recommendation, *Impairment-Related Work Expense Deduction, infra.*

[63] IRS, Pub 907, *Tax Highlights for Taxpayers with Disabilities* (2005). The example provided is the expense a taxpayer incurs for hiring attendant care at his or her workplace.

[64] IRS, Pub 529, *Miscellaneous Deductions* 13 (2006).

[65] IRS Pub 17, *Your Federal Income Tax* 137 (2006).

- Find out what they owe;
- Order a transcript of their tax return or account;
- Determine if the IRS has adjusted their account or received a payment;
- Find out where to send their tax return or payment;
- Request more time to pay or set up an installment agreement;
- Find out if they qualify for innocent spouse relief;
- And much more.

The AMC was initially established as a resource to provide Braille and other alternative formats for IRS employees with vision disabilities. In recent years, however, the AMC has also worked to provide these same services to taxpayers. AMC initiatives, such as Digital Talking Books, Talking Tax forms, Electronic Braille, Hard Copy Braille, Large Print, and Tactile Graphics have all benefited our visually impaired employees and taxpayers.

In addition, the IRS is also committed to making every document on IRS.gov accessible to the widest possible audience. Currently, most visitors are able to view IRS.gov using popular browsers and the following features: text descriptions provided for images and pictures; cascading style sheets used to format page content; HTML versions of many of the forms and publications; and direct links to main sections of each page for those using screen readers. The Accessibility link of IRS.gov allows taxpayers to download Talking Tax Forms and forms in Braille and Text formats.

To ensure IRS forms, publications and written communications are accessible to persons using special assistive technology, the IRS works with skilled accessibility contractors and IRS accessibility specialists. These efforts ensure that to the extent feasible, documents are accessible to persons using special assistive technology, including screen reading software, refreshable Braille displays, and voice recognition software. As stated in the National Taxpayer Advocate's report, the AMC produces 555 forms in PDF talking format, and 345 forms and publications in text files and Braille-ready format for taxpayers. In addition, taxpayers can request any form, publication, notice or bill in Braille or an alternative format.

The IRS continues to make a concentrated effort to provide more products and services in ways that have the broadest possible impact. For example, the IRS worked closely with two major blindness advocacy groups to determine public acceptance for the Digital Talking Book format. The IRS is also working with these groups to test the utility of "automated calculations" in tax forms. In addition, new publications and forms created in Adobe Acrobat 5.0, which is compliant with § 508 of the Rehabilitation Act, will be posted on the IRS.gov Accessibility site as they are published.

IRS.gov

The National Taxpayer Advocate states that although the IRS's Accessibility webpage contains a comment section, it does not ask for specific comments on Section 508 compliance issues and there is no formal process for determining if any such comments have merit. There are relatively few comments received annually. The IRS currently has procedures in place to assist taxpayers with IRS.gov accessibility issue comments. And, although the IRS does not specifically solicit § 508 comments or have formal procedures in place for dealing with them, any such feedback received is escalated and considered on a case-by-case basis.

At present, visitors to IRS.gov are able to view its content using the most popular browsers. Nevertheless, the IRS does see potential value in the National Taxpayer Advocate's recommendations to enhance the website by offering a speech option, providing some content in American Sign Language (ASL) via streaming video, and allowing taxpayers to manipulate the site to accommodate their individual needs. With the requirement that IRS.gov accommodate a broad user base in the general population, the IRS established the policy of supporting a comprehensive set of web browser/operating system combinations and must ensure that the site works properly with all browser/operating system combinations currently supported. We will explore the feasibility of adding these additional features as funding becomes available.

Education and Outreach

IRS education and outreach organizations, such as Stakeholder Partnerships Education and Communication (SPEC), target taxpayers with disabilities through partnerships with national and local organizations. Beginning in 2004, SPEC focused on obtaining research, working with external organizations, and developing employee training and other initiatives to better serve the disabled community. As a result, three research projects were initiated that provided customer demographics and other profile data to define these customers and their needs. National partnerships were formed with the National Disability Institute, World Institute on Disability, Department of Health and Human Services Office of Disability, Department of Education, Goodwill Industries International, Easter Seals, National Council on Independent Living, DisabilityInfo.gov, and others. Disability specific workgroups have been developed within 301 IRS-supported community based partnerships that provide EITC, free tax preparation, and asset building opportunities. As a result of these efforts, in 2006, 200 local partners made 330,000 education/outreach contacts and prepared 17,000 returns for persons with disabilities.

The IRS has also increased its efforts to educate taxpayers with disabilities regarding tax deductions and credits. In 2004, IRS worked with national partners to launch a disability initiative in 13 cities branded the "TaxFacts" campaign. Key objectives of this campaign were to engage affiliates of these partners to educate their customers on available tax deductions and credits and to develop a disability strategy within the IRS' local community based partnership. In 2006, this initiative, now titled the "Real Economic

Impact Tour," included 30 cities and for 2007 will expand to 54 cities. The IRS also developed Publication 3966, Living and Working with Disabilities, which provides a summary of existing tax credits and benefits that may be available to qualifying taxpayers with disabilities, parents of children with disabilities, and businesses or other entities wishing to accommodate persons with disabilities. This publication directs the user to other publications that are available in alternative formats. To date, over 1 million copies of this publication have been distributed and the product is available on many of the IRS' national partners' websites.

The IRS agrees that taxpayers with disabilities need access to IRS products and services and that taxpayers need to understand the specific tax law provisions that affect the disabled. The IRS offers TTY/TDD toll-free telephone service for hearing impaired taxpayers. The IRS uses its AMC to provide Braille and other alternative formats for visually impaired IRS employees and taxpayers alike. IRS.gov includes an Accessibility webpage and enables taxpayers with disabilities to visit the site using the most popular browsers. The IRS will continue to review its policies and programs to determine the feasibility of offering additional adaptive technologies, such as those suggested by the National Taxpayer Advocate. The IRS will also explore additional opportunities to partner with interest groups representing persons with disabilities or those that employ the disabled to share appropriate tax related information through fact sheets, forums, and other communication vehicles.

TAXPAYER ADVOCATE SERVICE COMMENTS

Access to IRS Assistance, Forms, and Publications

The National Taxpayer Advocate acknowledges and commends the IRS's effort to reach out to the deaf and hard-of-hearing community by offering the TTY/TDD relay service. However, this service still forces deaf and hard-of-hearing taxpayers who use ASL as their primary language to rely on the written word – their second language – which could result in miscommunication between the IRS employee and the taxpayer. Some deaf or hard-of-hearing taxpayers may be able to hook up a videophone and communicate with a translator by ASL. However, in order to use this service the taxpayer must have the appropriate TV and high speed Internet, and although the videophone can be obtained for free, the other items can be costly. Therefore, this service would not be accessible to taxpayers who have limited income. If the IRS provided video relay service in the TACs, which currently provide no accommodations for deaf taxpayers, all deaf or hard-of hearing taxpayers who use ASL could communicate in their primary language. Currently, deaf and hard-of-hearing taxpayers who attempt to utilize a TAC are forced to communicate with an IRS employee by passing notes. This arrangement can be confusing to the taxpayer and lead to miscommunication between the IRS employee and the taxpayer. The IRS has a responsibility to ensure that all taxpayers have equal access to the services that it offers, and clearly we have not achieved this goal with respect to the deaf and hard-of-hearing community.

The National Taxpayer Advocate commends the IRS's strides in providing accessible forms, publications, notices, and bills to taxpayers. However, many taxpayers are unaware of AMC services. As noted above, the IRS gives taxpayers inconsistent information regarding IRS services and does not even advertise some services on the IRS web page. The IRS should publicize this service on every form, publication, or notice that is provided or sent out to a taxpayer, including information on how to request IRS materials in an accommodating format, much like TAS's information is included on these materials. Further, when the taxpayer does discover this service and requests an accommodation, the IRS offers no way for the taxpayer to request all further IRS communications be made in the same accommodating format.

The National Taxpayer Advocate recognizes the challenges faced by the IRS in attempting to conform to Section 508 of the Rehabilitation Act. However, the National Taxpayer Advocate also recognizes the importance of complying with the law and providing equal access to IRS information to taxpayers with disabilities, as the statute requires. Although the IRS is working toward complying with this legislative mandate, much work remains. For instance, not only is it important that new information be designed to be § 508 compliant, but that old, noncompliant information is removed from IRS.gov. The IRS should also reconsider its policy of partnering with companies that are not required to and do not voluntarily meet the § 508 standards, such as those that make up the Free File Alliance.

IRS.gov

The National Taxpayer Advocate finds it unacceptable that the IRS has no process for addressing taxpayers' comments regarding § 508 compliance issues. The most likely reason the IRS receives few taxpayer comments regarding § 508 compliance is because it does not specifically solicit these types of comments. For the IRS to identify § 508 issues and provide a truly accessible website, it must hear taxpayers' comments regarding the barriers they face when navigating IRS.gov with accommodating software or devices.

The National Taxpayer Advocate understands the IRS's funding limitations, but recognizes the growing need of providing a user-friendly website for taxpayers with disabilities and the elderly population. This type of website has been developed by other government agencies and should be an achievable goal for the IRS as well.[66]

Education and Outreach

As stated previously, the National Taxpayer Advocate commends SPEC's efforts and accomplishments in reaching out to taxpayers with a disability and involving community organizations in this outreach and education effort. Further, the National Taxpayer Advocate recognizes the importance of partnering with these community organizations,

[66] National Institutes Of Health, *Elderly* at http://nihseniorhealth.gov/ .

but believes these organizations should not become substitutes for basic IRS customer service and outreach. While these organizations provide a valuable service, they also have geographic limitations and cannot reach every taxpayer with a disability needing assistance. For instance, it is commendable that 200 local partners made 330,000 education/outreach contacts and prepared 17,000 returns for persons with disabilities in 2006. Still, there are 51.2 million Americans with some type of disability, and while the outreach is impressive, it reaches only a small fraction of this population.[67] It is imperative that the IRS provide essential customer service and outreach to this population. Moreover, expecting taxpayers with disabilities to locate and use these organizations for the simplest of tasks is extremely burdensome to these taxpayers.

The National Taxpayer Advocate recognizes the IRS's involvement in the "Real Economic Impact Tour," which TAS is also partnering in, and the development of IRS Publication 3966, *Living and Working with Disabilities*. However, this and other IRS information addressing issues concerning disabled taxpayers is scattered all over IRS.gov and various community groups' websites. Instead of burdening a taxpayer with a disability who may not have access to the internet or may have difficulty navigating it, with the task of locating this information, the IRS should consolidate all the disability information on one centralized website. This would make it quick and easy for a taxpayer with a disability to obtain this information and allow the IRS to ensure the information is in an accessible format. Moreover, this website can solicit comments from disabled taxpayers by providing an email comment box.[68]

Small Business Outreach and Education

Although the IRS conducts education and outreach to taxpayers with a disability regarding possible tax deductions and credits, it appears SB/SE has done little or no education and outreach to small businesses regarding tax incentives for hiring or accommodating employees or customers with disabilities, or to taxpayers with disabilities who are attempting to start their own businesses. Nor has the IRS provided any examples of such outreach in its response to our concerns. This type of information is desperately needed because of confusion surrounding some of these tax incentives, for which the IRS has provided few IRS examples to clarify in what circumstances the incentives are available. Also, the IRS should reach out to taxpayers with a disability who are attempting to start their own business, since other federal agencies report that self-employment or owning a small business is an increasing trend in the disability community.[69]

[67] U.S Census Bureau, *Question and Answer Center*, at http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html.

[68] For an example of how taxpayer comments can be solicited and efficiently received, see the TAS Systemic Advocacy Management System (SAMS) website at http://www.irs.gov/advocate/article/0,,id=117703,00.html.

[69] Department of Labor, *Business Ownership - Cornerstone of the American Dream*, at http://www.dol.gov/odep/pubs/business/business.htm.

The IRS has taken steps towards offering accommodations to taxpayers with disabilities and reaching out to this community. However, the IRS still struggles to provide the full array of accommodations necessary for these taxpayers to have equal access to IRS information, inform taxpayers about these accommodations, and conduct outreach and education to taxpayers with disabilities, their caretakers, and employers.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS take the following steps to provide assistance, enhance access and promote tax compliance for taxpayers with disabilities:

- The IRS should develop a way to identify if a taxpayer has a disability and what type of disability the taxpayer has, in order to correspond with the taxpayer in a format that is easiest for the taxpayer. The IRS should develop a process to determine the taxpayer's preferred format for correspondence at the outset of interaction with the IRS, such as Braille, large print, or audio. This approach would ensure effective communication throughout the "life" of a tax return.
- The IRS should install video relay service in its Taxpayer Assistance Centers (TACs). This would allow taxpayers who are deaf or hard-of-hearing and whose primary language is American Sign Language (ASL) to communicate in their primary language.
- IRS.gov should include speech options, providing vital IRS information in ASL via streaming video and allowing taxpayers to change the font size and color on the site.
- The IRS should contract only with private companies that will guarantee all taxpayers equal access to information under § 508, and should provide the access (or service) itself if contractors cannot.
- The IRS should include information on all of its forms, publications, and notices about how taxpayers with a disability can request IRS materials in an alternative format.
- The IRS should design an area of IRS.gov that is solely dedicated to issues surrounding disability. This site should address what accommodations are available to taxpayers with a disability, what tax deductions or tax credits these taxpayers and their caretakers may be eligible for, and a comment section to allow the taxpayer to inform the IRS that a website, form or publication is not 508 compliant and to make other suggestions for service improvement. This website should also allow the user to change the font size and font color, and offer a speech option. SB/SE should have a section on this website to provide information to taxpayers with a disability who are self-employed or starting their own businesses.
- SB/SE should include on its current website more detailed information regarding the deductions and credits small businesses may be entitled to, either for hiring

employees with a disability, providing accommodations to employees with disabilities, or removing architectural barriers for taxpayers with disabilities.

- SB/SE should develop a specific outreach and education strategy beyond the Internet. This strategy should be modeled after SPEC's outreach and education efforts.

PROBLEMS

PROBLEM

TOPIC #21 INJURED SPOUSE ALLOCATIONS

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage & Investment Operating Division

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Operating Division

DEFINITION OF PROBLEM

If married taxpayers file a joint federal tax return claiming a refund, and one of the spouses has an outstanding federal tax debt, unpaid child support, debts owed to other federal agencies (*e.g.*, student loans from the Department of Education), or state income tax obligations, the IRS will offset the couple's refund against these debts.[1] These non-tax debts are tracked by the Treasury Department's Financial Management Service (FMS), which administers the Treasury Offset Program (TOP).[2] The spouse who is not liable for the debt can avoid having his or her portion of the refund offset against the debt by filing Form 8379, Injured Spouse Allocation, with the IRS.

There are three major issues concerning injured spouse allocations that can place an unnecessary burden on taxpayers. First, the IRS's processing time for injured spouse allocations is lengthy and sometimes the processing is done incorrectly.[3] For example, injured spouse allocations are still worked manually, increasing the likelihood of errors and slowing the processing of the allocation. Second, although the status of a debt at FMS changes daily, the IRS only receives these updates weekly, which can cause incorrect debt indicators on taxpayer accounts.[4] Finally, the community property question on the Form 8379 is not designed to determine where the taxpayer is domiciled – the IRS's standard for residency – but instead focuses on where the taxpayer is living.[5] Since community property laws vary from state to state, taxpayers who answer this question incorrectly could be adversely impacted.

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1 IRC § 6402.

2 The Treasury Offset Program is a centralized database system managed by the Financial Management Service (FMS) and Debt Management Service (DMS). The purpose of this program is to collect delinquent debts owed to federal and state agencies. Department of the Treasury, Treasury Offset Program at http://fms.treas.gov/debt/top.html (last visited Aug. 30, 2006).

3 Treasury Inspector General for Tax Administration, Ref. No. 2005-40-001 *Injured Spouse Guidance is not Consistent*, 5 (October 2004). (The Treasury Inspector General for Tax Administration (TIGTA) previously determined that the IRS takes about 10 or 11 weeks to process an injured spouse claim when it is filed with a return, significantly longer than the IRS takes to process a refund without an injured spouse claim).

4 IRM 21.4.6.4 (7) (Oct. 1, 2006).

5 IRS Form 8379, *Injured Spouse Allocation* (Jan. 2006).

ANALYSIS OF PROBLEM

Background

The IRS may offset a taxpayer's overpayment against outstanding federal tax liabilities before issuing a refund to the taxpayer.[6] While the IRS first applies the overpayment to outstanding federal tax liabilities, it makes any remaining amount available to FMS for offset through the Treasury Offset Program (TOP).[7] Nontax debts may include unpaid child support, debts owed to other federal agencies (*e.g.*, student loans from the Department of Education), and state income tax obligations.[8] When a couple files a joint return and a portion or all of the refund is offset under IRC § 6402, the nondebtor spouse may apply for "injured spouse" relief to receive his or her share of a joint refund.

For the injured spouse to obtain relief, he or she must timely file a Form 8379, Injured Spouse Allocation.[9] Once the injured spouse files Form 8379, the IRS's Wage and Investment (W&I) division conducts the following analysis to determine to what extent joint overpayments should be offset against separate liabilities:

(1) Identify the source of the overpayment;

(2) Characterize all or part of it as separate or community property under applicable state law;

(3) Offset at least 50 percent to the extent it is community property; and

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[6] IRC § 6402(a); IRM 25.18.5.1 (Feb. 15, 2005); IRM 21.4.6.4 (Oct. 1, 2006).

[7] IRC § 6402(c), (d), (e); IRM 21.4.6.2 (Oct. 1, 2006).

[8] IRM 21.4.6.2 (Oct. 1, 2006).

[9] The IRS does not view Form 8379 as a claim for refund by an injured spouse, but rather, as additional information for a jointly filed claim for refund (which may be made on the jointly filed income tax return). Thus, that jointly filed claim must be filed the later of three years from the time the return was filed or two years from the time the tax was paid. *See* IRC § 6511. When a husband and wife file a joint claim for refund but the nondebtor spouse does not include Form 8379, if the IRS partially disallows the claim for refund, the IRS sends a separate notice of claim disallowance to each spouse. *See* IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3201(d), 112 Stat. 685, 740 (1998). The nondebtor spouse will have two years from the date the notice of claim disallowance is issued to file Form 8379 with the IRS to administratively contest the allocation of the refund. The two-year period for filing Form 8379 after a claim for refund has been disallowed arises from the two years in which a taxpayer has to file suit in a United States district court or the Court of Federal Claims to contest the allocation of the refund. See IRC § 6532(a)(1). The IRS would rather have a taxpayer file Form 8379 in that two-year period to try to resolve the matter administratively than to file suit. A taxpayer should be wary, though, because a pending administrative reconsideration of a disallowed claim does not suspend the two-year period for filing suit, and if a taxpayer fails to timely file suit he or she would not be able to contest an IRS decision to uphold the disallowance in the courts. The two-year period can be extended if agreed upon in writing between the taxpayer and the IRS. *See* IRC § 6532(a)(2). If the IRS grants the claim for refund in full but then some or all of the refund is offset, the nondebtor spouse has an unlimited period in which to file Form 8379 because the IRS did not send a notice of claim disallowance. IRM 21.4.6.5.9.8 (Oct. 1, 2006) has been updated on SERP, which taxpayers cannot access, to reflect this new guidance. Further, as of this writing, this update is not available to taxpayers on www.irs.gov. *See* Most Serious Problem, *Transparency of the IRS, supra.*

(4) Analyze state law to determine if (a) more than 50 percent of any community property may be offset, and (b) any separate property of either spouse may be offset.[10]

W&I and TAS Injured Spouse Task Force

In April 2005, W&I asked the Taxpayer Advocate Service (TAS) to partner with the division to investigate the current processes and procedures for handling Forms 8379. The goal of the project is to determine the factors that impede service to taxpayers and result in a high volume of referrals to TAS.[11] The resulting task force reviewed statistically valid samples of approximately 600 W&I cases and approximately 600 TAS cases for a variety of factors. W&I's results were not complete at this writing, but TAS's results helped identify and validate the problems described above. The task force will conduct an in-depth analysis of the data to ultimately recommend and implement improvements to Injured Spouse policies, processes, and procedures as determined necessary. The National Taxpayer Advocate commends W&I for its work on this study.

Processing Time

Taxpayers are burdened by the lengthy time frame for processing injured spouse allocations and are sometimes harmed by IRS mistakes. The lengthy process begins when the taxpayer sends a Form 8379 attached to his or her original return; even though the injured spouse allocation and the joint return are filed together, they are processed separately. The normal processing time for a tax return is six weeks (three weeks if filed electronically).[12] The standard processing time for an injured spouse allocation is between 11 and 14 weeks.[13] Even if the original return with a Form 8379 is filed electronically, the processing time is still eleven weeks.[14] The main reason for this delay is the IRS's manual, rather than automated, calculation of the injured spouse's allocation. Moreover, IRS processing errors can make an already lengthy process even longer. Some of these errors include:

- The IRS not recognizing the Form 8379 when it is attached to an original return;[15]

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[10] Rev. Rul. 80-7, 1980-1, I.R.B. 17, Rev. Rul. 85-70, Rev. Rul. 85-70, 1985-22, I.R.B. 6, Rev. Rul. 2004-71, 2004-30, I.R.B. 74, Rev. Rul. 2004-72, 2004-30, I.R.B. 77, Rev. Rul. 2004-73, 2004-30, I.R.B. 80, Rev. Rul. 2004-74, 2004-30 I.R.B. 84.

[11] Taxpayer Advocate Management Information System (TAMIS), Injured Spouse Receipts, PCIC 340 (FY 2006).

[12] IRS, *Form Instructions 1040* (2005), and IRS, *Tax Topics 152 – Refunds – How Long They Should Take* available at http://www.irs.gov/taxtopics/tc152.html.

[13] IRS, *Tax Topics 203 - Failure to Pay Child Support, Federal Non–Tax and State Income Tax Obligations* available at http://www.irs.gov/taxtopics/tc203.html.

[14] IRS, *Form Instructions 1040* (2005).

[15] Taxpayer Advocate Management Information System (TAMIS). There were 421 returns, out of a representative sample of 581 returns, where a Form 8379 was attached to the taxpayer's original return (95 percent confidence interval 72.5 percent +/-3.6 percent); 199 of the 421 returns were filed on paper (95 percent confidence interval 47.3 percent +/- 4.8 percent); and 17 of the 199 returns or 8.5 percent were not recognized by the IRS as having a Form 8379 attached (95 percent confidence interval).

- Errors in calculating the allocation;[16] and
- Inaccurate debt indicators.

TABLE 1.21.1, NUMBER OF CASES WITH INACCURATE DEBT INDICATORS[17]

	Total Sample Size	No Debt Indicator Placed On Taxpayer's File	Freeze on taxpayer's refund was released — the refund was offset by FMS against a non-tax debt or a tax debt	Offsets were tax debts	Offsets were non-tax debts	Offset was both a tax debt and a non-tax debt	Offsets were subsequently reversed
Number of Cases	581	96 out of 581 cases	73 out of 96 cases	44 out of 73 cases	28 out of 73 cases	1 out of 73 cases	67 out of 73 cases
Percentage	N/A	16.5% +/- 3.0%	76% +/- 8.5%	60.3% +/- 11.2%	38.4% +/- 11.2%	1.4% +/- 2.7%	91.8% +/- 6.3%

The Taxpayer Advocate Service (TAS) has seen an 81.3 percent increase in its injured spouse caseload from FY 2005 to FY 2006. In FY 2004 TAS received 6,129 injured spouse cases, in FY 2005 TAS received 6,283 injured spouse cases, and in FY 2006 the total rose to 11,599.[18] Clearly, the dramatic increase in FY 2006 indicates a problem with injured spouse claims.

Manual Processing

Taxpayers can only file Form 8379 electronically if it is filed with an original return.[19] Further, although the taxpayer may file the form electronically, W&I calculates the injured spouse allocation manually and enters the computation into an electronic version of Form 8379-A, the injured spouse worksheet, as opposed to developing and utilizing an automated system.[20] This manual process increases the likelihood of error when calculating the injured spouse allocation.

> **EXAMPLE:** Taxpayer filed Form 8379 with the original return claiming an overpayment of $7,000 but the IRS calculated the injured spouse allocation at $3,560 and offset the remaining $3,440 against a TOP debt. The taxpayer contacted TAS. After reviewing the IRS's calculation, TAS determined the IRS had not properly recorded the number of Earned Income Tax Credit (EITC) qualifying children, as

16 Taxpayer Advocate Management Information System (TAMIS).

17 *Id.* The percentages provided in the table have a 95 percent confidence interval.

18 Taxpayer Advocate Management Information System (TAMIS), Injured Spouse Receipts, PCIC 340, FY 2004, FY 2005, and FY 2006.

19 IRM 21.4.6.5.9.2(5) (Oct. 1, 2006).

20 IRM 21.4.6.5.11 (Oct. 1, 2006).

reported by the taxpayer, on the IRS's internal injured spouse worksheet, and had incorrectly allocated the EITC. TAS disputed the IRS's calculation, recomputed the worksheet, and obtained for the taxpayer an additional refund of $2,500.[21]

If the IRS adopted an automated calculation system, similar to those used by tax preparation software firms to compute the electronic Form 1040, Individual Income Tax Return, it could reduce or eliminate errors in injured spouse allocations such as the one just described. Moreover, automation might also improve the rate at which W&I is able to process allocations. Currently, even when the taxpayer files a Form 8379 electronically, processing the allocation still requires an average of ten weeks.[22] The use of an automated calculation system could significantly benefit taxpayers and the IRS by reducing both the frequency of calculation errors and the processing time. Ultimately, this improvement may also save the taxpayer and the IRS time and money.

Inaccurate Debt Indicators

The Financial Management Service (FMS), a bureau of the Department of the Treasury, administers the Treasury Offset Program (TOP.)[23] The TOP is a centralized offset program, administered by the FMS, to collect delinquent debts owed to federal agencies and states (including past-due child support).[24] When the creditor-agencies report these debts to FMS, they are entered into a database system, which may be updated daily.[25]

The IRS, on the other hand, receives FMS information only on a weekly basis. Once received, the debt report is entered into an IRS computer system, which maintains a record of "debt indicators" on taxpayer accounts to identify the existence of a tax debt, a non-tax debt, or both. As a result, the lag time between daily FMS debt updates and weekly IRS debt indicator updates can lead to errors in identifying refunds subject to TOP offset.[26]

This situation can be problematic because the debt indicator is the basis upon which the IRS makes an initial decision about processing an injured spouse allocation. Thus, an incorrect debt indicator may cause a processing error. For example, when a taxpayer files a Form 8379 with the original return, the IRS freezes the overpayment until it manually processes the Form 8379. If there is no debt indicator shown on the IRS account, the IRS releases the freeze without computing the injured spouse allocation. If the IRS debt indicator is incorrect – *i.e.*, FMS's database shows a debt whereas the IRS's

21 Taxpayer Advocate Management Information System (TAMIS).

22 Treasury Inspector General for Tax Administration, Ref. No. 2005-40-00 *Injured Spouse Guidance is not Consistent*, 5 (October 2004). The ten-week average was determined by a TIGTA analysis of 70,238 claims for injured spouse relief that were e-filed.

23 IRM 21.4.6.2 (Oct. 1, 2006).

24 IRC § 6402(c), (d), and (e); 31 U.S.C. § 3720A.

25 IRM 21.4.6.34 (7) (Oct. 1, 2006).

26 IRM 21.4.6.4 (7) (Oct. 1, 2006).

database does not – FMS will apply the overpayment to the outstanding agency debt.[27] At this point, the injured spouse must contact the IRS to reverse the offset and reissue the amount allocable to the injured spouse.

> **EXAMPLE:** A taxpayer filed a Form 8379 with the original joint tax return claiming a total refund of $2,500.00. When the IRS processed the Form 1040, it placed a freeze on the account in order to manually process the Form 8379 and allocate the joint refund. There was no debt indicator set on the IRS's records, and the IRS released the freeze without computing the injured spouse allocation. The FMS database, however, did show a non-tax debt, resulting in FMS offsetting the overpayment. The taxpayer contacted TAS, which arranged for the injured spouse allocation and a refund of $2,500.[28]

Form 8379 May Result in Incorrect Community Property State Determination

The question posed to taxpayers on Form 8379 to determine if state community property laws apply to their situation is misleading. The form asks if the person's main home is in a community property state.[29] However, this single question is not enough to accurately ascertain whether the taxpayer is subject to a state's community property laws. Rather, the IRS should be asking where the taxpayer is domiciled. Where a taxpayer currently resides may not necessarily be his or her domicile. While there is no definition of "domicile" in the Code, the IRS defines the concept of "domicile" in regulations to mean an individual's fixed or permanent home, where an individual acquires a domicile by living there, even for a brief period of time, with no definite present intention of moving.[30] Moreover, when the IRS disallows community property benefits, it uses the following standard explanation for the IRS examiner's adjustment:

> Domicile is your place of historical residence and/or fixed and permanent abode. Merely residing in a new location for a period of time does not constitute the establishment of a domicile. Since you have not established that you were domiciled in a community property country or state during the taxable year, community property benefits are not allowed.[31]

> **EXAMPLE:** The IRS processed an injured spouse allocation and refunded $600 to the taxpayer. The taxpayer disputed this amount through TAS, claiming he moved from a non-community property state to a community property state during the course of the year and the majority of his wages were earned in the

[27] Taxpayer Advocate Management Information System (TAMIS).

[28] *Id.*

[29] IRS Form 8379, *Injured Spouse Allocation* (Jan. 2006).

[30] Treas. Reg. § 20.0-1(b)(1); § 25.2501-1(b).

[31] IRM Exhibit 4.10.10-2.

> non-community property state. TAS referred the inquiry to W&I, which recalculated the injured spouse allocation and refunded an additional $500.[32]

The IRS could avoid similar situations by revising Form 8379, to ask where the taxpayer is domiciled, as opposed to merely asking the location of his or her main home.

Eliminating Injured Spouse Issues

The National Taxpayer Advocate made recommendations in the 2001 and 2005 Annual Reports to Congress that would eliminate joint and several liability, and require married taxpayers to file tax information in separate columns on a joint return.[33] This split column tax return would identify separate items of income, deduction, credit, and payment for each spouse. Providing the IRS with income, deductions, credits, and payments in split columns would eliminate the need for one spouse to request injured spouse relief to prevent the IRS from offsetting his or her refund against a spouse's separate liabilities, since the IRS would have enough information to allocate a refund at the outset. This approach would allow the IRS to automatically ensure that one spouse's share of an overpayment will not be offset against the other spouse's separate liability.[34]

IRS COMMENTS

The Debt Collection Improvement Act of 1996 (DCIA) requires the federal government to withhold or reduce certain federal payments to recipients to satisfy delinquent non-tax debts owed to the United States. The Financial Management Service (FMS), a bureau of the Department of Treasury, administers the DCIA in part through the Treasury Offset Program (TOP). Through the TOP, FMS may reduce a federal tax refund to satisfy any past–due child support, federal non-tax debts such as education loans, or state income tax debts. However, before certifying an overpayment to FMS for refund, the IRS will first apply any overpayment against past-due federal tax debts. Once an offset occurs by either agency, the taxpayer will receive a notice identifying the amount of the original refund, the amount of the offset, the agency receiving the payment, and the address and telephone number of the agency.

In some cases, the IRS or FMS will reduce an overpayment resulting from a joint return where one of the spouses is not responsible for the debt. In that case, the taxpayer who is not responsible for the debt may file Form 8379, Injured Spouse Allocation, and request an allocation of the overpayment. If the taxpayer indeed qualifies as an "injured spouse", the taxpayer will receive his or her portion of the refund.

[32] Taxpayer Advocate Management Information System (TAMIS).

[33] National Taxpayer Advocate 2001 Annual Report to Congress 129; National Taxpayer Advocate 2005 Annual Report to Congress 407.

[34] National Taxpayer Advocate 2005 Annual Report to Congress 431.

Processing Time

As noted in the National Taxpayer Advocate's report, the IRS's processing time for injured spouse allocations can take from eight to 14 weeks. The instructions advise taxpayers that it takes the IRS approximately 14 weeks to process paper Forms 8379 and approximately 11 weeks to process electronically filed Forms 8379 that are filed with the joint return. If the Form 8379 is filed after the IRS has processed the joint return, it takes approximately 8 weeks.

In order to allocate an overpayment, the IRS must process the taxpayer's joint income tax return first, which generally takes six weeks for a paper return and three weeks for an electronically filed return. At that point, the IRS must manually allocate each spouse's income, adjustments to income, standard deduction or itemized deductions, number of exemptions, other taxes and federal income tax withheld. Through the allocation, the IRS determines the amount of tax owed by each spouse and any overpayment due to each.

Increase in TAS's Caseload

The IRS acknowledges the marked increase in the Taxpayer Advocate Service's injured spouse caseload in FY 2006 and believes at least part of that increase was due to the IRS's assistance to individuals affected by Hurricanes Rita, Katrina and Wilma. Beginning around September 2005, the IRS' Accounts Management (AM) Division dedicated employees at four of our Individual Master File (IMF) sites (two campus locations and two toll-free call sites) to answer the Federal Emergency Management Assistance (FEMA) disaster phone lines for approximately 90 days. To reduce the impact on other taxpayers, AM either reassigned much of these two campuses' workload through the Correspondence Imaging System or transshipped work to other campus locations throughout the nation. Unfortunately, this included the injured spouse inventory. The decrease in available employee resources to work these cases impacted inventory levels and the percentage of aged cases nationwide. This impact carried through the 2006 filing season. We do not anticipate these problems recurring in 2007.

We do not believe that TAS's increased injured spouse caseload for FY 2006 was due to IRS making more errors on these cases. The FY 2006 accuracy rate for all Adjustments cases based on National Quality Review System data was 88.1 percent, with injured spouse allocation case accuracy at 87.1 percent. This is an improvement over FY 2004 when the Adjustment's Accuracy rate was 84.9 percent and FY05 when it was 85.7 percent.

Injured Spouse Allocation Task Force

To improve how the Wage & Investment Division (W&I) and TAS work injured spouse cases, the two organizations formed a joint IRS-TAS Injured Spouse Allocation task force (ISATF) in mid-2005 to study injured spouse cases in W&I and TAS. The objectives of ISATF were to:

- Identify processing improvement opportunities in the Injured Spouse program;

- Recommend and implement changes to overcome the identified problems;
- Determine the reasons for the high volume of referrals of Injured Spouse issues to TAS;
- Identify actions W&I and/or TAS may take to reduce the number of injured spouse case referrals to TAS; and
- Determine if employees in W&I and TAS are correctly identifying TAS criteria.

This study is still underway. Both functions have analyzed approximately 600 cases each and are working now to understand the data that has been gathered.

IRS COMMENTS

The IRS agrees that the allocation process should be automated. However, the IRS does not agree that an automated calculation system similar to those used by tax preparation software firms will dramatically improve processing time for injured spouse allocations. This is because of the cyclical nature of the IRS's workload. Each year, the IRS receives a majority of Forms 8379 from March through July. During that same time period in FY 2006, the IRS received more than 50 percent of its annual correspondence and adjustments receipts and answered more than 50 percent of the 33 million assistor calls in the toll-free system. Peak volumes significantly affect the time frames for processing injured spouse allocations. In the future, we hope to process the Forms 8379 included with original tax returns at the same time we process the original returns, thereby significantly reducing the time involved. However, due to other competing systems modernization needs of the IRS, this change may not be realized until 2009 or beyond.

We also disagree that married taxpayers who file a joint income tax return should itemize their individual tax information in separate columns on a joint return. In FY 2004, the IRS processed 132,226,042 individual income tax returns, of which 51,975,649 or 39 percent, were joint returns. Data recently collected in the ongoing study of injured spouse allocations shows that less than one percent of taxpayers filing a joint return file for the injured spouse relief. Although separate reporting would improve injured spouse processing, it would increase the complexity of the tax return preparation and create additional burden on the majority of joint return filers that are not affected by injured spouse issues.

Finally, we disagree with the recommendation that we use the term "domicile" on Form 8379. Although the legally correct term, we believe it may confuse many taxpayers who use the form. However, we will revisit this issue when we revise Form 8379 in January 2008.

In summary, the IRS believes the increase in TAS injured spouse workload can be primarily attributed to reduced AM staffing that was redirected to FEMA disaster assistance work. A joint IRS-TAS task force is currently assessing the spike in TAS injured spouse receipts and IRS is committed to working with TAS to develop joint solutions to the

problems identified through this effort. Pending the outcome of that effort, the IRS does not currently endorse the National Taxpayer Advocate's automation proposal, we disagree with the proposal to add separate columns for each spouse on the joint return, and we need to further assess the suggested wording change for Form 8379.

TAXPAYER ADVOCATE SERVICE COMMENTS

Processing Time

The IRS has advised taxpayers it can take anywhere from 11 to 14 weeks to process an injured spouse allocation, depending on how the taxpayer submitted the request for injured spouse relief. However, the IRS's processing time for injured spouse allocations often exceeds this range. W&I's own case sample demonstrates that processing a request for injured spouse relief often takes longer than the IRS's standard timeframe.[35] Therefore, the IRS should conduct further research to identify what factors are causing this lengthy process and then address the identified issues.

Increase in TAS's Caseload

The Taxpayer Advocate Service has seen a significant increase in its injured spouse caseload over the past three years. While W&I suggests the increase is a result of having to move employees off injured spouse cases to address the issues surrounding the 2005 Gulf Coast hurricanes, the IRS also did not adequately staff its phones for the 2006 filing season, resulting in a backlog of processing. Moreover, these factors do not explain why W&I's processing time exceeds the 11 to 14 week timeframe almost one-third of the time.[36] W&I should work with TAS to investigate further why TAS's caseload has grown so much over the past three years.

Injured Spouse Allocation Task Force

As noted above, TAS is pleased to participate with W&I in the injured spouse allocation task force. Wage & Investment's partnership is an important step in identifying and remedying challenges surrounding the injured spouse process. The National Taxpayer Advocate encourages the task force to continue working towards the common goal of improving the processing of injured spouse allocations.

TAS Proposals

Developing an automated system to calculate the injured spouse allocations, rather than calculating them manually, could reduce the processing time. The National

[35] IRS, *Wage and Investment – Taxpayer Advocate Service Joint Task Force Injured Spouse Case Processing Interim Report, Draft Report* (Dec. 2006). W&I Accounts Management Receipts reviewed 600 cases. These cases were selected from cases received during a 12-month period beginning June 1, 2004 through May 31, 2005. Thirty-four percent of the W&I sample cases were processed outside the established timeframes. The overall confidence interval for the total volume of out of processing time returns is plus or minus 3.6 percent.

[36] *Id.*

Taxpayer Advocate recognizes W&I's high accuracy rate for injured spouse allocation cases, but believes an automated system will improve accuracy even more while minimizing processing time. Automation may not be the sole solution to the processing time issue, but it would make it easier to process the Form 8379 at the same time as the original return. For example, software similar to what tax preparation firms utilize would calculate the injured spouse allocation immediately and allow the return processing to continue, thereby reducing both the processing time and the potential for errors. The National Taxpayer Advocate recognizes the IRS's challenge in modernizing multiple systems. However, upgrading the injured spouse processing system sooner, rather than later, immediately frees up IRS employees to do other work and will almost certainly benefit the taxpayer.

Contrary to the IRS's response, having a husband and wife fill in separate columns on their joint return and identifying separate income, deductions, credits, and payments would simplify many areas of tax law, such as eliminating joint and several liability and special relief rules such as innocent and injured spouse. Currently, the only way to completely avoid injured spouse issues is for the couple to file separately, which means the taxpayers loses many significant benefits they would otherwise be entitled to receive. Since most taxpayers receive income information in a form that is separate or easily allocated, we do not believe our proposal imposes significant burden.

Asking the taxpayer where he or she is "domiciled" on Form 8379, rather than asking where the taxpayer's main home is located, would yield a more accurate answer as to the taxpayer's place of residency. Further, if the IRS is concerned that taxpayers will not understand what the word domicile means, it can simply place a definition on the form. This would be easy, since "domicile" is a legal term, defined in the regulations to mean an individual's fixed or permanent home, where an individual acquires a domicile by living there, even for a brief period of time, with no definite present intention of moving.[37] Asking the taxpayer where he or she is domiciled is the most accurate question for determining the taxpayer's place of residency.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS take the following steps to improve the processing of injured spouse allocations:

- Wage & Investment should begin tracking the following issues so processing problems can be identified and addressed.
  - The average cycle time for injured spouse allocations where the Form 8379 is filed electronically;
  - The average cycle time for injured spouse cases where the Form 8379 was filed separately;

[37] Treas. Reg. § 20.0-1(b)(1); § 25.2501-1(b).

- The average cycle time for injured spouse allocations where the Form 8379 is filed attached to the original return;
- The number and type of errors made when processing injured spouse allocations;
- The number and type of errors made as a result of calculating injured spouse allocations manually; and
- The number of Forms 8379 that contained taxpayer errors and the type of taxpayer errors.

- The IRS should calculate injured spouse allocations automatically rather than manually, which would reduce both errors and processing time.
- The IRS should clarify the community property question on Form 8379 to ask where the taxpayer is domiciled, rather than where the taxpayer's main home is located. This change would yield a more accurate answer as to the taxpayer's place of residence.
- The IRS should design a split column joint tax return that would separate spouses' income, deductions, credits, and payments. Adopting this recommendation would eliminate most problems surrounding injured spouse relief.

UPDATE

TOPIC #22 STATUS UPDATE: MAJOR IMPROVEMENTS IN THE QUESTIONABLE REFUND PROGRAM AND SOME CONTINUING CONCERNS

RESPONSIBLE OFFICIALS

Nancy Jardini, Chief, Criminal Investigation

Richard J. Morgante, Commissioner, Wage & Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

In the 2005 Annual Report to Congress, the National Taxpayer Advocate described serious problems with the administration of the Questionable Refund Program (QRP) by the IRS's Criminal Investigation (CI) function.[1] The QRP principally uses data mining software on the IRS's Electronic Fraud Detection System (EFDS) to cull the millions of refund claims filed by taxpayers each year in order to identify claims with questionable data elements.[2] The returns that are identified as having questionable elements are subjected to a verification process, whereby CI attempts to verify the accuracy of the information contained in the return. In the 2005 report, we detailed the results of a year-long statistically representative study of Taxpayer Advocate Service (TAS) QRP cases,[3] which included some significant findings:

- Tens of thousands of taxpayer refunds were permanently frozen due to CI's suspicion of fraud – without notice provided to the affected taxpayers or asking the taxpayers to provide documentation to support their claims.
- In 80 percent of the cases in the TAS study in which CI made a "fraud" determination, CI ultimately agreed after TAS intervention to release all or part of the refunds. In 66 percent of the cases, these taxpayers received the full amount of the original refund claimed or more. In additional 14 percent of cases, taxpayers received a partial refund.
- The median Adjusted Gross Income (AGI) of those taxpayers whose refunds were frozen was $12,850, and the median refund received was over $3,500 (*i.e.*, the taxpayers were in a low economic stratum).

[1] National Taxpayer Advocate 2005 Annual Report to Congress 25-54. Volume II of the 2005 Annual Report to Congress presented the results of a research study conducted on QRP cases received by TAS.

[2] Data mining is the application of database technology and techniques to uncover hidden patterns and subtle relationships in data. Government Accountability Office, *Data Mining: Federal Efforts Cover a Wide Range of Uses*, GAO-04-548 (May 4, 2004). The Electronic Fraud Detection System is the primary information system used to support the Criminal Investigation (CI) Division's Questionable Refund Program. Treasury Inspector General for Tax Administration, *The Electronic Fraud Detection System Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified*, Ref. No. 2006-20-108 (Aug. 9, 2006).

[3] In the TAS QRP study, we selected 500 TAS QRP cases to review and 27 of those cases were eliminated for failing to fall within the sample parameters. Thus, a total of 473 cases were used in the study. A sample size of at least 384 cases was required to obtain a 95 percent confidence level in the results of the review. A 95 percent confidence level means that the conclusions with respect to the sample have a 95 percent likelihood of being applicable to the population from which the sample was drawn.

- Nearly 75 percent of the taxpayers with frozen refunds had claimed the Earned Income Tax Credit (EITC) and ultimately, a majority of these taxpayers received the claimed EITC benefits.

As a result of the QRP study, members of Congress expressed concerns about the manner in which the QRP was being operated,[4] and the IRS Commissioner committed to making major changes to the QRP.[5] Since that time, the IRS has indeed made significant changes to the QRP and plans still more changes. It has taken the problems in the QRP seriously and worked hard to improve the program. Working with a variety of IRS functions, the Assistant Deputy Commissioner (Services and Enforcement) has made the improvement of the QRP a top priority. In this report, we will detail the changes that have been made. Additionally, because the QRP remains the number one reason taxpayers seek the assistance of the Taxpayer Advocate Service, we set forth our concern that some of the root causes of the problems associated with the QRP have not yet been addressed.[6]

ANALSYIS OF THE PROBLEM

Background

The Taxpayer Advocate Service first addressed problems with the QRP in 2003 after TAS's own inventory of frozen refund cases increased by 170 percent from 2002 to 2003.[7] CI began nationwide use of data mining techniques as part of the QRP in March 2003.[8] By Fiscal Year (FY) 2005, TAS had 28,639 QRP frozen refund cases in its inventory, an increase of over 400 percent from FY 2002. The large number of CI cases in TAS's inventory and the high incidence of full relief in these cases led TAS to undertake a study of its CI frozen refund cases. The results of the study are described in detail in Volume II of the National Taxpayer Advocate's 2005 Annual Report to Congress.

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4 Members of Congress wrote to the Secretary of the Treasury and to the Internal Revenue Commissioner raising questions about the Questionable Refund Program, including Senator Charles E. Grassley in correspondence to the Secretary dated January 20, 2006; Senator John Kerry and Senator Barack Obama in correspondence to the Commissioner dated January 19, 2006; Senator Harry Reid, Senator Max Baucus and Senator Patty Murray in correspondence to the Secretary dated January 21, 2006; and Congressman Charles B. Rangel and Congressman John Lewis in correspondence dated January 25, 2006.

5 IRS News Release, New Steps Taken To Improve Questionable Refund Program (Feb. 6, 2006), available at http://www.irs.gov/newsroom/article/0,,id=154285,00.html.

6 In fiscal year 2006, TAS received over 20,000 cases from taxpayers complaining about their refund claims which were frozen as part of the QRP. Taxpayer Advocate Management Information System (2006). In FY 2005, TAS received over 28,000 QRP cases. National Taxpayer Advocate 2005 Annual Report to Congress 31. While there were 8,000 fewer cases in 2006, a significant decrease in QRP cases was expected because for the 2006 filing season CI was without its Electronic Fraud Detection System, which allows CI to cull millions of tax returns by computer driven search techniques.

7 In FY 2002, TAS received 5,509 QRP frozen refund cases, while in FY 2003 TAS received 15,118 QRP cases, an increase of over 170 percent. National Taxpayer Advocate 2005 Annual Report to Congress 32.

8 Criminal Investigation officials informed TAS that data mining was instituted as part of the QRP in 2003 but did not believe that data mining was the cause of TAS's increased case load. Criminal Investigation presentation on the Questionable Refund Program (March 2005).

The problems with CI's operation of the QRP, as identified in the 2005 Annual Report to Congress, were systemic in nature and revolved around five root causes:

- The data mining selection process used in the QRP resulted in too many legitimate refund claims being frozen.
- Once refunds were held for verification process, taxpayers waited too long for resolution of their refund claims.
- CI did not provide notification to taxpayers whose refunds were frozen, so taxpayers did not have an opportunity to substantiate their claims.
- CI automatically froze refund claims of taxpayers believed to have committed fraud in a prior year. This policy dramatically expanded the inventory of frozen refund cases without much indication that the policy deterred fraud.
- Internal IRS procedures created systemic delays in the resolution of taxpayer inquiries.

Comprehensive Agreement to Change the QRP

As a result of the TAS study, the IRS agreed to dramatically alter the QRP procedures. The Commissioner established an Executive Steering Committee consisting of representatives from CI, TAS, the Examination functions of the Wage & Investment Division (W&I) and the Small Business/Self-Employment Division (SB/SE), the Accounts Management function in W&I, and Modernization & Information Technology Services. Although the Committee has not finished its work, it has already established and implemented changes to the QRP that we believe strike an appropriate balance between the government's interest in preventing fraud and taxpayers' right to notice and an opportunity to be heard.[9]

Notification to Affected Taxpayers and Opportunity to Be Heard

The IRS is subject to a statutory requirement to provide notice to taxpayers whose refund claims have been denied.[10] However, under the QRP as operated prior to the 2005 TAS study, taxpayers whose refunds were frozen generally did not receive notice of either the IRS's determination to freeze a refund or the IRS's conclusion as to the

[9] The changes to the QRP are based in part on a Memorandum Regarding IRS Criminal Investigation Questionable Refund Program Procedures, negotiated and agreed to by the National Taxpayer Advocate and the other business units participating on the Commissioner's Executive Steering Committee. The National Taxpayer Advocate believes that the IRS has acted in good faith in carrying out the changes set forth in the memorandum.

[10] IRC § 6402(k) provides: In the case of a disallowance of a claim for refund, the Secretary shall provide the taxpayer with an explanation for such disallowance.

existence of fraud.[11] CI did not send notices of claim disallowance when it froze taxpayer refunds. Taxpayers would receive notice about their refund claims only if CI referred a case to the Examination functions or, in some cases, if a taxpayer contacted the IRS to inquire about the status of the refund.[12] Additionally, once CI placed a freeze upon a refund, it retained control over the release of that freeze, so that if the Examination functions made a determination favorable to taxpayers, CI would still retain the authority to decide whether the freeze would be released.

Revised Refund Notice Procedures

Under the revised QRP procedures, taxpayers who have not received their refunds will receive multiple notices and opportunities to rebut the IRS's conclusions with respect to the refund claim. The first notice (CPO5) is sent to taxpayers approximately 35 days after CI places a hold on a refund claim and provides notice that the claim is under review due to concerns about information provided on the tax return. Taxpayers are advised to allow at least three weeks before contacting the IRS about the refund, and information about receiving assistance from TAS is provided in the letter.

After the issuance of the CPO5, frozen refunds will follow one of four paths:

1. The refund may be released if the taxpayer can provide substantiating information;
2. CI may send a letter (Letter 4115C) seeking additional information from the taxpayer, and if the taxpayer does not respond or responds with inadequate information the case will be referred to the IRS Accounts Management function, which will issue a claim disallowance letter;[13]
3. The refund may be sent to one of the Exam functions which will apply deficiency procedures as described below, and if the taxpayer inquires about his or her refund before the case reached Exam, an explanatory letter (Letter 4116C) will be issued; or
4. The case is retained by CI for further investigation as a possible fraudulent scheme.

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[11] In the mid 1990s, CI did provide notice of its actions to taxpayers. The IRS testified before the House Ways and Means Committee as follows:

> When we have delayed a refund in whole or in part, we are letting taxpayers know why. Our notice explains that the full refund or remaining refund will be sent within eight weeks unless we determine additional contact with the taxpayer is necessary to verify the claim.

Fiscal Year 1996 IRS Budget Request, Hearing Before the House Ways and Means Committee, 103rd Congress (Feb. 27, 1995). However, CI deviated from these standards in years subsequent to 1995. As part of the study, TAS learned that well over 200,000 taxpayers with frozen refunds never received any type of notice of CI's actions and CI took no action to resolve the disputed refund claims other than to place the claims in frozen status.

[12] For example, in fiscal year 2004, CI referred approximately 45,000 cases to the Examination functions. IRS Responses to TAS Information Requests, dated July 22, 2005 and July 29, 2005. On the other hand, CI concluded that fraud was present in connection with over 118,000 QRP refund claims. Treasury Inspector General for Tax Administration, Ref. No. 2006-20-108, *The Electronic Fraud Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified* (Aug. 9, 2006).

[13] IRC § 6402(k) requires the IRS to provide notice to taxpayers when it disallows their refund claims.

Under the revised QRP procedures, CI can no longer hold a QRP refund indefinitely. The IRS has established a 70-day time frame within which CI must either make the affirmative determination that the case requires further criminal investigation or take the affirmative step of routing the frozen refunds through one of the first three treatments described above. These treatments are discussed in more detail below.

Under the new QRP procedures, refund claims will be released within 70 days of the refund freeze unless CI takes an action to route the refund claim through another treatment. Thus, the default treatment will result in a refund release unless there is a basis to conduct further inquiry into the refund claim. This is an important change to the QRP procedures, which places the burden on CI to identify the basis for the continued hold on the refund.

In cases where the IRS continues to have questions about the validity of income or withholding credits reported, it will send Letter 4115C to taxpayers requesting verification to support the income and withholding claimed on the return. This contact provides an important opportunity for taxpayers to come forward and provide support for their refund claims. If the taxpayer does not respond to Letter 4115C within 45 days, the case is sent to the W&I Accounts Management function, which will issue a claim disallowance letter. The taxpayer receiving the disallowance letter will have the opportunity to request an independent review by the Office of Appeals.

In cases where CI's concerns about the legitimacy of the claim relate to credits other than withholding credits, such as the Earned Income Tax Credit or any other issue, CI will send the cases to one of the Examination functions in either SB/SE or W&I (collectively referred to as Exam). If the taxpayer inquires about his or her refund after the determination has been made to send the case to Exam, the IRS will send Letter 4116C, which informs the taxpayer that the case will be sent to Exam within 60 days. Within 30 days of receiving the case, Exam will either release the refund or send Letter 566H, which Exam uses to request documentation of the questionable items on the return. If the taxpayer substantiates the questioned items, the refund will be released. If Exam determines that the taxpayer's response is insufficient or if there is no taxpayer response, Exam will send an audit report disallowing all or part of the claimed refund. If the taxpayer does not respond to the audit report, provide additional information, or request an Appeals hearing, the IRS will send a Notice of Deficiency to the taxpayer, allowing the taxpayer to file a petition in the United States Tax Court if the taxpayer disagrees with Exam's position.[14]

Automatic Refund Freezes in Subsequent Years

Under the QRP as run prior to the TAS study, CI's policy after determining the presence of fraud was to automatically freeze a taxpayer's refund claims in subsequent years until the taxpayer had filed a specified number of legitimate returns. The IRS had little

[14] IRC §§ 6212 through 6215 establish deficiency procedures pursuant to which the taxpayer receives a notice of the proposed deficiency and allows the taxpayer 90 days to file a petition with the U.S. Tax Court.

current data showing that persons flagged for filing false refund claims were especially likely to continue to file false claims in future years. This is partly because taxpayers who file false claims and do not receive the claimed refund realize that the IRS is on to them. It is partly because initial IRS determinations of fraud are sometimes wrong, so subsequent freezes were based on an inaccurate premise that the taxpayer previously filed a false refund claim. The ultimate effect of this policy of freezing future refund claims automatically, without review, was to increase the IRS's inventory of frozen refunds significantly without much indication that the policy served to deter refund fraud.[15]

Under the revised QRP procedures, CI will no longer automatically freeze the future refund claims of taxpayers whose refund claims are frozen in the present year, except in a few categories of cases. This change will ease the burden on taxpayers affected by the QRP whose tax return related problems did not stem from an intent to defraud the government by filing a false return.

IRS Pre-Refund Program Office

As part of the restructuring of the QRP, the IRS is establishing a Pre-Refund Program Office that will manage the different programs devoted to refund claims.[16] Creating a combined Pre-Refund Program Office has a number of benefits. This step will enable the IRS to run some of its pre-refund screens simultaneously, thereby reducing the time taxpayers must wait for their refunds. For example, taxpayers whose refunds are selected through CI's data mining software as part of the QRP are often subsequently routed to the Exam functions which then subject the refund claims to separate data base applications, such as the Dependent Database, in order to identify issues that require further review by the Exam functions.[17] The IRS believes the consolidated program will allow either running the data mining and Dependent Database simultaneously, which would reduce the time refunds are frozen, or running the Dependent Database prior to or in lieu of CI's data mining software, which would move taxpayers to the examination and deficiency process first, instead of freezing the refunds in CI's inventory, only to be moved to Exam after months elapse.

[15] The 2005 TAS QRP study concluded that among TAS QRP cases there was a small probability (six percent) of a taxpayer repeatedly submitting refund returns indicative of fraud. National Taxpayer Advocate 2005 Annual Report to Congress Vol. II, 16.

[16] Summary of Results: Pre-Refund Program Strategy (July 25 – 26, 2006).

[17] The Dependent Database contains information from the U.S. Department of Health and Human Services about dependents such as information about the persons with whom children reside. Treasury Inspector General for Tax Administration, *Dependent Database Information is Complete and Examination Cases are Accurately Scored*, Ref. No. 2003-40-91 (Mar. 2003). IRS describes the Dependent Database as follows:

> The Dependent Database (DDb) is a tool that identifies non-compliant Earned Income Tax Credit (EITC) and dependent issues through the use of internal and external data elements and provides the ability to freeze refunds. The database is rule driven. If a rule condition is met as returns are processed through the DDb rule filtering process, the rule "fires" and the return is flagged for examination. Most of the selected returns are worked as pre-refund audits, which involve EITC claims. IRS, *Dependent Database*, available at http://www.irs.gov/privacy/article/0,,id=163758,00.html.

The role of the Pre-Refund Program Office is not yet fully developed; however, it appears that CI will retain ownership of the day-to-day decision making in the QRP. We believe that the QRP program should be administered by the civil tax functions in the IRS, because the nature of the work to be performed under the revised QRP, *i.e.*, interacting with taxpayers to obtain substantiating documentation, is the day-to-day work of these functions. In appropriate cases, these functions can make criminal referrals to CI as it does under regular examination procedures.[18]

Moreover, it makes sense to establish a central screening program through which each refund return passes. The various IRS functions – both civil and criminal – could develop appropriate screens for their respective tax administration mission. Each tax return's unique "score" would determine where the case should first be worked. This approach ensures that taxpayers' returns are subject to the correct amount of scrutiny but not to multiple and inappropriate delays.

Old Inventory of Frozen Refunds

As part of our discussions with CI for the 2005 Annual Report, we learned that CI had in excess of 216,000 frozen refund cases of varying age in which CI had taken no action other than to freeze the refunds. The IRS committed to work through this inventory of cases by creating a task force of IRS personnel to issue notices to the affected taxpayers and to assess the merits of each fraud determination.[19] If taxpayers do not come forward with evidence substantiating their refund claims, the IRS will disallow the refund using a claim disallowance notice or by referring the case to Exam as appropriate. To date, about 50,000 refund claims have been released, about 69,000 cases have been referred to Accounts Management (AM) for claim disallowance after the taxpayers were given notice and offered a chance to come forward with substantiating evidence, about 28,000 cases were referred to Exam, about 40,000 cases were referred by CI to AM or Exam but were returned to CI for a variety of reasons and are still being worked, and about 29,000 returns were determined to involve taxpayers with problems in multiple years and are still under consideration.[20]

TAS's Remaining Concerns

The changes to the QRP are significant, and we applaud the IRS for these efforts. The QRP process changes described above improve the procedures for those taxpayers whose refunds are held for scrutiny. However, we also believe the IRS should do more to ensure the selection process that identifies these taxpayers is improved so that fewer legitimate claims are unnecessarily subject to the QRP. There can be serious conse-

[18] For example, Exam employees have the ability to make a referral to CI through its internal referral procedures. IRM 4.1.5.1.1 (Oct. 24, 2006).

[19] With respect to this old inventory, the IRS issued Letter CP05A informing these taxpayers that the IRS has concerns with the claimed refund and asking the taxpayers to come forward with evidence substantiating the claimed refund.

[20] Criminal Investigations, Questionable Refund Program (Dec. 2006).

quences for taxpayers whose refunds are subject to QRP scrutiny, even in cases in which taxpayers ultimately receive full refund relief. At least among cases reviewed as part of the 2005 TAS QRP study, taxpayers whose refunds were frozen had a median Adjusted Gross Income (AGI) of $12,850 and the median refund was over $3,500 – fully 27 percent of their AGI for the year.[21] These are not taxpayers who can afford to be without such a substantial portion of their income. Moreover, taxpayers who received full refund relief waited an average of 8½ months for their refunds.[22]

The 2005 TAS CI study analyzed cases in which CI froze a taxpayer's refund claim and the taxpayer sought assistance from TAS. In this sample, CI ultimately agreed that the taxpayers were entitled to a full or partial refund in 80 percent of the cases (a full refund in 66 percent and a partial refund in 14 percent of the cases). Moreover, it is not at all clear that the remaining 20 percent of the taxpayers committed fraud; rather, it is only clear that these taxpayers did not receive the claimed refund. Because the QRP principally uses data mining as its source for questionable refund claims, it is reasonable to ask whether the rules which govern CI's data mining software are more over-inclusive than they need to be, and, if so, whether these rules can be more narrowly drawn.

Improving Data Mining Filters

The 2005 TAS QRP study demonstrated flaws not just in the lack of notice to affected taxpayers but also in the process by which CI makes its fraud determinations, a process which begins with the use of data mining software. As a result of the study, the IRS agreed to improve the accuracy of its data-mining software so that fewer valid refund claims are frozen.[23] To improve its data mining software, we have suggested that the IRS conduct research on a random sample of its frozen refund inventory. By sampling its frozen refund inventory, the IRS will learn important information that will assist it in both eliminating incorrect fraud determinations and identifying fraudulent schemes that the IRS is not detecting with its current approach. This iterative research should involve contacting taxpayers so that the IRS can determine whether the taxpayers can offer substantiation for their refund claims. This contact should not come from CI, which would likely have a chilling or intimidating effect on the taxpayer's willingness to communicate; rather, the contact should be made by assistors trained to communicate with taxpayers. Therefore, we have suggested that TAS should be involved in working with the IRS as a liaison with the taxpayers in the sample.

[21] National Taxpayer Advocate 2005 Annual Report to Congress 26.

[22] *Id.*

[23] IRS News Release, New Steps Taken To Improve Questionable Refund Program (Feb. 6, 2006), available at http://www.irs.gov/newsroom/article/0,,id=154285,00.html.

The importance of involving taxpayer input in arriving at the correct answer has been demonstrated in previous IRS research efforts.[24] In other legal contexts, allowing citizens an opportunity to tell their side of the story is so fundamental as to be a constitutional requirement.[25] However, under the old QRP procedures, CI would make a determination about taxpayer fraud without notice to the taxpayer or opportunity to be heard.[26] One of the consequences of such a one-sided process, as the 2005 TAS study demonstrated, is a high percentage of incorrect fraud determinations. By not involving taxpayers in the cases it is using to test its data mining software, the IRS is likely to make the same mistakes again and import those mistakes into its data mining rules.

At this time, however, IRS has agreed only to review a sample of case files *without* contacting the taxpayer. This approach ignores the lessons of the 2005 QRP study. We assume that when CI makes fraud determinations, it has some basis to do so in nearly all of its cases, including in the 80 percent of the fraud determinations in the TAS study which ultimately proved to be incorrect. One of the most important findings of the 2005 TAS QRP study, which has been illustrated in other TAS research studies as well, is that when we interact with taxpayers they can often provide substantiation for the claimed refund. Thus, the process currently being used to improve the filters ignores the taxpayers' side of the story, and will not result in needed improvements to the software.

We are particularly concerned about the changes being made to the data mining software for the 2007 filing season. Data mining software operates on the application of thousands of program rules which are re-written each year based on data collected from the prior year's fraud determinations. Thus, the data mining software for any given year will only be as effective in identifying fraudulent returns as the prior year's fraud determinations. Because the Electronic Fraud Detection System (EFDS) was not available for the 2006 filing season, the data mining software for the 2007 filing season will be based on the fraud determinations from the 2005 filing season. However, these cases were decided prior to the implementation of the new QRP procedures, and based on the results of the 2005 TAS study of the QRP, we do not believe these cases provide a reliable basis to establish rules for the data mining software. Thus, we are doubly concerned about the reliability of the data mining filters for the 2007 filing season – we are

[24] The 2004 joint TAS-IRS Earned Income Tax Credit (EITC) Audit Reconsideration Study, which studied EITC denials in the audit reconsideration process, provides evidence of the importance of taxpayer contact in arriving at the right conclusion. Of the taxpayers who came to TAS for assistance, 45 percent ultimately received additional EITC benefits, even though the IRS had initially denied the taxpayers' claims. However, the correct answer was only obtained through taxpayer contact and interaction. National Taxpayer Advocate 2004 Annual Report to Congress, Vol. II, 9. Studies such as the TAS QRP study and the TAS-IRS EITC Audit Reconsideration study demonstrate the importance of person-to-person contact with taxpayers for enabling taxpayers to articulate the basis for claimed refunds or other credits.

[25] For example, in *Goldberg v. Kelly*, 379 U.S. 254, 90 S.Ct. 1011, 25 L.Ed.2d 287 (1970), the Supreme Court held that the termination of citizens' benefits under the Aid to Families with Dependent Children program required pre-termination hearings with notice and opportunity to be heard for recipients.

[26] By analogy to the prosecution of criminals in other contexts, we believe that the likelihood of CI accurately predicting fraud under this one-sided approach would be akin to the likelihood of a judge determining guilt or innocence solely on the basis of an indictment, without hearing the side of the accused.

concerned that CI is using a flawed methodology to improve the filters by not involving taxpayers in its review of prior fraud determinations, and we are concerned that it is choosing from among a population of cases that were decided under procedures that produced too many "false positive" findings of fraud.

Resource Commitment – the 2007 Filing Season and Beyond

Under the revised QRP procedures, CI must determine whether to retain the case for further investigation to determine if it is part of a fraudulent scheme or release the refund, refer the case to the Exam function and or attempt to verify the taxpayers' refund claims and refer the cases which cannot be verified to Accounts Management for claim disallowance.

While we applaud this approach because it eliminates "default" freezes, we are concerned that these other functions are not prepared for the significant volumes of new cases they will receive in the 2007 filing season and beyond. It appeared to us that Exam's resources were stretched under the old QRP procedures when CI sent less than half of its frozen refund cases to Exam and when CI was not under a specific time limit to take action on the cases.[27] Although the IRS handled CI cases under the new procedures during the 2006 filing season, the 2006 filing season was not an indication of the case volumes that Exam and Accounts Management will experience in 2007 and beyond because EFDS, which allows the IRS to accomplish numerous functions in the QRP (such as running its data mining software, delivering thousands of cases at a time to the Operating Divisions, and generating automatic reports of case activity), was not available for the 2006 filing season. However, it will be available for the 2007 filing season.[28] Thus, Exam and Accounts Management should be planning for tens of thousands of additional cases in their inventories.

To gauge the extent to which the new QRP procedures are working or not working, we asked Local Taxpayer Advocates (LTAs) across the country to provide examples of cases from the 2006 filing season in which the procedures failed. We received dozens of cases from LTAs, and the dominant complaint among them was that while CI had referred the case to Exam, Exam had no record of the case in its inventory.[29] To probe the root causes of these problems and to determine what preparations were being made for the 2007 filing season, we posed a number of questions to CI, the Exam functions,

[27] In fiscal year 2004, CI referred approximately 45,000 cases to the Examination functions. IRS Responses to TAS information requests, dated July 22, 2005 and July 29, 2005. On the other hand, CI concluded the existence of fraud on over 118,000 QRP refunds, leaving over 70,000 frozen refund cases that were not referred to Exam. Treasury Inspector General for Tax Administration, *The Electronic Fraud Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified,* Ref. No. 2006-20-108 (Aug. 9, 2006).

[28] Treasury Inspector General for Tax Administration, *A Complete Certification and Accreditation is Needed to Ensure the Electronic Fraud Detection System Meets Federal Government Security Standards*, Ref. No. 2006-20-178 (Sept. 29, 2006).

[29] Eighty-five examples were provided by LTAs from cases listed on the Taxpayer Advocate Management Information System (TAMIS). For FY 2006, TAS received over 19,000 complaints from taxpayers about the QRP.

and Accounts Management as part of this Annual Report to Congress process. While the IRS has worked very cooperatively with TAS officials on the Executive Steering Committee and has shared information as part of that process, the IRS does not yet have the management reports in place to be able to identify the types of problems described above, much less resolve them expeditiously.

We understand that implementing these changes is hard work. However, to ensure that the problems that taxpayers used to experience with CI do not become the same problems that taxpayers experience in the future with Exam and Accounts Management, the IRS needs to acknowledge the increased work loads on these functions and provide these functions adequate resources to complete the work assigned to them.

CONCLUSION

We reiterate our praise for the IRS's efforts to reform the QRP. Clearly, the IRS agrees that the QRP as previously administered created an unnecessary burden for taxpayers. Taxpayers are now receiving notice as to why their refunds are delayed, and they are being provided an opportunity to provide substantiating evidence to support their refund claims. However, the IRS must work harder to improve the data mining filters that are responsible for identifying these questionable returns at the outset. We believe this process can only be effective if the IRS is willing to study cases that its filters wrongly flagged and incorporate the learned experience to improve its data-mining filters for the future. TAS has offered its Research function and its case advocates for the IRS to assist in this process. To date, the IRS has been unwilling to involve taxpayers in this process. Additionally, now that much of the work load of the QRP cases is falling on Exam and Accounts Management, the IRS needs to ensure that these functions can plan adequately for this substantial amount of new work and needs to provide the necessary resources for these functions to adjust to the new work load.

IRS COMMENTS

The IRS has made significant improvements to the process of identifying and stopping questionable refunds, and has many other process improvements planned for the 2007 filing season. In particular, the IRS has implemented new policies and procedures that include an enhanced taxpayer notification system; improved freeze management processes; a new inventory control and resource utilization system; development of a Concept of Operations (CONOPS) for the workload transfer process; a quality assurance system; and a new Pre-Refund Program Office that will evaluate and manage pre-refund strategies and resources across the agency.

Taxpayer Notification

Taxpayers are being properly notified of Criminal Investigation Division (CI) refund freezes and afforded due process. Additionally, questionable accounts are now referred

to either Examination or Accounts Management (AM) once the verification process has been completed. Four new notices have been created:

- The first notice (CP05) began in April. It is sent to all taxpayers whose refund is being delayed by CI *beyond* the initial 2 week re-sequencing period. It advises the taxpayers that their refund is being delayed for further review of the income, income tax withholding, or business income reported on the return. The notice further advises taxpayers that the IRS will contact them once the review is completed and at that time the taxpayer will either receive their refund or will be asked for additional information. Over 103,000 of these notices were issued in the 2006 filing season. There have been approximately 200 responses (.2 percent response rate) from taxpayers and 17,500 have been returned as undeliverable.
- If the Criminal Investigation Division (CI) verifies that a refund is questionable, the taxpayer receives a second notice. This notice is sent by CI on certain accounts (4115C) or by Examination (566H) if refundable credits, such as EITC are involved. Both letters explain why the IRS believes the refund claim is questionable and provide the taxpayer an opportunity to submit additional supporting documentation. CI has sent over 17,000 4115C letters. There have been approximately 800 responses (4.7 percent response rate) and 1,100 undeliverable.
- The third notice (4116C) is issued to taxpayers who inquire about their refund while it is in the transfer phase to Examination. This notice explains that their account is being transferred to Examination and that he or she will be contacted within 60 days. Over 1,700 of these letters have been sent.
- With respect to old inventory (refunds frozen prior to the 2006 filing season), the first notice to the taxpayer is a CP05A (AM work) or 566H. These notices explain that the IRS has found their refund questionable and provide the taxpayer an opportunity to submit additional supporting documentation. Approximately 70,000 of these notices have been sent.

In addition to these new notices, taxpayers who fail to substantiate the income or withholding after receiving these notifications will receive either a Certified Claims Disallowance Letter (105C) from Accounts Management or a Statutory Notice of Deficiency (90 Day letter) from Examination.

Freeze Management

Taxpayers' refunds can be frozen in two ways, either by a CI control placed on the account because of a previous year false return having been filed (Z Freeze) or by CI intercepting or stopping the refund from being issued (P Freeze). Only a portion of those returns hitting the data mining flags are frozen. A freeze occurs only after analysts have assessed the return and placed it in queue for employment verification.

Several actions were taken in 2006 to address the concerns regarding aging of accounts with frozen refunds.

UPDATE

- In February, CI implemented a policy requiring that the verification of employment, and therefore the reported income, be completed within 70 days of stopping the refund. Otherwise, the refund is released.
- In April 2006, a policy was implemented to restrict the use of the TC 918, which freezes the entire taxpayer's account.
- In June 2006, a master file programming change was implemented to systemically release the refund after 70 days if the account had not been updated to indicate the refund was false.
- In June 2006, a master file programming change was implemented to remove the CI controls on workload transferred to AM or Examination.
- In June 2006, CI implemented a procedural change to assess unpostable returns at the receiving site versus transferring returns to the controlling FDC. This allowed for better control and quicker verification.

Workload Transfer Process

Since early 2006, the QRP Working Group has made substantial progress in identifying and resolving QRP inventories. Actions were initiated that are expected to result in 88 percent of Old Inventory cases closed or in process in AM or Examination by January 31, 2007. Virtually all cases are expected to be closed by September 30, 2007. Enhanced roles and responsibilities have been identified and implemented for the Fraud Detection Centers, AM, and Examination.

Electronic Fraud Detection System, Data-Mining, and Sampling

With respect to the Electronic Fraud Detection System (EFDS), CI agrees that we need to partner with the Taxpayer Advocate Service (TAS) as we go forward to modify the data model. This will include sharing with TAS the projected outcomes from proposed modifications to the model. CI agrees with the National Taxpayer Advocate's suggestions to utilize research, sampling, and quality control processes to ensure that the IRS has a higher predictor of outcomes, with acceptable false positive and "no change" rates. With respect to the 2007 filing season, CI believes that the false positive rate should be at or close to the historical rate of five to six percent, consistent with the Exam "no change" rate. Also, given the many process improvements made to the program regarding freeze management and taxpayer notification, the potential for negatively impacting legitimate taxpayers for excessive periods of time has lessened substantially.

CI concurs with the National Taxpayer Advocate's recommendation that a sample review of frozen refund returns could be valuable in increasing the effectiveness of the QRP program. A study should be designed to include a statistically valid sample of all frozen refunds. A sample should be jointly analyzed by TAS and the IRS after returns have been subjected to the Processing Year 2007 QRP process. This would best utilize resources to ensure that we are evaluating results based on the new procedures.

With respect to data-mining, it should be noted that data mining does not cause refunds to be frozen or automatically determine returns to be fraudulent. Also, only returns determined to be actually fraudulent are used in the model-building algorithm; automatic refund freezes from prior year determinations are not used in building the model. In accordance with IRS policy, the only immediate consequence for a return being flagged is that the refund is delayed for two weeks (re-sequenced). Data mining predicts which refund returns have a likelihood of being fraudulent, and subsequently, CI personnel verify whether the refund is indeed questionable and, therefore, subject to further investigation.

The enhancements, changes, and improvements made to the QRP will reduce unnecessary hardships for taxpayers while at the same time improve the ability of the IRS to identify and stop questionable refunds.

TAXPAYER ADVOCATE SERVICE COMMENTS

We agree that the IRS has made significant improvements to the QRP and commend the IRS on the speed with which it undertook these changes. We look forward to working with the IRS on further refinements to QRP and on improving the data mining software. We are pleased that CI has agreed to conduct a sample review of its frozen refund returns. However, we reiterate the importance of working directly with taxpayers when sampling its frozen refund cases as part of the data mining improvement process. Moreover, we believe that CI will find it instructive and helpful if we jointly review those cases from TAS's 2005 study in which taxpayers received full or partial refund relief but CI originally verified as fraudulent. Information obtained from this review will most certainly help CI improve its filters to avoid false positives. Finally, we commit to working for the continued improvement of the QRP program through our participation in the Executive Steering Committee and our work with the Pre-Refund Program Office.

UPDATE

SECTION ONE

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INTRODUCTION

Section 7803(c)(2)(B)(ii)(VIII) of the Internal Revenue Code requires the National Taxpayer Advocate to include in her Annual Report to Congress, among other things, legislative recommendations to resolve problems encountered by taxpayers.

The chart that appears immediately following this Introduction summarizes congressional action on legislative recommendations the National Taxpayer Advocate has proposed in her 2001 through 2005 Annual Reports to Congress.[1] The Office of the Taxpayer Advocate places a high priority on working with the tax-writing committees and other staffs to try to resolve problems encountered by taxpayers. In addition to submitting legislative proposals in each annual report, the National Taxpayer Advocate meets regularly with members of Congress and their staffs and testifies at congressional hearings to describe the problems faced by taxpayers and to present legislative and administrative recommendations to mitigate those problems. As shown in the chart following this introduction, many of the recommendations included in our annual reports have received considerable congressional attention. The Office of the Taxpayer Advocate continues to work to ensure that each legislative recommendation we have made receives due consideration.

In the 109th Congress that just concluded, Congress enacted into law a proposal recommended by the National Taxpayer Advocate to consolidate appeals of Collection Due Process (CDP) determinations in the U.S. Tax Court.[2] Another provision enacted into law, which provides for Tax Court review of equitable claims in innocent spouse cases, was written in consultation with the Office of the Taxpayer Advocate.[3]

Also in the 109th Congress, the House of Representatives passed legislation to index Alternative Minimum Tax (AMT) exemption amounts for inflation. The National Taxpayer Advocate proposed to index AMT exemption amounts in her 2001 Annual Report to Congress.[4]

In addition, a number of legislative recommendations made by the National Taxpayer Advocate in previous annual reports were included in S. 1321, the Telephone Excise Tax Repeal Act of 2005, which the Senate Finance Committee approved in June 2006. Specifically, S. 1321 included the following proposals:

- **Regulation of Return Preparers.** Modeled on the National Taxpayer Advocate's proposal, § 203 of the bill instructs the Secretary of the Treasury to promulgate regulations establishing a system to regulate compensated unenrolled return prepar-

[1] An electronic version of the chart is available on the Taxpayer Advocate Service website at http://www.irs.gov/advocate. The electronic version of the chart will be periodically updated and will soon include a more detailed description of congressional action.

[2] Pension Protection Act, Pub. L. No. 109-280, § 855 (2006); National Taxpayer Advocate 2005 Annual Report to Congress 447-463. This change was also recommended by the Department of the Treasury.

[3] Tax Relief and Health Care Act, Pub. L. No. 109-432 (2006) (enacting H.R. 6111, 109th Cong. § 408).

[4] H.R. 4096, 109th Cong. (2005); National Taxpayer Advocate 2001 Annual Report to Congress 166-177.

ers. Preparers would be required to take an initial exam and to renew eligibility every three years, at which point they would be required to demonstrate completion of continuing education requirements.[5]

- **Increased Preparer Penalties.** Section 203(e) increases preparer penalties in IRC § 6695(a) through (c) from $50 to $1,000 or, in the case of three or more offenses in one calendar year, to $500 per occurrence. The National Taxpayer Advocate proposed to raise these penalties as well as others.[6]
- **Public Awareness Campaign on Registration Requirements.** Section 203(g) requires the Secretary to conduct a public awareness campaign on the return preparer registration requirements. The National Taxpayer Advocate proposed a similar campaign in her 2003 annual report.[7]
- **IRA Re-Contributions After Improper Levies.** Section 303 of the bill allows a taxpayer to re-contribute the amount withdrawn from an IRA pursuant to an improper IRS levy where the taxpayer returns the funds (including interest) to the account within 60 days of receipt. This provision is based on a proposal contained in the 2001 annual report.[8]
- **Extension of Time to Contest IRS Levies.** Section 308 extends the period of time for the IRS to return monetary proceeds from the sale of wrongfully levied property from nine months to two years. This proposal was included in the 2001 annual report.[9]
- **Direct Filing Portal.** Section 310 of the bill is based on a proposal made by the National Taxpayer Advocate to establish a direct filing portal.[10]
- **Regulation of Payroll Tax Deposit Agents.** Section 321 of the bill requires licensing and bonding or annual audits of payroll tax deposit agents. A similar proposal was made in the National Taxpayer Advocate's 2004 annual report as part of a package of small business burden reduction recommendations.[11]
- **Federal Tax Deposit Penalty.** The bill clarifies the application of the Federal Tax Deposit (FTD) penalty in IRC § 6656. In her 2001 annual report, the National Taxpayer Advocate proposed to reduce the maximum FTD penalty rate from ten to

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[5] S. 1321, 109th Cong. § 203 (2006); National Taxpayer Advocate 2002 Annual Report to Congress 216-230.

[6] S. 1321, 109th Cong. § 203(e) (2006); National Taxpayer Advocate 2003 Annual Report to Congress 270-301. The bill also requires that each document filed with the IRS be signed by the paid preparer (if any). Similarly, the 2003 annual report recommended a penalty of $100 per occurrence for failure to sign specified IRS forms.

[7] S. 1321, 109th Cong. § 203(g) (2006); National Taxpayer Advocate 2002 Annual Report to Congress 216-230.

[8] S. 1321, 109th Cong. § 303 (2006); National Taxpayer Advocate 2001 Annual Report to Congress 202-214.

[9] *Id.*

[10] S. 1321, 109th Cong. § 310 (2006); National Taxpayer Advocate 2004 Annual Report to Congress 471-477.

[11] S. 1321, 109th Cong. §321 (2006); National Taxpayer Advocate 2004 Annual Report to Congress 394-399.

two percent for taxpayers who make deposits on time but not in the manner prescribed in the Code.[12]

- **IRS Promotion of Estimated Tax Payments through EFTPS.** Section 705 of the bill requires the IRS to study the potential for increased collection of estimated tax payments through the Electronic Federal Tax Payment System (EFTPS) and to report its findings. This provision is based on a proposal included in the 2005 annual report.[13]
- **Study on Use of Voluntary Withholding Agreements.** Section 706 requires the Secretary to study the use of voluntary withholding agreements between independent contractors and service recipients. This provision is based on one of the National Taxpayer Advocate's proposals to reduce the tax gap included in her 2004 and 2005 annual reports.[14]

Several provisions of S.1321, although not based on legislative recommendations presented in the National Taxpayer Advocate's Annual Reports to Congress, were drafted in consultation with the Office of the Taxpayer Advocate. For example, § 311 of the bill requires the IRS to establish procedures encouraging Free File companies to provide accessible services for the blind as well as to provide clearer information regarding the availability of free state tax return preparation and filing. The National Taxpayer Advocate raised this issue in testimony before the Senate Finance Committee and the Senate Appropriations Committee.[15]

In the 108th Congress, four of our proposals were enacted into law – a uniform definition of a child,[16] an "above-the-line" deduction for contingent attorney fees and attorney fee awards in certain nonphysical personal injury cases,[17] authorization for the IRS to enter into partial-pay installment agreements,[18] and the availability of income averaging for commercial fishermen.[19] In addition, at least a dozen of our recommendations

[12] S. 1321, 109th Cong. § 405 (2006); National Taxpayer Advocate 2001 Annual Report to Congress 222.

[13] S. 1321, 109th Cong. § 705 (2006); National Taxpayer Advocate 2005 Annual Report to Congress 381-396.

[14] S. 1321, 109th Cong. § 706 (2006); National Taxpayer Advocate 2004 Annual Report to Congress 478-489; National Taxpayer Advocate 2005 Annual Report to Congress 381-396.

[15] S. 1321, 109th Cong. § 311 (2006); *Hearing on Tax Return Preparation Options for Taxpayers Before Senate Committee on Finance,* 109th Cong. (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service); *Hearing on Internal Revenue Service FY 2007 Budget Request Before Senate Comm. On Appropriations, Subcomm. On Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies*, 109th Cong. (Apr. 27, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service). The National Taxpayer Advocate has also noted the need for taxpayer consent before tax return information is sent overseas, which is addressed in § 512 of S. 1321. *See* S. 1321, 109th Cong. § 512 (2006); National Taxpayer Advocate 2004 Annual Report to Congress 80-81 (The National Taxpayer Advocate commented in a 2004 Most Serious Problem discussion that taxpayers should be informed before their tax return information is released to a foreign preparer.).

[16] Working Families Tax Relief Act, Pub. L. No. 108-311, § 201 (2004).

[17] American Jobs Creation Act, Pub. L. No. 108-357, § 703 (2004).

[18] *Id.* at § 843 (2004).

[19] American Jobs Creation Act, Pub. L. No. 108-357, § 314 (2004).

passed either the full House as part of H.R. 1528, the Taxpayer Protection and IRS Accountability Act of 2003, or the full Senate as part of S. 882, the Tax Administration Good Government Act of 2004.[20]

We continue to advocate for the proposals we have made previously. In this report, we present ten new Key Legislative Recommendations and five new Additional Legislative Recommendations.

KEY LEGISLATIVE RECOMMENDATIONS

Revising Congressional Budget Procedures to Improve IRS Funding Decisions

Under existing congressional budget procedures, the IRS is grouped together with the rest of the Department of the Treasury, the Department of Transportation, the Department of Housing and Urban Development and other agencies, and spending for all these programs must fit within a pre-established dollar cap. As a result, the IRS competes dollar-for-dollar against many other federal programs for resources. This procedure makes little sense. The IRS is the Accounts Receivable Department of the federal government. On a budget of about $10.6 billion, the IRS currently collects about $2.24 trillion a year. That translates to an average return-on-investment of about 210:1. If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line. Since the government is not a private company, maximizing the bottom line is not – in and of itself – an appropriate goal. But the public sector analogue should be to fund the IRS at a level that would maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. As the IRS has come under increasing pressure to close the "tax gap," it should be recognized that the IRS suffers from a "resources gap," and the IRS's lack of resources is a significant impediment to its ability to close the tax gap and thereby to reduce the federal budget deficit.

[20] The House bill contained our recommendations to exempt husband-and-wife co-owned businesses from the partnership filing requirements in most cases; to convert the penalty for failure to pay estimated tax into an interest charge; to require that interest be abated on certain erroneous refunds; to authorize the Secretary to grant a one-time abatement of penalties for first-time filers or filers with a consistent history of compliance; to reduce the penalty for failure to make payroll tax deposits in the manner prescribed from ten percent to two percent; to enhance the confidentiality of taxpayer communications with the Office of the Taxpayer Advocate; to give the National Taxpayer Advocate the authority to hire independent counsel; to authorize IRS employees to disclose information to local authorities when they hear imminent suicide threats; to authorize reinstatement of funds to retirement accounts when the IRS levied on the accounts in error or in flagrant disregard of rules or regulations; and to extend the time within which taxpayers or third parties can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. The Senate bill contained some of the foregoing recommendations as well as our recommendation to regulate unenrolled federal income tax preparers.

Repeal Private Debt Collection Provisions

The American Jobs Creation Act of 2004 authorized the IRS to enter into qualified collection contracts with private collection agencies.[21] In the 2005 Annual Report to Congress, we discussed how the complexity of federal tax law would impose heavy costs and burdens on the IRS to ensure that taxpayer rights would be fully protected.[22] In the Most Serious Problem section of this report, we address both the lack of a sound business case and lack of a tax administration case for the PDC initiative. As discussed in the Most Serious Problem, True Costs and Benefits of Private Debt Collection, the National Taxpayer Advocate recommends the repeal of IRC § 6306.

Uniform Definition of Qualifying Child

The Working Families Tax Relief Act introduced a uniform definition of a qualifying child, effective for tax years beginning after December 31, 2004. This measure brought about some uniformity for the great majority of taxpayers, who previously had to meet multiple tests just to determine whether they were eligible to claim an exemption, credit, or filing status under the basic family status provisions. The National Taxpayer Advocate recommends slight modifications to the uniform definition of a qualifying child to address certain unintended consequences.

Eliminate (Or Simplify) Phase-Outs

Phase-outs reduce the availability of various tax benefits to taxpayers as their income increases. Phase-outs also add needless complexity to the Internal Revenue Code. Such complexity is burdensome for taxpayers, reduces the effectiveness of tax incentives, makes it more difficult for taxpayers to estimate their tax liability and pay the correct amount of withholding or estimated taxes, and likely reduces tax compliance. Although policymakers may sometimes adopt phase-outs to reduce the cost to the federal government of providing popular tax benefits, they may be more costly than policymakers realize if they increase noncompliance. The National Taxpayer Advocate recommends that Congress repeal phase-outs. If outright repeal is not possible, Congress should reevaluate existing and proposed phase-outs to ensure they serve their intended purpose, without unduly impairing tax administration.

Increase the Exempt Organization Information Return Filing Threshold

Organizations exempt from taxation under IRC § 501(c)(3) (except private foundations) are generally required to file annual information returns with the IRS if their annual gross receipts are normally more than $25,000. This filing threshold has not been adjusted for inflation for 24 years, resulting in more small exempt organizations

[21] The American Jobs Creation Act of 2004, Pub. L. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004); now codified in IRC § 6306 and other portions of the Code.

[22] We focused on the need for the IRS to provide direct training to private collection agency employees; however, the IRS instituted a train-the-trainer program wherein the private collectors train themselves. National Taxpayer Advocate 2005 Annual Report to Congress 76.

being subject to the filing requirement than originally intended. The recently enacted Pension Protection Act of 2006 requires all exempt organizations not subject to the information return filing requirement to file electronically with the IRS a notice setting forth basic information, such as the organization's name, location, and tax identification number. Because all exempt organizations must now annually report to the IRS, small exempt organizations should not be subject to the complex information return filing requirements. We recommend that the exempt organization information return filing threshold be statutorily increased to $50,000 and that this threshold thereafter be adjusted for inflation, in increments.

Filing Issues

Filing a tax return is a taxpayer's entry point into the federal tax system. Considering that our tax system is based on voluntary compliance, it is in the best interest of both the taxpayer and the IRS to ensure that the filing process runs smoothly. When a taxpayer sits down to prepare a return with a commercial preparer, the taxpayer should not worry that his or her confidential tax information will be used or disclosed inappropriately. Further, if a taxpayer inadvertently designates the wrong account number to receive a refund, the IRS should have the proper authorization to resolve the issue.

Improve Offer In Compromise Program Accessibility

By accepting an offer to compromise a tax debt, the IRS collects money it would not otherwise collect and turns a noncompliant taxpayer into a compliant one. Despite offers being a good deal for both taxpayers and the IRS, the number of offers submitted and accepted has been declining in recent years, and fully 45 percent are simply returned to taxpayers without being considered. Recent legislation requires taxpayers who submit "lump-sum" offers to include a *nonrefundable* partial payment of 20 percent of the amount of the offer with the offer application. The IRS is likely to receive significantly fewer reasonable offers as a result of this requirement. Congress should repeal the partial payment requirement, or if repeal is not possible, it should: (1) provide taxpayers with the right to appeal to the IRS Appeals function the IRS's decision to return an offer without considering it on the merits; (2) reduce the partial payment to 20 percent of current income and liquid assets that could be disposed of immediately without significant cost; and (3) create an economic hardship exception to the requirement.

Elimination of Lengthy Collection Statute of Limitations Extensions

Prior to January 1, 2000 (the effective date of the IRS Restructuring and Reform Act of 1998 (RRA 98)), it was not uncommon for IRS collection personnel to ask taxpayers to extend the applicable collection statute for a period of years in order to guard against an expiration of the statute. Some extensions were for periods as long as ten, 20, 30, 40 or even 50 years. Through a combination of revisions to the law and changes to IRS policy, IRS collection personnel are now restricted in the extent to which they can request taxpayers to waive the collection statute of limitations; however, the changes were not

made retroactive. Consequently, there are still thousands of taxpayers (by our review in excess of 14,000 taxpayers with approximately 32,000 tax accounts) who granted lengthy CSED extensions in exchange for installment agreements prior to January 1, 2000 and who are still being subjected to collection action. Congress should eliminate the IRS's inventory of lengthy CSED extensions.

Levies on Fixed and Determinable Assets

Under present law, the IRS may place a single levy upon a taxpayer's fixed and determinable right to future benefits prior to the CSED to levy upon a taxpayer's retirement or disability benefits without any limitation in time. With the proposed change in law, the IRS would be able to levy upon a taxpayer's fixed and determinable right to retirement or disability benefits only in instances where the taxpayer has engaged in "flagrant" conduct. This recommendation impacts not only retirees and Social Security beneficiaries, but also victims of mass tort litigation. Under present law, the IRS is entitled to update its levy to demand full payment of all assessed and unassessed penalty and interest accruals, up to the full value of the taxpayer's distribution, as though the CSED had never expired. With the proposed change in law, the IRS could levy against a taxpayer's account only up to the dollar amount of taxes, penalties, and interest assessed as of the CSED.

Impairment Related Work Expenses

Congress has enacted a number of tax incentives designed to encourage employment of taxpayers with a disability. One of these incentives is the impairment-related work expense deduction. This deduction allows taxpayers who have a physical or mental disability to claim a deduction for ordinary or necessary business expenses, even if the expenses do not exceed two percent of the taxpayer's adjusted gross income. However, the number of taxpayers who use the deduction is limited because it can only be taken when taxpayers itemize. Congress should amend Internal Revenue Code § 67(d) to allow taxpayers to take the impairment-related work expense deduction as an above-the-line deduction from gross income or, alternatively, restructure the deduction as a credit against tax.

ADDITIONAL LEGISLATIVE RECOMMENDATIONS

Innocent Spouse Relief Fixes

One fundamental problem with the innocent spouse relief rules is that they often require a difficult factual inquiry into what a spouse knew when he or she signed the return in question. In her 2005 annual report, the National Taxpayer Advocate recommended repealing joint and several liability, allocating liability between spouses in accordance with each spouse's income, and also reducing the IRS's ability to collect the liability from the nonliable spouse without first attempting to collect from the liable

spouse. If this comprehensive solution is not possible, Congress should consider the following innocent spouse relief "fixes:"

1. Require the IRS to include the last date to petition the Tax Court in any final determination letter it issues, and provide that a taxpayer may petition the Tax Court at any time before the date specified in an innocent spouse determination letter;
2. Suspend the period for filing a petition in Tax Court to obtain judicial review of an innocent spouse determination while a bankruptcy stay is in effect and for 60 days thereafter;
3. Require the IRS to establish a process, similar to its "audit reconsideration" process, to reconsider innocent spouse determinations after it has issued a final notice of determination;
4. Provide the Tax Court with jurisdiction to review the IRS's community property relief determinations under IRC § 66(c);
5. Provide that a taxpayer may request equitable relief from liabilities under IRC § 6015(f) or IRC § 66(c) at any time the IRS could collect such liabilities; and
6. When equitable relief is granted under IRC § 6015 or IRC § 66(c), provide that any resulting overpayments should be refunded or credited solely to the requesting spouse's separate liability.

Military Issues

Members of the U.S. armed forces, especially those serving in designated combat zones, face some special federal income tax situations, and are entitled to certain tax benefits due to their service. Increased military action and overseas deployments have highlighted how benefits designed to help U.S. troops can instead have a negative impact on these taxpayers. The National Taxpayer Advocate recommends that Congress amend IRC § 32(c)(2)(B)(vi) to make permanent the provision allowing military personnel the option to include nontaxable combat pay received for service in a designated combat zone as earned income for the purpose of computing the EITC. Additionally, the National Taxpayer Advocate recommends that Congress amend the Code to require a former employer to provide a taxpayer the option of having federal income tax withheld from his or her differential pay.

Amend IRC 6511 to Allow Refund Claims Past the RSED When Excess Collection Is Due to IRS Error

The IRS sometimes levies on taxpayer accounts in excess of the tax liability owed. If the taxpayer does not file a refund claim within the statutorily-permitted time, the IRS will not honor the claim, even if the mistake is attributable solely to IRS negligence and the taxpayer did not learn of the error prior to the refund statute expiration date (RSED). The National Taxpayer Advocate recommends that the IRS be required to send

out annual statements to taxpayers under continuous levy showing payments received, penalties assessed, and interest charged. Alternatively, the National Taxpayer Advocate recommends that taxpayers be allowed two years from the date they learned of the excess collection to file a refund claim if the excess collection is due to IRS negligence.

Federal Oversight of Quasi-Governmental Retirement Plans

Congress has charged the Department of Labor with oversight responsibility over the administration of retirement plans offered by private entities. The Office of Personnel Management has oversight responsibility over the Civil Service Retirement System and the Federal Employees Retirement System. However, there is no parallel federal agency with oversight responsibility over the retirement plans of quasi-governmental entities. The National Taxpayer Advocate recommends that Congress designate a federal agency to maintain oversight responsibility for ensuring that quasi-governmental retirement plans carry out their fiduciary duties.

Collection Due Process and Uneconomical Levies

Recent court decisions have held that the Appeals hearing officer need not verify that the IRS conducted the IRC § 6331(j) review prior to proposing a levy action that triggers the CDP hearing. Courts have also held that the Appeals hearing officer need not take into account the uneconomical nature of the levy under the CDP "balancing" of the government's interests versus the intrusiveness of the action from the taxpayer's perspective. However, the failure to investigate and determine the uneconomical nature of a proposed levy action prior to a CDP hearing on the appropriateness of the levy action renders that hearing meaningless. Failure to weigh these two factors fails to provide the necessary oversight of IRS collection activity that Congress intended. Thus, the National Taxpayer Advocate recommends Congress amend IRC §§ 6330(c)(1), (c)(2)(A), and (c)(3)(C) to clarify that the Appeals hearing officer, prior to making his or her determination under IRC § 6330(c)(3), consider the IRS analysis required under IRC §6331(j) in balancing the government's interest in efficient tax collection with the taxpayer's legitimate concern about the intrusiveness of the proposed levy action.

Alternative Minimum Tax				
Repeal the Individual AMT National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate 2004 Annual Report to Congress 383-385.	Repeal the AMT outright.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 1186	English	3/9/2005	Referred to the Ways & Means Committee
	S 1103	Baucus	5/23/2005	Referred to the Finance Committee
	HR 2950	Neal	6/16/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 43	Collins	1/7/2003	Referred to the Ways & Means Committee
	HR 1233	English	3/12/2003	Referred to the Ways & Means Committee
	S 1040	Shelby	5/12/2003	Referred to the Finance Committee
	HR 3060	N. Smith	9/10/2003	Referred to the Ways & Means Committee
	HR 4131	Houghton	4/2/2004	Referred to the Ways & Means Committee
	HR 4164	Shuster	4/2/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 437	English	2/6/2001	Referred to the Ways & Means Committee
	S 616	Hutchinson	3/26/2002	Referred to the Finance Committee
	HR 5166	Portman	7/18/2002	Referred to the Ways & Means Committee
Index AMT for Inflation National Taxpayer Advocate 2001 Annual Report to Congress 82-100.	If full repeal of the individual Alternative Minimum Tax (AMT) is not possible, it should be indexed for inflation.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 703	Garrett	2/9/2005	Referred to the Ways & Means Committee
	HR 4096	Reynolds	10/20/2005	Passed House 12/7/2005; Placed on Senate Legislative Calendar 12/13/2005.
Legislative Activity 108th Congress	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 5505	Houghton	1/3/2003	Referred to the Ways & Means Committee
Eliminate Several Adjustments for Individual AMT National Taxpayer Advocate 2001 Annual Report to Congress 82-100.	Eliminate personal exemptions, the standard deduction, deductible state and local taxes, and miscellaneous itemized deductions as adjustment items for individual Alternative Minimum Tax purposes.			
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	S 1861	Harkin	10/7/2005	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 1939	Neal	5/12/2003	Referred to the Ways & Means Committee

Tax Preparation and Low Income Taxpayer Clinics				
Matching Grants for LITC for Return Preparation National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.	Create a grant program for return preparation similar to the Low Income Taxpayer Clinic (LITC) grant program. The program should be designed to avoid competition with VITA and should support the IRS' goal (and need) to have returns electronically filed.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614.
Legislative Activity 108th Congress	S 476	Grassley	2/27/2003	Referred to the Finance Committee
	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/an amendment - referred to Senate
	HR 3991	Houghton	3/19/2001	Referred to the Ways & Means Committee
	HR 7	Baucus	7/16/2002	Reported by Chairman Baucus, with an amendment referred to the Finance Committee
Regulation of Income Tax Return Preparers National Taxpayer Advocate 2002 Annual Report to Congress 216-230; National Taxpayer Advocate 2003 Annual Report to Congress 270-301.	Create an effective oversight and penalty regime for return preparers by taking the following steps: • Enact a registration, examination, certification, and enforcement program for federal tax return preparers; • Direct the Secretary of the Treasury to establish a joint task force to obtain accurate data about the composition of the return-preparer community and make recommendations about the most effective means to ensure accurate and professional return preparation and oversight; • Require the Secretary of the Treasury to study the impact cross-marketing tax preparation services with other consumer products and services has on the accuracy of returns and tax compliance; and • Require the IRS to take steps within its existing administrative authority, including requiring a checkbox on all returns in which preparers would enter their category of return preparer (*i.e.*, attorney, CPA, enrolled agent, or unenrolled preparer) and developing a simple, easy-to-read pamphlet for taxpayers that explains their protections.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee

	Bill Number	Sponsor	Date	Status
(Legislative Activity 109th Congress continued)	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee

Public Awareness Campaign on Registration Requirements National Taxpayer Advocate 2002 Annual Report to Congress 216-230.	Authorize the IRS to conduct a public information and consumer education campaign, utilizing paid advertising, to inform the public of the requirements that paid preparers must sign the return prepared for a fee and display registration cards.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614.
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee

Increase Preparer Penalties National Taxpayer Advocate 2003 Annual Report to Congress 270-301.	Strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006: Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)

	Bill Number	Sponsor	Date	Status
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Small Business Issues				
Health Insurance Deduction/ Self-Employed Individuals National Taxpayer Advocate 2001 Annual Report to Congress 223; National Taxpayer Advocate 2004 Annual Report to Congress 388-389.	Allow self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 663	Bingaman	3/17/2005	Referred to the Finance Committee
	S 3857	Smith	9/16/2006	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 741	Sanchez	2/12/2003	Referred to the Ways & Means Committee
	HR 1873	Manzullo Velazquez	4/30/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	S 2130	Bingaman	4/15/2002	Referred to the Finance Committee
Married Couples as Business Co-owners National Taxpayer Advocate 2002 Annual Report to Congress 172-184.	Amend IRC § 761(a) to allow a married couple operating a business as co-owners to elect out of subchapter K of the IRC and file one Schedule C (or Schedule F in the case of a farming business) and two Schedules SE if certain conditions apply.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/an amendment (5/19/2004)
	S 842	Kerry	4/9/2003	Referred to the Finance Committee
	HR 1640	Udall	4/3/2003	Referred to the Ways & Means Committee
	HR 1558	Doggett	4/2/2003	Referred to the Ways & Means Committee
Income Averaging for Commercial Fishermen National Taxpayer Advocate 2001Annual Report to Congress 226.	Amend IRC § 1301(a) to provide commercial fishermen the benefit of income averaging currently available to farmers			
Legislative Activity 108th Congress	Public L. No.: 108-357 § 314 (2004).			
Election to be treated as an S Corporation National Taxpayer Advocate 2004 Annual Report to Congress 390-393.	Amend IRC § 1362(a) to allow a small business corporation to elect to be treated as an S corporation no later than the date it timely files (including extensions) its first Form 1120S, U.S. Income Tax Return for an S Corporation.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee

Regulation of Payroll Tax Deposits Agents National Taxpayer Advocate 2004 Annual Report to Congress 394-399.	Require payroll services to meet certain qualifications to protect businesses that use payroll service providers from tax deposit fund misappropriation or fraud.			
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	S 3583	Snowe	6/27/2006	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Tax Gap Provisions				
Reporting on Customer's Basis in Security Transaction National Taxpayer Advocate 2005 Annual Report to Congress 433-441.	Require brokers to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated by a sale) on Form 1099-B.			
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	S 2414	Bayh	3/14/2006	Referred to the Finance Committee
	HR 5176	Emanuel	4/25/2006	Referred to the Ways & Means Committee
	HR 5367	Emanuel	5/11/2006	Referred to the Ways & Means Committee
IRS Promote Estimated Tax Payments Through EFTPS National Taxpayer Advocate 2005 Annual Report to Congress 381-396.	Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.			
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Study of Use of Voluntary Withholding Agreements National Taxpayer Advocate 2004 Annual Report to Congress 478-489; National Taxpayer Advocate 2005 Annual Report to Congress 381-396.	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholdings agreements between independent contractors and service-recipients as defined in IRC § 6041A(a)(1).			
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614

<table>
<tr><th colspan="5">Joint and Several Liability</th></tr>
<tr><td>Tax Court Review of Request for Equitable Innocent Spouse Relief
National Taxpayer Advocate 2001 Annual Report to Congress 128-165.</td><td colspan="4">Amend IRC § 6015(e) to clarify that taxpayers have the right to petition the Tax Court to challenge determinations in cases seeking relief under IRC § 6015(f) alone.</td></tr>
<tr><td>Legislative Activity 109th Congress</td><td colspan="4">Public L. No: 109-432, § 408 (2006)</td></tr>
<tr><th colspan="5">Collection Issues</th></tr>
<tr><td>Return of Levy or Sale Proceeds
National Taxpayer Advocate 2001 Annual Report to Congress 202-214.</td><td colspan="4">Amend IRC § 6343(b) to extend the period of time within which a third party can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. This amendment would also extend the period of time available to taxpayers under IRC § 6343(d) within which to request a return of levied funds or sale proceeds.</td></tr>
<tr><td></td><td>Bill Number</td><td>Sponsor</td><td>Date</td><td>Status</td></tr>
<tr><td rowspan="3">Legislative Activity 109th Congress</td><td>S 1321</td><td>Santorum</td><td>6/28/2005</td><td>9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336.
9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614</td></tr>
<tr><td>HR 1528</td><td>Portman</td><td>6/20/2003</td><td>Passed/agreed to in Senate, w/an amendment (5/19/2004)</td></tr>
<tr><td>HR 1661</td><td>Rangel</td><td>4/8/2003</td><td>Referred to the Ways & Means Committee</td></tr>
<tr><td rowspan="2">Legislative Activity 107th Congress</td><td>HR 3991</td><td>Houghton</td><td>3/19/2002</td><td>Defeated in House</td></tr>
<tr><td>HR 586</td><td>Lewis</td><td>2/13/2001</td><td>4/18/02 passed the House w/an amendment - referred to Senate</td></tr>
<tr><td>Reinstatement of Retirement Accounts
National Taxpayer Advocate 2001 Annual Report to Congress 202-214.</td><td colspan="4">Amend the following Internal Revenue Code sections to allow contributions to individual retirement accounts and other qualified plans from the funds returned to the taxpayer or to third parties under IRC § 6343:
• §401 – Qualified Pension, Profit Sharing, Keogh and Stock Bonus Plans
• §408 – Individual Retirement Account, SEP-Individual Retirement Account
• §408A – Roth Individual Retirement Account</td></tr>
<tr><td></td><td>Bill Number</td><td>Sponsor</td><td>Date</td><td>Status</td></tr>
<tr><td>Legislative Activity 109th Congress</td><td>S 1321</td><td>Santorum</td><td>6/28/2005</td><td>9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336.
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<tr><td rowspan="3">Legislative Activity 108th Congress</td><td>HR 1528</td><td>Portman</td><td>6/20/2003</td><td>Passed/agreed to in Senate, w/an amendment (5/19/2004)</td></tr>
<tr><td>HR 1661</td><td>Rangel</td><td>4/8/2003</td><td>Referred to the Ways & Means Committee</td></tr>
<tr><td>S 882</td><td>Baucus</td><td>4/10/2003</td><td>S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)</td></tr>
<tr><td rowspan="2">Legislative Activity 107th Congress</td><td>HR 586</td><td>Lewis</td><td>2/13/2001</td><td>4/18/02 passed the House w/ an amendment - referred to Senate</td></tr>
<tr><td>HR 3991</td><td>Houghton</td><td>3/19/2002</td><td>Defeated in House</td></tr>
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<tr><td>Consolidation of Appeals of Collection Due Process Determinations
National Taxpayer Advocate 2004 Annual Report to Congress 451-470.</td><td colspan="4">Consolidate judicial review of CDP hearings in the United States Tax Court, clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over CDP cases, and address the Tax Court's standard of review for the underlying liability in CDP cases.</td></tr>
<tr><td>Legislative Activity 109th Congress</td><td colspan="4">Pub. L. No. 109-280, § 855 (2006).</td></tr>
<tr><td>Partial Payment Installment Agreements
National Taxpayer Advocate 2001 Annual Report to Congress 210-214.</td><td colspan="4">Amend IRC § 6159 to allow the IRS to enter into installment agreements that do not provide for full payment of the tax liability over the statutory limitations period for collection of tax where it appears to be in the best interests of the taxpayer and the Service.</td></tr>
<tr><td>Legislative Activity 108th Congress</td><td colspan="4">Public L. No. 108-357, § 833 (2004).</td></tr>
<tr><td colspan="5">Penalties & Interest</td></tr>
<tr><td>Interest Rate and Failure to Pay Penalty
National Taxpayer Advocate 2001 Annual Report to Congress 179-182.</td><td colspan="4">Repeal the failure to pay penalty provisions of IRC § 6651 while revising IRC § 6621 to allow for a higher underpayment interest rate.</td></tr>
<tr><td rowspan="3">Legislative Activity 108th Congress</td><td>Bill Number</td><td>Sponsor</td><td>Date</td><td>Status</td></tr>
<tr><td>HR 1528</td><td>Portman</td><td>6/20/2003</td><td>Passed/agreed to in Senate, w/an amendment (5/19/2004)</td></tr>
<tr><td>HR 1661</td><td>Rangel</td><td>4/8/2003</td><td>Referred to the Ways & Means Committee</td></tr>
<tr><td>Interest Abatement on Erroneous Refunds
National Taxpayer Advocate 2001 Annual Report to Congress 183-187.</td><td colspan="4">Amend IRC § 6404(e)(2) to require the Secretary to abate the assessment of all interest on any erroneous refund under IRC § 6602 until the date the demand for repayment is made, unless the taxpayer (or a related party) has in any way caused such an erroneous refund. Further, the Secretary should have discretion not to abate any or all such interest where the Secretary can establish that the taxpayer had notice of the erroneous refund before the date of demand and the taxpayer did not attempt to resolve the issue with the IRS within 30 days of such notice.</td></tr>
<tr><td rowspan="2">Legislative Activity 109th Congress</td><td>Bill Number</td><td>Sponsor</td><td>Date</td><td>Status</td></tr>
<tr><td>HR 726</td><td>Sanchez</td><td>2/9/2005</td><td>Referred to the Ways & Means Committee</td></tr>
<tr><td rowspan="2">Legislative Activity 108th Congress</td><td>HR 1528</td><td>Portman</td><td>6/20/2003</td><td>Passed/agreed to in Senate, w/ an amendment (5/19/2004)</td></tr>
<tr><td>HR 1661</td><td>Rangel</td><td>4/8/2003</td><td>Referred to the Ways & Means Committee</td></tr>
<tr><td>First Time Penalty Waiver
National Taxpayer Advocate 2001 Annual Report to Congress 188-192.</td><td colspan="4">Authorize the IRS to provide penalty relief for first-time filers and taxpayers with excellent compliance histories who make reasonable attempts to comply with the tax rules.</td></tr>
<tr><td rowspan="3">Legislative Activity 108th Congress</td><td>Bill Number</td><td>Sponsor</td><td>Date</td><td>Status</td></tr>
<tr><td>HR 1528</td><td>Portman</td><td>6/20/2003</td><td>Passed/agreed to in Senate, w/ an amendment (5/19/2004)</td></tr>
<tr><td>HR 1661</td><td>Rangel</td><td>4/8/2003</td><td>Referred to the Ways & Means Committee</td></tr>
<tr><td rowspan="2">Legislative Activity 107th Congress</td><td>HR 1528</td><td>Houghton</td><td></td><td>Introduced in the House</td></tr>
<tr><td>HR 3991</td><td>Houghton</td><td>3/19/2002</td><td>Defeated in House</td></tr>
<tr><td>Federal Tax Deposit (FTD) Avoidance Penalty
National Taxpayer Advocate 2001 Annual Report to Congress 222.</td><td colspan="4">Reduce the maximum Federal Tax Deposit penalty rate from ten to two percent for taxpayers who make deposits on time but not in the manner prescribed in the Code.</td></tr>
</table>

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
	Bill Number	Sponsor	Date	Status
Legislative Activity 108h Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	Defeated in House

Family Issues				
Uniform Definition of a Qualifying Child National Taxpayer Advocate 2001 Annual Report to Congress 78-100.	Create a uniform definition of "qualifying child" applicable to tax provisions relating to children and family status.			
Legislative Activity 108th Congress	Public L. No. 108-311, § 201 (2004).			
Means Tested Public Assistance Benefits National Taxpayer Advocate 2001 Annual Report to Congress 76-127.	Amend the IRC §§ 152, 2(b), and 7703(b) to provide that means-tested public benefits are excluded from the computation of support in determining whether a taxpayer is entitled to claim the dependency exemption and from the cost of maintenance test for the purpose of head-of-household filing status or "not married" status.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Credits for the Elderly or the Permanently Disabled National Taxpayer Advocate 2001 Annual Report to Congress 218-219.	Amending IRC § 22 to adjust the income threshold amount for past inflation and provide for future indexing for inflation.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 107th Congress	S 2131	Bingaman	4/15/2002	Referred to the Finance Committee

Electronic Filing Issues	
Direct Filing Portal National Taxpayer Advocate 2004 Annual Report to Congress 471-477.	Amend IRC §6011(f) to require the IRS to post fill-in forms on its website and make electronic filing free to all individual taxpayers.

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614

Office of the National Taxpayer Advocate

Confidentiality of Taxpayer Communications National Taxpayer Advocate 2002 Annual Report to Congress 198-215.	Strengthen the independence of the National Taxpayer Advocate and the Office of the Taxpayer Advocate by amending IRC §§ 7803(c)(3) and 7811. Amend IRC § 7803(c)(4)(A)(iv) to clarify that, notwithstanding any other provision of the Internal Revenue Code, Local Taxpayer Advocates have the discretion to withhold from the Internal Revenue Service the fact that a taxpayer contacted the Taxpayer Advocate Service (TAS) or any information provided by a taxpayer to TAS.

	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee

Access to Independent Legal Counsel National Taxpayer Advocate 2002 Annual Report to Congress 198-215.	Amend IRC § 7803(c)(3) to provide for the position of Counsel to the National Taxpayer Advocate, who shall advise the National Taxpayer Advocate on matters pertaining to taxpayer rights, tax administration, and the Office of Taxpayer Advocate, including commenting on rules, regulations, and significant procedures, and the preparation of amicus briefs.

	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee

Other Issues

Disclosure Regarding Suicide Threats National Taxpayer Advocate 2001Annual Report to Congress 227.	Amend IRC § 6103(i)(3)(B) to allow the IRS to contact and provide necessary return information to specified local law enforcement agencies and local suicide prevention authorities, in addition to federal and state law enforcement agencies in situations involving danger of death or physical injury.

	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee

Attorney Fees National Taxpayer Advocate 2002 Annual Report to Congress 161-171.	Allow successful plaintiffs in nonphysical personal injury cases who must include legal fees in gross income to deduct the fees "above the line." Thus, the net tax effect would not vary depending on the state in which a plaintiff resides.
Legislative Activity 108th Congress	Public Law 108-357, § 703 (2004).
Attainment of Age Definition National Taxpayer Advocate 2003 Annual Report to Congress 308-311.	Amend IRC § 7701 by adding a new subsection as follows: "Attainment of Age. An individual attains the next age on the anniversary of his date of birth."

	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 4841	Burns	7/15/2004	7/21/04 Passed House – 7/22/04 Received in the Senate
Home-based Service Workers National Taxpayer Advocate 2001 Annual Report to Congress 193-201.	Amend IRC § 3121(d) to clarify that home-based service workers (HBWs) are employees rather than independent contractors.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 107th Congress	S 2129	Bingaman	4/15/2002	Referred to the Finance Committee

RECOMMENDATION

#1 REVISING CONGRESSIONAL BUDGET PROCEDURES TO IMPROVE IRS FUNDING DECISIONS

PROBLEM

The Internal Revenue Service is the Accounts Receivable Department of the United States Government. On a budget of about $10.6 billion,[1] the IRS currently collects about $2.24 trillion a year.[2] That translates to an average return-on-investment (ROI) of about 210:1.[3]

Rather than recognizing the IRS's unique role as the revenue generator for the federal government, however, the congressional budget rules treat spending for the IRS exactly the same way they treat spending for all other federal agencies.

The current budget procedures work essentially as follows: Early each year, a spending ceiling is established for a category of programs that currently includes the Department of Transportation, the Department of the Treasury (of which the IRS is a part), the Department of Housing and Urban Development, the Judiciary, the District of Columbia, and independent federal agencies. The House and Senate Appropriations subcommittees with jurisdiction over this grouping of federal programs then must apportion the total number of dollars it receives among them. If more funding is provided for transportation programs, for example, less funding is available for the IRS. Thus, the IRS competes dollar-for-dollar against many other federal programs for resources.

These procedures make little sense. The IRS collects about 98 percent of all revenue the federal government receives.[4] The more revenue the IRS collects, the more revenue Congress may spend on other programs or may use to cut taxes or reduce the deficit. The less revenue the IRS collects, the less revenue Congress has available for other purposes.

If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line.

1 Department of the Treasury, *FY 2007 Budget in Brief* at 59.

2 Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006). The IRS actually collected $2.51 trillion on a gross basis in FY 2006, but issued $277 billion in tax refunds.

3 When collecting tax from the vast majority of taxpayers who file returns and pay all or substantially all of the tax they owe voluntarily, the cost the IRS incurs per taxpayer is very low. As the IRS attempts to collect tax from noncompliant taxpayers through broader outreach efforts or through examination and collection actions, the cost per taxpayer rises substantially. Therefore, the *marginal* ROI the IRS achieves as it attempts to collect unpaid taxes is likely to be considerably lower than the average ROI of 210:1 that the IRS achieves on taxes paid voluntarily. But if the IRS were given more resources, most data indicate that the IRS could generate a substantially positive marginal ROI.

4 In FY 2006, the IRS collected $2.237 trillion. Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 95 (Nov. 2006). Total federal receipts for FY 2006 were projected to be $2.285 trillion. Office of Management and *Budget, Budget of the United States Government Fiscal Year 2007, Historical Tables* at 30 (table 2.1).

Since the IRS is not a private company, maximizing the bottom line is not – in and of itself – an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. If the IRS were given more resources, studies show the IRS could collect substantially more revenue.

Former IRS Commissioner Charles Rossotti has written:

> When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of the job, by far, was dealing with the IRS budget. The reaction was usually "Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn't you be able to get it?"[5]

Yet obtaining a little extra money to bring in a lot of extra money remains an intractable challenge for the IRS. Over the past few years, Congress has focused increasing attention on the "tax gap" – the difference between taxes owed and taxes paid. As part of this discussion, it should be recognized that the IRS currently suffers from a "resources gap," and the IRS's lack of resources is a significant impediment to its ability to help close the tax gap and thereby reduce the federal budget deficit.[6]

Finally, leaving aside the fiscal implications of the tax gap, the National Taxpayer Advocate believes that the size of the tax gap raises important equity concerns. Compliant taxpayers pay a great deal of money each year to subsidize noncompliance by others. Using data from the 2001 National Research Program study: Dividing the estimated 2001 net tax gap of $290 billion[7] by the estimated 108,209,000 households that existed in the United States in that year[8] shows that each household was effectively assessed an

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[5] Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 278 (2005). On pages 278-286, Mr. Rossotti presents an interesting personal perspective on the budget process and the politics behind the chronic under-funding of the IRS.

[6] The chairman and ranking member of the Senate Budget Committee supported additional funding for the IRS in the FY 2007 budget resolution. Senator Judd Gregg acknowledged that the existing budget procedures have the effect of shortchanging the IRS. He said: "We've got to talk to the [Congressional Budget Office] about scoring on [additional funding provided to IRS]. Clearly there's a return on that money." Dustin Stamper, *Everson Pledges to Narrow Growing Tax Gap,* 110 Tax Notes 807 (Feb. 20, 2006). Similarly, Senator Kent Conrad stated: "Rather than a tax increase, I think the first place we ought to look … is the tax gap. If we could collect this money, we'd virtually eliminate the deficit." Emily Dagostino, *Senate Budget Resolution Would Increase IRS Enforcement Funding,* 110 Tax Notes 1129 (Mar. 13, 2006).

[7] *See* IRS News Release 2006-28, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts). The National Research Program study estimated that the "gross tax gap" was about $345 billion and the "net tax gap" (*i.e.,* the gross tax gap reduced by late payments and amounts collected as a result of IRS enforcement actions) was about $290 billion.

[8] U.S. Census Bureau, Population Division (data as of March 2001).

average "surtax" of about $2,680 to subsidize noncompliance.[9] That is not a burden we should expect our nation's taxpayers to bear lightly.[10]

EXAMPLES

Example 1: IRS Under-funding Leaves Billions of Dollars on the Table

In his final report to the IRS Oversight Board in 2002, former Commissioner Rossotti presented a discussion titled "Winning the Battle but Losing the War" that detailed the consequences of the lack of adequate funding for the IRS. He identified 11 specific areas in which the IRS lacked resources to do its job, including taxpayer service, collection of known tax debts, identification and collection of tax from non-filers, identification and collection of tax from underreported income, and noncompliance in the tax-exempt sector.

Commissioner Rossotti provided estimates of the revenue cost in each of the 11 areas based on IRS research data. In the aggregate, the data indicated that the IRS was failing to collect $29.9 billion each year and that it would have taken an additional $2.2 billion in resources to collect those additional tax liabilities.

Example 2: IRS Under-funding Gave Rise to Outsourcing Tax Collection

In the same report, former Commissioner Rossotti reported the IRS was receiving sufficient resources to work only 40 percent of some 4.5 million accounts receivable cases each year. IRS research estimated that with an additional $296.4 million, the agency could collect $9.47 billion.[11] That translates to a return on investment of 32:1. Among collection cases handled solely through phone calls, the IRS has estimated an ROI of about 13:1.[12]

Yet Congress has not provided the IRS with sufficient funding to work these accounts. This lack of funding led the Administration to request authority to outsource the collection of certain tax debts to private collection agencies. Congress granted the requested authority in 2004,[13] and the IRS began to send cases to private debt collectors in September of 2006.

[9] The IRS's most current estimate of the tax gap is based primarily on audits it conducted on tax returns filed for 2001.

[10] Significantly, the IRS Oversight Board reports there is substantial public support for an enhanced IRS compliance program provided that it is balanced. The Oversight Board conducts an annual survey of taxpayer attitudes and found that two-thirds of taxpayers support additional funding for both IRS assistance and enforcement. *See* IRS Oversight Board, *2005 Taxpayer Attitude Survey*.

[11] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002).

[12] Government Accountability Office, GAO-06-1000T, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches,* at 17 (July 26, 2006).

[13] Pub. L. No. 108-357, § 881(a)(1) (enacting IRC § 6306).

Under the terms of the program, the IRS is paying out commissions of nearly 25 percent of each dollar collected to the private collection agencies. The IRS is also bearing significant additional costs to create, maintain, and oversee the program.[14]

While the ROI of using private collectors is impossible to quantify with precision, internal IRS estimates show that the IRS, if given the funding, could generate a substantially higher ROI than private contractors receiving commissions of nearly 25 percent can produce. For each dollar a PCA collects, the IRS will receive about 75 cents and the PCA will keep about 25 cents, resulting in an ROI of, at best, 3:1. The significant administrative costs the IRS is incurring to run the program, including the opportunity costs of pulling experienced IRS personnel off higher dollar work to assist with this initiative, reduce the ROI further. Despite supporting the use of private debt collectors because of IRS resource limitations, IRS Commissioner Mark Everson has repeatedly acknowledged that IRS employees could collect unpaid taxes more cheaply and efficiently.[15]

The result of under-funding the IRS in this area is that the government is not maximizing its revenue collection and the risk of taxpayer rights violations has been heightened due to the use as collectors of non-governmental employees who will receive only limited taxpayer-rights training.[16]

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations:

1. Congress should consider revising its budget rules in a manner that allows the budget and appropriations committees to make a judgment about the answer to the question: "What level of funding will maximize tax compliance, particularly voluntarily compliance, with our nation's tax laws, with due regard for protecting taxpayer rights and minimizing taxpayer burden?" and then set the IRS funding level accordingly, without regard to spending caps.
2. In allocating IRS resources, Congress should keep in mind that tax compliance is a function of both high quality taxpayer service and effective tax-law enforcement, and it is essential that the IRS continue to maintain a balanced approach to improving tax compliance. Previous attempts to give the IRS

[14] For a detailed discussion of the private debt collection program, see Most Serious Problem, *True Costs and Benefits of Private Debt Collection, supra.*

[15] *See, e.g.,* Dustin Stamper, *Everson Admits Private Debt Collection Costs More, Defends Return Disclosure Regs,* 111 Tax Notes 11 (Apr. 3, 2006).

[16] Senator Max Baucus recently highlighted another example of the counterproductive impact of shortchanging IRS funding. In FY 2006, Congress imposed a one-percent across-the-board funding rescission on domestic discretionary spending, and the IRS absorbed a reduction of about $100 million as a consequence. Citing GAO data, Senator Baucus estimated that the $100 million in "savings" would ultimately cost the U.S. Treasury about $1 billion in lost tax collections. He stated: "[E]ven small reductions in collection and taxpayer services are penny-wise, pound-foolish. Sparing the IRS budget may be the best way to bring in more owed revenue and end deficit spending." News Release, Senator Max Baucus, *$100 Million Budget Cut to IRS May Cost $1 Billion or More in 2006 Tax Collections* (May 22, 2006).

additional funding beyond the levels provided under the spending caps have focused exclusively on providing additional funding for enforcement activities. That is probably because the *direct* ROI resulting from enforcement actions is most susceptible to measurement. However, it is important to emphasize that direct enforcement revenue in FY 2006 came to only $48.7 billion, or 2 percent, of total IRS tax collections of $2.24 trillion.[17] The remaining 98 percent of IRS tax collections resulted from a combination of taxpayer service programs and the *indirect* (*i.e.*, deterrent) effect of IRS enforcement actions. To increase compliance, the IRS should make improvements in both taxpayer service and enforcement – and in the technology needed to support them.

3. Congress should provide increases in IRS personnel funding at a steady but gradual pace, perhaps two percent to three percent a year above inflation. We do not think the IRS can ramp up its staffing more quickly without encountering significant transitional difficulties. However, Congress should consider providing more rapid funding increases for technology and research improvements, as the transitional challenges of absorbing additional resources are probably less significant in these areas and the potential exists to generate substantial productivity gains.
4. To assist Congress in performing its oversight responsibilities and determining the appropriate IRS funding level in future years, Congress should require the IRS to provide annual or semiannual reports detailing the IRS's progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would require to perform the additional work, and the likely return-on-investment of performing that work. In this connection, Congress should consider directing the IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its ROI estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions, including the downstream costs of such work. Improved methods should also be developed to verify, retrospectively, the *marginal* ROI that the IRS has achieved for each category of work.

[17] In FY 2006, IRS enforcement activities (collection actions, examinations, and document matching) resulted in the direct collection of $48.7 billion. Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006). Total tax collection by the IRS, after the issuance of tax refunds, was $2.24 trillion. Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 95 (Nov. 2006).

PRESENT LAW[18]

For each fiscal year, the Executive Branch develops a detailed budget proposal that the President transmits to Congress. Congress then analyzes the President's proposal, holds hearings, and develops a budget resolution that reflects its priorities.

Like most federal agencies, the IRS begins to prepare its budget request in earnest roughly two years before the beginning of the fiscal year for which it would take effect. The IRS request is subject to review and approval by the IRS Oversight Board and is then submitted to the Secretary of the Treasury for consideration.[19] The Treasury Department has the authority to modify the IRS budget request as it deems appropriate, and it then submits a budget request for the full Treasury Department, including the IRS, to the Office of Management and Budget (OMB) for its consideration. OMB receives and modifies budget requests from all departments and agencies and ultimately prepares a comprehensive government-wide budget proposal that the President submits to Congress no later than the first Monday in February.

After receiving and studying the President's budget proposal, Congress begins developing a budget for the upcoming fiscal year, which begins on October 1st. The Congressional Budget and Impoundment Control Act of 1974, as amended (the "Budget Act"), provides the blueprint for today's congressional budget process.[20] The Budget Act created the House and Senate Budget Committees and requires them to develop a budget resolution each year setting forth budgetary levels for the upcoming fiscal year and planning levels for at least the four succeeding years. Among other things, the budget resolution sets out an aggregate spending total and a breakdown of that total by committee with jurisdiction over the spending.

Federal spending is generally classified as either "mandatory" or "discretionary." Mandatory spending refers to outlays that are required by criteria established in legislation within the jurisdiction of the authorizing committees, rather than by action of the appropriations committees. Examples include Social Security and Medicare benefits, veterans' benefits, and interest paid on the public debt. Discretionary spending refers to all other spending and is determined annually by the appropriations committees.

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[18] The description of present law is drawn largely from a report prepared by the staff of the Senate Budget Committee. *See* Staff of the Senate Comm. On the Budget, 105th Cong., *The Congressional Budget Process* (Comm. Print 1998).

[19] See IRC § 7802(d)(4), which provides that the IRS Oversight Board shall have the responsibility "[t]o (A) review and approve the budget request of the Internal Revenue Service prepared by the Commissioner; (B) submit such budget request to the Secretary of the Treasury; and (C) ensure that the budget request supports the annual and long-range strategic plans [of the IRS]."

[20] Pub. L. No. 93-344, 88 Stat. 297 (1974), as amended.

Section 302(a)(2) of the Budget Act requires the budget resolution to allocate levels of budget authority and outlays to each committee.[21] All discretionary outlays are allocated to the Appropriations Committee, and section 302(b) of the Budget Act requires the Appropriations Committee to sub-allocate its allocation among its subcommittees. Thus, as a practical matter, each Appropriations subcommittee competes against every other Appropriations subcommittee for dollars.

Once a subcommittee obtains its § 302(b) sub-allocation, it generally has the authority to apportion its funding as it sees fit among the programs within its jurisdiction. IRS spending falls under the jurisdiction of the subcommittee with responsibility for the budgets of the Department of Transportation, the Department of the Treasury (which includes the IRS), the Department of Housing and Urban Development (HUD), the Judiciary, the District of Columbia, and independent agencies. Colloquially, this is referred to as the "TTHUD subcommittee," and the bill the subcommittee produces is referred to as the "TTHUD appropriation." Thus, as a practical matter, a second level of competition occurs at this level, as each Federal agency is essentially pitted for dollars against the other agencies within the Appropriations subcommittee's jurisdiction.

The appropriations ceiling of the TTHUD subcommittee is not affected by the revenue the IRS collects as a result of its appropriated funds. In FY 2006, the overall TTHUD appropriation was $88.2 billion.[22]

REASONS FOR CHANGE

Spending caps were instituted in 1990 to help control federal spending at a time when Congress became concerned that the budget deficit was spiraling out of control.[23] Significantly, the caps appear to have been imposed with classic spending programs in mind.

The IRS, however, is not a classic spending program. Because the IRS produces a substantially positive return on the funding it receives, more funding for the IRS, within reasonable limits, should produce the opposite effect of more funding for most programs – more resources for the IRS should *reduce* the federal deficit.

Moreover, as a practical matter, the IRS does not fare well in a competition for dollars against true spending programs. Where federal funding for local transportation programs or HUD grants are at stake, for example, state and local governments, private businesses, and advocacy groups will advocate forcefully for their interests, and

[21] The term "budget authority" refers to the authority Congress grants to government agencies to enable them to enter into obligations that will result in outlays. The term "outlays" refers to disbursements made by the U.S. Treasury in the form of checks or cash.

[22] *See* H.R. Conf. Rep. No. 109-307 (2005) (setting FY 2006 TTHUD appropriation at $89,135,149,000); Pub. L. No. 109-148, Title III, chap. 8, § 3801 (imposing an across-the-board rescission of one percent against domestic discretionary spending, including the TTHUD appropriation).

[23] Omnibus Budget Reconciliation Act of 1990, Title XIII (Budget Enforcement Act), Pub. L. No. 101-508, 104 Stat. 1388 (1990).

Members of Congress will try to deliver funding for their constituents. By contrast, few outside interests advocate forcefully for more IRS funding. Thus, the nature of the process for allocating dollars between the IRS and other programs under the jurisdiction of the TTHUD Appropriations subcommittee operates to shortchange IRS funding levels.[24]

In light of the IRS's unique role as the government's revenue generator, we believe IRS funding decisions should stand on their own and not be subject to the general spending caps.

EXPLANATION OF RECOMMENDATIONS

In this section, we will explain each of the recommendations listed above in more detail.

Recommendation #1: Revise Process for Making IRS Funding Decisions

In light of the IRS's unique role as the accounts receivable department of the federal government, we recommend that Congress amend the budget rules so that it can first make a judgment about what funding level will maximize federal tax compliance and then fund the IRS at that level, without regard to other budget decisions. In making its judgment about the appropriate IRS funding level, due consideration should be given to protecting taxpayer rights, minimizing taxpayer burden, and preserving principles of equity.

One way to implement this approach would be to keep the IRS within the TTHUD appropriation bill but break that bill into two parts – one providing a funding cap for the IRS and one providing a funding cap for all other programs. The budget committees would set the funding cap for the IRS.[25] The appropriations committees then would retain discretion to appropriate funds at the cap or at a lesser level and to provide direction concerning how the funds are to be spent. The rules should explicitly authorize the committees to set the cap at a level that they believe will maximize tax compliance, especially voluntary compliance, with due regard for the protection of taxpayer rights and minimization of taxpayer burden. In setting the cap and making funding decisions, the budget and appropriations committees would consider the President's budget request as well as input from the tax-writing committees, the Congressional Budget Office (CBO), the Joint Committee on Taxation, the Government Accountability Office, the Congressional Research Service and any other office that they choose to consult to obtain revenue estimates and guidance concerning the likely return on IRS spending.

We offer this approach only as an illustration of a way to implement the general principle we are recommending. We do not have sufficient expertise in the congressional budget process to craft a comprehensive solution, and we are cognizant of the important

[24] *See* Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 282 (2005) (noting bluntly that "[t]he IRS has no supporters lobbying members of Congress, contributing to political action committees, or knocking on doorbells before elections.").

[25] Two caps would have to be established for total appropriations – one for the IRS and one for all other discretionary spending.

roles that the budget committees, the appropriations committees, and the tax-writing committees play. Our overriding recommendation is simply that the committees of jurisdiction collaborate to devise and implement procedures that reflect the general principles we have outlined.

We note that in each of the past two years, the Administration proposed a contingent budgetary mechanism known as a "program integrity cap" in an attempt to provide the IRS with additional funding. Under this mechanism, additional funding for tax-law enforcement would have been provided if, but only if, Congress agreed to fund at least the existing base of enforcement activities. The Senate endorsed the concept, but the House did not go along. Although there may have been subtle differences in detail, a similar approach was used in FY 1995 to give the IRS additional funding.[26] Because the budget and appropriations committees have become familiar with this mechanism, it may be a viable to way to channel additional funding to the IRS.

However, we have two concerns about the use of program integrity caps. First, the mechanism operates simply to mitigate the effects of what we are arguing is a flawed

[26] For FY 1995, the congressional budget resolution provided for an adjustment of budget resolution spending levels to allow additional funding for an "Internal Revenue Service Compliance Initiative." H. Con. Res. 218, 103rd Cong. § 25 (1994) (enacted). The provision authorized an adjustment to reflect amounts of additional new budget authority or additional outlays of up to $405 million per year provided certain conditions were met. Although there is no indication the initiative failed or generated strong opposition, control of Congress changed the next year and the provision was repealed for subsequent years. H. Con. Res. 67, 104th Cong. § 209 (1995) (enacted). The joint explanatory statement accompanying the conference report on the FY 1995 budget resolution provision (which originated as Section 54 of the Senate amendment to the House-passed budget resolution) provided additional information about the specifics of the approach:

> Section 54 of the Senate amendment allows for additional appropriations for an Internal Revenue Service Compliance initiative. If the Congress appropriates the base amounts requested for the Internal Revenue Service in the President's budget for fiscal year 1995 and a variety of other conditions are met, then Congress can also appropriate additional amounts for a compliance initiative without triggering points of order that might otherwise lie against such legislation.
>
> Under sections 54(a) and 54(b) of the Senate amendment, upon the reporting of an appropriation bill funding the compliance initiative and the satisfaction of the conditions listed, the Chairman of the appropriate Budget Committee must file revised appropriations caps, allocations to the Appropriations Committee, functional levels, and aggregates to clear the way for the incremental spending for the initiative. This procedure parallels that used in reserve funds … , which allow deficit-neutral legislation to proceed without points of order even if that legislation pays for direct spending with revenues. Similarly, section 54 of the Senate amendment allows appropriations legislation to proceed without points of order if it is demonstrated that the revenues raised by those appropriations would offset the costs of the appropriations.
>
> The first parenthetical language in the matter after subsection (a)(3) establishes the first condition precedent, that the Congress appropriate the base amounts requested for the Internal Revenue Service in the President's Budget for fiscal year 1995. Subsection (d) lists the other conditions: enactment of a Taxpayer Bill of Rights 2, initiation of an Internal Revenue Service educational program as mandated by the Taxpayer Bill of Rights 1 and 2, a finding by the Congressional Budget Office that by virtue of revenues raised, the appropriations will not increase the deficit, and a restriction of funds made available pursuant to this authority to carrying out Internal Revenue Service compliance initiative activities.
>
> The House resolution contains no such provision.
>
> The conference agreement contains as section 25 a provision similar to that in Section 54 of the Senate amendment. In particular, section 25(a)(2) of the conference agreement more explicitly spells out the condition precedent that Congress first appropriate the base amounts requested for the Internal Revenue Service in the President's Budget for fiscal year 1995 before the provisions of this section apply. Similarly, the conference agreement revises subsection (d), which sets forth the other conditions precedent.

H.R. Conf. Rep. No. 103-490 at 58 (1994).

conceptual approach to funding the IRS. It would not alter the existing framework under which the IRS competes for funding against other government programs, and it would not explicitly peg future IRS funding decisions to the goal of maximizing tax compliance. Second, the mechanism in the past has been proposed solely to boost enforcement spending (*i.e.,* the additional funding could be used only for tax-law enforcement and would only be provided if Congress agreed to fund at least the existing base of enforcement activities). As discussed below in more detail, tax compliance is a function not only of enforcement but also of taxpayer service, and it is important to maintain a balanced approach between the two. If program integrity caps are used in the future, we urge that consideration be given to providing additional funding for taxpayer service as well as enforcement.

Recommendation #2: Maintain a Balanced Approach to Tax Compliance That Emphasizes the Central Role of Taxpayer Service Programs as Well as Enforcement Actions

In FY 2006, IRS enforcement activities (which include collection actions, examinations, and document matching) resulted in the direct collection of $48.7 billion. The IRS has cited this figure, a modest increase over direct revenue collected in the prior year, as a measure of its progress in improving tax compliance.

As noted above, however, direct enforcement revenue constituted only about 2 percent of the $2.24 trillion the IRS collected in FY 2006.[27] Fully 98 percent of IRS collections resulted from the IRS's taxpayer service programs and the *indirect* deterrent effects of its enforcement actions.[28]

When it comes to tax compliance, taxpayer service represents the carrot and enforcement represents the stick. Both play critical roles.[29] Indeed, the IRS's five-year strategic plan is based on the formula: "Service + Enforcement = Compliance."[30] The IRS views service as helping taxpayers to understand their tax obligations through such activities

[27] In FY 2006, IRS enforcement activities (collection actions, examinations, and document matching) resulted in the direct collection of $48.7 billion. Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006). Total tax collection by the IRS, after the issuance of tax refunds, was $2.24 trillion. Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006).

[28] IRS enforcement actions have two indirect deterrent effects – one on other taxpayers and one on the future compliance of the taxpayer against whom enforcement action was taken. First, as word of tax enforcement actions against some taxpayers spreads, other taxpayers realize there is a risk that noncompliance on their part will be detected, and that realization makes them more likely to comply. Second, once a taxpayer has faced enforcement action in one year, the taxpayer himself is more likely to comply in future years.

[29] In 1996, for example, IRS researchers estimated that every dollar the IRS spent on return preparation generated $396 of additional tax revenue. *See* Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996). *See* Most Serious Problem: *Small Business Outreach, supra*; Most Serious Problem: *Limited English Proficient (LEP) Taxpayers: Language and Cultural Barriers to Tax Compliance, supra*; Most Serious Problem: *Reasonable Accommodations for Taxpayers with Disabilities, supra.*

[30] *See IRS Strategic Plan 2005-2009*. In the Preface to this report, the National Taxpayer Advocate discusses an alternative way to view IRS programs based on taxpayer behavior.

as publicizing the requirement to file tax returns and pay taxes, publishing tax forms and explanatory guidance, answering taxpayers' tax-law questions and even preparing tax returns, and assisting taxpayers who need other help in complying.[31] The IRS views enforcement as including such activities as verifying compliance on the part of taxpayers, reaching determinations about a taxpayer's correct tax liability if different from what the taxpayer reported, litigating against taxpayers where disputed issues arise, and taking actions to collect unpaid tax.

With additional funding, the IRS can do more through taxpayer service to improve compliance. For example, many small businesses are started by individuals who lack detailed knowledge of the tax laws and do not have the resources to hire tax attorneys or accountants. When they hire a few workers, they often do not realize that they are assuming tax reporting, tax withholding, and tax payment obligations, and they often do not understand enough about the details of complying with the requirements to do so with reasonable effort.

Another example: The largest chunk of the tax gap is attributable to income underreporting. Consideration should be given to the possible benefits of launching an advertising campaign each tax season that links the payment of taxes with civic duty and emphasizes our shared responsibility for supporting our nation's important services and benefits. If done well, such a campaign could change attitudes toward the tax system. Even if a public campaign only reduced underreporting by two or three percent, the dollars involved could translate to a significant return on investment. Moreover, if this campaign were incorporated into secondary education civics and business administration lessons, we could help future taxpayers understand the importance of compliance with tax obligations.

An analysis of IRS enforcement data illustrates both the lack of adequate enforcement resources and the payoff of closing as much of the tax gap as possible through improved taxpayer service. The IRS examination rate is currently less than one percent, and the majority of examinations are limited-scope examinations conducted by mail.[32] Traditional face-to-face audits occur at a rate of only 0.023 percent, or about one out of every 435 taxpayers.[33] Even if the IRS were somehow able to double the examination rate, more than 98 percent of taxpayers would not be examined each year and only about one out of every 217 taxpayers would be subject to a face-to-face audit.

[31] Former Commissioner Rossotti has written:

> Some critics argue that the IRS should solve its budget problem by reallocating resources from customer support to enforcement. In the IRS, customer support means answering letters, phone calls, and visits from taxpayers who are trying to pay the taxes they owe. Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money.

Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

[32] Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006).

[33] *Id.*

In short, many aspects of taxpayer service are akin to a wholesale operation that reaches groups of taxpayers (*e.g.*, outreach and education), while IRS audits constitute a far more costly retail operation that requires individual taxpayer contact. Thus, the IRS should pursue a balanced approach to tax compliance that puts priority emphasis on improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.[34]

Recommendation #3: Provide Steady But Gradual Increases in IRS Funding

In former Commissioner Charles Rossotti's final report to the IRS Oversight Board in 2002, he described the serious total staffing shortages the IRS was facing. He stated that the IRS needed "steady growth in staff in the range of 2 percent per year."[35] The context shows he was discussing real increases (*i.e.*, increases above those required to maintain current services).

At first blush, real annual staff growth of two percent might appear to be an extremely limited request, but the IRS faces significant challenges in adding and training staff. Examination and collection procedures, in particular, are complex, as is the underlying tax law, and experienced personnel must be pulled off revenue-producing priority cases to provide extensive training to new hires. Moreover, new hires generally have lower productivity rates and require significantly closer supervision than experienced employees to ensure they do not take incorrect actions, including actions that impair or violate taxpayer rights.

However, the IRS probably can absorb more rapid funding increases in technology and research, both of which have the potential to increase IRS productivity substantially.

Better technology would allow the IRS to achieve significant efficiencies in a broad range of taxpayer service and enforcement areas. For example, it would allow the IRS to offer taxpayers a wider range of e-filing options to increase the number of taxpayers who file their returns electronically rather than on paper (which would save IRS the cost of manually entering data from the roughly 64 million individual income tax returns it received on paper last year),[36] and it would allow the IRS to expand its document-matching capabilities, which tend to produce high returns on investment because automated processes are relatively inexpensive to operate and maintain.

[34] For research purposes, we believe it is important to study inadvertent errors as well as deliberate misreporting. Knowledge about inadvertent errors can be used to clarify ambiguous laws or administrative guidance both to help increase future compliance and to better apply IRS outreach, education, and other voluntary compliance initiatives.

[35] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 18 (Sept. 2002).

[36] Internal Revenue Service Data Book: 2005, table 3 (showing total number of individual income tax returns filed in FY 2005 was 132,844,632) and table 4 (showing total number of individual income tax returns filed electronically in FY 2005 was 68,476,328). The total number of individual income tax returns filed on paper in FY 2005 – 64,368,304 – is the difference between these numbers.

Better research would allow the IRS to assess the most cost effective ways of meeting taxpayer service needs and to target its limited enforcement resources to maximize its return on investment. We discuss the importance of obtaining more accurate ROI estimates for the IRS's major categories of work under Recommendation #4 below.

In the past, congressional support for additional IRS funding has come in fits and starts. It will not be helpful to provide too much additional funding immediately. It also will not be helpful to provide additional funding for a year or two and then to change direction. To maximize its ability to do its job, the IRS needs to receive gradual but steady real increases in its total funding every year for at least the next five to ten years.

Recommendation #4: Direct the IRS to Improve the Accuracy of Its ROI Estimates and Report to Congress Annually or Semiannually on Its Progress

To assist Congress in performing its oversight responsibilities and determining the appropriate IRS funding level in future years, Congress should require the IRS to provide annual or semiannual reports detailing the IRS's progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would need to perform the additional work, and the likely return-on-investment of performing that work. Much of this information was published in former Commissioner Rossotti's final report to the IRS Oversight Board,[37] but we have not seen updated statistics published in this format since that time.

To provide Congress with meaningful information, the IRS will need to conduct more research to improve the accuracy of its ROI calculations. As we have noted above, direct enforcement revenue constitutes only about two percent of the revenue the IRS collects. Ninety-eight percent of the revenue the IRS collects derives from its taxpayer service programs and the indirect deterrent effect of its enforcement activities. Yet the IRS currently does not have adequate data on which to make accurate estimates of the ROI of its various categories of work, including taxpayer service programs and the indirect effect of its enforcement activities as a whole and broken down by their key components. Developing better data should be made a priority objective. Moreover, ROI estimates should include costs relating to the downstream consequences – such as increased phone calls or correspondence, Appeals conferences, and Taxpayer Advocate Service cases – of the various categories of IRS work.

We acknowledge that developing reasonably accurate modeling is a significant challenge and will require a commitment of resources. Nonetheless, we have recommended in the past and continue to believe that this information will more than pay for itself by

[37] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002).

helping the IRS make better resource allocation decisions and will provide Members of Congress with additional information on which to base future funding decisions.[38]

Possible Concerns About This Proposal

In talking with congressional staff and others when formulating this proposal, a number of helpful questions and concerns emerged. We list and attempt to address some of the more significant ones.

Concern #1: ***The Congressional Budget Office cannot accurately quantify the return on investment associated with most IRS expenditures. How can Congress be expected to set a budget level based on the goal of maximizing tax compliance if CBO can't determine what that level is?***

Response: We think it is important to avoid making the "perfect" the enemy of the "good." If Congress believes more funding will improve compliance and increase net tax revenue, it should not be hamstrung in its ability to provide that funding because of the limitations of existing modeling. Just as a business sets a budget for its accounts receivable department by making its best judgment on the basis of available information, Congress should make its best judgment based on available information about the optimal IRS funding level to maximize tax compliance. In making its judgment, it would of course take into account the best estimates and advice of the CBO and others.

Our suggestion that IRS funding be ramped up slowly should also help to allay this concern: Congress can reassess each year whether the IRS is spending its funding wisely and make appropriate adjustments, if warranted. Moreover, if Congress provides the IRS with the funding to conduct much-needed research about the ROI of various categories of its work, this information will inform congressional funding decisions in the future.

Concern #2: ***Congress periodically hears special pleas that various government programs should be exempt from the budget caps. If the IRS is exempted, wouldn't that create a slippery slope that ultimately could undo the function of the caps?***

Response: The case for treating the IRS differently is unique. The IRS collects 98 percent of all federal revenue. No other agency or program can make that claim. And as a consequence of the IRS's role as the government's revenue generator, the availability of funds for Congress to appropriate to other agencies and programs rests on the IRS's ability to maximize tax compliance. That is why we believe Congress should make IRS funding decisions based solely on its judgment about what funding level would maximize compliance, especially voluntary compliance, with due regard

[38] The congressional budget rules currently prohibit the CBO or OMB from treating changes in discretionary appropriations to the IRS as giving rise to scorable increases in tax receipts. See H.R. Conf. Rep. No. 101-964 (1990). *See also* Office of Management and Budget, *OMB Circular No. A-11*, Part 8, Appendix A, Principle 14 (2006). Since changes to IRS funding levels undoubtedly have an impact on tax collections, this prohibition seemingly reflects the current difficulty of devising accurate estimates.

for the protection of taxpayer rights and minimization of taxpayer burden. To do otherwise actually shortchanges other programs.

Moreover, excessive concern about "slippery slopes" can result in reluctance to make meritorious exceptions to general rules. If an exception is meritorious, it is important to provide a rationale that explains the exception and draws the exception narrowly. We think the case for making IRS funding decisions without regard to spending caps constitutes a meritorious exception.

Concern #3: ***Would setting a goal of maximizing compliance cause millions more taxpayers to get audited every year and potentially lead to rampant violations of taxpayer rights?***

Response: We would oppose that outcome strongly and do not believe our proposal should lead to that result. Our proposal emphasizes (1) gradual increases in funding in the range of two percent a year (after inflation); (2) the need to bolster taxpayer service programs and not merely enforcement; and (3) the overriding importance of protecting taxpayer rights and minimizing taxpayer burden. With a current face-to-face audit rate of only one out of every 435 taxpayers, the IRS can do considerably more compliance work before audit rates become unacceptably high – and it can certainly improve and expand taxpayer services without burdening anyone.

Moreover, Congress will serve as a natural check against potential IRS overzealousness, assisted by input from the National Taxpayer Advocate, the IRS Oversight Board, the Treasury Inspector General for Tax Administration (TIGTA), and the Government Accountability Office (GAO). If taxpayers begin to experience significant inconvenience as a result of new IRS initiatives, they will complain to their elected representatives and Congress will have the opportunity to intervene, just as it did when it passed the IRS Restructuring and Reform Act of 1998 in response to taxpayer complaints about IRS overzealousness in the 1990s.

Concern #4: ***In the past, there has not always been a sense that the IRS has spent its funding wisely. What kind of oversight is needed?***

Response: The tax-writing committees and the Appropriations subcommittees with jurisdiction over IRS funding should conduct oversight and make judgments, assisted by input from the GAO, TIGTA, the IRS Oversight Board, and the National Taxpayer Advocate.

Concern #5: ***How much difference will more funding make in closing the tax gap?***

Response: The National Taxpayer Advocate has long advocated three broad strategies for closing the tax gap: (1) fundamental tax simplification, with an emphasis on making economic transactions more transparent; (2) expanded third-party information reporting and, in certain situations, tax withholding on non-wage income; and (3) a more robust IRS compliance program that appropriately balances taxpayer service and enforcement.

More robust taxpayer service and enforcement initiatives will not close a $290 billion tax gap by themselves, but they could well reduce the gap by tens of billions of dollars. As discussed above, former Commissioner Rossotti's final report to the IRS Oversight Board indicated that the IRS was leaving $29.9 billion on the table each year and that it would take an additional $2.2 billion in resources to collect those additional tax liabilities. While better research is needed to develop revised and more precise estimates, these data provide a general sense of the return more robust compliance could produce.

Concern #6: ***Would this proposal undermine the role of the IRS Oversight Board, the Treasury Department, or the Office of Management and Budget in developing the Administration's budget request for the IRS?***

Response: No. The IRS fulfills one part of the broader mission of the Treasury Department, and the Treasury Department historically has exercised (and should exercise) significant oversight over the IRS. Under existing procedures, the IRS budget request is (1) subject to review and approval by the IRS Oversight Board, (2) reviewed and modified by the Secretary of the Treasury and his budget staff, and (3) submitted by the Secretary of the Treasury to the Office of Management and Budget, which ultimately makes decisions about the Administration's budget request on behalf of the President. No part of this proposal would alter those procedures in any way.

RECOMMENDATION
#2 REPEAL PRIVATE DEBT COLLECTION PROVISIONS

PROBLEM

The American Jobs Creation Act of 2004 authorized the IRS to enter into qualified collection contracts with private collection agencies.[1] In the 2005 Annual Report to Congress, we discussed how the complexity of federal tax law would impose heavy costs and burdens on the IRS to ensure that taxpayer rights would be fully protected.[2] In the Most Serious Problem section of this report, we address both the lack of a sound business case and lack of a tax administration case for the PDC initiative. As discussed in the Most Serious Problem, True Costs and Benefits of Private Debt Collection, the National Taxpayer Advocate recommends the repeal of IRC § 6306.

EXAMPLE

The IRS placed a continuous levy on a taxpayer's Alaska Permanent Fund dividend payment to satisfy a delinquent tax debt. The taxpayer claimed to the IRS that he had already sent a payment to the IRS to satisfy the debt. The taxpayer believed the IRS was still investigating his claim that the payment had been received when his account was assigned to a private debt collection agency, which began calling the taxpayer on an almost daily basis for payment. Pursuant to the IRS's Private Debt Collection Policies and Procedures Guide, private collectors are encouraged to maintain pursuit of full payment even when the IRS is receiving payments by levy.[3] The taxpayer came to TAS which traced the taxpayer's payment and discovered that the taxpayer had in fact paid the delinquent amount to the IRS. TAS obtained a return of the IRS's levy proceeds and had the case transferred back to the IRS from the private debt collector.

RECOMMENDATION

Repeal IRC § 6306, thereby terminating the PDC initiative.

PRESENT LAW

Internal Revenue Code § 6306(a) authorizes the IRS to enter into "qualified collection contracts." A qualified collection contract is a contractual arrangement between the IRS and private collection agencies (PCAs) in which the PCAs are engaged to:

- Locate and contact taxpayers;

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1 The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004); now codified in IRC § 6306 and other portions of the Code.

2 We focused on the need for the IRS to provide direct training to private collection agency employees; however, the IRS instituted a train-the-trainer program wherein the private collectors train themselves. National Taxpayer Advocate 2005 Annual Report to Congress 76.

3 IRS Private Collection Agency Policy and Procedures Guide 49-51 (2006).

- Request full payment from taxpayers: if the taxpayers cannot make full payment, PCAs are authorized to offer installment agreements providing for full payment of the liability for a period of up to five years; and
- Obtain specified financial information from taxpayers.[4]

As compensation for these services, IRC § 6306(c) authorizes PCAs to retain up to 25 percent of the amount collected from taxpayers.[5] PCAs employees are also subject to certain restrictions.[6]

REASONS FOR CHANGE

As we set out in detail in the Most Serious Problem, True Costs and Benefits of Private Debt Collection, the central tenets underpinning the Private Debt Collection initiative are not supported by the facts:

- The initiative is not cost effective;
- The cases assigned to private collectors are not "easy;"
- The IRS is substantially different from other federal agencies using private collectors; and
- The hidden costs to customer service, transparency, consistency and tax compliance make this initiative cost prohibitive.[7]

Cost Efficiency

The IRS acknowledges that it performs this work more efficiently than private collectors, but has stated as justification for the initiative that it does not have the resources to work these cases.[8] More recently, however, the IRS has told us that it will not work these cases, even if additional resources are allocated to the IRS.[9] This reasoning is contrary to the typical rationale used by the federal government for contracting out its functions, which focuses first on whether the particular work to be performed is commercial (and thus capable of being contracted out) and not inherently governmental

4 IRC § 6306(b)(1).

5 The IRS is also paying PCAs an administrative fee for certain unresolved accounts. IRS Request for Quotations, Request No. TIRNO-05-Q-00187, at I-20 and I-34 (¶ J.4.4.12).

6 PCAs are:
- Prohibited from engaging in any act from which IRS employees are prohibited; IRC § 6306(b)(2).
- Prohibited from utilizing subcontractors to contact taxpayers, provide quality assurance services, and compose debt collection notices; IRC § 6306(b)(3)(A)-(C).
- Subject to the Fair Debt Collection Practices Act (15 U.S.C. § 1692), to the extent not superseded by other provisions; IRC §§ 6304 and 7602(c).

7 For full discussion of these issues, see Most Serious Problem, *True Costs and Benefits of Private Debt Collection, supra.*

8 *FY 2007 Appropriations for the Internal Revenue Service: Hearing Before the Subcomm. on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, House Comm. on Appropriations,* 109th Cong., 2nd Sess (Mar. 29, 2006)(testimony of Mark W. Everson, Commissioner of Internal Revenue).

9 IRS, *Filing and Payment Compliance* (Nov. 14, 2006).

(and thus not capable of being contracted out), and then focuses on whether the private sector or public sector can perform the work more cost efficiently.[10] The IRS has never certified the types of activities being performed by collectors as "commercial" as part of its annual Federal Activities Inventory Report (FAIR) Act reporting requirements,[11] and, at least until 2003, the IRS considered tax collection as inherently governmental.[12]

No Easy Cases

The cases which the IRS planned to send to private collectors in the first phase of the initiative (Release 1.1) were significantly more complex than anticipated. For the next phase of the initiative (Release 1.2), the IRS has installed data systems to automate processes, thereby using fewer IRS personnel for manual processing. The IRS is relying on these data systems to assign many more cases than have been assigned to date, and the IRS expects to assign cases with more complex features. For example, the IRS plans to assign cases with associated unresolved delinquent tax return investigations. Thus, the cases will not just involve simple balance due accounts; rather, private collectors will be asked to handle complicated issues such as whether taxpayers have an obligation to file a tax return, issues which are, in fact, inherently governmental. As the example above demonstrates, private collection employees are also working on cases with active levies pending. Private collection agencies are not trained to handle these cases. Moreover, the IRS data systems and selection software are not always able to screen the cases which the IRS agrees are inappropriate for assignment.

> **EXAMPLE:** During the design phase of this initiative, the IRS agreed that it would be inappropriate to assign existing Taxpayer Advocate Service cases to private collectors. However, the data systems used for Release 1.2 of the PDC initiative are not capable of identifying and screening out TAS cases automatically. The IRS's solution is to manually review all 446,000 cases for assignment in the next three years for TAS involvement.

Screening out TAS cases is vitally important since these taxpayers have demonstrated they are experiencing an economic or systemic burden or significant hardship. However, manually reviewing all cases for assignment dramatically adds to the need for IRS manual involvement in the process, thereby adding still more costs to the initiative.

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[10] IRS Office of Competitive Sourcing, IRS A-76 Primer, (Feb. 2005), available at http:www.irs.gov/pub/cmp-src/learn_more/irs_a76_primer.pdf; *see also* Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

[11] Federal Activities Inventory Reform Act of 1998, Pub. L. No. 105-270, 112 Stat. 2362; now codified at 31 U.S.C.A. § 501, *see* Note § 5; *see also* IRS Federal Activities Inventory Reform Act certifications, available at: http://www.treas.gov/offices/management/dcfo/procurement/fair/inventories/index.html.

[12] In OMB Circular A-76 (which sets forth the standards under which federal work is subject to competitive sourcing), as it existed in 1999, the collection of taxes was specifically listed as an inherently governmental function. In 2003, OMB Circular A-76 was revised to remove all specific examples of inherently governmental functions; *see also* General Accounting Office, *IRS: Issues Affecting IRS's Private Debt Collection Pilot* (Jul. 18, 1997), indicating that the IRS and the Department of Treasury have long considered the collection of taxes to be an inherently governmental function.

Comparison to Other Federal Agencies

In the Most Serious Problem section of this report, we analyze the validity of the comparison of the IRS, with its vast collection resources and tax compliance mission, to other federal agencies as justification for the initiative. At this point in the initiative, the private collectors are using 75 collection representatives and the IRS is using 65 employees to monitor them. Unlike other federal agencies, the IRS clearly has the resources to do what the private collectors are doing. However, the IRS has indicated that even if it had more resources it would not work these cases; the priority is too low.[13] As we have pointed out elsewhere in this report,[14] the real issue is one of collection strategy and the IRS's willingness to make initiating contact with taxpayers a major part of that strategy.

Hidden Costs of Private Debt Collection

More important than the financial costs, are the hidden costs that make private debt collection cost prohibitive: costs to customer service, transparency of operations, consistent treatment for similarly situated taxpayers and tax compliance. The IRS has made tremendous strides in customer service over the past 6 years; however, private collection agencies become the face of the IRS for many taxpayers assigned to private collectors. Taxpayers with special needs, such as those who have limited English proficiency or are disabled, are not being well served by private collection agencies.[15]

Elsewhere in this report we discuss the importance of transparency in the operations of the IRS toward maintaining the public's trust and confidence in the government.[16] However, the private collection agencies have designated their operational plans as proprietary information that cannot be disclosed without their consent. The National Taxpayer Advocate was unable to report on troubling aspects of private collection agency collection scripts in this report. To the extent the IRS wishes to release any part of these plans, it must first ask the PCAs' permission. Thus, the IRS has surrendered an important part of the public's trust for the sake of this initiative.

Consistent treatment for similarly situated taxpayers is a goal that the IRS strives to achieve; however, with up to ten different private collection agencies in Release 1.2, each with their own collection scripts, form letters, and operational plans, it appears that the IRS has also surrendered this goal for the sake of the initiative.

[13] IRS, *Filing and Payment Compliance* (Nov. 14, 2006).

[14] *See* Most Serious Problems, *Early Intervention in Collection Cases* and *Levies, supra.*

[15] For discussion of taxpayers with special needs, see Most Serious Problems, *Reasonable Accommodations for Taxpayers with Disabilities and Limited English Proficiency Taxpayers: Language and Cultural Barriers to Tax Compliance, supra.*

[16] *See* Most Serious Problem, *Transparency Of The IRS, supra.* For a detailed discussion of the lack of transparency of private collection agency operations, see also Most Serious Problem, *True Costs and Benefits of Private Debt Collection, supra.*

Lastly, we do not know the effect on tax compliance from this initiative – it is too early to be sure; however, we do know that the IRS is risking much for a small return on investment, if any.[17] In its response to the Most Serious Problem on private debt collection in this report, the IRS lauds the fact that at least now these cases are being worked. There may be some element of truth to this statement; however, we think it faint praise, inasmuch as it is the IRS that refuses to work these cases, even if additional resources are allocated.

EXPLANATION OF RECOMMENDATION

The IRS's Private Debt Collection initiative is not cost efficient, adds unnecessary costs and burdens to taxpayers, diminishes the improved image of the IRS, and surrenders too many valuable components of our tax administration system. Therefore, Congress should repeal IRC § 6306 and thereby terminate the Private Debt Collection initiative.

[17] Taxpayers pay over $2 trillion dollars in taxes voluntarily each year. Statistics of Income, *IRS Data Book, 2004-2005*, available at http://www.irs.gov/taxstats/article/0,,id=102174,00.html. The IRS predicts that this initiative will net approximately $1 billion over ten years.

RECOMMENDATION

#3 UNIFORM DEFINITION OF QUALIFYING CHILD

PROBLEM

Until 2005, the Internal Revenue Code contained multiple definitions of a "child" for purposes of the Code's most basic provisions.[1] Taxpayers ended up with vastly different – and in many cases inaccurate – results among these provisions with respect to the same child.[2] The National Taxpayer Advocate recommended in 2001 that Congress adopt a uniform definition of a qualifying child.[3]

The Working Families Tax Relief Act (WFTRA)[4] introduced a uniform definition of a qualifying child (UDOC). This measure brought about some uniformity for the great majority of taxpayers, who previously had to meet multiple tests just to determine whether they were eligible to claim an exemption, credit, or filing status under the basic family status provisions. This legislation was supported by the Bush administration, the Joint Committee on Taxation, the National Taxpayer Advocate, the American Bar Association Section of Taxation, the American Institute of Certified Public Accountants, the Tax Executives Institute, and many academics.[5]

The new law, effective for tax years beginning after December 31, 2004, has done just what it set out to do – it has provided uniformity for *most* taxpayers, reduced the burden of recordkeeping for *most* taxpayers, and eliminated the need for the IRS to inquire into the most personal aspects of *most* taxpayers' lives. As with any legislation attempting simplification via uniformity, there inevitably are winners and losers; that is the price of tax simplification.

[1] IRC § 2(b) (Head of Household); IRC § 21 (Child and Dependent Care Credit); IRC § 24 (Child Tax Credit); IRC § 32 (Earned Income Tax Credit); IRC § 151 (Dependency Exemption); and IRC § 7703(b) (Determination of Marital Status).

[2] For example, a child could qualify the taxpayer for head of household (or for head of household filing status) because the taxpayer paid more than half the actual cost of maintaining a home for the child and the taxpayer, but the child may not qualify as a dependent of the taxpayer because the taxpayer did not pay more than half the support of the child, including any imputed support of the child.

[3] National Taxpayer Advocate 2001 Annual Report to Congress 82-100.

[4] The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166 (2004).

[5] *See, e.g.*, Lindy Paull, Chief of Staff, Joint Committee on Taxation, Testimony Before the House Committee on Ways and Means (July 17, 2001); Staff of the 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 Internal Revenue Code*, JCS-3-01, vol. II, at 44 - 66 (Apr. 2001); Gene Steuerle, *How Complexity Arises for Low-Income Taxpayers*, 92 Tax Notes 561 (July 23, 2001); National Taxpayer Advocate, 2001 Annual Report to Congress, 82-100; Les Book, *The IRS's EITC Compliance Regime: Taxpayers Caught in the Net*, 81 Or. L. Rev. 351, 371-72 (2002); Department of the Treasury, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002); Tax Executives Institute, *Letter Regarding Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002); Robert Greenstein, Executive Director, Center on Budget and Policy Priorities, Statement Before the House Appropriations Subcommittee on Transportation and Treasury (May 7, 2003); The Honorable Fred T. Goldberg, Jr., Commissioner, Internal Revenue Service, 1989 -1992, Testimony Before the House Committee on Ways and Means (June 15, 2004); Elizabeth Maresca, Associate Clinical Professor, Fordham University School of Law, Testimony Before the House Committee on Ways and Means (June 15, 2004); American Bar Association Section of Taxation, *Letter Regarding Pending Tax Legislation* (June 30, 2004); American Bar Association Section of Taxation, *Letter Regarding H.R. 1308 – Working Families Tax Relief Act of 2004* (Oct. 18, 2004).

Some commentators have expressed concerns that the new definition and certain related changes have not truly led to simplification, and have raised examples where the new rules have unintended consequences.

EXAMPLES

Example 1: Parent Provides Support for Child Living With Grandparents

A six-year-old boy lives the entire year with his grandparents, who are married and receive $20,000 in pension income for the year. Throughout the year, the boy's father sent payments totaling $25,000 to the grandparents for the support of the child. The boy is the qualifying child of the grandparents because the relationship, residency, age, and support tests are met. Even though the father provided more than half the support of his son, the father may not claim the son as a qualifying child because the father did not share a principal place of abode with his son for over half of the taxable year. The father also cannot claim his son as a qualifying relative because the son is a qualifying child of the grandparents.

Example 2: Parentless Teenage Twins Who Live with a Neighbor

The twins are qualifying children with respect to each other (they meet the residency, relationship, age, and support tests). The neighbor provides all of the support for the teenage children, but under the current rules would not be able to claim the children as qualifying relatives because each child is a qualifying child of the other.[6]

Example 3: Live-In Boyfriend Who Provides Support for Girlfriend and Her Child

A single mother lives with her boyfriend and her ten-year-old son. The mother has no earned income; the boyfriend earns $30,000 per year and supports his girlfriend and her son. Under the current rules, the son is the qualifying child of the girlfriend (he meets the residency, relationship, age and support tests). The boyfriend may not claim the girlfriend's son as a qualifying child because the child does not meet the relationship test. The boyfriend may not claim the girlfriend's son as a qualifying relative because the son is the qualifying child of the girlfriend. Further, if the relationship is in violation of local law, the girlfriend will not be considered a member of the boyfriend's household for determination of household status.[7]

[6] The children meet all of the tests for a qualifying relative with respect to the neighbor because the children have the same principal place of abode as the neighbor for the entire tax year and are part of the neighbor's household (relationship test), the children do not have gross income in excess of the amount of the dependency exemption, and the neighbor provides more than half of the support for the children. *See* IRC § 152(d). However, the requirement that a qualifying relative cannot be the qualifying child of the taxpayer or another taxpayer prevents the neighbor from claiming the children. *See* IRC § 152(d)(1)(D). But for this requirement, the neighbor would be entitled to claim the children as qualifying relatives.

[7] IRC § 152(f)(3) provides that an individual shall not be treated as a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

Example 4: Affluent Family with a "Boomerang" Older Child

The parents in this home earn $400,000 and live with their 28-year-old son, who earns $25,000 a year as a medical resident, and also have two teenage daughters. The daughters are qualifying children of the parents (the daughters meet the residency, relationship, age, and support tests), but the parents do not benefit from claiming dependency deductions for their daughters because of the alternative minimum tax. Under the current rules, if the parents do not claim the daughters as dependents, the 28-year-old son can claim his younger siblings as qualifying children.[8]

Example 5: Another Taxpayer with a "Boomerang" Older Child

A single parent in this home earns $75,000. The 28-year-old son earns $10,000 in income and lives at home with his parent. The son fails the age test for a qualifying child. The son is not a qualifying relative because he makes more than the exemption amount.[9] Thus, the single parent cannot claim the child for purposes of the dependency exemption or the head of household status. Prior to the UDOC, the parent could have filed as head of household because there was no "exemption amount" limitation.

RECOMMENDATIONS

To address the concerns identified above, the National Taxpayer Advocate recommends that Congress consider the following changes to the Uniform Definition of a Qualifying Child:

1. Amend IRC § 152(d)(1)(D) so that the term "qualifying relative" means an individual "who is not claimed as a qualifying child of such taxpayer or of any other taxpayer for any taxable year in the calendar year in which such taxable year begins."
2. Amend IRC § 152(c)(4)(A) to incorporate the following parent-preference rule:

   If a parent resides with his or her qualifying child for more than one-half of the year, a taxpayer who is not the child's parent shall not be eligible to claim the child as a qualifying child. The foregoing rule shall not apply to a taxpayer if the taxpayer is eligible to claim the child's parent for the dependency exemption.

[8] Under the tie-breaker rule in IRC § 152(c)(4), if an individual is claimed as a qualifying child by two or more taxpayers, such individual shall be treated as the qualifying child of the taxpayer who is the parent of the individual. If more than one parent claims the individual, then the child will be considered the qualifying child of the parent who resided with the child for the longer period of time. If both parents resided with the child for the same amount of time, then the parent with the higher adjusted gross income (AGI) for such taxable year is entitled to claim the child as a qualifying child. If no parent claims the child as a qualifying child, then the taxpayer with the highest AGI for such taxable year is entitled to claim the child as a qualifying child. Note that the tie-breaker rule does not apply unless two or more taxpayers actually claim the same individual as a qualifying child. This is in contrast to the limitation in IRC § 152(d)(1)(D) that denies an individual from being treated as a qualifying relative if such individual is a qualifying child of any taxpayer, even if not actually claimed as a qualifying child of any taxpayer.

[9] IRC § 152(d)(1)(B).

PRESENT LAW

Under UDOC, a dependent must be either a "qualifying child" or a "qualifying relative."[10] The other family status provisions incorporate the definition of a qualifying child, but retain rules specific to each code section (such as age and income restrictions).

Qualifying Child

In general, an individual must meet four tests to be a qualifying child under UDOC;

1. **Relationship Test.** The child must be the taxpayer's child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or descendent of one of these relatives. An adopted child includes a child lawfully placed with a taxpayer for legal adoption even if the adoption is not final. An eligible foster child is any child placed with a taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.[11]
2. **Residency Test.** The child must have the same principal place of abode as the taxpayer for more than half of the tax year. Exceptions apply for temporary absences for special circumstances: children who were born or died during the year, children of divorced or separated parents, and kidnapped children.[12]
3. **Age Test.** The child must be under a certain age, depending on the tax benefit claimed.[13]
4. **Support Test.** The child cannot provide more than half of his or her own support during the year.[14]

Qualifying Relative

If an individual does not meet the requirements for a qualifying child, the individual may be a dependent of the taxpayer if the individual meets the requirements to be a qualifying relative. In general, an individual must meet four tests to be a qualifying relative.

1. **Relationship Test.** The individual must be a child or a descendant of a child; a brother, sister, stepbrother, or stepsister; the father or mother, or an ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister of the taxpayer; a brother or sister of the father or mother of the taxpayer; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or an individual (other than the spouse) who, for the taxable year of the taxpayer, has the

10 IRC § 152(a).

11 IRC §§ 152(c)(1)(A), 152(c)(2), and 152(f)(1).

12 IRC §§ 152(c)(1)(B) and 152(f)(6); Treas. Reg. §§ 1.152-1(b) and 1.152-2(a)(2)(ii).

13 IRC §§ 152(c)(1)(C) and 152(c)(3).

14 IRC § 152(c)(1)(D).

same principal place of abode as the taxpayer and is a member of the taxpayer's household.[15]

2. **Gross Income Test.** An individual must have gross income for the taxable year less than the exemption amount.[16]
3. **Support Test.** The taxpayer must provide more than one-half of the individual's support for the calendar year in which the taxable year begins.[17]
4. **Not a Qualifying Child.** To be a qualifying relative, an individual may not be a qualifying child of the taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which the taxable year begins.[18]

Tie-Breaker Rule

Sometimes a child meets the tests to be a qualifying child of more than one taxpayer. However, only one taxpayer can treat the child as a qualifying child. If the taxpayers have the same qualifying child, they may decide among themselves who will claim the child. If they cannot agree and more than one taxpayer files a return claiming the same child, the IRS will use the tie-breaker rules explained in the table below to determine which taxpayer will be allowed to claim the child.[19] In the past, these tiebreaker rules applied only to a qualifying child for the Earned Income Tax Credit (EITC). For tax years beginning after December 31, 2004, generally, a child is treated as the qualifying child of only one taxpayer for all of the provisions that employ the uniform definition of a qualifying child (head of household filing status under IRC § 2, the child and dependent care credit under IRC § 21, the child tax credit under IRC § 24, the earned income credit under IRC § 32, and the dependency exemption under IRC § 151). This rule is applied to these provisions as a group, rather than on a section-by-section basis.[20] That is, taxpayers may not "split the baby" to divide the benefits.[21]

REASONS FOR CHANGE

The UDOC was intended to simplify a complex and cumbersome process. We must recognize that there will be losers in tax simplification. We must also recognize that, as with most new legislation, there will be some unintended consequences.

For taxpayers in situations such as those described in the examples above, we need to decide whether not getting the intuitively "right" answer warrants muddying up and

[15] IRC §§ 152(d)(1)(A) and 152(d)(2). However, IRC § 152(f)(3) provides that an individual shall not be treated as a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

[16] IRC § 152(d)(1)(B).

[17] IRC § 152(d)(1)(C).

[18] IRC § 152(d)(1)(D).

[19] IRC § 152(c)(4).

[20] CC Notice 2006-86, 2006-41 I.R.B. 680.

[21] There is an exception to the "split the baby" rule for divorced or separated parents, discussed below.

complicating the Code. We also must be careful not to undermine the very clear benefits of the UDOC – or, in other words, to throw out the qualifying child with the bathwater. In adopting a single definition of a child where five[22] definitions existed previously, Congress provided a monumental service to approximately 160 million Americans.[23] To blow these examples out of proportion and then add back to the Code five different definitions of a child by repealing the WFTRA would be a disservice to 160 million people and would constitute terrible public policy.

The National Taxpayer Advocate recommends that Congress proceed cautiously with any proposed changes to the UDOC. Each modification potentially weakens prior simplification efforts and may lead to additional unintended consequences.

EXPLANATION OF RECOMMENDATIONS

Examples 1 through 3 above are situations in which the UDOC denies tax benefits to taxpayers who we might want to receive them, due to a quirk in the definition of a qualifying relative. According to the definition of a "qualifying relative" in IRC § 152(d)(1)(D), an individual who is a qualifying child of another taxpayer may not be a qualifying relative. This definition allows a situation in which an individual may not be claimed as a qualifying relative solely because the individual met the definition of a qualifying child of a taxpayer, even if such individual was not actually claimed as a qualifying child by any taxpayer.

Congress can eliminate the problem in Examples 1 through 3 by adding two simple words – "claimed as" – to IRC § 152(d)(1)(D) so that the term "qualifying relative" means an individual "who is not **claimed as** a qualifying child of such taxpayer or of any other taxpayer for any taxable year in the calendar year in which such taxable year begins."

This change treats taxpayers as mature individuals who are able to structure their affairs rationally and decide among themselves who is the "right" person to claim various family status benefits. Note that to be a qualifying relative, an individual must still meet the support test and the gross income test. All of these limitations were in the Code prior to enactment of the UDOC, so this change merely opens the door for the individual to meet the definition of a qualifying relative.

Example 4 describes a situation where the UDOC rules allow a windfall for taxpayers who clearly were not the intended beneficiaries of these rules. Here, allowing taxpayers to decide among themselves enables taxpayers to game the system, or at least come up

[22] UDOC made changes to five of the six definitions of a child; it did not affect IRC § 7703(b) (Determination of Marital Status).

[23] The family status provisions potentially affect 81 million taxpayers and 79 million children. IRS Compliance Data Warehouse, *Tax Year 2004 Individual Return Transaction File.*

with a result that does not accurately reflect the economic responsibilities and circumstances of the household.[24]

One solution would be to bring back the recently repealed "cares for" test as applied to siblings.[25] However, the "cares for" test was difficult to administer and involved the submission of a great deal of personal information on the part of the taxpayer and the exercise of discretion on the part of IRS examination employees. As a result, the National Taxpayer Advocate endorses the approach suggested by the American Bar Association that provides an appropriate trade-off between increased complexity and precision.[26] This recommendation provides for a parent-preference rule that eliminates the "claimed as" requirement of the tie-breaker rule in IRC § 152(c)(4)(A) so that each taxpayer's eligibility to claim a qualifying child could be determined without reference to another taxpayer's tax return information. In situations where IRC § 152(b)(1) (which prohibits an individual who is a dependent of another taxpayer from claiming any dependents) precludes a parent from claiming a qualifying child, a non-parent can claim the qualifying child.

Example 5 above describes a situation in which reasonable minds might differ as to whether the result is a problem. The parent in Example 5 may be able to claim the son as a dependent if the son meets the requirements for a qualifying relative. There is no age requirement for qualifying relatives, so the son being 28 years old does not prevent his parent from claiming him as a qualifying relative. But because the son makes more than the exemption amount ($3,300 in 2006), he is not considered a qualifying relative of his parent.

Note that if the son was between jobs and earned less than the exemption amount, the parent would be able to claim head of household status and claim the son as a dependent. The National Taxpayer Advocate does not consider this to be an unreasonable policy. That is, if your able-bodied adult child has an economic setback, then all the taxpayers of the U.S. will help that person get on his feet via the tax system. But if your able-bodied adult child is staying with you to save a few dollars, we will not ask other taxpayers to subsidize that decision. We recommend no change for this "unintended" consequence in Example 5.

[24] Note that this problem has existed within the EITC context for several years (*i.e.*, pre-UDOC enactment). Nothing in IRC § 32 prevents taxpayers who are eligible to claim a child for the EITC from agreeing among themselves who should actually claim the credit. The tie-breaker rule in the pre-2005 IRC § 32(c)(1)(C) applied only when an individual was actually claimed by two or more taxpayers. So in this case, under the pre-2005 rules, if the parents did not claim the children, the 28-year-old son could claim his siblings if he cared for the siblings as his own children and is otherwise eligible for the EITC.

[25] Under the prior rules, IRC § 32(c)(3)(B)(i)(II) required that a taxpayer claiming as a qualifying child a brother, sister, stepbrother, or stepsister, or a descendant of any such individual must care for the child as the taxpayer's own child. There was a great deal of uncertainty on the part of taxpayers as to what constituted "caring for" the child as one's own child. *See Gilmore v. Commissioner*, T.C. Summ. Op. 2004-38; *Barajas v. Commissioner*, T.C. Summ. Op. 2002-59. Because the "cares for" test was vague and hard to administer, Congress eliminated the "cares for" requirement when it passed the UDOC rules.

[26] American Bar Association Section of Taxation, *Report Regarding the Uniform Definition of Qualifying Child* 8-9 (July 24, 2006).

RECOMMENDATION

#4 ELIMINATE (OR SIMPLIFY) PHASE-OUTS

PROBLEM

Phase-outs reduce the availability of various tax benefits to taxpayers as their income increases.[1] Over 60 million returns are affected each year by one or more phase-outs.[2] As an example, the dependent care tax credit is gradually reduced for taxpayers with incomes between $15,000 and $43,000.[3] Increasing marginal income tax rates as income rises would similarly impose a greater amount of tax on higher income taxpayers. Unlike an increase in marginal rates, however, phase-outs often tax an additional dollar earned by a low or middle income taxpayer more heavily than an additional dollar earned by a high income taxpayer.

Phase-outs also add needless complexity to the Internal Revenue Code. Such complexity is burdensome for taxpayers, reduces the effectiveness of tax incentives, makes it more difficult for taxpayers to estimate their tax liability and pay the correct amount of withholding or estimated taxes, and likely reduces tax compliance. Although policymakers may sometimes adopt phase-outs to reduce the cost to the federal government of providing popular tax benefits, they may be more costly than policymakers realize if they increase noncompliance.

EXAMPLES

The following examples illustrate how phase-outs create surprisingly high effective marginal tax rates for low and middle income taxpayers and increase complexity for everyone.

Example 1: Earned Income Tax Credit and Dependent Care Tax Credit

If a single taxpayer, who has two qualifying children, earned $33,000 in wage income and received a $500 bonus in 2005, she would get the benefit of only about 52 percent of the bonus. At her income level, she is in the phase-out range for both the earned income tax credit (EITC) and for the dependent care tax credit.[4] At the end of the year, after filling out four different forms, schedules, and worksheets, she would discover that the $500 bonus had cost her $240 in refundable tax credits – $105 in EITC (from $471

[1] For purposes of this discussion, we use the term "phase-out" to include phase-downs, which also reduce (but do not eliminate) benefits as income increases. However, we do not use the term phase-out to include reductions in tax benefits resulting from changes in items other than income. For example, we do not use the term phase-out to refer to a reduction in the credit for producing fuel from nonconventional sources as the price of oil increases, or to refer to a reduction in the credit for qualified electric vehicles over time. IRC § 45k (credit for producing fuel from a nonconventional source); IRC § 30 (credit for qualified electric vehicles).

[2] This data is compiled from the Individual Return Transaction File (IRTF) for Tax Year 2004 from the Compliance Data Warehouse (CDW).

[3] IRC § 21(a)(2).

[4] IRC § 21; IRC § 32. We assume she files as head of household and has $6,000 in qualified child care expenses.

to $366) and $135 in the refundable portion of the child tax credit (from $1,664 to $1,529).[5] In other words, each dollar of the bonus would reduce these credits by about 48 cents. In contrast, taxpayers in the highest income tax bracket generally pay the IRS only 35 cents of each additional dollar they earn.[6]

Example 2: Social Security Benefit Exclusion and Hope Credit

If a 63-year-old retiree with $15,000 in social security benefits, $10,000 in wage income, $23,000 in taxable pension income and two children in college received the same $500 bonus in 2005, he could face an effective marginal tax rate of more than 83 percent.[7] Because the nontaxable portion of his social security benefits is phased-out as his income increases, the $500 bonus would increase his taxable income by $925. Since he is in the 15 percent tax bracket, the additional income would increase his federal income tax by $135 (approximately 15 percent x $925).[8] Because the taxpayer is also in the phase-out range for the Hope credit for educational expenses, the bonus would reduce his Hope credit by $279 (from $2,994 to $2,715).[9] Thus, at the end of the year, after completing an additional worksheet and tax form, the taxpayer would discover that his $500 bonus increased his income tax liability by about $414 ($135 + $279) so he would only get to keep $86 (or 17 percent).[10] In contrast, if the $500 bonus were paid to

5 *See id*; IRC § 24. The reduction in the refundable portion of the child tax credit is caused, in part, by the phase-out of the dependent care tax credit, as reflected on lines 48, 52, 66, and 68 of Form 1040. For a discussion of how to figure the EITC, see Publication 596, *Earned Income Credit* (2005) and Form 1040, *Instructions* (2005). The taxpayer is directed to the following forms, schedules, and worksheets: Form 2441, *Child and Dependent Care Expenses*; Form 1040 Instructions, *Child Tax Credit Worksheet*; Form 1040 Instructions, *Worksheet A-Earned Income Credit or Worksheet B-Earned Income Credit*; and Schedule EIC, *Earned Income Credit.*

6 IRC § 1. Further, many taxpayers probably fill out additional forms, schedules, and worksheets only to find out they are not eligible for the benefits and some who are eligible may not bother to find out. Commentators have suggested that one of the benefits of the child tax credit is that it ameliorates the effect of the EITC phase-out in some cases. *See, e.g.*, Lawrence Zelenak, *Redesigning The Earned Income Tax Credit As A Family-Size Adjustment To The Minimum Wage*, 57 Tax L. Rev. 301, 307 (Spring 2004). Even if it does, complicating the law with another credit that has its own phase-out requires more forms, worksheets and schedules, which will undoubtedly lead to mistakes involving over- and under-claims.

7 This analysis assumes that before computing the Hope credit phase-out, each child would qualify for the full $1,500 credit. It also ignores employment taxes, which would increase the taxpayer's marginal tax rate by another 7.65 percent, as well as state income taxes and college financial aid computations based on income. *See, e.g.*, IRC § 3101. Such taxes and aid reductions could easily mean that the bonus generates liabilities that exceed 100 percent of the bonus.

8 *See* Form 1040, *Instructions* 68 (2005) (tax tables).

9 For taxpayers in the phase-out range, the Hope credit can be computed by multiplying the tentative credit of $3,000 by a fraction the numerator of which is $53,000 minus the taxpayer's modified adjusted gross income (MAGI) and the denominator of which is $10,000. In the first scenario with no bonus, the taxpayer's MAGI is $43,025, so the fraction is .998 (($53,000-$43,025)/$10,000)), and the credit is $2,994 ($3,000*.998). In the second scenario a bonus that increases the taxpayer's MAGI by $925 to $43,950, so the fraction is .905 (($53,000-43,950)/$10,000) and the credit is $2,715 ($3,000*.905).

10 The taxpayer would have to fill out Form 1040, *Social Security Benefits Worksheet*, the worksheets in Publication 590, or the worksheet in Publication 915 to determine how the bonus would affect the tax treatment of his social security benefits. He would need to fill out Form 8863, *Education Credits*, to determine the amount of his Hope credit.

someone in the highest 35 percent income tax bracket they would typically get to keep $325 ($500 – ($500 x 35 percent)).

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress eliminate phase-outs. In the event the cost considerations make outright repeal unrealistic, then the National Taxpayer Advocate recommends Congress consider the questions discussed below (in the Explanation of Recommendation section) with respect to each existing phase-out, and require a discussion of these questions to be included with any proposal that includes a phase-out.

PRESENT LAW

The Internal Revenue Code contains more than 20 tax benefits that are phased-out for higher income taxpayers, as shown on Table 2.4.1 below. It uses different measures of income to determine whether and how to reduce each tax benefit. For example, some phase-outs use "earned income" from personal services, others use "adjusted gross income" (AGI), and others start with AGI but then apply certain modifications to adjust it in a variety of ways.[11] The effect of marital and filing status on the phase-out range also varies from phase-out to phase-out. Since some phase-outs are adjusted for inflation and others are not, the combination of ways that multiple phase-outs affect a taxpayer may change every year, even if the taxpayer's filing status and income stay the same.

[11] "Adjusted gross income" is "gross income" reduced by certain deductions. *See* IRC § 62.

TABLE 2.4.1, SELECTED 2005 INDIVIDUAL INCOME TAX PROVISIONS WITH INCOME-BASED PHASE-OUTS[12]

Provision	Joint Filer	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-out	Indexed for Inflation	Operation
1. Dependent care tax credit (sec. 21)	$15,000-$43,000	Same as joint filers	No credit, unless separated	AGI	No	35% credit percentage reduced (but not below 20%) by one point for each $2,000 over the threshold
2. Credit for elderly and disabled (sec. 22)	$10,000-$20,000 if one qualifying spouse; $25,000 if two qualifying spouses	$7,500-$17,500	$5,000-$12,500	AGI	No	Credit reduced by one-half of the income over the threshold and by certain nontaxable payments
3. Adoption credit (sec. 23)	$159,450-$199,450	Same as joint filers	No credit	MAGI #1*	Yes	Credit reduced ratably over the phase-out range
4. Child tax credit (sec. 24)	$110,000	$75,000	$55,000	MAGI #1*	No	Credit reduced by $50 for each $1,000 (or fraction thereof) of income that exceeds the threshold
5. Hope credit (sec. 25A)	$87,000-$107,000	$43,000-$53,000	No credit	MAGI #1*	Yes	Credit reduced ratably over the phase-out range
6. Lifetime learning credit (sec. 25A)	$87,000-$107,000	$43,000-$53,000	No credit	MAGI #1*	Yes	Credit reduced ratably over the phase-out range
7. Retirement contribution credit (sec. 25B)	50% credit: $0-$30,000; 20% credit: $30,000-32,500; 10% credit: $32,500-$50,000	HOH: 50% credit: $0-$22,500; 20% credit: $22,500-$24,375; 10% credit: $24,375-$37,500; Other single filers use MFS table	50% credit: $0-$15,000; 20% credit: $15,000-$16,250; 10% credit: $16,250-$25,000:	MAGI #1*	No[13]	Credit percentage level declines at specific income thresholds
8. Earned income tax credit (sec. 32)	No children: $8,530-$13,750; One child: $16,370-$33,030; More than one child: $16,370-$37,263	No children: $6,530-$11,750; One child: $14,370-$31,030; More than one child: $14,370-$35,263	No credit	Greater of (a) earned income or (b) AGI	Yes	Credit reduced by percentage of income over the threshold

[12] The Joint Committee on Taxation published a similar table in 2001. *See* Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. II, 80 (Apr. 2001)), *available at* http://www.house.gov/jct/s-3-01vol2.pdf. Phase-out ranges that have been adjusted for inflation reflect adjustments for 2005. *See* Rev. Proc. 2004-71, 2004-50 I.R.B. 970 (Dec. 13, 2004).

[13] The adjusted gross income amounts used to determine the applicable percentage for calculating the credit are adjusted for inflation beginning in calendar year 2007. IRC § 25B(b)(3); Rev. Proc. 2006-53, 2006-48 I.R.B. 996, § 2.01 (Nov. 9, 2006).

Provision	Joint Filer	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-out	Indexed for Inflation	Operation
9. AMT exemption (sec. 55(d)(3))	$150,000-$382,000	$112,500-$273,500	$75,000-$191,000	Alternative minimum taxable income (AMTI)	No	Exemption reduced by 25% of the AMTI in excess of the threshold
10. Overall limitation on itemized deductions (sec. 68)[14]	$145,950-various	Same as joint filers	$72,975-various	AGI	Yes	Deductions reduced by lesser of 3% of AGI over threshold or 80% of itemized deductions
11. Exclusion of social security and railroad retirement benefits (sec. 86)	First tier: $32,000; Second tier: $44,000;	First tier: $25,000; Second tier: $34,000	First and second tiers: $0, unless separated	MAGI #2* plus one-half of the benefits	No	Includible amount is generally 50% of income between first and second tier (up to 50% of benefits), plus 85% of income in excess of second tier, but not more than 85% of benefits
12. Exclusion of interest from education savings bonds (sec. 135)	$91,850-$121,850	$61,200-$76,200	No exclusion	MAGI #3*	Yes	Exclusion reduced ratably over the phase-out range
13. Exclusion for adoption assistance programs (sec. 137)	$159,450-$199,450	Same as joint filers	No exclusion	MAGI #4*	Yes	Exclusion reduced ratably over the phase-out range
14. Personal exemption (sec. 151)[15]	$218,950-$341,450	Single: $145,950-$268,450; HOH: $182,450-$304,950	$109,475-$170,725	AGI	Yes	Exemption reduced ratably over the phase-out range
15. Deduction for IRA with retirement plan (sec. 219)	$70,000-$80,000	$50,000-$60,000	$0-$10,000	MAGI #5*	No[16]	Deduction reduced ratably over the phase-out range; special rounding rules apply

[14] The limitation on itemized deductions is reduced by 1/3 in tax years beginning in 2006 and 2007, reduced by 2/3 in tax years beginning in 2008 and 2009, and repealed for tax years beginning after December 31, 2009. However, it is set to return for taxable years beginning after December 31, 2010. IRC § 68(g) and (f); Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, 115 Stat. 38 § 901 (June 7, 2001).

[15] The phase-out of the personal exemption is reduced by 1/3 in tax years beginning in 2006 and 2007, reduced by 2/3 in tax years beginning in 2008 and 2009, and repealed for tax years beginning after December 31, 2009. IRC § 151(d)(3)(E); Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, 115 Stat. 38, § 901 (June 7, 2001). However, it is set to return for taxable years beginning after December 31, 2010. *Id.*

[16] This phase-out is adjusted for inflation beginning in calendar year 2007. IRC § 219(g)(8); Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (Nov. 9, 2006).

Provision	Joint Filer	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-out	Indexed for Inflation	Operation
16. Deduction for IRA with spouse in a retirement plan (sec. 219(g)(7))	$150,000-$160,000	N/A	$0-$10,000	MAGI #5*	No[17]	Deduction reduced ratably over the phase-out range; special rounding rules apply
17. Deduction of interest on qualified student loans (sec. 221).	$105,000-$135,000	$50,000-$65,000	No deduction	MAGI #6*	Yes	Deduction reduced ratably over the phase-out range
18. Qualified tuition deduction (sec. 222)[18]	$130,000-$160,000	$65,000-$80,000	No deduction	MAGI #7*	No	Maximum deduction limited to $4,000 below range, $2,000 within range, and eliminated for income above the range
19. Eligibility for Roth IRA (sec. 408A)	$150,000-$160,000	$95,000-$110,000	$0-$10,000	MAGI #8*	No[19]	Contribution limits reduced ratably over the phase-out range; special rounding rules apply
20. Eligibility for IRA to Roth IRA conversion (sec. 408A)[20]	$100,000	Same as joint filers	Not eligible for rollover	MAGI #8*	No	Not eligible for conversion if income exceeds threshold
21. Passive rental real estate loss deduction or credit (sec. 469(i))	$100,000-$150,000	Same as joint filers	$50,000-$75,000; Not eligible if living with spouse	MAGI #9*	No	Deduction or deduction equivalent credit reduced by 50% of income above lower threshold
22. Passive rental real estate credit attributable to rehabilitation credit (sec. 469(i))	$200,000-$250,000	Same as joint filers	$100,000-$125,000; Not eligible if living with spouse	MAGI #9*	No	Credit reduced by 50% of income above lower threshold

[17] This phase-out is adjusted for inflation beginning in calendar year 2007. IRC § 219(g)(8); Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (Nov. 9, 2006).

[18] The qualified tuition deduction expires for tax years beginning after 2005. IRC § 222(e). However, it may be retroactively extended. For example, the Estate Tax Extension of Tax relief Act of 2006 (H.R. 5970) would retroactively extend it to tax years beginning before 2008.

[19] This phase-out is adjusted for inflation beginning in calendar year 2007. IRC § 408A(c)(3)(C); Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (Nov. 9, 2006).

[20] For tax years beginning after 2009, conversions of traditional IRAs to Roth IRAs will be allowed without any restrictions based on modified AGI and taxpayer filing status. *See* IRC § 408A(c)(3)(B), as amended by Section 512 of the Tax Increase prevention and Reconciliation Act of 2005 (TIPRA), P.L. 109-222 (May 17, 2006).

Provision	Joint Filer	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-out	Indexed for Inflation	Operation
23. Eligibility for Coverdell education accounts (sec. 530)	$190,000-$220,000	$95,000-$110,000	Same as single	MAGI #1*	No	Contribution limits ratably reduced over the phase-out range
24. First time D.C. homebuyer credit (sec. 1400(C))	$110,000-$130,000	$70,000-$90,000	$70,000-$90,000	MAGI #1*	No	Credit ratably reduced over the phase-out range

* MAGI #1 is AGI computed without regard to IRC §§ 911, 931 and 933. IRC § 23(b)(2)(B); IRC § 24(b); IRC § 25A(d)(3); IRC § 25B(e); IRC § 530(c)(2); IRC § 1400C(b)(2).

MAGI #2 is AGI computed without regard to IRC §§ 135, 137, 199, 221, 222, 911, 931 and 933. IRC § 86(b)(2).

MAGI #3 is AGI computed after application of IRC §§ 86, 469 and 219 but without regard to IRC §§ 135, 137, 199, 221, 222, 911, 931 and 933. IRC § 135(c)(4).

MAGI #4 is AGI computed after application of IRC §§ 86, 135, 219 and 469 but without regard to IRC §§ 137, 199, 221, 222, 911, 931, and 933. IRC § 137(b)(3).

MAGI #5 is AGI computed after application of IRC §§ 86 and 469 but without regard to IRC §§ 135, 137, 199, 219, 221, 222, and 911. IRC § 219(g)(3).

MAGI #6 is AGI computed after application of IRC §§ 86, 135,137, 219, and 469 but without regard to IRC §§ 199, 221, 222, 911, 931, and 933. IRC § 221(b)(2)(C); Treas. Reg. § 1.221-1(d)(2).

MAGI #7 is AGI computed after application of IRC §§ 86, 135,137, 219, 221 and 469 but without regard to IRC §§ 199, 911, 931, and 933. IRC § 222(b)(2)(C).

MAGI #8 is MAGI #5 reduced by amounts included in gross income under IRC § 408A(d)(3) or by reason of a required distribution under IRC § 408A(c)(5). IRC § 408A(c)(3)(C).

MAGI #9 is AGI computed without regard to IRC §§ 86, 135, 137, 199, 219, 221, 222 and certain passive activity losses. IRC § 469(i)(3)(F).

REASON FOR CHANGE

Phase-outs reduce middle class work incentives, create inequity

Most tax experts agree that phase-outs should be simplified or eliminated.[21] One reason for such agreement may be that phase-outs often cause an additional dollar earned by a low or middle income taxpayer to be taxed more heavily than an additional dollar earned by a higher income taxpayer.[22] If higher marginal tax rates reduce incentives to work and earn more income, phase-outs reduce such incentives for low and middle income taxpayers more than for high income taxpayers.[23]

In addition, because phase-outs are based on different measures of income, they may cause two taxpayers with the same amount of income to be liable for different amounts of tax. Such differences in tax liability may violate notions of horizontal equity or fairness.

Phase-outs may result from the budget process rather than tax policy goals

Phase-outs sometimes serve no coherent policy goal that cannot be better served by simply adjusting marginal tax rates. One policy reason for the dependent care and child tax credits is that the tax code should recognize that families with children have less of an "ability to pay" than families with the same income, but without children.[24] The policy is based on recognizing the cost of children, not on level of income. Thus, a phase-out of these credits based on income is inconsistent with the underlying policy.

To be sure, some phase-outs could be based on the notion that high income taxpayers do not need a given tax incentive. For example, policymakers could deny Individual

[21] *See, e.g.*, Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. II, 88 (Apr. 2001), *available at* http://www.house.gov/jct/s-3-01vol2.pdf; American Bar Association, American Institute of Certified Public Accountants, and Tax Executives Institute, Inc., *Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002) (Attachment B: Simplification of Phase-Outs Based on Income Levels), *available at* https://www.abanet.org/tax/pubpolicy/2002/020913lt-atb.pdf; Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, xiv* (Nov. 2005), *available at* http://www.taxreformpanel.gov/final-report/. *See also*, Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 Va. Tax Rev. 645, 731 (Spring 2003) (arguing that the case against phase-outs has been overstated, but stating that the Joint Committee Report's proposal to eliminate certain phase-outs deserves consideration because of the effect of phase-outs on effective marginal tax rates).

[22] For an analysis of the effect of various phase-outs on marginal rates, see Joint Committee on Taxation, JCS-3-98, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (Feb. 3, 1998) *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=1998_joint_committee_on_taxation&docid=f:46072.wais.

[23] To conclude that phase-outs affect taxpayer behavior (rather than just incentives) would require an assumption that taxpayers generally know how phase-outs affect them. As discussed below, however, phase-outs are complex, concealing their true operation, perhaps blunting any rational behavioral response by taxpayers. Thus, it is possible that phase-outs might not have a significant effect on hours worked by taxpayers. However, if policymakers assume a given tax benefit will affect behavior, for consistency they should assume a phase-out of the benefit will to some extent also affect behavior.

[24] *See, e.g.*, S. Rept. No. 105-33, at 3 (1997) (noting "[T]he Committee believes that the individual income tax structure does not reduce tax liability by enough to reflect a family's reduced ability to pay taxes as family size increases."); H.R. Rept. No. 105-48, at 310 (1997) (same).

Retirement Account (IRA) deductions to high income taxpayers for tax policy reasons. Since the purpose of the IRA deduction is to provide an incentive to save for retirement,[25] policymakers could determine that the savings rate for high income taxpayers is sufficient and they do not need any extra tax incentive to save for retirement.

However, the uncertainty generated by a phase-out may reduce the effectiveness of a tax incentive even among taxpayers who are not subject to it, blunting any tax policy justification for the phase-out. If an eligible taxpayer cannot be certain at the beginning of the year that he or she will be eligible for the IRA deduction, he or she may not make an IRA contribution. Even if the taxpayer makes an extra effort at the end of the year to find out that he or she would be eligible, he or she may be less likely to have the resources to fund a significant IRA contribution on short notice.

These potential drawbacks suggest that phase-outs are sometimes enacted based on revenue considerations rather than sound tax policy.[26] When the Joint Committee on Taxation "scores" how much a tax benefit provision will cost the government, the provision will cost less if it does not apply to higher income taxpayers. The net cost could be the same if the provision were enacted without a phase-out but paired with a marginal tax rate increase applicable to certain middle and high income taxpayers. Although, unlike phase-outs, a marginal rate increase would not subject low and middle income taxpayers to higher effective marginal tax rates than high income taxpayers, Congress may be unwilling to vote for a visible tax rate increase even if it is paired with a tax benefit. Thus, complicated phase-out provisions may sometimes be used to make tax hikes at various income levels more palatable rather than because they make sense from a tax policy standpoint.

Phase-outs create confusion and complexity

Indeed, phase-outs are good at obscuring their true effect. Policymakers, taxpayers, and those charged with explaining tax benefit rules to taxpayers may have difficulty keeping track of the details of how a given phase-out works and who it affects. This complexity is exacerbated by the fact that different phase-out provisions are based on different measures of income, use different phase-out methods, and are only sometimes indexed

[25] *See* H.R. Rept. No. 93-770, at 124-125 (1974), *reprinted in* 1974-3 C.B. 244, 367-368.

[26] *See* Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. I, 67 (Apr. 2001), *available at* http://www.house.gov/jct/s-3-01vol2.pdf; Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, Ch. 5, 64 (Nov. 2005), *available at* http://www.taxreformpanel.gov/final-report.

for inflation.[27] The phase-outs shown on Table 2.4.1 above use 12 different measures of income.

Such complexity is also burdensome for taxpayers because determining whether they are eligible for a given tax benefit requires them to fill out an additional worksheet, form, or schedule, which is like filling out another tax return. The staff of the Joint Committee on Taxation estimated that for 2001, over 30 million phase-out worksheets would be required, and noted that most worksheets contain 10 to 20 lines which may themselves require additional computations.[28] The taxpayer must recalculate his or her income on these quasi-returns and then apply the appropriate income-based limitation.[29] Each extra entry and computation adds time and expense to the return filing process, and also increases the likelihood that taxpayers will make errors.

Complexity reduces tax compliance

Since phase-outs make it more difficult for taxpayers to predict whether or not they will be eligible for a given tax incentive, they also make it more difficult for taxpayers to estimate their liability ahead of time, potentially leading to noncompliance, or estimated tax or under-withholding penalties. Taxpayers who owe a balance upon filing their return are more likely than others to understate their liabilities.[30] Moreover, one study found that more than 20 percent of such taxpayers with a balance due failed to pay it in full.[31] Thus, the complexity associated with phase-outs likely reduces tax compliance.[32]

For other taxpayers who can estimate how phase-outs will affect them, phase-outs provide planning opportunities. Such taxpayers can shift income, such as capital gains, from one year to another (or to related taxpayers) to avoid phase-outs, at least in some

27 In contrast to phase-outs, phase-ins, such as the one applicable to the earned income tax credit, increase tax benefits as a taxpayer's income increases. Although, in general, phase-ins can generate complexity as readily as phase-outs, the phase-in applicable to the EITC furthers the purpose of the credit, which is to provide an additional incentive for low income taxpayers to earn more income, perhaps justifying its existence. *See generally*, S. Rept. No. 94-36, at 33 (1975), *reprinted in* 1975-1 C.B. 590, 595; H.R. Rept. No. 94-19, at 10 (1975), reprinted in 1975-1 C.B. 569, 573-74. We do not currently recommend eliminating the EITC phase-in.

28 *See* Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. II, 87 (Apr. 2001), *available at* http://www.house.gov/jct/s-3-01vol2.pdf.

29 The Joint Committee on Taxation staff estimated that eliminating nine phase-outs would allow the IRS to eliminate approximately 75 worksheet or form lines. Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. II, 89 (Apr. 2001), *available at* http://www.house.gov/jct/s-3-01vol2.pdf.

30 Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

31 *Id.*

32 Potential reductions in tax compliance are apparently not taken into account when the Joint Committee on Taxation generates an estimate of the cost of a tax expenditure that includes a phase-out provision. See Joint Committee on Taxation, JCX-1-05, *Overview of Revenue Estimating Procedures and Methodologies used by the Staff of the Joint Committee on Taxation*, 11 (Feb. 2, 2005), *available at* http://www.house.gov/jct/x-1-05.pdf (stating "[u]nlike revenue estimates, tax expenditure estimates do not include behavioral responses or possible interaction with other incentives.").

years. For example, a taxpayer could manage his capital gain income so as to avoid the Hope credit phase-out. The taxpayer could either liquidate assets to pay for college in the year before the expenditures or borrow to finance college and wait to liquidate assets until after the year(s) in which he makes educational expenditures. In contrast, another taxpayer might liquidate assets in the same year as paying the educational expenses, increasing his taxable income in those years and subjecting himself to the Hope credit phase-out.[33] Such planning opportunities may reduce horizontal equity and the perceived fairness of the tax system, which may in turn, reduce tax compliance.

Phase-outs reduce interest in improving tax rules and tax administration

Because phase-outs reduce the number of people who can claim a tax benefit, such as the EITC or the dependent care credit, they also reduce the constituency for sensible tax laws and the demand for the IRS to adopt sensible procedures for administering them. If middle and high income taxpayers are relatively unaffected by a tax provision, they and their advisors may have little incentive to suggest ways to improve it. Thus, over time, eliminating phase-outs could have the effect of improving income tax legislation and administrative guidance relating to tax benefit programs.

Phase-outs burdensome, not "efficient"

The notion that phase-outs are somehow efficient because they relieve middle and high income taxpayers (*i.e.,* those who are fully phased-out of a tax benefit) from having to fill out the additional worksheets, forms, and schedules that are associated with a tax benefit is probably not correct. In many cases, such ineligible taxpayers still have to fill out the worksheets, schedules, and forms (or at least read or pay to have an advisor read the instructions) only to discover that they are not eligible for the benefit. Even if phase-outs reduced paperwork and complexity for certain high income taxpayers, the benefit of such reductions would be very small because such taxpayers are typically better equipped than low and middle income taxpayers to deal with such paperwork and complexity by having a tax preparer or computer software fill out complex worksheets, forms, and schedules.[34] Further, phase-outs require low and middle income taxpayers to fill out more lines on worksheets, forms, and schedules to claim tax benefits. Such burdens likely more than offset any potential efficiency gains obtained by high income taxpayers.

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that Congress eliminate phase-outs based on the tax administration considerations discussed above. Alternatively, if the cost of outright repeal makes that unrealistic, then the National Taxpayer Advocate recom-

[33] Higher income taxpayers can use a similar strategy to avoid the phase-out of the AMT exemption in alternate years.

[34] W&I Research Group 5, *Nationwide Analysis Tax Year 2003*, Pub. 4210 (Sept. 2005) (suggesting low income taxpayers are less likely to use preparers than high income taxpayers).

mends policymakers consider the following questions with respect to each existing phase-out and as they draft tax reform proposals. The National Taxpayer Advocate also recommends that Congress require a discussion of these questions to be included with any proposal that includes a phase-out.

1. Can we identify a tax policy reason (other than revenue scoring) for using each phase-out? Do those tax policy benefits outweigh the cost of complexity and noncompliance that the phase-out will generate? If so, do such policy reasons suggest a particular income level at which a phase-out makes sense?
2. Is it feasible to use a single measure of income for each phase-out, such as "adjusted gross income?" Is there a good policy reason to deviate from the existing measures of income that outweighs the complexity such deviation will create? Will those policy reasons justify increasing the number of computations and "quasi-returns" (*i.e.*, additional forms, schedules, and worksheets) that taxpayers have to fill out each year and the noncompliance that such complexity will generate?
3. Are there important tax policy reasons not to index each phase-out for inflation? Unless phase-outs are indexed for inflation, the real income level set by policymakers to trigger them will drift downward each year until the tax benefit affects only a few of the lowest income taxpayers while burdening all taxpayers with a needlessly complex tax code. Unindexed phase-outs might also begin to overlap with other phase-outs that are indexed for inflation, producing unexpectedly high effective marginal tax rates at certain income levels.
4. Should phase-outs create penalties for married or unmarried taxpayers or otherwise affect taxpayers differently based on filing status?
5. Should phase-out ranges be wide or narrow? Phase-out ranges that eliminate tax benefits gradually (*e.g.*, ratably) over a reasonably wide phase-out range are less likely to create unexpectedly high effective marginal tax rates. When phase-outs result in unexpectedly high effective marginal tax rates they make it difficult for taxpayers to predict their liability ahead of time, reduce the incentive to work, and create planning opportunities for taxpayers who are able to shift income from one year to the next or to related individuals or entities. However, phase-outs with wider phase-out ranges generally affect more taxpayers directly, and also provide some tax benefit to more taxpayers.
6. Is there any tax policy reason for phase-out formulas to differ as widely as they do? Uniform and simple phase-out formulas might make it easier for taxpayers to figure out how additional income will affect their tax benefits. They might also allow the IRS to reduce the number of forms, worksheets, and schedules that taxpayers need to fill out.
7. Is there a good policy reason for phase-out ranges to overlap? On one hand, overlapping phase-outs can create unexpectedly high effective marginal income

tax rates for taxpayers in those ranges. On the other hand, creating standard phase-out ranges, as proposed by some practitioner groups, could have the advantage of increasing the transparency of the tax code because taxpayers may be more likely to know what the phase-out range is and whether they are likely to be subject to it.[35] Uniform ranges might also enable the IRS to reduce the number of forms, worksheets, and schedules required to administer phase-outs.

[35] *See* American Bar Association, American Institute of Certified Public Accountants, and Tax Executives Institute, Inc., *Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002) (Attachment B: Simplification of Phase-Outs Based on Income Levels), *available at* https://www.abanet.org/tax/pubpolicy/2002/020913lt-atb.pdf (proposing three standard phase-out ranges: one for benefits targeted to low income taxpayers, one for benefits targeted to middle income taxpayers, and one for benefits targeted to high income taxpayers).

RECOMMENDATION

#5 INCREASE THE EXEMPT ORGANIZATION INFORMATION RETURN FILING THRESHOLD

PROBLEM

Under Internal Revenue Code § 501, certain specified organizations are exempt from federal taxation. These organizations, however, are generally required to file information returns with the IRS. When a tax exempt organization required to file an information return fails to do so or does not complete the return correctly, the Code imposes penalties on the organization.[1]

IRC § 501 exempts several types of organizations from federal taxation. The vast majority are formed for "religious, charitable, scientific, testing for public safety, literary, or educational purposes" under IRC § 501(c)(3).[2] In fiscal year 2005, there were more than one million § 501(c)(3) exempt organizations on file with the IRS.[3] Most of these organizations are small public charities.[4] More than 60 percent of exempt organizations on file with the IRS have less than $100,000 in net assets, and more than half have less than $25,000 in income.[5]

These small exempt organizations have limited resources and rely heavily on the services of volunteers. About half of all exempt organizations rely solely on volunteer staffs and another third have fewer than ten employees[6] Many exempt organizations do not have professional tax or accounting staffs and rely on volunteers to ensure that the organization complies with its filing requirements and accurately prepares its returns.[7]

The tax exempt information return filing requirements are complex. Exempt organizations are generally required to file IRS Form 990, Return of Organization Exempt from Income Tax, or Form 990-EZ, Short Form Return of Organization Exempt from Income Tax. The IRS estimates that the time to prepare and complete Form 990 (and accompanying schedules) is more than 216 hours – or 27 working days, and time to complete

1 *See* IRC § 6652(c)(1)(A).

2 In FY 2005, more than 1 million of the 1.7 million total tax exempt organizations were formed under IRC § 501(c)(3) (more than 61 percent). IRS Data Book 2005, Table 22-*Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years 2002-2005.*

3 IRS Data Book 2005, Table 22.

4 IRC § 501(c)(3) also provides that certain "private foundations" are exempt from federal taxation. "Private foundation" is defined in IRC § 509(a). Because the filing requirements for private foundations differ from the filing requirements of public charities, this section of the National Taxpayer Advocate's Annual Report to Congress deals only with organizations exempt from taxation under IRC § 501(c)(3) that are not private foundations.

5 IRS, *SOI Tax Study, Exempt Organizations: IRS Master File*, at http://www.irs.gov/taxstats/charitablestats/article/0,,id=97186,00.html.

6 IRS Tax Exempt and Government Entities Division, *FY 2005 Strategic Assessment* 3.

7 *Id.*

Form 990-EZ (the "short form") is more than 133 hours (nearly 17 working days).[8] Exempt organizations that do not have accounting staffs or cannot afford professional assistance to complete these returns are likely to make mistakes and file returns with incorrect or incomplete information.

When an exempt organization files an incorrect or incomplete return, it is subject to penalties. The IRS can abate these penalties if an exempt organization can show that a late or incomplete return was attributable to "reasonable cause;"[9] but when an exempt organization – particularly a smaller one – has to devote resources to working with the IRS to abate penalties, it draws resources from the organization's charitable functions.

Under current law, exempt organizations with annual gross receipts that are normally more than $25,000 must file an information return with the IRS.[10] This $25,000 filing threshold was set administratively in 1982 and has not been adjusted for inflation in 24 years.[11] The statutory filing threshold of $5,000 has not been changed since it was enacted in 1969.[12] In the meantime, the Consumer Price Index has increased 449 percent since 1969 and 109 percent since 1982.[13] Thus, an exempt organization with gross receipts of $25,100 for the 2006 tax year must file an information return, even though its gross receipts would have been only $ 4,572 in 1969 dollars and $12,010 in 1982 dollars. Conversely, $5,100 of gross receipts in 1969 would be equal to $28,001 in today's dollars and $25,100 of gross receipts in 1982 would be equal to $52,459 today. Because the filing threshold has not been adjusted for inflation, many small exempt organizations must deal with burdensome and complex filing requirements.

The outdated filing threshold will affect more and more exempt organizations as it remains static. The number of section 501(c)(3) organizations on file with the IRS has increased 15 percent since 2002.[14] The growth of the exempt organization sector is one reason that all exempt organizations not required to file an information return with the IRS must file an annual electronic notice with the IRS setting forth basic information about the organization.[15]

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8 2005 Instructions for Forms 990 and 990-EZ, 45. For a more detailed discussion about the complexities of the exempt organization filing requirements, *see* National Taxpayer Advocate 2005 Annual Report to Congress 295-298.

9 IRC § 6652(a)(3); IRM 3.12.12.2.6.8 – Reasonable Cause; IRM 20.1, *See* Rev. Proc. 79-8, 1979-1 C.B. 487; Policy Statement P-2-7, P-2-9, and P-2-11.

10 IRS, *Instructions for Form 990 and Form 990-EZ* 2 (2005).

11 Announcement 82-88, 1982-25 IRB 23.

12 IRC § 6033(a)(3)(A)(ii).

13 United States Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator,* available at www.bls.gov/cpi.

14 IRS Data Book 2005, Table 22. IRC § 501(c)(3) organizations have increased from 909,574 in 2002 to 1,045,979 in 2005.

15 IRC § 6033(i).

EXAMPLE

In 1987 Mr. and Mrs. Siddons formed ABC Co. as a chartering organization to sponsor Troop 416 of the Boy Scouts of America. Troop 416 is located in Springfield, a small town in the midwestern United States. Upon its formation, ABC Co. applied for and received tax exempt status under IRC § 501(c)(3). ABC Co.'s primary function is to solicit and receive donations to support the troop. Since 1987, ABC Co. has been staffed by Mr. and Mrs. Siddons and Mr. Hastings, proprietor of the local hardware store. In 1998, the Siddons' son, Whitey, an English teacher at Springfield High School, also began helping out with ABC Co. All four individuals serve on a volunteer basis and receive no compensation.

For tax years 1987 through 2001, ABC Co. averaged less than $25,000 in gross receipts. Nearly all of ABC Co.'s receipts are from donations made by the scouts' parents and local businesses and from Troop 416's annual mulch sale.

Since 1987, Troop 416's membership has expanded and ABC Co.'s receipts from donations have increased. Additionally, the Troop 416's mulch supplier has increased prices. The troop sells about the same amount of mulch each year, but gross receipts from the mulch sale have increased because the troop has to increase the price each year to cover its costs. For tax years 2000 through 2002, ABC Co. averaged more than $30,000 in gross receipts. For its 2005 tax year, ABC Co.'s gross receipts were nearly $35,000.

Because its gross receipts had increased above the $25,000 filing threshold for 2000 through 2002, ABC Co. began filing Form 990-EZ in 2003 (for its 2002 tax year). Whitey Siddons volunteered to file ABC Co.'s information returns because he had taken two semesters of basic accounting while earning his English degree at State University. In 2004, the IRS informed ABC Co. that it had been assessed a penalties totaling $1,500 for ABC Co.'s 2002 tax year because ABC Co. had failed to file required schedules with its 2002 Form 990-EZ. Paying this penalty will put Troop 416's planned summer trip to the Philmont Scout Ranch in jeopardy. Neither Whitey nor the other ABC Co. volunteers have dealt with the IRS before, and they are concerned that hiring a lawyer or accountant to handle the problem may cost as much as paying the penalty.

RECOMMENDATION

Amend Internal Revenue Code section 6033(a)(3)(A)(ii) to (1) increase the statutory information return filing threshold for IRC § 501(c)(3) organizations (excluding private foundations) from $5,000 to $50,000, and (2) provide that the statutory filing threshold be adjusted for inflation in subsequent years.

CURRENT LAW

Internal Revenue Code § 501(a) provides that an organization described in section 501(c) shall generally be exempt from federal income taxation. Section 501(c)(3) provides that certain organizations organized and operated exclusively for religious,

charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition are exempt from federal income taxation under section 501(a). Code section 509(a) provides that certain section 501(c)(3) organizations are defined as private foundations. Organizations organized under section 501(c)(3) that are not private foundations under section 509(a) are generally referred to as public charities.

IRC § 6033(a) requires, with certain exceptions, every organization exempt from tax under section 501(a) to file an annual information return with the IRS. Most exempt organizations that are not private foundations must file Form 990, Return of Organization Exempt from Income Tax.[16] An organization required to file Form 990 may file instead a Form 990-EZ, Short Form Return of Organization Exempt from Income Tax, if the organization's gross receipts during the year are less than $100,000 and its total assets at the end of the year are less than $250,000.[17] An organization that meets the Form 990-EZ filing requirements can still file Form 990, if it chooses to do so.[18]

Code § 6033(a)(3)(A)(ii) provides that a tax exempt organization is exempt from filing an information return with the IRS if its annual gross receipts are normally not more than $5,000.[19] Section 6033(a)(3)(B) provides that the Secretary of the Treasury may relieve any organization from the 6033(a)(1) filing requirement where the Secretary determines that such filing is not necessary to the "efficient administration of the internal revenue laws." Treas. Reg. § 1.6033-2(g)(6) delegates this authority to the Commissioner of Internal Revenue.

With the Tax Reform Act of 1969 (1969 Act), Congress began requiring more exempt organizations to file information returns with the IRS.[20] The 1969 Act also provided, that certain section 501(c)(3) organizations were exempt from information return filing if their annual gross receipts were normally not more than $5,000.[21] This statutory $5,000 gross receipts threshold remains in place today.[22] However, the IRS has twice increased

[16] Treas. Reg. § 1.6033-2(a)(2)(i). Tax exempt private foundations must file Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation. *Id.*

[17] IRS, *Instructions for Form 990 and Form 990-EZ* 2 (2005).

[18] *Id.*

[19] The Code and regulations also provide that the following organizations are exempt from the filing requirement: (1) a church, an interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church (IRC § 6033(a)(3)(A)(i), Treas. Reg. § 1.6033-2(g)(1)(i)); (2) a school below college level affiliated with a church or operated by a religious order (IRC § 6033(a)(3)(C)(ii), Treas. Reg. § 1.6033-2(g)(1)(vii)); a mission society sponsored by, or affiliated with, one or more churches or church denominations, more than one-half of whose activities are conducted in, or directed to persons in a foreign country (IRC § 6033(a)(3)(C), Treas. Reg. § 1.6033-2(g)(1)(iv)); an exclusively religious activity of any religious order (IRC § 6033(a)(3)(A)(iii), Treas. Reg. § 1.6033-2(g)(1)(ii)); and a state institution whose income is excluded from gross income under IRC § 115(a) (IRC § 6033(a)(3)(B), Treas. Reg. § 1.6033-2(g)(1)(v)).

[20] Pub. L. No. 91-172 § 101(d) (1969).

[21] *Id.*

[22] IRC § 6033(a)(3)(A)(ii).

the filing threshold administratively under the authority granted in IRC § 6033(a)(3)(B). For tax years ending on or after December 31, 1976, the gross receipts filing threshold was increased to $10,000.[23] On January 1, 1982, the IRS increased the threshold to $25,000 for tax years ending on or after December 31, 1982.[24] To determine whether an organization's gross receipts do not normally exceed $25,000, the IRS uses the following formula:

- If an organization has been in existence a year or less, then its gross receipts can be up to $37,500.
- If an organization is between one and three years old, then the average of its last two years of receipts can be up to $30,000.
- If an organization has been in existence for three years or more, then the average of its preceding three years cannot exceed $25,000.[25]

Internal Revenue Code § 6652(c)(1)(A) imposes a $20 per day penalty (up to $10,000 or five percent of the organization's yearly gross receipts) for each day a return required under § 6033 is not filed or filed with missing or incomplete information. For exempt organizations with annual gross receipts exceeding $1 million, the penalty is $100 per day (up to $50,000).[26]

For tax years beginning after 2006, IRC § 6033(i) requires organizations exempt from information reporting under IRC § 6033(a)(3)(A)(ii) or (a)(3)(B) to electronically file an annual notice with the IRS setting forth:

- The organization's legal name;
- Any name under which such organization operates or does business;
- The organization's mailing address and Internet web site address (if any);
- The organization's taxpayer identification number (TIN);
- The name and address of a principal officer; and
- Evidence of the continuing basis for the organization's exemption from the information return filing requirements.[27]

An organization required to file these notices that fails to do so for three consecutive years will lose its tax exempt status.[28]

[23] *See* Rev. Proc. 83-23, 1983-1 C.B. 687 and Announcement 82-88, 1982-25 IRB 23.

[24] Announcement 82-88, 1982-25 IRB 23.

[25] IRS, *Instructions for Form 990 and Form 990-EZ* 3 (2005).

[26] IRC § 6652(c)(1)(A).

[27] IRC § 6033(i).

[28] IRC § 6033(j)(1).

REASONS FOR CHANGE

Congressional Intent and Legislative History

Under current law, more small tax exempt organizations are required to file an annual information return with the IRS than was originally intended. In the Tax Reform Act of 1969 Congress provided that certain § 501(c)(3) organizations were required to begin filing information returns, but organizations would remain exempt from information return filing if their annual gross receipts were normally not more than $5,000.[29] The Code does not provide for this filing threshold to be adjusted for inflation. The 1969 Act also provided that the Secretary of the Treasury could relieve any exempt organization from the information return filing requirement where the Secretary determines that filing an information return is "not necessary to the efficient administration of the internal revenue laws."[30] The Secretary has delegated this authority to the IRS.[31]

The 1969 Act increased the reporting requirements for exempt organizations to "provide the Internal Revenue Service with the Information needed to enforce the tax laws" and to prevent certain exempt organizations from abusing the tax exemption provisions without IRS scrutiny.[32] Congress did not intend, however, for the increased filing requirements to reach small organizations. Congress did not want to force these small organizations "to consume the few assets they possess in order to hire lawyers and accountants to prepare an annual [return]."[33] Thus, Congress included the $5,000 statutory filing exception in the 1969 Act.

Administrative Adjustments and Economic Change

Congress has not changed the statutory $5,000 annual gross receipt filing threshold since 1969,[34] but the IRS has increased the filing threshold administratively under its section 6033(a)(3)(B) discretionary exception authority. For tax years ending on or after December 31, 1976, the gross receipts filing threshold was increased to $10,000.[35] On January 1, 1982, the IRS increased the threshold to $25,000 for tax years ending on or after December 31, 1982.[36] Both increases came because the IRS realized that the information return filing threshold was not high enough to "relieve relatively small

[29] Pub. L. No. 91-172 § 101(d) (1969).

[30] IRC § 6033(a)(3)(B).

[31] Treas. Reg. § 1.6033-2(g)(6).

[32] *See* S. Rep. No. 91-552, 52 (1969); H.R. Rep. No. 91-413, pt. 1, 36 (1969); H.R. Conf. Rep. No. 91-782, 286 (1969); Cong. Rec., S15,646-48 (Nov. 24, 1969).

[33] Cong. Rec., S15647 (Nov. 24, 1969) (statement of Sen. Curtis). *See also* Cong. Rec., H7096 (Aug. 7, 1696) (statement of Congressman Mills listing Boy Scouts, Girl Scouts, and the PTA as examples of organizations that should be exempt from the filing requirements).

[34] IRC § 6033(a)(3)(A)(ii).

[35] Announcement 77-62 (April 25, 1977); *see* Rev. Proc. 83-23, 1983-1 C.B. 687 and Announcement 82-88, 1982-25 IRB 23.

[36] Announcement 82-88, 1982-25 IRB 23.

organizations from the [Form 990] filing requirements."[37] Twenty-four years after this last adjustment, however, the $25,000 filing threshold remains in place.

While the filing threshold has remained constant, economic conditions have changed. Since 1982, the Consumer Price Index (CPI) has increased 109 percent.[38] Thus, an exempt organization with gross receipts of $25,000 in 1982 would have gross receipts of over $52,000 in 2006 dollars.[39] Conversely, an exempt organization with $25,000 in gross receipts today would have had just under $12,000 in gross receipts in 1982 dollars. In other words, when adjusted for inflation, the $25,000 filing threshold requires information return filing by exempt organizations that have gross receipts of less than half of the threshold as enacted in 1982. The CPI has also increased nearly 450 percent since the $5,000 statutory exception was first enacted.[40]

Effects on Small Exempt Organizations

Requiring "relatively small" exempt organizations to grapple with the complex Form 990 filing requirements unnecessarily drains resources from both small exempt organizations and the IRS. Small exempt organizations that rely on volunteers rarely have access to professional tax advice. So, the current filing threshold requires many small volunteer-run organizations to take their chances filing the required returns themselves, or to turn to the IRS for help.

Complex Requirements

Volunteers attempting to file an exempt organization's information return must make a significant time commitment. Table 2.5.1 shows the latest IRS estimates for preparing and completing Forms 990 and 990-EZ.

TABLE 2.5.1, ESTIMATED TIME FOR COMPLETING FORMS 990 AND 990-EZ AND RELATED SCHEDULES[41]

Form	Record-keeping	Learning about the law or form	Preparing the form	Copying, assembling, and sending the form to the IRS	Total
990	102 hr., 36 min.	15 hr., 4 min.	21 hr., 8 min.	1 hr., 4 min.	139 hr., 52 min.
990-EZ	29 hr., 10 min.	11 hr., 36 min.	14 hr., 24 min.	32 min.	55 hr., 42 min.
Schedule A	49 hr., 44 min.	9 hr., 26 min.	10 hr., 39 min.	__	69 hr., 49 min.
Schedule B	4 hr., 46 min.	1 hr., 23 min.	1 hr., 31 min.	__	7 hr., 40 min.

[37] Announcement 82-88, 1982-25 IRB 23.

[38] United States Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator,* available at www.bls.gov/cpi.

[39] *Id.*

[40] United States Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator,* available at www.bls.gov/cpi.

[41] IRS, *Instructions for Form 990 and Form 990-EZ*, 45 (2005).

According to the information shown in Table 2.5.1, it will take an exempt organization 217 hours and 31 minutes to prepare, complete and file Form 990 with Schedules A and B. That task would take one person working full time more than 5 ½ weeks to complete.[42] And the 990-EZ "short" form will take 133 hours and 11 minutes to prepare; keeping a full time person busy for over three weeks.[43]

Limited IRS Resources

When volunteers and exempt organization staff who are not "tax people" have to prepare and file these lengthy and complex returns, they may try and turn to the IRS for assistance. Unfortunately, the assistance the IRS can offer may not be particularly helpful. Calls to the IRS concerning exempt organization filing requirements are routed to the IRS Tax Exempt and Government Entities Division's (TE/GE) toll-free customer assistance line. For fiscal years 2003 through 2005, the TE/GE toll-free line answered only about 60 percent of its calls.[44] This low service rate is mostly attributable to the extraordinarily high demand in customer phone calls. From fiscal year 1999 to fiscal year 2003, calls to TE/GE's toll-free customer assistance line grew 243 percent.[45] As a result, even though TE/GE is answering more calls every year, the ratio of calls answered to calls received is generally decreasing.[46] These numbers indicate that more and more exempt organizations are turning to the IRS for help with filing requirements and other questions, but the IRS does not have the resources to provide the help needed. As a result, exempt organizations that do not have tax experts on staff may be on their own.[47]

Penalties and Abatements

When volunteers without tax expertise have to prepare lengthy and complex information returns, mistakes are likely. When an exempt organization files an information return with missing or incorrect information, the IRS is required to assess a Daily Delinquency Penalty (DDP) on the organization until the missing information is supplied or the defect is cured.[48] If the penalized organization later supplies the missing return or information, or corrects the error, and can show reasonable cause for the mistake, the IRS will abate the assessed DDPs.[49] IRS DDP abatement rates demonstrate

[42] 217 hours and 35 minutes divided by 40 hours per week equals 5.4 work weeks.

[43] 133 hours and 14 minutes divided by 40 hours per week equals 3.3 work weeks.

[44] Telephone Data Report, TE/GE Toll Free Customer Service, Cincinnati, FY 2003-2004; TE/GE Cincinnati Call Center, Call Data Summary FY 2005. *See also* TE/GE, *Strategic Assessment FY 2006* 2. The IRS Wage and Investment Division (W&I) recently began operating the TE/GE toll-free customer assistance line in conjunction with other IRS help lines. It is anticipated that this change will improve the TE/GE line service level.

[45] TE/GE, *Strategic Assessment FY 2006* 2.

[46] *Id.*

[47] For a more detailed discussion of this subject, see National Taxpayer Advocate 2005 Annual Report to Congress 302-304.

[48] IRC § 6652(c)(1)(A).

[49] IRC § 6652(a)(3); IRM 3.12.12.2.6.8 – Reasonable Cause; IRM 20.1, Rev. Proc. 79-8, Policy Statement P-2-7, P-2-9, and P-2-11.

that most exempt organizations are able to cure defects in their returns and show that the mistakes or omissions were due to reasonable cause. Table 2.5.2 shows the number of DDPs assessed and abated from tax years 1992 through 2005.

TABLE 2.5.2, DAILY DELINQUENCY PENALY ASSESSMENTS AND ABATEMENTS[50]

Year	Number of Penalties Assessed	Number of Penalties Abated	Percent	Amount of Penalties Assessed	Amount of Penalties Abated	Percent
2000	61,065	43,959	72.0	$175,478,613	$145,588,460	83.0
2001	57,451	39,631	69.1	$165,128,263	$129,909,678	78.7
2002	69,575	45,470	65.4	$207,557,338	$149,111,426	71.8
2003	74,249	41,690	56.1	$229,901,830	$138,919,162	60.4
2004	81,154	45,903	56.6	$235,925,748	$143,219,698	60.7
2005	88,714	49,752	56.1	$251,000,718	$150,157,959	59.8
Total	**432,208**	**266,405**	**61.6**	**$1,264,992,510**	**$856,906,383**	**67.7**

Table 2.5.2 indicates that for the last six tax years, the IRS has abated almost 62 percent of all assessed DDPs and nearly 68 percent of all assessed DDP dollars. These high abatement numbers indicate that exempt organizations are making frequent but correctable errors when filing required information returns.[51] Table 2.5.3 shows the most common Form 990 and 990-EZ filing errors.

TABLE 2.5.3, THE MOST COMMON FORM 990 AND 990-EZ FILING ERRORS[52]

Form 990	Form 990-EZ
Missing Schedule B or the box in Item M is not checked[53]	Missing Schedule B or the box in Item H is not checked[54]
Missing or incomplete Schedule A	Missing or incomplete Schedule A
Missing signature	Request to file Form 990 (total assets more than $250,000)
Part IV-A, Schedule A (support schedule) is missing or incomplete	Request to file Form 990 (gross receipts more than $100,000)
Part IV (reconciliation of revenue/expenses) is missing or incomplete	Missing signature
Clarification of subsection (request copy of determination letter)	Clarification of subsection (request copy of determination letter)

[50] IRS Enforcement Revenue Information System (ERIS) and Statistics of Income (SOI) for EO Returns, 2000-2005 DDP assessments and abatements.

[51] For a more detailed discussion on the IRS's high DDP abatement rate and possible administrative remedies, see National Taxpayer Advocate 2005 Annual Report to Congress 292-314.

[52] Most Common Reasons the IRS May Need to Contact You (available at http://www.irs.gov/charities/article/0,,id=96359,00.html).

[53] Item M on Form 990 requires a filing organization to check a box if the organization is not required to file Schedule B.

[54] Item H on Form 990-EZ requires a filing organization to check a box if the organization is not required to file Schedule B.

Table 2.5.3 demonstrates that most Form 990 and 990-EZ errors are attributable to inadvertent and clerical mistakes. The top two errors for both forms are missing or incorrect Schedules A or B. These errors are probably so frequent because many smaller exempt organizations do not realize they have to file these schedules with their return. It also appears that these errors are generally curable and that the affected organizations should be able to demonstrate that the errors were due to reasonable cause. The high DDP abatement rate indicates that this scenario is playing out on an annual basis.

The continuing cycle of DDP assessment and abatement is not good for anyone. Exempt organizations that receive DDP assessments that are due to curable errors must use their limited resources to work with the IRS to try and receive abatements. Or they may simply pay the penalties to avoid dealing with the IRS at all – this latter course not only wastes the organization's limited resources, but the organization is likely to be penalized again if does not work with the IRS to find out *why* the IRS assessed penalties. The DDP assessment/abatement cycle also wastes IRS resources. When more than 60 percent of all assessed DDPs are eventually abated, IRS employees are spending significant time determining whether the mistakes that gave rise to the assessments were attributable to reasonable cause.

Many DDP assessments could be avoided altogether if smaller exempt organizations were not required to file an information return. Because the most frequent filing mistakes are attributable to inadvertent and clerical errors, it follows that most errors that trigger a DDP assessment are being made by smaller exempt organizations that rely on volunteers to prepare and file their information returns.[55] Increasing the information return filing threshold to $50,000 and adjusting the threshold for inflation in the future would "relieve relatively small [tax exempt] organizations from the filing requirements" and prevent these small organizations and the IRS from using their valuable resources to deal with DDP assessments and abatements.

Small Exempt Organizations: Flying Below the Radar?

Since it increased the information return filing threshold to $25,000 in 1982, the IRS has said next to nothing about it.[56] Thus, the only stated rationale for setting the threshold at $25,000 is that it was intended to "relieve relatively small organizations from the filing requirements."[57] To our knowledge, the IRS has never publicly explained

[55] The IRS no longer tracks Form 990 and 990-EZ error frequency, but when it last reported error frequency in 1998, more than half of all Form 990 and 990-EZ errors were attributable to missing or incorrect Schedules A. IRS, *Common Errors Found on Form 990 and Form 990-EZ* (available at http://www.qual990.org/common_errors.html). The National Taxpayer Advocate recommends that the IRS resume error frequency tracking so that it may better educate exempt organizations about common errors and how these errors can be prevented.

[56] We found only two official IRS pronouncements that mention Announcement 82-88: Rev. Proc. 83-23 (establishing and maintaining for reference purposes a list of 501(c)(3) organizations exempt from filing) and PLR 8337094 (June 17, 1983) (holding that local chapters of a social welfare organization organized under IRC § 501(c)(4) were not required to file a Form 990 if their annual gross receipts were normally below the $25,000 filing threshold).

[57] Announcement 82-88.

why it has not adjusted this threshold for inflation for nearly a quarter century. One possible explanation could be, however, that the IRS is concerned that raising the filing threshold could allow many smaller organizations to operate under the IRS's radar. In fact, this was one of the primary reasons Congress increased exempt organization filing requirements in 1969.[58] When there is no IRS scrutiny, the potential for abusing the tax exempt laws or operating illegitimate "charities" is high. Thus, any IRS concerns about small organizations abusing the Code's exemption provisions are valid and the IRS's failure to raise the filing threshold is understandable.

These concerns are largely alleviated, however, by the enactment of the Pension Protection Act of 2006. Section 1223 of this Act amended Code section 6033 to require organizations exempt from the information filing requirements under sections 6033(a)(3)(A)(ii) or (a)(3)(B) to file electronically with the IRS an annual notice setting forth basic information including the organization's name (and any previous names), mailing address, Internet web site address (if any), TIN, name and address of a principal officer, and evidence of the continuing basis for the organization's exemption from the information return filing requirements.[59] An organization required to file these notices that fails to do so for three consecutive years will lose its tax exempt status.[60]

Under this new provision all exempt organizations that are exempt from filing because their annual gross receipts do not normally exceed the filing threshold are required to provide the IRS with basic information on an annual basis. These annual electronic "check ins" will prevent any tax exempt organization from operating under the IRS's radar.[61] This reporting requirement should minimize concerns about illegitimate exempt organizations avoiding IRS scrutiny because of an increased filing threshold. Because all small tax exempt organizations are now required to electronically submit basic information to the IRS, the filing threshold should be increased to $50,000 to relieve those "relatively small" organizations that were never intended to be subject to the complex and cumbersome Form 990 filing requirements. And the $50,000 filing threshold should be adjusted for inflation in later years to prevent those "relatively small" organizations from being subject to the information return filing requirements solely because of inflation.

An increased filing threshold would greatly benefit small tax exempt organizations. These organizations would no longer have to comply with the cumbersome and complex Form 990 requirements and no longer have to deal with Daily Delinquency

58 *See* S. Rep. No. 91-552, 52 (1969); H.R. Rep. No. 91-413, pt. 1, 36 (1969); H.R. Conf. Rep. No. 91-782, 286 (1969); Cong. Rec., S15,646-48 (Nov. 24, 1969).

59 IRC § 6033(i).

60 IRC § 6033(j)(1).

61 Exempt organizations are also generally subject to state filing requirements. In California, for example, exempt organizations must file Form 3500, Exempt Application, and Form 199, California Exempt Annual Information Return, with the California Franchise Tax Board. (California Franchise Tax Board, Publication 927, *Exempt Organizations: Nonprofit doesn't mean tax exempt* (Jul. 2003). State filing requirements also help to prevent small exempt organizations from operating without government oversight.

Penalties when they make mistakes. An increased filing threshold would also benefit the IRS. If fewer exempt organizations were required to file information returns, there would be fewer calls to TE/GE's overburdened toll-free customer assistance line. The IRS could also devote fewer resources to dealing with DDP abatements. Further, because all small exempt organizations are now required to file annual electronic notices with the IRS, there is very little risk that relieving more small exempt organizations from the filing requirements will increase noncompliance or abuse of the tax exempt provisions of the Code.[62] With these new protections in place, information return filing by "relatively small" exempt organizations is not necessary to the efficient administration of the internal revenue laws. In fact, relieving these small organizations of the burdens of information return filing would actually increase administrative efficiency.

EXPLANATION OF RECOMMENDATIONS

A $50,000 filing threshold approximates the 109 percent CPI increase since the $25,000 threshold became effective in 1982.[63] And providing that the increased threshold be adjusted for inflation will prevent small organizations from being captured by the filing requirements as the CPI continues to increase.

Increasing the filing threshold and adjusting it for inflation thereafter could be accomplished administratively.[64] There are, however, several disadvantages of waiting for the IRS to increase the threshold by administrative action. As a starting point, the initial exempt organization filing threshold was *statutory*. Congress included the $5,000 gross receipts threshold in the 1969 Act to avoid placing filing burdens on small exempt organizations.[65] Congress failed, however, to provide for this initial $5,000 to be adjusted for inflation. Because the initial gross receipts filing threshold was statutory and because Congress has not adjusted this threshold for inflation for 37 years, a statutory threshold increase is appropriate.

There are at least three more reasons why a statutory threshold adjustment is preferable to an administrative adjustment. First, administrative changes are subject to Treasury and IRS workload priorities. There are eight projects related to exempt organizations listed on the Treasury/IRS 2006-2007 Priority Guidance Plan, none of which are related to the information return filing threshold.[66] Second, there is no indication that the IRS is planning on, or even thinking about, considering whether the current $25,000 filing

[62] The IRS could cross reference the information obtained under the new electronic notice requirement with information from state oversight agencies to identify organizations that are abusing the tax exemption provisions.

[63] *See* United States Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator*, available at www.bls.gov/cpi.

[64] IRC § 6033(a)(3)(B); Treas. Reg. § 1.6033-2(g)(6).

[65] Cong. Rec., S15647 (Nov. 24, 1969) (statement of Sen. Curtis). See also Cong. Rec., H7096 (Aug. 7, 1696) (statement of Congressman Mills listing Boy Scouts, Girl Scouts, and the PTA as examples of organizations that should be exempt from the filing requirements).

[66] Department of the Treasury, *2006-2007 Priority Guidance Plan*, (Aug. 15, 2006).

threshold continues to be appropriate. The current threshold has been in place for 24 years and the IRS has said almost nothing about the threshold since it was adopted in 1982. Third, even if the IRS administratively increased the filing threshold sometime in the near future, there is no indication that the IRS would also administratively provide for the threshold to be adjusted for inflation. Based on the IRS's lack of action in the past, it is unlikely that any increase would be revisited or reevaluated for economic appropriateness for many years.

These problems could all be avoided by codifying a $50,000 threshold to be adjusted for inflation in future years. By acting legislatively, Congress can ensure that small exempt organizations will not be burdened with the Form 990 filing requirements and thus be free to use their full resources to fulfill their charitable and community service purposes. This change is now possible because small exempt organizations must file electronically with the IRS every year. This new filing requirement will prevent exempt organizations of any size from disappearing entirely.

RECOMMENDATION

#6 FILING ISSUES

Filing a tax return is one of taxpayers' main entry points into the federal tax system. Considering that the system is based on voluntary compliance, it is in the best interest of both the taxpayer and the IRS to ensure that the filing process runs smoothly. When a taxpayer sits down to prepare a return with a commercial preparer, the taxpayer should not worry that his or her confidential tax information will be used or disclosed inappropriately. Further, if a taxpayer inadvertently designates the wrong account number to receive a refund, the IRS should have the proper authorization to resolve the issue.

The National Taxpayer Advocate continues to call for the establishment of minimum levels of competency for return preparation by developing a federal system to register, test, and certify unenrolled return preparers. She also believes that Congress and the IRS can improve preparer oversight by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.[1]

USE AND DISCLOSURE OF TAX RETURN INFORMATION

PROBLEM

Section 7216 of the Internal Revenue Code and the regulations thereunder do not prohibit tax return preparers from using or disclosing tax return information for purposes of soliciting business. The existing regulations and proposed regulations thereunder permit a preparer to use or disclose the information for purposes of soliciting business, if the taxpayer has given written consent for the preparer to do so.[2] However, taxpayers often receive stacks of forms to sign when hiring preparers to handle their taxes. There is no real way to determine whether taxpayers completely understand that they are authorizing the preparer to release their data to a third party, and from that point, their privacy and confidentiality may not be protected.

EXAMPLE:

A taxpayer goes to a paid preparer to have his federal and state individual tax returns done. The preparer asks him to sign a stack of papers on which he has highlighted the

[1] National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; *Regulation of Federal Tax Return Preparers, Hearing Before U.S. House of Representatives Committee on Ways and Means, Subcommittee on Oversight*, 108th Cong. (July 20, 2005) (statement of Nina. E. Olson, National Taxpayer Advocate, Internal Revenue Service); *Tax Return Preparation Options for Taxpayers, Hearing Before the U.S. Senate Committee on Finance*, 109th Cong. (April 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

[2] Treas. Reg. § 301.7216-3(a) permits a tax return preparer, with the written consent of a taxpayer, to use tax return information to promote nontax products and services currently offered by the preparer or a member of the preparer's affiliated group. Prop. Treas. Reg. § 301.7216-3(a) eliminates the affiliated group restriction, thereby essentially allowing a preparer to use or disclose tax return information, with the written consent of the taxpayer, for purposes of soliciting business for anyone.

appropriate place for the taxpayer's signature. The preparer briefly explains what each form contains. The taxpayer signs a form which the preparer explains as "a form providing me consent to analyze your tax information to determine if any products or services will benefit you." The taxpayer signs the consent form along with the others in the stack but does not realize that the form authorizes the preparer to analyze (or "use") the tax information for purposes of marketing nontax-related products or services, and this "analysis" has no time limits. The preparer completes the taxpayer's federal return, then tells the taxpayer he is due a $2,000 refund and can have his check tomorrow, but first he has to fill out a refund anticipation loan application from Bank X and a separate disclosure consent form. When the taxpayer signs both forms, he does not understand that the preparer will share confidential tax return information with Bank X and that the tax laws do not prevent Bank X from disclosing the information to an independent third party.

RECOMMENDATION

Congress should amend IRC §§ 7216 and 6713 to:

- Prohibit use or disclosure of tax return information for purposes other than tax preparation and filing of returns. The statutes should specifically prohibit the use or disclosure of information for the business solicitation of nontax-related products or services, including but not limited to those related to tax refund delivery and the protection from IRS audit.
- Specifically state the exception currently in Treas. Reg. § 301.7216-2(e), which provides that IRC §§ 7216(a) does not apply to a tax return preparer who is lawfully engaged in the practice of law or accountancy. This exception allows the individual to use or disclose tax return information to another employee or member of the preparer's law or accounting firm for purposes of rendering other legal or accounting services for the taxpayer.
- Clarify the reach of IRC § 7216(a) to include preparers of returns other than income tax returns, volunteers, individuals who perform other businesses in addition to return preparation, and contractors performing services in connection with return preparation.
- Specifically state that the regulations issued thereunder must require safe harbor language to include in all written consents. The safe harbor language should address the limitations and duration of the consents as well as provide detailed contact information for the taxpayers to report violations or inquire about their rights.
- Prohibit the disclosure or use of information to or by any tax return preparer located outside of the United States, unless the taxpayer has provided written consent.

PRESENT LAW

Internal Revenue Code § 7216 imposes a criminal penalty on preparers of income tax returns who knowingly or recklessly make unauthorized uses or disclosures of tax return

information,[3] while IRC § 6713 imposes a civil penalty for preparers' improper use or disclosure of such information. Both statutes and the regulations issued thereunder establish privacy protections by limiting a preparer's ability to use or disclose confidential information. The existing statutes and regulations permit a preparer, with the written consent of a taxpayer, to use tax return information to promote nontax products and services offered by the preparer or a member of the preparer's affiliated group.[4] Moreover, with written taxpayer consent, a preparer may disclose tax return information to any third party as directed by the taxpayer.

Treasury Regulation § 1.301.7216-2 includes exceptions to the written consent requirements of IRC § 7216. Such exceptions include, but are not limited to, the following:

- Use or disclosure in the case of related taxpayers;
- Disclosure pursuant to an order of the court or a federal or state agency;
- Use or disclosure for use in revenue investigations or court proceedings;
- Disclosure by attorneys and accountants;
- Disclosures by or to certain fiduciaries;
- Disclosures by one officer, employee, or member of the tax return preparer to another officer, employee, or member of the same tax return preparer; and
- Use or disclosure in preparation or audit of state returns.

In December 2005, the IRS and Treasury issued proposed regulations and a related draft revenue procedure.[5] The preamble to the proposed regulations states the proposed rules address taxpayers' consent to the disclosure or use of tax return information in an electronic environment. The proposed changes also focus on provisions designed to ensure that taxpayers give knowing, informed, and voluntary consent for such uses and disclosures. The proposed regulations allow preparers to obtain written consent for solicitation of services or facilities furnished by any person rather than limiting solicitations to the services or facilities offered by the preparer or a member of the preparer's "affiliated group." The proposed regulations would also require the taxpayer to consent in writing before the preparer releases information overseas, even when the overseas recipient is with the same firm.[6]

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[3] IRC § 7216(a) specifically states that the section applies to "returns of tax imposed by chapter 1". Further, Treasury Reg. § 301.7216-1(b)(1) defines "tax return" as "any return (or amended return) of the income tax imposed by chapter 1 or 2 of the Code."

[4] Treas. Reg. § 301.7216-3.

[5] The Department of Treasury and the IRS have placed the IRC § 7216 regulation project on the *Office of Tax Policy and Internal Revenue Service 2006 – 2007 Priority Guidance Plan*, Tax Administration, Item 35 (Aug. 15, 2006).

[6] REG. 137243-02, 2006-3 I.R.B. (containing Prop. Treas. Reg. §§ 301.7216-1 to -3); Notice 2005-93, 2005-52 I.R.B. 1204 (containing Proposed Revenue Procedure 2005-93). For a more detailed discussion of the benefits included in the proposed regulations and revenue procedure, see *Tax Return Preparation Options for Taxpayers: Hearing Before the Senate Comm. on Finance*, 109th Cong. 2nd Sess. (Apr. 4, 2006) (Statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

Notice 2005-93 contains the proposed revenue procedure detailing the format and contents of consents for preparers to use and disclose tax return information under IRC § 7216. The procedure contains mandatory language to include in consents, addressing the limitations and duration of the consents. It also contains mandatory language detailing contact information for the Taxpayer Advocate Service, so taxpayers can learn more about their rights under IRC § 7216, as well as contact information for the Treasury Inspector General For Tax Administration (TIGTA) to report violations.7

REASONS FOR CHANGE

After the IRS and Treasury released the aforementioned proposed regulations and draft revenue procedure for public comment, the rules came under fire for not protecting taxpayers enough. A number of consumer protection groups argued the rules would allow commercial tax preparers to share and even sell confidential taxpayer information to third party marketers and database brokers.[8] Further, after the initial disclosure of tax return information to a third party, the tax laws and regulations would not restrict the redisclosure of information by the third party.[9]

Concerns raised about the proposed rules have also received congressional attention. Section 512 of S.1321, The Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act, directs the Secretary to amend the regulations under IRC § 7216 to prohibit the disclosure or use of information to or for any person unless such disclosure or use is in connection with preparing or filing, or providing services in connection with the preparation or filing of, a tax return. The bill also directs the Secretary to amend the regulations to prohibit use or disclosure of information to or by any tax return preparer located outside of the United States unless the taxpayer has granted consent to such disclosure or use, a provision that is consistent with the approach taken in the proposed regulations. However, S.1321 was never enacted into law.

In the Senate Report issued in connection with S.1321, the Finance Committee stated it found the use of tax information as a source of clients or data in nontax preparation lines of business "troubling." Specifically, the Committee stated it was "concerned that tax return preparers are exploiting their position of trust to market products and services unrelated to the preparation of a tax return …. Taxpayers may not understand how these products work, or even that they are giving consent to these products or services as a part of the stack of forms they signed during the tax preparation process." To address

7 IRS Notice 2005-93, 2005-52 I.R.B. 1 (Dec. 7, 2005).

8 *See, e.g.*, National Consumer Law Center, IRS Proposal Would Let Tax Preparers Sell Citizen Tax Records to Third Parties (March 8, 2006).

9 Several commentators also objected to the requirement to obtain written consent for use or disclosure involving overseas activities by tax return preparers because this requirement would add unnecessary and burdensome steps to the current tax return processes of many multinational practices. *See, e.g.*, American Institute of Certified Public Accountants, Comments on Proposed Regulations, REG-137243-02 Regarding Guidance to Facilitate Electronic Tax Administration – Updating of Section 7216 Regulations (Mar. 8, 2006).

these concerns, the Committee stated that it is appropriate to prohibit the use or disclosure of tax return information for a nontax preparation purpose.

The Committee also stated it is important for a taxpayer, with or without multinational dealings, to provide knowing consent to the transmission of tax return information to tax return preparers overseas, because of the difficulty of policing IRC § 7216 violations outside the United States.[10] Finally, the Committee recommended that both IRC §§ 6713 and 7216 expand the definition of "tax return preparer" to reflect current technology and business practices. The term should thus include preparers of returns other than income tax returns, volunteers, individuals who perform other businesses in addition to return preparation, and contractors performing services in connection with return preparation.[11]

EXPLANATION OF RECOMMENDATIONS

The privacy of tax return information is fundamental to tax administration. Taxpayers need assurance that their information is protected during and after the tax preparation and filing experience. Accordingly, Congress should amend both IRC § 7216 and § 6713 to include clear language safeguarding the confidential nature of this information. The statutes should include explicit language to provide the following protections.

Prohibition on Use or Disclosure for Purposes Other than Tax Preparation and Filing

Internal Revenue Code §§ 7216 and 6713 should include language prohibiting the use or disclosure of tax return information for purposes other than tax preparation and filing of returns. In addition, the statutes should specifically state that such prohibition includes, but is not limited to, the use or disclosure of tax return information for purposes of soliciting products or services offered in relation to refund delivery or protection from IRS audit. The regulations issued thereunder can provide examples of preparers obtaining written consents for the purpose of marketing nontax-related products, including refund anticipation loans, and audit protection. The regulation could illustrate the distinction between marketing products and advice rendered during the tax preparation process. For example, a preparer is allowed to advise a taxpayer of the existence of software products to track trade or business expenses or assign value to charitable contributions. However, a preparer should not be able to take this process one step further and actually disclose the taxpayer's information to the software vendor, with or without the taxpayer's written consent.

[10] S. Rep. No. 109-336, 109th Cong., 2d Sess. 86-90 (2006).

[11] *Id.* at 84-96.

Exception for Accountants and Attorneys

IRC § 7216 should also specify that preparers engaged in the lawful practice of law or accountancy[12] are still permitted to use or disclose tax return information to another employee of their firms for purposes of rendering other legal or accounting services. This would allow state licensed accountants or attorneys to use or disclose the information to provide such additional services as business or estate planning.[13]

Expand Definition of "Tax Return Preparer"

Internal Revenue Code § 7216(a) specifically states that the section applies to "returns of tax imposed by chapter 1." Further, Treasury Reg. § 301.7216-1(b)(1) defines "tax return" as "any return (or amended return) of the income tax imposed by chapter 1 or 2 of the Code." The definition of "tax return preparer" in Treas. Reg. § 301.7216-1(b)(2) hinges on the definition of "tax return." Thus, IRC § 7216 only applies to preparers of income tax returns.

As stated by the Senate Finance Committee, IRC § 7216 must reflect current technology and business practices. Thus, it should clearly reach preparers of returns other than income tax returns, volunteers, individuals who perform other businesses in addition to return preparation, and contractors performing services in connection with return preparation. This would require amendments to IRC § 7216(a) and Treas. Reg. §§ 301.7216-1(b)(1) and (2).

Require Safe Harbor Language

Internal Revenue Code § 7216 should specifically state that the regulations issued thereunder provide safe harbor language for written consents. There is no reference to such language in the existing statute and regulations. However, Notice 2005-93 contains the proposed revenue procedure detailing the format and contents of consents for preparers to use and disclose tax return information under IRC § 7216. The proposed procedure contains mandatory language to include in consents, addressing the limitations and duration of the consents. As noted above, it also contains mandatory language detailing contact information for the Taxpayer Advocate Service, so taxpayers can learn more about taxpayer rights under IRC § 7216 as well as contact information for the TIGTA to report violations.[14]

Due to the importance of providing such necessary information on limitations, duration of consents, and contact information, the statute should require the IRS to issue safe harbor language to be included in written consents. Section 7216 must detail exactly what type of information the safe harbor language should include. The regulations can

[12] The National Taxpayer Advocate highly recommends that Treasury and the IRS amend the regulations to clearly define the term "practice of accountancy." In addition to state licensed accountants and attorneys, the definitions should include enrolled agents, a designation granted by the IRS Office of Professional Responsibility.

[13] *See* Treas. Reg. § 301.7216-2(e) and Prop. Treas. Reg. § 301.7216-2(h).

[14] IRS Notice 2005-93, 2005-52 I.R.B. 1 (Dec. 7, 2005).

either specify the language, or as in the proposed regulations, the regulations can provide that the IRS will issue such guidance in the form of a revenue procedure.[15]

Written Consent Required Before Use or Disclosure to or by Preparer Located Overseas

IRC §§ 7216 and 6713 should prohibit the disclosure or use of information to or by any tax return preparer located outside the country, unless the taxpayer has provided written consent. Due to the fundamental importance of protecting taxpayers from unknowingly having their confidential tax information disclosed overseas, where the IRS has very little chance of enforcing disclosure rules, the language should be part of the statutes rather than in the regulations.

The Taxpayer Advocacy Panel (TAP) has raised a real concern that disclosing confidential tax return information overseas without adequate safeguards, even with the taxpayer's written consent, increases the potential for identity theft and gross abuse of taxpayer data. To address these concerns, the TAP recommended that, in addition to obtaining the taxpayer's written consent, the preparer should redact all identifying information before releasing the information overseas. The proposed redaction would entail replacing all personal data (such as Social Security numbers, dates of birth, telephone numbers, and financial account information) with a combination client number or similar cross-identifier.[16] The National Taxpayer Advocate believes that this recommendation is worthy of exploration. It is unclear whether the proposed redaction requirement is feasible; however, identity theft is a serious issue, and the IRS should give due consideration to the TAP's recommendation.

The National Taxpayer Advocate is unpersuaded by comments on the proposed regulations which essentially state that requiring a written consent before disclosing abroad would place an unnecessary burden on multinational practices. Multinational practices are complex in nature, and requiring an additional written consent before releasing data overseas does not seem unreasonable. Further, multinational taxpayers may be equally unaware of the transfer of data across borders and deserve the same protections as individual taxpayers with solely domestic dealings.[17]

[15] *See* Prop. Treas. Reg. § 301.7216-3(a)(3).

[16] Letter from Larry T. Combs, Chair, Taxpayer Advocacy Panel, to Mark W. Everson, Commissioner, Internal Revenue Service (Aug. 18, 2006) (available at http://www.improveirs.org/Events/2006_Recoms_to_IRS_Commiss.pdf).

[17] The European Union has strict privacy laws restricting the transfer of data across borders. *See* http://ec.europa.eu/justice_home/fsj/privacy/overview/index_en.htm.

MISDIRECTED TAX REFUND DEPOSITS

PROBLEM

The National Taxpayer Advocate has previously raised the issue of misdirected income tax refunds.[18] As the IRS launches its new split-refund program,[19] the risk of taxpayers inadvertently providing incorrect routing transfer numbers (RTNs) or account numbers for purposes of direct deposit increases significantly. There are no procedures allowing the IRS to resolve the issue when a taxpayer inadvertently provides the wrong RTN or account number to the IRS for purposes of direct deposit of an income tax refund. Financial institutions are not required to verify whether the name on the designated account matches the name of the depositor/taxpayer. The IRS has no authority to take money out of the incorrect account or receive confidential information from the financial institution about the owner of the incorrect account. The IRS can only contact and rely on the financial institution to persuade the incorrect account owner to return the misdirected funds. While the institution is required to take corrective action when the mistake is its own, it is not required to do anything if the mistake is made by the taxpayer.

EXAMPLE:

A taxpayer hired a paid preparer who completed her federal income tax return, which showed a $2,000 refund. The preparer explained the various refund delivery options and the taxpayer chose to have the return electronically filed with the refund direct deposited into her checking account. After waiting about three weeks without receiving the refund, the taxpayer looked up its status on the "Where's My Refund?" service on the IRS website, which showed that the refund was already deposited into the account. The taxpayer looked back at the return and realized she mistakenly gave the preparer an incorrect bank account number (with two digits switched). She called the IRS and was told it was her mistake, but the IRS would contact the bank for her. After a few weeks, the taxpayer received a letter from the IRS stating that it has no authority to retrieve the refund from the incorrect account and instructing her to contact the bank directly to resolve the issue.

RECOMMENDATION

Amend the Internal Revenue Code to create a process through which the IRS can work with financial institutions to (1) identify the account holder of a misdirected income tax

[18] National Taxpayer Advocate 2005 Annual Report to Congress 315-325, 464-465.

[19] The IRS's split refund program allows taxpayers who choose to direct deposit income tax refunds the ability to designate up to three accounts at financial institutions on the new IRS Form 8888. IRS, News Release, IRS Expands Taxpayers' Option for Direct Deposit of Refunds (May 31, 2006).

refund deposit, and (2) request the return of misdirected funds by the account holder of the account which incorrectly received the funds.[20]

PRESENT LAW

The Right to Financial Privacy Act prohibits financial institutions from releasing financial records except under limited circumstances.[21] Specifically, 12 U.S.C. § 3402 bars government authorities from accessing financial information of any customer from a financial institution unless the records are reasonably described and are disclosed as enumerated in 12 U.S.C. §§ 3404 through 3408, which include customer authorizations, administrative subpoena or summons, search warrants, judicial subpoenas, or formal written requests. Section 3402 also provides for limited exceptions, one of which includes 12 U.S.C. § 3413. Section 3413(c) provides "[n]othing in this chapter prohibits disclosure of financial records in accordance with procedures authorized by [the Internal Revenue Code]." The Internal Revenue Code does not currently include procedures through which the IRS can obtain information about an account holder who receives a misdirected direct deposit refund.

REASONS FOR CHANGE

In 2004, the IRS Wage & Investment (W & I) division's Accounts Management function created a task force to investigate the problem of misdirected refunds. In its final report, the task force concluded "[a]lthough the number of misdirected deposits is minimal, compared to the total direct deposits, the impact on the taxpayer is substantial." The report stated that misdirected deposits for calendar year 2004 amounted to less than .004 percent of the 49.3 million direct deposits. However, the number of direct deposited refunds increases each year.[22]

The number of direct deposits is certain to grow significantly in the 2007 filing season with the beginning of the split-refund program, which allows taxpayers to allocate their refunds among up to three different accounts at U.S. financial institutions. Taxpayers designate the accounts on IRS Form 8888, Direct Deposit of Refund. While the goal of the initiative is to encourage higher savings and more banking, it also increases the risk of taxpayers providing incorrect RTNs or account numbers, which will result in misdirected deposits.[23]

[20] The IRS should also explore the ability of financial institutions to perform name verification before the funds are deposited into the account. This analysis should determine whether existing technology supports matching. It should also explore the feasibility of name matching in cases where the ownership of the bank accounts does not correlate precisely with the information given to the IRS. For example, a married couple has a joint checking account with the primary account holder listed as the secondary Tax Identification Number (TIN) on the tax return. Another concern is where taxpayers designate accounts owned by family members or friends. Direct Deposit Task Force, Direct Deposit Study (Jun. 2005).

[21] 12 U.S.C. § 3401 *et seq.*

[22] Direct Deposit Task Force, Direct Deposit Study (June 2005). The Taxpayer Advocate Service participated in the Direct Deposit Task Force.

[23] *See* IRS News Release, IRS Expands Taxpayers' Options for Direct Deposit of Refunds (May 31, 2006).

Once a tax refund is misdirected due to taxpayer error, the IRS may contact the financial institution and ask it to return the money. If the institution does not comply, the IRS sends the taxpayer a letter explaining what happened and instructing the taxpayer to contact the financial institution to resolve the issue.[24] The institution is not authorized to release information to the IRS about the owner of the incorrect account.[25] If the IRS received information about the account holder, it could institute erroneous refund procedures to recover the funds.[26]

EXPLANATION OF RECOMMENDATIONS

The Right to Privacy Act clearly states that the restrictions on disclosing financial information are subject to the provisions of the Internal Revenue Code.[27] However, the Code does not currently authorize the IRS to receive information from a financial institution about the owner of a financial account which incorrectly receives a misdirected direct deposit refund. If the Code were amended to authorize the IRS to receive a limited amount of information about the account holder, the IRS would be able to contact the account holder. Further, the Code should provide procedures for the IRS to request the account holder to return the misdirected funds. If the account holder refuses to return the money, the IRS can institute erroneous refund procedures.[28]

REGULATION OF ENROLLED RETURN PREPARERS

Recommendation

The National Taxpayer Advocate continues to recommend that Congress should:

- Enact a registration, examination, certification, and enforcement program for unenrolled return preparers;[29] and
- Impose an effective oversight and penalty regime for preparers and others associated with the commercial tax preparation sector.[30]

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24 IRM § 21.4.1.4.7.

25 12 U.S.C. § 3402; National Taxpayer Advocate 2005 Annual Report to Congress 323-325.

26 IRM § 21.4.5.1 *et seq.* The IRS will recover a misdirected deposit by voluntary repayment, filing an Erroneous Refund Suit against the taxpayer under IRC § 6532(b), and by offsets. IRM § 21.4.5.14. However, IRM § 21.4.5.10 states that the IRS is not responsible for misdirected direct deposits that are a result of bank error or the taxpayer providing the wrong Routing Transit Number (RTN) or bank account number. Accordingly, the IRM provision states that the IRS will not reissue the refund if error in cases of bank or taxpayer error.

27 12 U.S.C. § 3413.

28 IRC § 7405; IRM § 21.4.5.1 *et seq.*

29 For more details on the proposed program, see National Taxpayer Advocate 2002 Annual Report to Congress 216-230 (Key Legislative Recommendation: Regulation of Federal Tax Return Preparers).

30 For a more detailed discussion of the proposal to increase preparer penalties, see National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

EXPLANATION OF RECOMMENDATION

Since 2002, the National Taxpayer Advocate has advocated the establishment of minimum levels of competency for return preparation by developing a federal system to register, test and certify unenrolled return preparers. She has also proposed to strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate. These proposals have been discussed at length in previous Annual Reports to Congress and congressional testimony.[31]

[31] National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; *Regulation of Federal Tax Return Preparers, Hearing Before U.S. House of Representatives Committee on Ways and Means, Subcommittee on Oversight*, 108th Cong. (Jul. 20, 2005) (statement of Nina. E. Olson, National Taxpayer Advocate, Internal Revenue Service); *Tax Return Preparation Options for Taxpayers, Hearing Before the U.S. Senate Committee on Finance*, 109th Cong. (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

RECOMMENDATION

#7 IMPROVE OFFER IN COMPROMISE PROGRAM ACCESSIBILITY

PROBLEM

By accepting an offer to compromise a tax debt, the IRS collects money it would not otherwise collect and turns a noncompliant taxpayer into a compliant one by requiring the taxpayer, as a condition of the offer agreement, to timely file returns and timely pay taxes for the following five years.[1] In short, accepting a reasonable offer is a good deal for both the taxpayer and the government.

Despite offers being good for both taxpayers and the IRS, between FY 2001 and FY 2006 the number of offers submitted by taxpayers declined by 53 percent and the number of offers accepted has declined by 62 percent.[2] In FY 2006, the IRS returned fully 45 percent of all offers without even considering them on the merits.[3] Although the IRS's imposition of a $150 offer in compromise (OIC) user fee and 2004 revisions to the OIC form may have reduced the number of unrealistic OIC submissions, the decline in submissions may also be due to an increasing number of taxpayers and practitioners reaching the conclusion that the offer process is not working as well as it should, even with respect to reasonable offers.[4]

OIC submissions are likely to decline even further as a result of recent legislation. Section 509 of P.L. 109-222, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), effective July 16, 2006, makes it more difficult for taxpayers to submit an OIC. For example, TIPRA requires taxpayers who submit "lump-sum" offers to include a nonrefundable partial payment of 20 percent of the amount of the offer with the offer application.[5] Upon reviewing a representative sample of offers accepted by the IRS immediately prior to TIPRA's effective date, TAS found that about 72 percent

LEGISLATIVE RECOMMENDATIONS

[1] Form 656, *Offer in Compromise* (Jul. 2004). An IRS study found that about 80 percent of taxpayers in its sample with accepted OICs remained substantially compliant during the requisite period. SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 6 (Sept. 2004).

[2] The number of offers submitted by taxpayers has declined from 125,390 in FY 2001 to 58,586 in FY 2006 and the number of offers accepted by the IRS has also declined from 38,643 in FY 2001 to 14,734 in FY 2006. SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2004-FY 2006); Collection Activity Report No. 5000-108 (FY 2001-FY 2005).

[3] SB/SE, *Offer in Compromise Program*, *Executive Summary* (FY 2006).

[4] TIGTA has concluded that the OIC user fee, imposed in November 2003, is responsible for reducing OIC submissions by 28 percent, but it is difficult to conclude that the continued reduction in OIC submissions in FY 2005 is due to the OIC fee. *See* Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005). The Form 656, *Offer in Compromise*, was revised in July 2004, and the revision was publicized in October 2004.

[5] TIPRA also requires taxpayers who submit "periodic payment offers," which are paid in more than five installments, to include the first proposed installment along with any offer. IRC § 7122(c)(1). For additional details, *see* Notice 2006-68, 2006-31 I.R.B. 105. The IRS recently issued further guidance. *See* Memorandum For Directors, Collection Area Offices, From Frederick W. Schindler, Director, Collection Policy, *Interim Guidance Memorandum for Internal Revenue Manual 5.8, Offer in Compromise* (Jul. 28, 2006) (hereinafter referenced as an IRM dated July 28, 2006).

of taxpayers submitting offers that the IRS ultimately accepted did not appear to have sufficient funds available to make the required TIPRA payment before the offer was accepted.[6] Thus, the IRS may receive significantly fewer reasonable offers as a result of the partial payment requirement.

Although taxpayers whose income is below the federal poverty threshold are exempt from both the OIC user fee and the partial payment requirements,[7] the National Taxpayer Advocate, the Government Accountability Office (GAO), and tax practitioners have all expressed concern that the partial payment requirement could reduce the accessibility of the OIC program to low income taxpayers and others who are experiencing financial difficulties.[8] The following hypothetical example illustrates the difficulty some taxpayers now face in submitting offers.

EXAMPLE

The IRS determines that a taxpayer with a $150,000 liability has $150 in assets and $210 per month of net disposable income not required for reasonable basic living expenses.[9] The IRS would require the taxpayer to pay at least $10,230 to compromise the liability, determined by adding 48 months of future income ($210 x 48 =$10,080) to the taxpayer's $150 in assets.[10] The taxpayer is required to include a nonrefundable $2,046 partial payment and a $150 user fee with his lump-sum offer application. The taxpayer's parents would be willing to lend him $10,080 if they could be sure he would use the money to fund an OIC and make a fresh start. Based on current statistics, the IRS returns or rejects most OICs. If the IRS returned or rejected the OIC, the $2,046 partial payment would be applied to the taxpayer's liability rather than to the OIC. Thus, the taxpayer's parents decline to loan him the money to make an offer.

RECOMMENDATION

Modify Internal Revenue Code § 7122(c) so that taxpayers are not required to include a partial payment with "lump-sum" offer applications.

Alternatively, modify the OIC rules as follows:

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6 The margin of error for this figure was +/- 4.3 percent. TAS Research, *Sources of OIC Funding* (Oct. 2006) (preliminary analysis).

7 *See* Treas. Reg. § 300.3(b)(1)(ii); Notice 2006-68, 2006-31 I.R.B. 105.

8 *See, e.g.*, Government Accountability Office, GAO-06-525, *IRS Offers In Compromise, Performance Has Been Mixed; Better Management Information and Simplification Could Improve the Program*, 38-39 (Apr. 2006); ABA Tax Sec., *Comments in Response to Notice 2006-68 Regarding Definition of "Low-Income" and Waiver Authority under Section 7122(c)(2)(C)* (Oct. 16, 2006), *available at* http://www.abanet.org/tax/pubpolicy/2006/101606notice2006-68.pdf.

9 We assume the taxpayer's income exceeds the low income threshold.

10 Form 656, *Offer in Compromise* 6 (Jul. 2004). Less than 48 months of future income would be required if less than 48 months remained on the statute of limitations period for collection. IRM 5.8.5.5.5(2) (Sept. 1, 2005).

1. Provide taxpayers with the right to appeal to the IRS Appeals function the IRS's decision to return an OIC before or after accepting it for processing. The IRS could use the existing Collection Appeals Process, which allows it to review appeals in just 5 days.[11]
2. Provide an exception to the partial payment requirement for taxpayers who do not have immediate access to current income and liquid assets that could be used to fund an offer without incurring significant costs (*e.g.*, taxable income or penalties resulting from the withdrawal of assets from a qualified retirement plan). For those taxpayers who have immediate access to such funds, the partial payment requirement should be 20 percent (for lump-sum offers) of any current income and liquid assets that could be disposed of immediately without significant cost.
3. Apply the low income exception in cases where payment of the combined OIC user fee and partial payment (or borrowing for such payments) would cause an economic hardship.

PRESENT LAW

Partial Payments Required by TIPRA

A "lump-sum" offer, one payable in five or fewer installments, must be accompanied by a down payment of 20 percent of the amount of the offer.[12] Other offers, payable in six or more installments (called periodic payment offers), must be accompanied by a down payment of the amount of the first proposed installment.[13] The taxpayer must make additional installments while the IRS is evaluating a periodic payment offer or it is deemed withdrawn.[14]

IRS Return of Offers

If a taxpayer fails to submit the required partial payment along with the OIC or to meet various other requirements, the IRS may return it to the taxpayer as "unprocessable."[15] If the IRS returns the OIC as unprocessable, it will retain any partial payment, but refund the $150 OIC user fee.[16] If the IRS returns the OIC after accepting it for processing, the IRS will retain both the partial payment and the user fee.[17] The IRS will

11 *See generally*, IRM 8.7.2 (Dec. 1, 2006).

12 IRC § 7122(c)(1)(A).

13 IRC § 7122(c)(1)(B).

14 IRC § 7122(c)(1)(B)(ii).

15 IRC § 7122(d)(3)(C); Treas. Reg. § 301.7122-1(d)(2).

16 *See* Notice 2006-68, 2006-31 I.R.B. 105.

17 *See, e.g.*, Treas. Reg. § 300.3(b)(3); IRM 5.8.3.5 (Jul. 28, 2006); IRM 5.8.1.9 (Jul. 28, 2006). Processable OIC returns based on the taxpayer's failure to provide requested financial information are subject to managerial review. *See* Treas. Reg. 301.7122-1(f)(5)(ii).

reconsider its decision to return an OIC in certain limited circumstances, but the taxpayer cannot appeal the OIC return decision to the Appeals function.[18]

Low Income Waiver

Both the OIC user fee regulations and TIPRA authorize the IRS to define a threshold below which a taxpayer will be considered "low income" and exempt from the OIC user fee and partial payment requirements.[19] The IRS defined "low income" as income below 100 percent of the federal poverty level for both purposes.[20] However, we understand the IRS is revising its offer in compromise form, Form 656, which would increase these thresholds to about 250 percent of the federal poverty level.

REASON FOR CHANGE

No Appeal of OIC Return Decisions

Historic Reasons for Returning an OIC

Under procedures in effect as of June 2006, before TIPRA became effective, the IRS would return OICs as unprocessable and refund any user fee, if the taxpayer:

- Had not filed all returns;
- Was not current with employment tax deposits for the current quarter and the prior two quarters;
- Was in bankruptcy; or
- Did not submit the OIC user fee.[21]

Similarly, the IRS would return OICs after accepting them for processing (called "processable returns"), but retain the user fee, for various reasons, including the IRS's determination that:

- The OIC was submitted solely to delay collection;

[18] See Treas. Reg. § 301.7122-1(f)(5)(ii) (noting that "return of the offer does not constitute a rejection of the offer for purposes of this provision and does not entitle the taxpayer to appeal the matter to Appeals…."). Collection personnel will reconsider the decision to return an OIC if: (1) The offer was returned in error; (2) The offer was returned because the IRS did not receive sufficient information, and (a) The taxpayer timely sent the information to the IRS but the IRS did not associate it with the case; (b) Serious illness or injury of the taxpayer prevented the taxpayer from submitting the information timely (illness or injury of the representative will not be considered); or (c) There was a death in the taxpayer's immediate family or disaster (such as a fire or flood) that prevented the taxpayer from timely mailing the information; (3) The offer was returned because the taxpayer failed to perfect it by providing an additional Form 656 and application fee when the original Form 656 included both joint and separate liabilities or individual or joint and corporation or partnership liabilities; (4) The offer was returned because the taxpayer submitted a fee waiver form, Form 656-A (instead of paying the $150 fee) that the IRS did not accept and the taxpayer later provided proof that the IRS reached an incorrect conclusion; or (5) The offer was returned because the taxpayer failed to make sufficient estimated tax payments, or withholding and the taxpayer later provided proof that such payments or withholding were not required. IRM 5.8.7.3.1 (Sept. 1, 2005).

[19] *See* Treas. Reg. § 300.3; IRC § 7122(c)(2)(C).

[20] *See* Treas. Reg. § 300.3(b)(1)(ii); Notice 2006-68, 2006-31 I.R.B. 105.

[21] *See* IRM 5.8.3.4.1 (Sept. 1, 2005).

- The taxpayer failed to file a tax return or pay a liability;
- The taxpayer was in bankruptcy;
- The OIC was no longer processable;
- The taxpayer failed to supply sufficient financial information; or
- The OIC was accepted for processing in error.[22]

Current Reasons for Returning OICs

Under new procedures, the IRS is using similar criteria to determine whether to return an OIC. However, the IRS will now return an OIC if the taxpayer fails to submit the required partial payment.[23] We understand the IRS may also begin returning OICs after accepting them for processing if they include unassessed tax periods.[24] Another change is that the IRS is no longer requiring taxpayers to file all required returns before accepting an OIC for initial processing.[25] Instead, the IRS will wait until after accepting the OIC for processing to return it if the taxpayer has not filed all returns within the time allowed by the IRS. Thus, there is no reason to expect the IRS to return significantly fewer OICs.

Partial Payment Requirement Increases Taxpayer Burden Resulting from OIC Returns

As noted above, when the IRS returns an OIC for any reason, it retains any partial payment it has received.[26] In the past, only the $150 user fee was at stake if the IRS returned a processable OIC, but now 20 percent of the offer (or other partial payment) is also at stake. Thus, the potential economic impact of the IRS's decision to return an OIC will be much greater than under prior law. This impact will multiply each time the taxpayer has to resubmit an OIC.

The IRS Often Returns OICs

Although in FY 2006 the IRS disposed of fewer OICs by returning them to taxpayers than it did in 2004, it still returned 45 percent of all OICs either before (26 percent) or after (19 percent) accepting them for processing and before evaluating whether to accept or reject them, as shown on the following table.[27]

[22] *See, e.g.*, Treas. Reg. § 301.7122-1(f)(5)(ii); Rev. Proc. 2003-71, 2003-36 I.R.B. 517 § 5.04; IRM 5.8.3 (Sept. 1, 2005); Form 656, *Offer in Compromise*, 2 (Jul. 2004). IRS data suggests that it also returns offers for other reasons that are not clearly reflected in the IRM. *See, e.g.*, National Taxpayer Advocate 2004 Annual Report to Congress 311, 317 (reprinting IRS OIC return data).

[23] We note the IRS is not currently requiring taxpayers to submit the full amount of the partial payment due on a lump-sum offer before they begin to process the OIC, but is requiring payment of the first installment on a periodic payment offer. Notice 2006-68, §§ 2.02 and 3.01; IRM 5.8.3.13 (Jul. 28, 2006).

[24] Instructions to Form 656, *Offer in Compromise* 6 (Nov. 2006) (draft).

[25] *See* IRM 5.8.3.13 (Jul. 28, 2006).

[26] *See, e.g.*, IRM 5.8.3.5 (Jul. 28, 2006); IRM 5.8.1.9 (Jul. 28, 2006).

[27] SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2006).

TABLE 2.7.1, OIC DISPOSITIONS BY FISCAL YEAR[28]

Fiscal Year	FY 2001		FY 2002		FY 2003		FY 2004		FY 2005		FY 2006	
Disposition	Number	%	Number	%	Number	%	Number	%	Number	%	Number	%
Not Processable	16,185	14	32,897	23	30,406	22	38,553	31	22,713	25	16,733	26
Processable Return	27,751	25	50,492	35	49,079	36	32,358	26	20,068	22	12,350	19
Withdrawn/ Terminated	16,654	15	13,621	10	8,431	6	7,859	6	7,377	8	5,407	8
Rejected	13,976	12	16,952	12	27,336	20	25,654	21	22,105	24	14,945	23
Accepted	38,643	34	29,140	20	21,570	16	19,546	16	19,080	21	14,734	23
Total	**113,209**		**143,102**		**136,822**		**123,970**		**91,343**		**64,169**	

If a taxpayer wants the IRS to consider an offer that was returned, he or she must often submit another OIC. The GAO determined that 40 percent of the IRS's OIC inventory in FY 2005 was made up of repeat offers, many of which the IRS had previously returned.[29] Given the new partial payment requirement, many taxpayers may no longer be able to afford to resubmit returned offers because the IRS does not refund the partial payment (or allow the taxpayer to apply the payment to another OIC) when it returns an offer.

OIC Returns are De Facto Rejections Which Involve Discretion and Judgment

OIC returns amount to *de facto* rejections, which involve the exercise of discretion and judgment.[30] Differences of opinion could occur in any number of ways. For example, consider the following situations involving processable OIC returns:

- The IRS returns an OIC because it determines the taxpayer has not filed a tax return. The taxpayer claims that he or she is not required to file the return in question.
- The IRS returns an OIC because it determines the taxpayer is not current with estimated tax payments. The taxpayer disputes the IRS's determination that he or she has underpaid estimated taxes because the taxpayer has had significant changes in current year income and business expenses.
- The taxpayer claims the low income exception for the partial payment or OIC user fee. The IRS disallows the exception and returns the OIC. The taxpayer does not agree with the IRS's determination of his or her current income.

[28] SB/SE, *Offer in Compromise Program*, *Executive Summary* (FY 2004-FY 2006); Collection Activity Report No. 5000-108 (FY 2001-FY 2005).

[29] Government Accountability Office, GAO-06-525, *IRS Offers In Compromise, Performance Has Been Mixed; Better Management Information and Simplification Could Improve the Program* 13-14 (Apr. 2006).

[30] *See* National Taxpayer Advocate 2004 Annual Report to Congress 319-320, 339 (Most Serious Problem: Offers In Compromise).

- The IRS returns an OIC because it determines the taxpayer did not provide additional financial information, as requested. The information requested by the IRS was actually included in the taxpayer's response, but not in the specific form requested by the IRS.
- The IRS returns an OIC because it determines the taxpayer did not provide additional financial information, as requested. However, the IRS did not actually need the information it requested to fully process the OIC.
- The IRS returns an OIC because it determines that the taxpayer submitted it "solely to delay collection." The taxpayer does not agree.

In these types of situations, the taxpayer may be unsuccessful in resolving the dispute through routine communication with IRS Collection function employees and managers who are involved in the return decisions. Moreover, it is possible for IRS employees to "get it wrong" when they make OIC return decisions. In one study, the Treasury Inspector General for Tax Administration (TIGTA) determined 15 percent of the OICs returned after acceptance for processing were returned in error.[31] An IRS study indicated that 24 percent of all resubmitted OICs were ultimately accepted, suggesting that in some cases the IRS's decision to return the OIC may not have been necessary.[32]

Given the significant exercise of discretion involved in OIC return decisions, the IRS should afford taxpayers who have had processable OICs returned the opportunity to have their cases reviewed by Appeals. Although such an appeal might delay collection efforts in some cases, it is necessary to provide consistent treatment of taxpayers and help address the decline in OIC submissions, especially now that taxpayers have more at stake when the IRS returns an OIC. The IRS could minimize such delay by adopting procedures similar to its Collection Appeals Program (CAP), which provide for processing appeals in just 5 days.[33]

Low Income Exception Not Broad Enough to Preserve OIC Program Accessibility

Both the OIC user fee regulations and TIPRA authorized the IRS to define a threshold below which a taxpayer will be considered "low income" and exempt from the user fee and partial payment requirements.[34] The preamble to the OIC user fee regulations explains:

> "Offers from low income taxpayers are excepted from the fee in light of section [7122(d)(3)(A)], which prohibits the IRS from rejecting an offer from a low income taxpayer solely on the basis of the amount offered.... Requiring payment of a user

[31] *See* Treasury Inspector General for Tax Administration, Ref. No. 2003-30-182, *Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program* 1 (Sept. 2003).

[32] *See* SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 4-5 (Sept. 2004).

[33] IRM 8.7.2.2 (Dec. 1, 2006).

[34] *See* Treas. Reg. § 300.3; IRC § 7122(c)(2)(C).

fee from a low income taxpayer would undermine section [7122(d)(3)(A)] in cases where the taxpayer does not have the ability to pay the fee."[35]

In the Internal Revenue Service Restructuring and Reform Act of 1998, Congress defined a taxpayer as "low income" for purposes of receiving assistance from a low income taxpayer clinic as 250 percent of the federal poverty level established by the Department of Health and Human Services (DHHS).[36]

Poverty Level "Low Income" Definition Too Low

The National Taxpayer Advocate and the practitioner community unsuccessfully urged the IRS not to adopt an OIC user fee, or if it was adopted to set the "low income" user fee exception threshold at 250 percent of the federal poverty level.[37] Although the IRS is modifying its definition of "low income," the IRS initially defined a person as "low income" for purposes of the OIC user fee exception if his or her income was below 100 percent of the federal poverty level.[38]

Presumably, taxpayers who do not make enough money to provide for basic living expenses should be classified as low income. The federal poverty level for a family of four is $20,000.[39] The same family would be allowed $48,660 per year to provide for basic living expenses (not including expenses for health or child care) under the IRS's own expense standards, assuming they lived in the District of Columbia and needed two cars.[40] $48,660 is nearly 250 percent of the federal poverty level (250 percent X $20,000 = $50,000). Thus, the IRS has implicitly concluded that such a family of four living in Washington, DC, needs an income of about 250 percent of the poverty level to provide

[35] T.D. 9086, 68 FR 48,785 (Aug. 15, 2003) (preamble).

[36] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 § 3601(a) (1998); IRC § 7526(b)(1)(B)(i). The monthly OIC low income threshold for households in the 48 contiguous states is $833 for one person, $1,083 for two, $1,333 for three, $1,667 for four, $1,917 for five, $2,167 for six, $2,417 for seven, $2,667 for eight, and an additional $333 for each additional person. Form 656, *Offer In Compromise* (Jul. 2004) (instructions and worksheet for Form 656-A, *Income Certification for Offer In Compromise Application Fee*). It is annually adjusted for inflation.

[37] *See,* T.D. 9086, 68 FR 48,785 (Aug. 15, 2003); National Taxpayer Advocate FY 2002 Annual Report to Congress 18, n12. *See also*, Herbert N. Beller, American Bar Association, Section of Taxation, *ABA Members Suggest Waiving Proposed OIC User Fees for Low Wage Earners*, 2003 TNT 30-39 (Feb. 13, 2003); National Society of Accountants, *Accounting Group Won't Back Proposed User Fee for OIC Program*, 2003 TNT 34-18 (Feb. 20, 2003); The Chicago Bar Association, Bar Association Members Oppose Proposal to Charge OIC User Fee, 2003 TNT 34-17 (Feb. 20, 2003); Joseph Barry Schimmel, *Attorney Challenges Definition of 'Low-Income Taxpayer' for Proposed OIC Regs*, 2003 TNT 11-33 (Jan. 16, 2003).

[38] *See* Treas. Reg. § 300.3(b)(1)(ii); Notice 2006-68, 2006-31 I.R.B. 105.

[39] The poverty guidelines are available at http://aspe.hhs.gov/poverty/06poverty.shtml.

[40] The national standard expense allowance for a family of four earning $20,000 is $941 per month. The local standard expense allowance for a family of four living in the District of Columbia is $1,878 per month or the taxpayer's actual expenses, whichever is less. Assuming the family owned two cars, the transportation standard expense allowance would be $803 ($471+$332) per month for ownership costs, and $433 per month for operating costs. $941 + $1,878 + $803 + $433 = $4,055 per month. $4,055 X 12 months = $48,660 per year. Even if the family did not have any vehicles, the IRS would permit them to retain $37,416 per year ($941 for national standards + $1,878 for local standards + $299 for public transportation X 12 months) plus necessary expenses for health and child care.

for basic living expenses. Perhaps for this reason, we understand that the IRS is working to increase these thresholds to about 250 percent of the federal poverty level.

Partial Payment Requirement Will Reduce OIC Program Accessibility

Even if the IRS increases the low income threshold, however, the partial payment requirement will reduce the number of meritorious offers the IRS receives from taxpayers experiencing financial difficulty. Taxpayers generally must offer the net equity in their assets plus their *future income* for several years.[41] Since future income is not yet in the taxpayers' hands, they must fund offers with assets that the IRS would not ordinarily collect, such as home equity, qualified retirement plans (*e.g.*, an IRA) in addition to unsecured loans or gifts from family or other third parties. Many taxpayers will be unable to access these funding sources to satisfy the 20 percent down payment requirement before the IRS has accepted their offers. For example, unless the IRS can provide assurances that it will accept the offer:

- A lender may not lend against property subject to a tax lien;
- A taxpayer might hesitate to withdraw funds from an IRA, incurring federal, state, and local income tax and a ten percent penalty for early withdrawal;[42] and
- A third party such as a friend, relative, or employer who would otherwise give or loan funds for the offer might not be willing to provide funds after all, since before the IRS accepts the offer, the third party cannot be sure those funds will help the taxpayer make a fresh start.

At the time the 20 percent down payment is required, taxpayers and third parties have no assurance that the IRS will accept an offer, especially since the IRS accepted only about one in four offers in FY 2006.[43] Thus, some taxpayers who would otherwise be able to submit meritorious offers will not be able to do so because they cannot afford to pay 20 percent of the offer amount without any prior assurance that the IRS will review and accept it.

Further, in a representative sample of 414 offers accepted by the IRS immediately prior to TIPRA's effective date, TAS found the funds that taxpayers proposed to use to pay the offer amount were most often from sources that would probably not be available in the absence of an accepted offer, as follows.[44]

[41] The number of years of future income required depends on the payment term: four years for cash offers, five years for short term deferred payment offers, or the period remaining before expiration of the statute of limitations period for collection for deferred payment offers. *See* Form 656, *Offer in Compromise*, 6 (Jul. 2004). A lump-sum offer must be paid in full within five months of acceptance in order to use only four years of future income. IRM 5.8.3.5(1) (Jul. 28, 2006).

[42] The IRS generally will not levy on a qualified plan unless the taxpayer's behavior has been "flagrant." *See* IRM 5.11.6.2 (Mar. 15, 2005). If it does, no early withdrawal penalty applies. IRC § 72(t)(2)(A)(vii).

[43] SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2006).

[44] TAS Research, *Sources of OIC Funding* (Oct. 2006) (preliminary analysis). TAS obtained a sample of closed case files from the Brookhaven and Memphis campuses that had not yet been sent offsite.

TABLE 2.7.2, SOURCE OF FUNDING FOR ACCEPTED OFFERS

Funding Source	Number[45]	Percent[46]	Margin of Error (+/-)
Friends or Family	232	56.0	4.8
Commercial Loan	24	5.8	2.3
IRA / 401K	9	2.2	1.4
Property Sale	10	2.4	1.5
Unsecured Credit	5	1.2	1.1
Current Income	123	29.7	4.4
Other	7	1.7	1.2
None Listed	18	4.3	2.0

The same study found about 72 percent of taxpayers submitting offers that the IRS ultimately accepted did not appear to have sufficient funds available to make the required TIPRA payment before the offer was accepted.[47] Even among taxpayers whose income exceeded 250 percent of the poverty level, about 71 percent did not have sufficient funds to make the required payment.[48] Thus, many taxpayers who otherwise would have submitted acceptable offers may no longer be able to afford to submit them.

One alternative may be for such taxpayers to submit "low-ball" offers based on the amount of the partial payment they can afford, rather than what would be a reasonable offer amount. However, the IRS may be more likely to return such offers as "solely to delay collection." Since the IRS would retain any partial payment submitted with the offer, taxpayers who would otherwise have been able to submit acceptable offers may be discouraged from using the offer process.

OIC User Fee May Have Reduced OIC Program Accessibility and Meritorious Offers

Recent experience with the $150 OIC user fee, applicable to offer applications beginning in November 2003, is also consistent with the notion that the 20 percent partial payment requirement will reduce the number of meritorious offer submissions and acceptances even among taxpayers eligible for the low income exception. TIGTA concluded the volume of OICs received from taxpayers at almost all income levels – even those eligible for the low income exception – declined after implementation of the user

[45] TAS sampled 414 cases, but these figures add to 428 because some taxpayers used multiple funding sources.

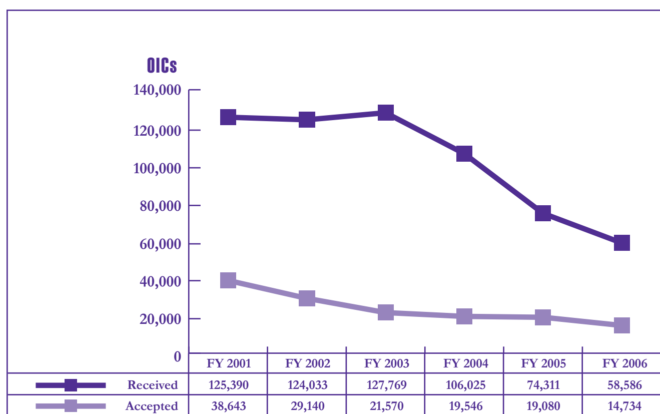
[46] Percentages exceed 100 percent because some taxpayers had multiple funding sources.

[47] The margin of error for this figure was +/- 4.3 percent. TAS Research, *Sources of OIC Funding* (Oct. 2006) (preliminary analysis).

[48] The margin of error for this figure was +/- 6.4 percent. The study found that about 49 percent of accepted offers came from taxpayers whose incomes exceeded 250 percent of the poverty level.

fee.[49] The number of offers accepted by the IRS also declined.[50] Since the OIC user fee was implemented, both OIC submissions and acceptances have been declining, as shown below.

TABLE 2.7.3, OICS RECEIVED AND ACCEPTED BY FISCAL YEAR[51]



	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Received	125,390	124,033	127,769	106,025	74,311	58,586
Accepted	38,643	29,140	21,570	19,546	19,080	14,734

Assuming the IRS only accepts meritorious offers, the fact that the number of offers accepted has declined from 21,570 in FY 2003 to 14,734 in FY 2006, or about 32 percent, suggests that meritorious offer submissions are also declining.[52]

Declining OIC Program Accessibility Will Increase Collection Accounts

The combination of the $150 OIC user fee and the new 20 percent down payment requirement will increase the difficulty taxpayers face in getting the IRS to consider their offers. As a result, the partial payment requirement is likely to reduce the number of meritorious offer submissions and acceptances even further, which in turn is likely to increase the number of unresolved collection accounts and reduce federal revenue.[53]

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[49] *See* Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005). TIGTA speculated that low income taxpayers may not have known that they were exempt from the fee. *Id.*

[50] The IRS accepted 21,570 offers in FY 2003, 19,546 in FY 2004, 19,080 in FY 2005. SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2003-FY 2005).

[51] SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2004-FY 2006); Collection Activity Report No. 5000-108 (FY 2001-FY 2005).

[52] SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2004-FY 2006). Another explanation could be that the IRS is returning and rejecting meritorious offers in greater numbers.

[53] No data is currently available that would shed light on how the requirement is affecting OIC acceptances, but preliminary data suggest that the requirement may have accelerated the decline in OIC receipts. Monthly OIC receipts in FY 2005 exceeded monthly receipts in FY 2006 by 814 in May, 619 in June, -1,574 in July (reflecting an increase in advance of the TIPRA effective date), 1,911 in August, and 1,790 in September. SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2005-FY 2006). Receipts continued the decline in early FY 2007, with October 2006 receipts of 3,772, which is 1,148 below the 4,920 received in October 2005. SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2007-October).

EXPLANATION OF RECOMMENDATION

Eliminate the Partial Payment Requirement

The National Taxpayer Advocate recommends that Congress eliminate the partial payment requirement for lump-sum offers. This change is expected to improve accessibility of the OIC program.

Provide for Appeals of OIC Return Decisions

If the partial payment requirement is not eliminated, the National Taxpayer Advocate recommends that Congress give taxpayers the ability to appeal OIC return decisions (both before and after acceptance for processing), as well as deemed withdrawals, to the IRS Appeals function. Appeals could use its CAP procedures, which provide for processing appeals in five days.[54] If an OIC is not considered "pending" (*i.e.*, because it was not accepted for processing), the IRS could still levy during any such appeal.[55] The National Taxpayer Advocate recommends that any such levy amounts be treated as deposits that can be used to fund the offer if it should not have been returned.

Since the possibility that the IRS will unreasonably return an OIC and keep the nonrefundable partial payment may prevent taxpayers from obtaining the funds needed to submit an offer, such a process might improve accessibility of the OIC program. It might also help to restore taxpayers' and practitioners' confidence that if they follow the rules, the IRS will at least evaluate their offers on the merits. Such confidence might encourage taxpayers and practitioners that it is worthwhile to submit reasonable offers that the IRS can accept.

Expand Exceptions to the Partial Payment Requirements

Exception for Taxpayers with Insufficient Liquid Assets and Current Income

The National Taxpayer Advocate recommends creating an exception to the partial payment requirement for taxpayers who do not have immediate access to current income or liquid assets that could be used to fund an offer without significant costs. For example, the exception should apply when the taxpayer has insufficient current income and liquid assets to pay the offer amount and proposes to fund it with:

- Amounts provided (via gift or loan) by one or more third parties;
- Borrowing against illiquid assets such as real property; or
- Amounts from a qualified retirement account, the withdrawal of which would constitute a taxable event.

To the extent the taxpayer can fund the offer using current income or liquid assets that can be used without incurring significant costs, however, the partial payment requirement should be 20 percent of the amount of the offer that the taxpayer can obtain from

54 IRM 8.7.2.2 (Dec. 1, 2006).

55 IRC § 6331(k)(1) (prohibiting levy while an OIC is pending); Treas. Reg. § 301.7122-1(d)(2).

current income and the disposal of such liquid assets net of any transaction costs. The IRS could create an online calculator to help taxpayers determine the applicable partial payment and OIC user fee. This recommendation is intended to enable taxpayers who do not have sufficient liquid assets to comply with existing partial payment requirements to submit reasonable offers along with a partial payment that reasonably reflects their ability to pay.

Exception for Economic Hardship

The National Taxpayer Advocate also recommends that Congress allow the IRS to apply the low income exception to a taxpayer if payment of the combined OIC user fee and partial payment (or borrowing for such payments) would result in an economic hardship.[56] This may occur if a taxpayer's allowable expenses exceed income, even if the income exceeds 250 percent of the federal poverty level. For example, if a taxpayer has a medical condition requiring an expensive treatment not fully covered by insurance and the partial payment and user fee (or costs to obtain such funds, such as income tax on an IRA withdrawal or closing costs on a home equity loan) would deplete assets or income which may be needed for that treatment, the taxpayer would be exempt from the OIC user fee and partial payment requirements. Since effective tax administration (ETA) offers based on hardship, as well as OICs based on doubt as to collectibility involving special circumstances, both involve situations where payment of the liability would result in an economic hardship, the IRS should also have discretion to automatically apply the low income exception to such offers.[57]

[56] Economic hardship could be defined by reference to IRC § 6343 and Treas. Reg. § 301.6343-1(b)(4).

[57] Because the current OIC fee regulations recognize that such taxpayers may not be able to afford the fee, they provide that the IRS will refund the fee (or apply it to the offer) when an ETA or doubt as to collectibility offer based on special circumstances is accepted based on economic hardship. See Treas. Reg. § 300.3(b)(2)(i) and (ii). However, it does not make sense for the IRS to require the taxpayer to make a payment that it will later refund if it determines that the payment caused an economic hardship. The IRS should rely on the taxpayer's determination regarding what will constitute an economic hardship, subject only to subsequent verification, especially since we rely on a signed statement from the taxpayer to determine initial eligibility for the low income OIC fee exception. *See* Form 656-A, *Income Certification for Offer in Compromise Application Fee* (Jul. 2004).

RECOMMENDATION

#8 ELIMINATION OF LENGTHY COLLECTION STATUTE OF LIMITATIONS EXTENSIONS

PROBLEM

The IRS generally has ten years to collect a tax liability.[1] The running of the ten-year statutory period for collections is suspended in situations when taxpayers elect certain rights that have the effect of bringing a temporary halt to the IRS's collection actions.[2] The date beyond which the IRS is no longer permitted to collect a tax is known as the collection statute expiration date (CSED).

Prior to January 1, 2000 (the effective date of the CSED related provisions of the IRS Restructuring and Reform Act of 1998 (RRA 98)),[3] it was not uncommon for IRS collection personnel to ask taxpayers to extend the applicable collection statute for a period of years to guard against an expiration of the statute. Some extensions were for periods as long as ten, 20, 30, 40, or even 50 years. Through a combination of revisions to the law and changes to IRS policy, IRS collection personnel are now restricted in the extent to which they can request taxpayers to waive the collection statute of limitations; however, the changes were not made retroactive. Consequently, there are still thousands of taxpayers (by our review in excess of 14,000 taxpayers with approximately 32,000 tax accounts) who granted lengthy CSED extensions in exchange for installment agreements prior to January 1, 2000, and who are still being subjected to collection action.[4]

EXAMPLE

The IRS assessed a liability against a taxpayer for the 1990 tax year on June 10, 1991, establishing a collection statute expiration date (CSED) of June 10, 2001. In 1997, a revenue officer requested that the taxpayer to sign a Form 900 (Tax Collection Waiver) to avoid enforced collection efforts and in conjunction with the taxpayer entering into an installment agreement with the IRS. The Form 900 waiver extended the collection statute of limitations period 25 years to June 10, 2026. In 2001, the taxpayer's economic circumstances changed, and he became unemployed. The taxpayer defaulted on his installment agreement in the year 2000. When the taxpayer's wife obtained employment in 2002, the IRS levied her salary. The taxpayer came to the Taxpayer Advocate Service (TAS) for assistance, and TAS assisted with a levy release, which the IRS agreed

1 IRC § 6502(a).

2 IRC §§ 6331(i)(5) and 6503(a) provide that the running of the statutory period for collection is suspended during periods in which the IRS cannot levy upon the taxpayer's assets. There are a number of actions that taxpayers can take that have the affect of bringing a temporary cessation to collection activity, such as requesting a Collection Due Process hearing under IRC §§ 6330 and 6320 (see IRC § 6630(e) for suspension provision) or filing a bankruptcy petition (*see* IRC § 6503(h) for suspension provision).

3 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 3461(c), 112 Stat. 685.

4 In September of 2006, the Taxpayer Advocate Service Research function requested a review of the IRS's data bases for delinquent accounts in which a waiver was granted prior to January 1, 2000 and which are still open collection accounts. The results of the research demonstrated that there were at least 14,000 such taxpayers.

to in exchange for a resumption of payments on the installment agreement. The taxpayer recalled signing the Form 900 in 1991, but indicated to the TAS case advocate that he did not understand the consequences of signing the form, *i.e.*, he did not understand that the waiver allowed the IRS to pursue the debt for an additional 25 years beyond the date which the law generally required the IRS to cease collection action.

RECOMMENDATIONS

Eliminate the IRS's inventory of lengthy CSED extensions by enacting legislation that will terminate all CSED extensions on accounts that were in existence before January 1, 2000 and were granted in connection with installment agreements. This provision should be similar to RRA 98 section 3461(c), which eliminated many lengthy CSED extensions as of December 31, 2002 but which did not apply to CSED extensions granted in connection with installment agreementss.[5] To ensure that taxpayers who granted the IRS CSED extensions prior to the effective date of RRA 98 are subject to the same policies and procedures applicable to taxpayers today, a new sunset provision should be enacted to give the IRS two years to take enforcement action if it is appropriate to do so, after which the collection statute will expire.

PRESENT LAW

Over the last six years, the law and IRS policy with respect to CSED extensions has evolved favorably with respect to taxpayers. Prior to RRA 98, IRS collection personnel who sought to protect against expiration of the collection statute routinely sought CSED extensions from taxpayers through a signed Form 900 (Tax Collection Waiver). Moreover, IRS guidance predating RRA 98 (an example of which is set out below) was lacking as to when it was appropriate to seek CSED extensions from taxpayers as well as the appropriate duration of the CSED extension:

> The ten year collection period may, *at any* time prior to its expiration, be extended for *any period of time* agreed upon by the taxpayer and the district director.[6] (emphasis added)

Without specific guidelines on CSED extensions, some IRS collection personnel erred towards seeking lengthy CSED extensions. Taxpayers do not always understand the implications of signing the Form 900 (Tax Collection Waiver) or other CSED extension documents. As the following excerpt from an RRA 98 Senate Committee report demonstrates, Congress focused on collection statute extensions because of its concern that taxpayers were often times not informed about their legal rights or about the consequences of extending both the assessment and collection periods:

[5] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 3461(c)(2), 112 Stat. 685.

[6] IRM 53(11)(1) (Oct. 28, 1993). This IRM provision is no longer in force and effect and has been superseded by new procedures.

> The Committee believes that taxpayers should be fully informed of their rights with respect to the statute of limitations on assessment. The Committee is concerned that in some cases taxpayers have not been fully aware of their rights to refuse to extend the statute of limitations, and have felt that they had no choice but to agree to extend the statute of limitations upon the request of the IRS. Moreover, the Committee believes that the IRS should collect all taxes within 10 years, and that such statute of limitation should not be extended.[7]

The Senate version of RRA 98 section 3461(c) eliminated all CSED extensions; however, the House of Representative's version sought only to ensure that taxpayers were provided notification of their rights with respect to CSED extensions. In the Conference Committee, a compromise provision was adopted eliminating all CSED extensions, except for those in connection with installment agreements and levy releases.[8]

RRA 98 Changes to the Law on CSED Extensions

RRA 98 brought about numerous changes to the practice of seeking CSED extensions. Section 3461(c) of RRA 98 amended section IRC § 6502, effective as of January 1, 2000, to limit the IRS's ability to secure from taxpayers agreements to extend the statutory period for collection. As a result of this change, under current law, the IRS and taxpayers can now only agree to an extension of the statutory limitations period for collection under 6502(a) in two circumstances:

1) The extension is agreed to at the same time as an installment agreement between the taxpayer and the IRS; or

2) The extension is agreed to prior to a release of levy.[9]

Additionally, RRA 98 section 3461(c)(2)(B) contained a sunset provision which terminated certain CSED extensions (*i.e.*, all CSED extensions except those entered into in connection with an installment agreement) effective December 31, 2002.[10] Congress also mandated that the IRS inform taxpayers about their right to refuse to extend the CSED.[11]

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[7] Internal Revenue Service Restructuring and Reform Act of 1998, Pub L. No. 105-206, Sen. Rep. 105-174, Sec. 3461 (June 24, 1998).

[8] *Compare* Sen. Rep. 105-174 87 (June 24, 1998) and House of Rep. No. 105-599 286 (June 24, 1998) to final version of RRA 98 § 3461(c).

[9] IRC § 6502(a)(2).

[10] If a waiver was secured in conjunction with the granting of an installment agreement, the period for collection expires ninety days after the date specified in the waiver. If the waiver was not obtained in conjunction with an installment agreement, such as in conjunction with an offer in compromise, the period for collection expired on the later of December 31, 2002, or the end of the original collection statute. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 3461(c)(2), 112 Stat. 685.

[11] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 3461(b)(2), 112 Stat. 685.

Although RRA 98 did not eliminate CSED extensions in connection with installment agreements or levy releases, the changes enacted as part of RRA 98 reflected a congressional belief "that the IRS should collect all taxes within 10 years, and that such statute of limitations should not generally be extended."[12] Consequently, the IRS changed its policy such that it would no longer seek CSED extensions in excess of five years beyond the CSED.[13] This change in policy was not made retroactive; thus, the accounts of thousands of taxpayers with lengthy CSED extensions have remained active in the IRS's collection inventory.

American Jobs Creation Act of 2004: Partial Pay Installment Agreements

In 2004, Congress granted the IRS authority to enter into partial pay installment agreements for situations when the outstanding liability cannot be fully satisfied within the remaining time period before the expiration of the CSED.[14] In conjunction with the new authority to enter into partial pay installment agreements, the IRS again limited the extent to which collection personnel could seek extensions of the collection statute of limitations to those situations in which a partial pay installment agreement were granted.[15] However, even in cases in which taxpayers qualify for partial pay installment agreements, the IRS requests CSED extensions in limited circumstances.[16] Thus, under current policy, the IRS generally no longer permits extensions of the CSED in connection with installment agreements or levy releases.

REASONS FOR CHANGE

The evolution of the law and policy with respect to CSED extensions has been favorable to taxpayers, such that taxpayers are no longer asked to waive an important right to qualify for an installment agreement.[17] Because the changes were not given retroactive application, however, there are thousands of taxpayers subject to collection action because of the lengthy CSED extensions. Table 2.8.1 shows the results of research

[12] Joint Tax Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998 105 (Nov. 24, 1998).

[13] *See* IRS 5.14.2.1(3) (Jul. 7, 2005), (referencing policy); *see also* Treasury Inspector General for Tax Administration, *Improvements Are Needed to Comply with Legal and Procedural Requirements for Collection Statute Extensions and Installment Agreements* 5 (Aug. 2001) (indicating that despite change policy the audit discovered instances of lengthy CSED extensions obtained from taxpayers).

[14] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 843(a) (2004); see IRM 5.19.1.5.5 for partial pay installment agreement procedures.

[15] IRM 5.14.2.1 (Jul. 7, 2005).

[16] CSED extensions in connection with partial pay installment agreements will only be sought where there is an asset that will come into the possession of a taxpayer after the CSED and liquidation of that asset offers the best case resolution (in lieu of liquidating existing assets to partially pay the liability). IRM 5.14.2.2.3(1)(a) (Jul. 7, 2005).

[17] Courts have held that this waiver of the collection statute of limitations period is not a contract, but rather is a waiver of a defense. *See Strange v. United States*, 282 U.S. 270, 276 (1931); *Florsheim Bros. Drygoods Co. v. U.S.*, 280 U.S. 453, 468 (1930). For more recent case discussing this principle, *see Foutz v. U.S.*, 72 F.3d 802 (10th Cir. 1995) (holding that new law extending collection statute of limitations period from six years to ten years rendered debt collectible and a waiver of the six year collection statute prior to the enactment of the new law was not a contract binding government to collect in a shorter collection period).

analysis by the Taxpayer Advocate Service Research function, which reveals that there are over 32,000 active accounts with lengthy CSED extensions in the IRS's collection inventory. The table also demonstrates that the IRS has received at least one payment in the last 16 months from 14 percent of the taxpayers with lengthy CSED extensions. These payments are made up of voluntary payments from taxpayers and involuntary levy payments.

TABLE 2.8.1, TAX ACCOUNTS WITH LENGTHY CSED EXTENSIONS

Extension Period	No Payment Since Sept. 1, 2005	With Payment Since Sept. 1, 2005	Total
10-19 years	22,110	3,803	25,913
20-29 years	3,732	589	4,321
30-39 years	1,034	164	1,198
40-49 years	368	48	416
≥ 50 years	471	73	544
Total	**27,715**	**4,677**	**32,392**

Because some of the tax accounts in the table above reflect taxpayers with multiple accounts, Table 2.8.2 below provides the number of taxpayers affected by lengthy CSED extensions, equaling approximately 14,000 taxpayers.

TABLE 2.8.2, TAXPAYERS WITH LENGTHY CSED EXTENSIONS

Extension Period	No Payment Since Sept. 1, 2005	With Payment Since Sept. 1, 2005	Total
10-19 years	8,264	3,406	11,670
20-29 years	1,560	0	1,560
30-39 years	331	136	467
40-49 years	113	43	156
≥ 50 years	134	61	195
Total	**10,402**	**3,646**	**14,048**

These findings are consistent with the IRS's 2003 study of accounts with extended CSEDs which found that in 2002 there were approximately 20,000 taxpayers with extended CSEDs, of which approximately 15,000 made payments (both voluntary payments and involuntary payments) of approximately $17,000,000.[18] Each year there are marginally fewer affected taxpayers as some extended CSEDs expire, and each year the IRS collects less from these extended CSED accounts.[19] However, as the tables above demonstrate, the CSEDs of many of these taxpayers will extend far into the future, subjecting these taxpayers to potential collection action when, presumably, they will

[18] IRS Research Project, *Payment Compliance for IMF Installment Agreements Resulting from IRC 6159*, 3 (Jan. 31, 2003).

[19] In 2001, for example, the IRS collected approximately $36 million from extended CSED accounts while it collected less than half of that in 2002. *Id.*

no longer be of working age. Moreover, these taxpayers are being subject to collection action or potential collection action under a collection policy which was abandoned by the IRS for all other taxpayers over five years ago. It is not equitable to subject these 14,000 taxpayers to such dramatically different treatment.[20] Consistent treatment for similarly situated taxpayers is a vital component of our tax administration system.[21]

There are other reasons for Congress to legislatively eliminate these lengthy CSED extensions. The IRS has experienced longstanding problems maintaining adequate systems for tracking CSEDs; thus, the accuracy of the information it has for these taxpayers is questionable. In our 2004 Annual Report to Congress, we detailed serious problems with the IRS's data systems which could not accurately calculate taxpayer CSEDs.[22] As a result of the 2004 report, the IRS and TAS established a task force to address CSED (CSED Task Force) related problems. Together, the IRS and TAS identified tens of thousands of taxpayer accounts that had incorrect CSEDs. While much progress was made, one of the most significant problems identified with incorrect CSEDs still awaits correction almost two years later.[23]

There are also problems for the IRS in administering collection of lengthy CSED accounts, and these problems can translate into additional burden upon taxpayers. Because RRA 98 section 3461 terminated CSED extensions entered into before January 1, 2000 to the extent they were not in connection with installment agreements, current collection efforts on these cases requires a determination as to whether the CSED extension was obtained in conjunction with an installment agreement.[24] Because some of these accounts can be decades old, it is not unusual for there to be a dispute about whether the CSED extension was granted or whether it was in conjunction with an installment agreement or levy release. The burden of proving the existence of the collection waiver lies with the government, and in court, the government must attempt to

[20] For example, compare a taxpayer seeking an installment agreement before RRA 98 who was asked to extend the CSED for 50 years as a condition of obtaining the installment agreement to a taxpayer today who can obtain an installment agreement or partial pay installment agreement without any CSED extension.

[21] One of the objectives of RRA 98 was consistent treatment for similarly situated taxpayers which was accomplished through a reorganization of the IRS into operating divisions. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, Part Two, Title I.A.1, IRS Mission and Restructuring (§§ 1001 and 1002) 17.

[22] National Taxpayer Advocate 2004 Annual Report to Congress 180-192.

[23] In the 2004 report, we assisted the IRS in identifying limitations in the IRS data systems that caused incorrect calculations in certain situations where taxpayers filed offers in compromise with the IRS. National Taxpayer Advocate 2004 Annual Report to Congress 180-192. The IRS has developed a fix for this particular problem so that new accounts can be calculated correctly; however, the implementation of the system has been delayed several times and is now on schedule for implementation in 2007.

[24] For discussion of IRS policy of determining when an installment agreement is obtained "in conjunction with" a CSED extension and disputes arising from the IRS's determination, see National Taxpayer Advocate 2004 Annual Report to Congress 185.

produce the original CSED extension signed by the taxpayer.[25] When there is a dispute about whether a CSED extension was agreed to and under what circumstances, the IRS often relies on its account transcripts rather than original documents. The fact that some of these extensions may be 10, 20, 30, 40 or even 50 years old, only increases the likelihood of these disputes.

EXPLANATION OF RECOMMENDATION

Eliminating the IRS's inventory of extended CSED accounts in which taxpayers have granted lengthy CSED extensions makes sense from a taxpayer fairness perspective and from a tax administration perspective. In 1998, the Senate was prepared to eliminate all CSED extensions based in part on its findings that taxpayers were not adequately informed about their rights and its belief that the IRS should be able to collect its debts within 10 years. Since that time, the IRS has almost fully implemented the Senate's position by permitting CSED extensions only for partial pay installment agreements, and even in that instance, CSED extensions are limited to certain narrow factual circumstances. However, the IRS has made these policy corrections prospectively, leaving thousands of taxpayers behind with the prospect of potential collection action long into the future.

By enacting this legislation, Congress would be taking the final necessary step towards resolving the problem of lengthy CSED extensions. Enacting this legislation would not let these taxpayers "off the hook" but would give them a reasonable sense of certainty for the conclusion of the debt and would give the IRS two years to attempt resolution on the account. Thus, we have recommended creating a sunset provision terminating collection on these accounts as of December 31, 2008.

[25] *United States v. McGaughey*, 977 F.2d 1067, 1071 (7th Cir. 1992), *cert. denied*, 507 U.S. 1019 (1993) (holding government has burden of proving existence of waiver of collection statute of limitations and in this case, the IRS demonstrated a reasonable search for original documents and secondary evidence was sufficient to demonstrate existence of waiver).

RECOMMENDATION
#9 LEVY ACTIONS ON FIXED AND DETERMINABLE RIGHTS

PROBLEM

A levy is a legal seizure of property to satisfy a tax debt.[1] The IRS levy program is a necessary means of collection, and when used appropriately is a fundamental component of tax enforcement. If a taxpayer does not pay a tax liability in full or otherwise come to an agreement to resolve the matter, the IRS may levy against any property (or right to property) that belongs to the taxpayer or is subject to a federal tax lien, unless it is exempt.[2]

The IRS generally has ten years from the date of the assessment to collect the tax by levy.[3] However, in practice, it is possible for the IRS to collect these payments well after the expiration of the statutory collection period for collecting the tax. For example, streams of payments (such as retirement and Social Security benefits, pensions, royalties, bond interest payments, and fixed trust payments) may be seized by a levy that attaches to all future payments to which the taxpayer is entitled, so long as there is a fixed and determinable right to these payments at the time of levy.[4]

Furthermore, under the IRS's interpretation of current law, a levy served prior to the collection statute expiration date (CSED) may be updated post-CSED to reflect the full amounts of tax, penalty, and interest due as of the date of the final payment, as though the CSED had not expired, for any period listed on the levy.

EXAMPLE

The IRS assessed taxes and penalties totaling $50,000 against a taxpayer in April 1995. The taxpayer began receiving $923 a month (the average monthly payment for a Social Security beneficiary[5]) from the Social Security Administration in January 2004. In September 2004, the IRS placed a levy on this taxpayer's fixed and determinable right to Social Security benefits.

By this time, the taxpayer owes the IRS $72,000 in back taxes, penalties, and interest. Each month, the IRS receives $223 of the taxpayer's Social Security benefits. If we assume an interest rate of five percent, more than $10 of interest will accrue daily (over $300 per month) on the $72,000 liability. Because the IRS applied the levy prior

[1] Internal Revenue Code (IRC) § 6331 provides the IRS with statutory authority to levy funds held by a third party.

[2] See IRC § 6334 for an enumeration of property exempt from levy.

[3] *See* IRC § 6502.

[4] *See* Treas. Reg. § 301.6343-1(b) (levy on a fixed and determinable right to payment includes payments to be made after the CSED does not become unenforceable upon the CSED); Rev. Rul. 55-210, 1955-1 C.B. 544 (only one notice of levy needs to be served to effectively reach vested benefits subsequently payable in other contexts).

[5] Social Security Administration, Office of Policy, Research, Evaluation and Statistics, *Monthly Statistical Snapshot, Table 2, Social Security Benefits* (Aug. 2006).

to the April 2005 CSED, it may continue to receive the taxpayer's Social Security payments until the taxpayer's death (because the $223 levy is less than the monthly interest accrual).

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress pass legislation to:

1. Restrict the IRS's ability to levy under section 6331(a) upon a taxpayer's fixed and determinable right to future retirement and disability benefits (including Social Security and private pension and disability plan benefits) unless the taxpayer has exhibited flagrant conduct; and
2. Exclude post-CSED accruals of penalties and interest from IRS collection when the IRS makes a pre-CSED levy upon a taxpayer's fixed and determinable rights to future payments.

PRESENT LAW

Internal Revenue Code (IRC) § 6502 provides generally that the tax may be collected by levy or by a proceeding in court, but only if the levy is made or the proceeding begun within ten years after the date of assessment. If the IRS has levied prior to the expiration of this statutory period, the IRS may receive payments in the future. Each tax assessment has a collection statute expiration date (CSED).

Pursuant to IRC § 6331(a), the IRS may levy against any property (or right to property) that belongs to the taxpayer or is subject to a federal tax lien if a taxpayer does not pay a tax liability in full or otherwise come to an agreement to resolve the matter, unless it is exempt.[6]

Treas. Reg. § 301.6343-1(b)(1)(B)(ii) provides that a levy reaches all property rights at the time the levy is made, including the right to receive payments at some point in the future, and will not be released under this condition unless the liability is satisfied. Thus, certain streams of payments can be seized by a single levy that attaches to all future payments to which the taxpayer is entitled, so long as there is a fixed and determinable right at the time of levy. The liability remains enforceable to the extent of the value of the levied upon property.

IRC § 6601(e) and § 6665 provide that interest and penalties, respectively, shall be assessed, collected, and paid in the same manner as taxes.

[6] See IRC § 6334 for an enumeration of property exempt from levy.

REASONS FOR CHANGE

Retirement Benefits

Distributions from retirement plans and Social Security Administration (SSA) benefits are intended to provide for the welfare of the elderly and the disabled. Generally, this population relies heavily on these monthly distributions to meet their basic living expenses. For example, Social Security provides at least half of the total income for 65 percent of beneficiaries aged 65 or over, and is the *only* source of income for more than 20 percent of this population.[7]

The IRS will not levy under § 6331(a) on accumulated funds (the corpus) in retirement assets, such as an IRA, unless the taxpayer has engaged in "flagrant" conduct.[8] The Service does not apply the "flagrant" conduct standard to the stream of payments from retirement assets, such as an IRA.[9] Instead, IRM 5.11.6.1(1) provides that "discretion" should be used before levying retirement income.

When the IRS levies on Social Security income payments, it uses the standard of "discretion."[10] It does not use the standard of "flagrant" conduct because the IRS is not seeking accumulated funds from the SSA.

Today, for example, if a taxpayer were receiving a monthly retirement payment from both an IRA and Social Security, the IRS would use the same standard in serving a levy–the IRS would use its discretion. The National Taxpayer Advocate believes that the IRS should use the flagrant standard for levies on a stream of monthly retirement payments from Social Security or an IRA or private pension. The IRS should be consistent in its approach to levying on retirement assets and retirement benefits. Congress should allow the IRS to levy on taxpayers' fixed and determinable rights to retirement and disability benefits only in cases where taxpayers have exhibited flagrant conduct, the same standard the IRS uses when it contemplates levy action on retirement assets.

Post-CSED Accruals

Taxpayers may find themselves in situations where the payments they are able to make are less than the interest accrual associated with their underlying IRS liabilities. Unless circumstances change to enable a taxpayer to pay down the tax debt, such a taxpayer would be indebted to the IRS for eternity.

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7 Social Security Administration, *Fast Facts & Figures About Social Security, 2005* (Sept. 2005). For a more detailed overview of the demographics of the population receiving Social Security benefits, see Most Serious Problem, *Levies, supra.*

8 IRM 5.11.6.2(5) (Mar. 15, 2005).

9 IRM 5.11.6.2(1) states "These instructions cover money accumulated in a pension or retirement plan, as well as Individual Retirement Arrangements (IRAs). They do not deal will levying retirement income."

10 In contrast, the IRS does not use any standard with respect to Federal Payment Levy Program (FPLP) levies on Social Security payments under IRC 6331(h); the FPLP is an automated process with no income filter. *See* Most Serious Problem, *Levies, supra*, and Most Serious Problem, *Collection Issues of Low Income Taxpayers, supra.*

Limiting the amount subject to levy to the balance due at the CSED would provide taxpayers and the IRS with the opportunity to achieve closure with respect to an assessment. Congress intended to provide the IRS a finite window of time to collect assessed taxes by virtue of the CSED (generally ten years from the date of assessment). It is unfair to subject taxpayers who have fixed and determinable rights to future payments to IRS collection action until death.

EXPLANATION OF RECOMMENDATION

This recommendation protects the retirement benefits of elderly and disabled taxpayers from IRS levies, absent flagrant conduct. Under present law, the IRS, by virtue of placing a single levy upon a taxpayer's fixed and determinable right to future benefits prior to the CSED, is able to levy upon a taxpayer's retirement or disability benefits without any limitation in time. With the proposed change in law, the IRS would be able to levy upon a taxpayer's fixed and determinable right to retirement income only in instances where the taxpayer has engaged in "flagrant" conduct. Examples of flagrant conduct include situations where a taxpayer has been convicted of tax evasion for the tax debt or has been assessed with a fraud penalty for the tax debt.[11]

This recommendation impacts not only retirees and Social Security beneficiaries, but also victims of mass tort litigation. For example, in 1989 the *Exxon Valdez* oil spill catastrophe gave rise to thousands of tort claims by those whose livelihoods were impacted by the accident. The distribution of proceeds to plaintiffs was delayed by multiple appeals and other legal proceedings; some plaintiffs did not receive any distributions until 2005. Many of these plaintiffs had outstanding federal tax liabilities from prior years. Because the plaintiffs had a fixed and determinable right to damages, the IRS was able to serve upon the settlement fund administrators a mass levy via magnetic tape in 1990, prior to the CSED.

Under present law, the IRS is entitled to update its levy to demand full payment of all assessed and unassessed penalty and interest accruals, up to the full value of the taxpayer's distribution, as though the CSED had never expired. With the proposed change in law, the IRS could levy against a taxpayer's account only up to the dollar amount of taxes, penalties, and interest assessed as of the CSED.

[11] *See* IRM 5.11.6.2(5) (Mar. 15, 2005).

RECOMMENDATION

#10 IMPAIRMENT RELATED WORK EXPENSES

PROBLEM

Congress has created a number of tax credits and deductions to increase the employment rate for workers who have disabilities. One of these incentives is the impairment-related work expense deduction.[1] However, the taxpayer can only take this deduction if he or she itemizes instead of using the standard deduction.[2] This approach makes the deduction unavailable for many disabled taxpayers, who have low incomes and fewer deductible expenses, and thus benefit more from the standard deduction.[3] Generally, itemizing deductions is beneficial for taxpayers who have higher income and deductible expenses such as medical care, mortgage interest, state and local taxes, charitable contributions, and casualty losses.

EXAMPLE

Mary is legally blind and earns $15,000 a year. She had to spend $1,200 on equipment and devices for accommodating her disability in the workplace. Mary is filing her return as a single person and would like to deduct the $1,200. To do so, Mary must itemize but she only has another $2,300 in deductible expenses for a total deduction of $3,500. While this would reduce her taxable income to $11,500, taking the standard deduction for single individuals, which is $5,000 in 2005, would reduce Mary's taxable income to $10,000. Financially it makes more sense for Mary to take the standard deduction, but she will be unable to deduct the $1,200 she spent on equipment and devices that enable her to work.

RECOMMENDATION

Amend Internal Revenue Code § 67(d) to allow taxpayers to take the impairment-related work expense as an above-the-line deduction from gross income or, alternatively, restructure the deduction as a credit against tax.

PRESENT LAW

The impairment-related work expense deduction applies to taxpayers who have a physical or mental disability. This disability must functionally impair or substantially limit one or more major life activities (*e.g.*, performing manual tasks, walking, speaking, breathing, learning, and working).[4] These expenses must be ordinary and necessary

[1] IRC § 67(d).

[2] IRC §§ 63 and 67(b)(6)(d).

[3] U.S Census Bureau, *Question and Answer Center*, at http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html. The median income for people with a nonsevere disability is $22,000, compared to $25,000 for people with no disability and $12,000 for people with a severe disability. The poverty rate for people ages 25 to 64 with a nonsevere disability is 11 percent. This compares to 26 percent for those with severe disabilities and eight percent of those with no disabilities.

[4] Treas. Reg. § 1.190-2(a)(3).

business expenses for attendant care at the taxpayer's place of work or other ordinary and necessary expenses connected to the taxpayer's place of work.[5] If the taxpayer meets these guidelines, he or she can deduct these expenses, even if the expense does not exceed two percent of the taxpayer's adjusted gross income.[6]

REASON FOR CHANGE

Americans with disabilities are employed at a significantly lower rate than those without disabilities.[7] This low employment rate can be attributed to a number of factors, including a lack of appropriate job opportunities, limited access to public transportation, and the burden of additional costs for accommodations in the workplace. The impairment-related work expense tax deduction gives taxpayers with disabilities an incentive to enter the workforce and helps alleviate additional costs they may incur. Unfortunately, the usefulness of this deduction is limited because it is only available to taxpayers who itemize deductions.[8] Therefore, to better assist disabled taxpayers entering into the workforce, Congress should abolish this limitation and allow eligible taxpayers to use the deduction in all circumstances, or convert the deduction to a credit applied against the taxpayer's tax liability.

EXPLANATION OF RECOMMENDATION

Currently, the number of taxpayers who use the impairment-related work expense deduction is limited because it can only be taken when taxpayers itemize.[9] Eliminating this barrier and allowing taxpayers to use the deduction, regardless of whether they itemize, will allow more taxpayers with a disability to claim the deduction. Alternatively, the deduction could be converted to a tax credit, which would offset the taxpayer's tax liability. Broadening the applicability of the deduction or credit will have a positive impact on the disability community. For example, it will help reduce the burden of

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[5] IRC §§ 67(d) and 162.

[6] IRC § 67(b)(6), (d).

[7] U.S Census Bureau, *Question and Answer Center*, at http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html. There are 11.8 million Americans (comprising six percent of the population) between the ages of 16 and 64 who report the presence of a medical condition that makes it difficult to find a job or remain employed. Fifty-six percent of people ages 21 to 64 having some type of disability were employed in the 2001. Out of the 56 percent, the employment rate ranges from 82 percent of those with a nonsevere disability to 43 percent with a severe disability. Forty-four percent of people with a nonsevere disability work full-time, year-round. This compares to 53 percent of those without a disability and 13 percent with a severe disability.

[8] IRC § 67(d).

[9] Tax Year 2004 Individual Returns Transaction File (IRTF) located on the IRS Compliance Data Warehouse. In tax year 2004, there were 1.4 million returns reporting a positive value on the "Other Deductions" line of Schedule A. This represents 3.1 percent of all Schedule A filers. The total amount of all "other deductions" claimed, which includes expenses besides impairment-related work expenses, was only 1.6 percent of all itemized deductions reported on Schedule A. The number of taxpayers who claim the impairment related work expense cannot be separately identified because the IRS does not break out the other deductions information. These low numbers indicate that the impairment-related work expense deduction is claimed at a low rate.

costly accommodations, and encourage taxpayers with disabilities to enter the workforce.[10]

Adopting this recommendation would set the impairment-related work expense deduction apart from other miscellaneous deductions. Congress already treats the deduction differently than some others by not applying the two percent adjusted gross income threshold.[11] Congress should use its authority to broaden the availability of the impairment-related work expense deduction to help taxpayers with disabilities enter and remain in the workforce.

[10] Freedom Scientific, at http://www.freedomscientific.com/. This company sells screen reading programs (JAWS) and screen magnification programs (Magic) for the blind and visually impaired. The development of this technology has been very helpful to individuals who are blind or visually impaired. However, these programs can also be very expensive for persons of limited means, costing from $1,000 to $2,000 or more.

[11] IRC § 67(b)(6)(d). The impairment-related work expense deduction is not subject to the two percent floor that applies to miscellaneous itemized deductions. Generally, miscellaneous itemized deductions shall be allowed only to the extent that the aggregate of the deduction exceeds two percent of the person's adjusted gross income.

INTRODUCTION: "INNOCENT SPOUSE" RELIEF FIXES

Federal income tax liabilities of married persons are sometimes imposed by law on or collected from a spouse who did not earn the income subject to tax and who, as a result, may have no ability to pay the liability. Under current law, these problems are addressed in part by the relief rules of Internal Revenue Code (IRC) §§ 6015 and 66, which we refer to, collectively, as the "innocent spouse" rules.[1] In general, these relief rules either reallocate income (and other items) between spouses or relieve one spouse of liability for tax attributable to the other. One fundamental problem with the innocent spouse rules is that they often require a difficult factual inquiry into what a spouse knew when he or she signed the return in question.

In her 2005 annual report, the National Taxpayer Advocate proposed a comprehensive solution to the problems posed by the taxation of married taxpayers and existing relief rules.[2] The proposal would repeal joint and several liability and allocate liability between spouses in accordance with each spouse's income. It would also reduce the IRS's ability to collect the liability from the nonliable spouse without first attempting to collect from the liable spouse, which it has the ability to do in community property jurisdictions. Specifically, the National Taxpayer Advocate recommended that Congress:

- Eliminate joint and several liability for joint filers.[3] Require married taxpayers to file a split-column tax return, which identifies separate items of income, deduction, credit, and payment, similar to the combined return adopted by a number of states.
- Repeal the rule of *Poe v. Seaborn*[4] that each spouse is taxed on one-half of any community income (*i.e.*, generally income earned by either spouse or generated by community property during marriage and sometimes income generated by separate property during marriage). Instead, apply the federal rules for allocating a nonresident alien's community income to all couples, with slight modification.[5]
- Require the IRS to exhaust efforts to collect against assets under the liable spouse's control before collecting against assets under the nonliable spouse's control, unless such efforts would be futile.[6]

In the event that Congress does not enact these recommendations, there are a number of problems with the existing innocent spouse rules that Congress should address, as follows.

1 *See* IRC § 6015 (joint and several liability relief); IRC § 66 (community property relief).

2 *See* National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse).

3 Revise IRC § 6013(d), which imposes joint and several liability.

4 *Poe v. Seaborn*, 282 U.S. 101 (1930).

5 *See* IRC § 879(a). Our 2005 proposal would allocate "other income" to the spouse with control of the income.

6 This requirement would mirror what is required before the IRS may collect on a transferee liability under current law. *See, e.g., U.S. v. Russell*, 241 F.2d 879 (1st Cir. 1957); IRM 4.10.13.3 (Mar. 30, 2005).

ADDITIONAL LEGISLATIVE RECOMMENDATION: EXTEND PERIOD FOR FILING A TAX COURT PETITION; IMPROVE FINAL DETERMINATION LETTERS

PROBLEM

Even though the IRS's relief determination under IRC § 6015 is subject to judicial review,[7] the IRS is not required to provide and does not provide taxpayers with the last date to petition the U.S. Tax Court in the final determination letters it issues to them in connection with requests for innocent spouse relief. In contrast, IRS deficiency determinations are similarly subject to judicial review, but Congress has directed the IRS to assist taxpayers by providing them with the last date to petition the Tax Court in notices of deficiency.[8] Providing such assistance is important because it may be difficult for some taxpayers to determine the deadline for filing a petition in Tax Court without professional assistance, assistance which many taxpayers who need relief may be unable to afford. Sixty-five percent of the taxpayers who request innocent spouse relief make less than $30,000 per year.[9] Thus, it may be even more helpful for the IRS to include the last date to petition the Tax Court in innocent spouse determination letters than to include it in notices of deficiency.

Perhaps one reason the IRS does not include the last date to petition the Tax Court in its notice of determination letters is that if the IRS enters a date beyond the requisite period and the taxpayer relies on it, then the taxpayer could miss the filing deadline. In contrast, if the IRS enters a date beyond the requisite period for filing a Tax Court petition in a notice of deficiency, then a taxpayer will not be harmed as long as he or she files the petition on or before the date contained in the notice of deficiency because IRC § 6213(a) provides that a taxpayer may petition the Tax Court any time on or before the date specified in the notice.

EXAMPLE

The IRS denied innocent spouse relief to W and she petitioned the Tax Court.[10] Because W was unrepresented, she had difficulty computing the deadline for filing a

[7] IRC § 6015(e).

[8] IRC § 6213(a); IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3463(a), 112 Stat. 685 (1998).

[9] W&I Research, *Strategic Forecasting & Analysis, Innocent Spouse Data Summary* (Oct. 3, 2005) (statistics based on 2001 data).

[10] As a result of recent litigation, various courts held that the Tax Court did not have jurisdiction to review the IRS's innocent spouse determinations under IRC § 6015(f) where the IRS had not asserted a deficiency (*i.e.*, cases involving only equitable relief from underpayments of tax reported on the return). *See, e.g., Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *rev'g Ewing v. Comm'r*, 118 T.C. 494 (2002); *Bartman v. Comm'r*, 446 F.3d 785 (8th Cir. 2006) (following the Ninth Circuit's decision in Ewing); *Sjodin v. Comm'r*, 97 A.F.T.R.2d (RIA) 2622 (8th Cir. 2006); *Billings v. Comm'r*, 127 T.C. 7 (2006). The National Taxpayer Advocate originally planned to include a recommendation to provide such jurisdiction. However, a bill to provide Tax Court jurisdiction (H.R. 6111) in these circumstances passed both houses of Congress and was signed by the President on December 20, 2006. Thus, for purposes of this discussion we assume the Tax Court has jurisdiction to review all IRS determinations under IRC § 6015.

petition with the Tax Court. As a result, W missed the deadline for filing a timely petition.

RECOMMENDATION

Require the IRS to include the last date to petition the Tax Court in any final determination letter the IRS issues in connection with an election or request for innocent spouse relief in a manner similar to that provided by IRC § 6213(a).[11] Provide that a taxpayer may petition the Tax Court within 90 days of the date of the determination or by the date specified in the letter, whichever is later.[12]

ADDITIONAL LEGISLATIVE RECOMMENDATION: SUSPEND THE PERIOD FOR FILING A TAX COURT PETITION DURING BANKRUPTCY

PROBLEM

The period for filing a Tax Court petition to obtain judicial review of an IRS innocent spouse relief determination is not suspended during bankruptcy. Any such petition must be filed on or before the 90th day after the IRS mails its final determination.[13] The taxpayer may not file a Tax Court petition during a bankruptcy proceeding in violation of the bankruptcy stay.[14] In contrast, while a bankruptcy stay is in effect and for 60 days thereafter, the period for filing a petition for the Tax Court to redetermine a deficiency is suspended.[15]

EXAMPLE

The IRS denied innocent spouse relief to W and sent her a final notice of determination immediately before she had to file for bankruptcy to prevent other creditors from foreclosing on her assets. The bankruptcy lasted beyond the 90 day period for filing a petition in Tax Court. As a result, W had no opportunity to file a timely Tax Court petition.

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[11] The National Taxpayer Advocate made a similar recommendation in her 2001 report. *See* National Taxpayer Advocate 2001 Annual Report to Congress 159-165.

[12] Although legislation is not required to allow the IRS to revise its determination letters to include the last date for filing a petition, legislation is required to allow taxpayers to rely on the date shown in such letters.

[13] IRC § 6015(e)(1).

[14] *See Drake v. Comm'r*, 123 T.C. 320 (2004). *See also, In re Drake*, 336 B.R. 155 (Bankr. D. Mass. 2006). A "stay" is automatically triggered when a bankruptcy petition is filed. This stay prohibits the commencement or continuation of legal or enforcement activities with respect to the debtor. *See generally*, 11 U.S.C. 362. The Tax Court, in *Drake v. Comm'r*, found that the filing of a petition by the taxpayer/debtor violated the stay. The Bankruptcy Court, in *In re Drake*, concluded that the issuance of the final notice by the IRS also violated the stay. The government has appealed the decision in *In re Drake* and the appeal is currently pending.

[15] IRC § 6213(f). The IRS is authorized to issue a notice of deficiency during the pendency of a bankruptcy proceeding as a specific exception to the automatic stay. *Id.*

RECOMMENDATION

Suspend the period for filing a petition in Tax Court to obtain judicial review of an innocent spouse determination while the stay resulting from a bankruptcy filing is in force and for 60 days thereafter in a manner similar to that provided by IRC § 6213(f).[16]

ADDITIONAL LEGISLATIVE RECOMMENDATION: REQUIRE THE IRS TO ESTABLISH A RECONSIDERATION PROCESS FOR INNOCENT SPOUSE DETERMINATIONS

PROBLEM

Except in very limited circumstances, the IRS has no process that allows it to reconsider an innocent spouse determination after it issues a final determination letter.[17] Additionally, except in limited circumstances, a taxpayer cannot file a second claim for innocent spouse relief for the same tax liability, even if the taxpayer's circumstances have changed.[18] The lack of a reconsideration process may be a problem for taxpayers if they are unable to articulate all of the relevant facts or to provide sufficient documentation when they first seek innocent spouse relief. The IRS considers factors such as economic hardship, which may change over time, in determining whether to grant relief.[19] Thus, the IRS's determination may also depend on when the taxpayer seeks relief. As a result, the IRS may deny relief to some taxpayers simply because they sought relief before their financial situation deteriorated, because they failed to emphasize important facts, failed to recognize the importance of providing certain documentation, or simply failed to timely respond to follow-up questions from the IRS.

In contrast, after an audit that results in a deficiency assessment, a taxpayer has an opportunity to request "audit reconsideration" by Compliance if he or she provides additional information not considered during the original examination.[20] One primary

[16] The National Taxpayer Advocate made a similar recommendation in her 2004 report. *See* National Taxpayer Advocate 2004 Annual Report to Congress 490.

[17] *See* IRM 25.15.7.11.10 (Sept. 1, 2006) (referencing LEM 25.15.1.4 (May 5, 2005), which describes those limited circumstances).

[18] Treas. Reg. § 1.6015-1(h)(5). The IRS will consider a second election for relief under IRC § 6015(c) to separate the liability (a "separate liability election"). IRC § 6015(c)(3)(A)(i); Treas. Reg. § 1.6015-3(a). The separate liability election allows a taxpayer who is divorced, legally separated, widowed, or was not a member of the same household as his or her spouse for a 12-month period to elect to limit his or her liability for deficiencies on the joint return to the proportion of the deficiency allocable to his or her items. IRC § 6015(c). A taxpayer may file a separate liability election if, upon making an initial election or request for relief, the taxpayer was ineligible to elect separation of liability **solely** because he or she was not divorced, widowed, or legally separated, or had not been a member of the same household as the nonrequesting spouse during the requisite period, and the taxpayer satisfies this requirement when filing the second separate liability election. *See* Treas. Reg. § 1.6015-1(h)(5).

[19] Rev. Proc. 2003-61, 2003-2 C.B. 296.

[20] *See* IRM 4.13.1.4(1)(d) (Oct. 1, 2006); IRM 1.2.1.3.16 (Sept. 20, 1999) (Policy Statement P-2-89). Sometimes taxpayers request audit reconsideration because they did not appear for the audit, moved and did not receive IRS correspondence, or have new documentation to present. *See* IRM 4.13.1.3 (Oct. 1, 2006).

purpose of the audit reconsideration process is to help ensure that assessed liabilities are correct and that the IRS resolves cases with similar facts in a consistent manner.[21]

The IRS may realize some cost savings as a result of its decision not to establish a reconsideration process for innocent spouse determinations, but any such savings come at the expense of collecting the correct amount of tax from innocent spouses. The absence of a reconsideration process may also result in more litigation of innocent spouse issues, however, perhaps eliminating any such cost savings. Moreover, without a reconsideration process, the IRS will be less likely to resolve cases with similar facts consistently.

EXAMPLE

The IRS sent W a final notice of determination denying her request for innocent spouse relief that she had prepared and submitted without the assistance of a tax practitioner. Two years later, when W's financial situation deteriorated so that full payment of the liability would create an economic hardship, she sought advice from a practitioner. The practitioner advised her that the IRS would likely have granted her request for relief if she had emphasized certain important facts and provided more complete documentation. Since the IRS also considers "economic hardship" as a factor in determining whether to grant innocent spouse relief, the practitioner advised that W's existing financial situation would make the IRS even more likely to grant relief. W could not obtain relief, however, because she could not submit another election or request for relief and the IRS would not reconsider its final innocent spouse determination.

RECOMMENDATION

Require the IRS to establish a process, similar to its audit reconsideration process, to reconsider innocent spouse determinations after it has issued a final notice of determination.[22]

[21] *See* IRM 4.13.1.1(2) (Feb. 1, 2003).

[22] The National Taxpayer Advocate made a similar recommendation in her 2001 and 2005 reports. *See* National Taxpayer Advocate 2005 Annual Report to Congress 334, 343; National Taxpayer Advocate 2001 Annual Report to Congress 159-165. Although IRS may not need any additional legislative authority to create such a process, the IRS seems to believe that it requires the authority to rescind a notice of determination, similar to its authority under IRC § 6212(d), to create an audit reconsideration-type process for innocent spouse determinations. *See* National Taxpayer Advocate 2005 Annual Report to Congress 326, 340 (Most Serious Problem: Innocent Spouse Processing, IRS Comments).

ADDITIONAL LEGISLATIVE RECOMMENDATION: PROVIDE THE TAX COURT WITH JURISDICTION TO REVIEW COMMUNITY PROPERTY RELIEF DETERMINATIONS UNDER IRC § 66(C)

PROBLEM

The Tax Court lacks jurisdiction to review the IRS's determinations regarding relief from community property law under IRC § 66(c).[23] In contrast, the Tax Court has jurisdiction to review IRS determinations under IRC § 6015(b), (c), and (f).[24] Some taxpayers may, nonetheless, obtain judicial review of IRS determinations under IRC § 66 in connection with collection due process (CDP) or deficiency proceedings.[25]

Upon filing a lien and before filing a levy, the IRS must provide the taxpayer an opportunity for a CDP hearing, in which he or she can raise various issues including "appropriate spousal defenses" to collection.[26] Since a taxpayer may appeal the IRS's CDP determination to a court, he or she may be able to obtain judicial review of the IRS's community property relief determinations in such proceedings, assuming the taxpayer raised the issue of community property relief in the CDP hearing.[27] However, a taxpayer is not entitled to a CDP hearing in connection with a refund offset.[28] This means a taxpayer who is seeking community property relief under IRC § 66(c) and is only subject to a refund offset, rather than a lien or levy, may have no ability to obtain judicial review of an IRS determination under IRC § 66(c), whereas another similarly situated taxpayer may be able to obtain judicial review.[29]

One significant purpose of judicial review is to ensure the IRS's determinations are correct. We are not aware of any evidence that the IRS's ability to make correct determinations regarding the allocation of community income under IRC § 66(c) is superior to its ability to make correct determinations regarding the allocation of joint and several liability under IRC § 6015.

[23] In *Bernal v. Comm'r*, 120 T.C. 102, 107-108 (2003) the Tax Court confirmed that it did not have jurisdiction to review the IRS's determination to deny equitable relief under IRC § 66(c). While the case only involved a denial of equitable relief under IRC § 66(c), not a denial of traditional relief under IRC § 66(c), the court stated that it had jurisdiction to review IRC § 66(c) claims in a deficiency proceeding, but not in a "stand alone" proceeding, because IRC § 66 did not contain a parallel provision to § 6015, granting jurisdiction to the Tax Court to review claims under IRC § 66. *See also Christensen v. Comm'r*, T.C. Memo 2005-299.

[24] IRC § 6015(e)(1). As discussed above, a bill (HR 6111), which provides the Tax Court with jurisdiction to review the IRS's innocent spouse determinations under IRC § 6015(f), was signed by the President on December 20, 2006.

[25] *See, e.g., Beck v. Comm.*, T.C. Memo 2001-198, AOD-122827-02 (Dec. 9, 2002).

[26] IRC § 6330(c)(2)(A)(i); IRC § 6320.

[27] *See* IRC § 6330(d)(1).

[28] *See, e.g., Boyd v. Comm'r,* 124 T.C. 296 (2005); *Bullock v. Comm'r*, T.C. Memo 2003-5.

[29] It may be possible for a taxpayer to obtain judicial review of an IRS determination under IRC § 66 in connection with a claim for refund. However, taxpayers can not obtain judicial review of the IRS's denial of a claim for refund until the liability is paid in full. *See* IRC § 7422; *Flora v. U.S.* 362 U.S. 145 (1960). In addition, the taxpayer must file any claim for refund within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later. IRC § 6511(a).

EXAMPLE

A married couple "domiciled" in a community property state separated in February 2000, but each spouse's earnings continued to be community property under state law until the divorce.[30] In early 2001, W filed a separate 2000 return, which erroneously included all of the income she earned and omitted all of H's income. The IRS audited W's 2000 return and determined she was liable for tax on one-half of the community income, including income earned by H after the separation. W timely requested community property relief under IRC § 66(c), but the IRS determined W did not qualify because she could not establish she did not know or have reason to know about H's income. W may not petition the Tax Court to review the IRS's determination under IRC § 66(c).

RECOMMENDATION

Provide the Tax Court with jurisdiction to review the IRS's community property relief determinations under IRC § 66(c).

ADDITIONAL LEGISLATIVE RECOMMENDATION: ELIMINATE THE TWO-YEAR LIMITATION PERIOD FOR TAXPAYERS SEEKING EQUITABLE RELIEF UNDER IRC § 6015 OR IRC § 66

PROBLEM

Taxpayers must request equitable relief under IRC § 6015 or IRC § 66 within the two-year period beginning on the date of the IRS's first collection activity against the taxpayer with respect to the liability.[31] In contrast, the IRS generally has ten years from the date of any assessment to collect the liability.[32]

The doctrine of "equitable recoupment" has sometimes been applied as a defense against tax claims that would otherwise be barred by a statute of limitations.[33] Equitable recoupment is a defense arising out of some feature of the transaction occurring in a different year upon which the plaintiff's action is grounded. "Setoff" is a related defense that is also applied without regard to the statute of limitations period.[34] It allows one party to defend against tax claims on the basis that the other party owes amounts to it

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[30] Which state's law applies depends on a person's "domicile." *See, e.g., U.S. v. Mitchell*, 403 U.S. 190 (1971); IRM 25.18.1.2.1 (Feb. 15, 2005). A domicile is the permanent legal home the taxpayer intends to use for an indefinite or unlimited period, and to which, when absent, he or she intends to return. *Id.*

[31] The Internal Revenue Code only applies the two-year limitation to taxpayers seeking traditional relief under IRC § 6015(b) or separate liability elections under IRC § 6015(c), potentially raising an inference that the two-year limitation should not apply to requests for equitable relief under IRC § 6015(f). *See* IRC § 6015(b)(1)(E) (applicable to elections under IRC § 6015(b)); IRC § 6015(c)(3)(B) (applicable to elections under IRC § 6015(c)). However, the IRS applies the two-year limitation to request for equitable relief. See Rev. Proc. 2003-61, 2003-2 C.B. 296, § 4.01(3) and § 5 (applicable to equitable relief requests under both IRC § 6015(f) and IRC § 66(c)).

[32] IRC § 6502(a)(1).

[33] *See, e.g., Bull v. U.S.*, 295 U.S. 247 (1935).

[34] *See, e.g., Lewis v. Reynolds*, 284 U.S. 281 (1932); *Dysart v. U.S.*, 340 F.2d 624 (Ct. Cl. 1965).

attributable to the same tax year. Even if taxpayers may not use the doctrines of "equitable recoupment" or "setoff" as a defense that would allow them to obtain innocent spouse relief without regard to any time limits, these doctrines provide a logical basis for allowing taxpayers to raise innocent spouse relief as a defense to the IRS's collection of the liability with respect to which such relief would otherwise be granted (*i.e.*, without regard to any time limits). If a taxpayer does not owe a liability by reason of the innocent spouse rules, it should not matter when he or she seeks equitable relief as long as the IRS may continue to assess or collect those very liabilities.

EXAMPLE

A married couple filed a joint return for 1999. H concealed some of his income and did not report it on the joint 1999 return. In 2003, the IRS assessed additional tax against the couple as a result of H's unreported income. H ignored the assessment and concealed collection notices sent to the couple's home, including Letter 1058(c), *Notice of Intent to Levy and Notice of Your Right to a Hearing*, addressed to W.[35] In 2006, more than two years after the IRS sent Letter 1058(c), W learned of the deficiency and separated from H. W is not eligible for equitable relief under IRC § 6015 because more than two years have passed since the IRS began collection activities against her.[36]

RECOMMENDATION

Provide that a taxpayer may make a request for equitable relief from liabilities under IRC § 6015(f) or IRC § 66(c) at any time the IRS could collect such liabilities (*i.e.*, anytime before expiration of the collection statute of limitations period).[37]

ADDITIONAL LEGISLATIVE RECOMMENDATION: EXPAND AVAILABILITY OF REFUNDS TO INNOCENT SPOUSES

PROBLEM

If a taxpayer pays or the IRS collects a liability with respect to which the IRS ultimately grants innocent spouse relief, the IRS can only pay refunds or credit the innocent spouse's separate account in certain limited circumstances.[38] The IRS is required to pay refunds to taxpayers to the extent attributable to "traditional" innocent spouse relief

[35] Letter 1058(c) is usually sent via certified mail, return receipt requested. *See* IRM 5.19.8.4 (Oct. 1, 2002). Even if sent via certified mail, the U.S. Postal Service will deliver it to anyone who receives mail at the address unless the sender pays extra for Restricted Delivery. *See* http://pe.usps.com/text/dmm300/dmm300_landing.htm (last visited Dec. 12, 2006).

[36] *See* IRC § 6015(b)(1)(E), (c)(3)(B); Treas. Reg. § 1.6015-5(b)(1); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.01(3) and § 5. A similarly limited period applies to requests for equitable relief under IRC § 66(c). *See id.*

[37] The IRS could make such a change without legislation.

[38] For the remainder of this discussion, we use the term "refunds" to reference both refunds and credits.

pursuant to IRC § 6015(b).[39] However, the IRS is not permitted to pay refunds as a result of a "separate liability election" under IRC § 6015(c).[40] In addition, the IRS can-not pay refunds to a taxpayer in connection with a grant of equitable relief for liabilities with respect to which the taxpayer would otherwise qualify for relief under IRC § 6015(c).[41] Further, the IRS can not pay refunds to a taxpayer in connection with a grant of equitable relief under IRC § 6015(f) or IRC § 66(c), unless the taxpayer can establish that he or she provided the funds for which he or she seeks a refund and: (a) In a case involving a deficiency, the payments were made pursuant to an installment agreement that the taxpayer entered into after filing a request for relief and has not defaulted on; and (b) In a case involving an underpayment of tax, the payments were not made with the joint return, were not joint payments, and were not made by the nonrequesting spouse.[42] In any event, the taxpayer may obtain a refund or credit only with respect to payments made within three years of the time the return was filed or two years from the time the tax was paid, whichever is later.[43]

Because the IRS may not issue a refund as a result of a separate liability election under IRC § 6015(c), such an election may provide little relief to the spouse who learns of his or her rights under IRC § 6015 long after collection efforts against him or her have begun. However, this "no-refund" rule was adopted only with respect to separate liability elections to prevent inappropriate use of the election to direct refunds to one spouse or the other.[44] These same concerns did not exist with respect to other types of innocent spouse relief where the IRS had to determine that it was inequitable not to grant relief before any refund could be paid. Presumably, the IRS would not grant equitable relief in "inappropriate" situations. If it is inequitable for the IRS to collect a liability from an innocent spouse, it is similarly inequitable for the IRS to retain amounts collected to satisfy the liability. For the same reasons, it makes no sense to withhold refunds of tax attributable to community income that the IRS has reallocated to another person pursuant to IRC § 66(c). In any event, refunds are limited to amounts paid within three years of filing the return or two years of paying the liability, whichever is

[39] IRC § 6015(g)(1). A taxpayer may obtain "traditional" relief from a deficiency attributable to an erroneous item of the nonrequesting spouse on a joint return if he or she seeks relief within the requisite period, the requesting spouse did not know or have reason to know of the deficiency, and it would be "inequitable" to hold the requesting spouse liable. *See* IRC § 6015(b).

[40] IRC § 6015(g)(3); Treas. Reg. § 1.6015-3(c)(1). A "separate liability" election is a type of innocent spouse relief that, in certain circumstances, allows a taxpayer who is divorced, legally separated, widowed, or was not a member of the same household as his or her spouse for a 12-month period to elect to limit his or her liability for deficiencies on the joint return to the proportion of the deficiency allocable to his or her items. IRC § 6015(c).

[41] Treas. Reg. § 1.6015-4(b).

[42] Rev. Proc. 2003-61, 2003-2 C.B. 296 4.04.

[43] IRC § 6511(a).

[44] *See* H. Conf. Rep. 599, 105th Cong., 2d Sess. 259 (1998) (stating that "[S]pecial rules apply to prevent the inappropriate use of the election. The separate liability election may not be used to create a refund, or to direct a refund to a particular spouse.").

later.[45] To the extent refunds are unavailable even after the IRS determines it would be inequitable to collect amounts that it has already collected, the innocent spouse rules are not fulfilling their intended purpose – to address inequities resulting from joint and several liability and community property rules. Instead, they are penalizing taxpayers who voluntarily pay the IRS.

EXAMPLE

W received an IRS collection notice and timely requested equitable relief under IRC § 6015(f). W entered into an installment agreement to pay the amount requested by the IRS, but she had difficulty making the payments and defaulted on it. Although the IRS ultimately determined to grant W's request for relief, it would not refund any of her payments, even though they were applied to a liability the IRS later determined that it would be inequitable for her to pay.

RECOMMENDATION

When equitable relief is granted under IRC § 6015 or IRC § 66(c), any resulting overpayments should be refunded or credited solely to the requesting spouse's separate liability.[46] Taxpayers would still only be able to obtain a refund with respect to payments made within three years of filing the return or two years of paying the liability, whichever is later.[47]

[45] IRC § 6511(a).

[46] The National Taxpayer Advocate made a similar recommendation in her 2001 report. See National Taxpayer Advocate 2001 Annual Report to Congress 155-165. We note that because the Code does not prohibit the IRS from paying refunds except with respect to separate liability elections, legislation is not necessarily required to implement this recommendation.

[47] IRC § 6511(a).

MILITARY ISSUES

PROBLEM

Members of the U.S. armed forces, especially those serving in designated combat zones, face special federal income tax situations and are entitled to certain tax benefits due to their service.[1] Increased military action and overseas deployments have highlighted how benefits designed to help U.S. troops can negatively impact these taxpayers instead. In 2005, approximately 207,000 active duty military personnel were deployed as part of Operation Iraqi Freedom and could potentially be affected by these provisions.[2] This does not take into account the numerous other military personnel deployed to other combat zones.

EARNED INCOME TAX CREDIT – NONTAXABLE COMBAT PAY ELECTION

Military personnel who receive nontaxable combat pay from their service in a designated combat zone can choose to have the IRS consider the pay as earned income for the purpose of computing the Earned Income Tax Credit (EITC).[3] An amendment to IRC § 32(c)(2)(B)(vi) to allow for this election was included in the Gulf Opportunity Zone Act of 2005.[4] However, the nontaxable combat pay election will expire after tax year 2007.

EXAMPLE

John and Mary are married and have one child. John is a member of the armed forces serving in a designated combat zone for the entire year. The couple's only income is John's military pay, which totals $17,000 in nontaxable combat pay for 2005. When completing their joint tax return for tax year 2005, John and Mary make an election under IRC § 32(c)(2)(B)(vi) to have John's combat pay treated as earned income for purposes of computing the EITC. This election brings their combined earned income to $17,000 for tax year 2005 and allows them to claim an EITC of $2,558.[5] If, however, John and Mary could not elect to have John's combat pay as earned income for EITC purposes, he and Mary would not have earned income and could not claim the EITC.

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1 IRC § 112 excludes from gross income certain combat zone compensation of members of the Armed forces. IRC § 7508 provides a 180-day extension after departing the combat zone for filing, paying, and performing certain other tax related acts. IRC § 692 is a special provision for members of the Armed Forces who die in a combat zone. IRC § 4253(b) exempts from excise tax any telephone call from a member of the armed forces which originates from a combat zone.

2 U.S. Department of Defense, *Active Duty Military Personnel Strengths by Regional Area and Country, December 31, 2005*, *available at* http://siadapp.dior.whs.mil/personnel/MILITARY/history/hst1205.pdf.

3 IRC § 32(c)(2)(B)(vi).

4 Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, § Stat. 26 (2005). This provision was extended in § 106 of the Tax Relief and Health Care Act of 2006, signed into law on December 20, 2006.

5 John and Mary meet all of the other requirements for claiming the EITC. *See* IRC § 32.

The inability to include John's nontaxable combat pay in earned income for purposes of the EITC would reduce John and Mary's EITC from $2,558 to $0.[6]

RECOMMENDATION

Amend IRC § 32(c)(2)(B)(vi) to make permanent the provision allowing military personnel the option to include nontaxable combat pay, received for service in a designated combat zone, as earned income for the purpose of computing the EITC.[7]

INCOME TAX TREATMENT OF DIFFERENTIAL PAY

Differential pay is a series of voluntary employer payments that make up the difference between the regular civilian salary of an employee called to active duty and the amount paid by the military.[8] These payments are not considered wages and therefore are not subject to federal income tax withholding.[9] However, differential pay is still considered income and must be reported on a federal tax return.[10] The most recent IRS guidance regarding the tax treatment of differential pay is Revenue Ruling 69-139, which concludes, using two different hypothetical examples, that differential pay is not wages.[11] The IRS continues to rely on Revenue Ruling 69-139 in determining the tax treatment of differential pay.[12]

Military reservists do not have the option of asking their civilian employer to withhold taxes from the differential pay. The only option for the taxpayer receiving differential pay is to make quarterly estimated tax payments to the IRS to avoid a substantial tax liability at the end of the year.

EXAMPLE

Jeanette is a member of the armed forces on active duty. She is a single taxpayer with no children and is entitled to claim only the standard deduction. During tax year 2005, she receives $25,000 in military pay plus $25,000 in differential pay from her civilian

[6] If John and Mary had two or more qualifying children for purposes of the EITC, the inability to include John's nontaxable combat pay in earned income for purposes of the EITC would reduce John and Mary's EITC from $4,262 to $0.

[7] S. 1824, *A Bill to Amend the Internal Revenue Code of 1986 to Strengthen the Earned Income Tax Credit;* H.R. 5601, *To Amend the Internal Revenue Code of 1986 to Strengthen the Earned Income Tax Credit.*

[8] A taxpayer need not serve in a combat zone to receive differential pay.

[9] Rev. Rul. 69-136.

[10] Rev. Rul 69-136; IRS, *Employers with Employees in a Combat Zone: Military Differential Pay*, Q-38 – 39, *available at* http://www.irs.gov/newsroom/article/0,,id=129833,00.html.

[11] The basis for this conclusion is that the employment relationship between the employer and the employee was terminated when the employee was called to active duty. Therefore, the differential payments are not "'wages' for services performed in 'employment' … [and] therefore, are not 'wages' subject to taxes imposed by the Federal Insurance Contributions Act and the Federal Unemployment Tax Act or to the Collection of Federal Income Tax at Source on Wages." Rev. Rul. 69-139.

[12] IRS, *Employers with Employees in a Combat Zone: Military Differential Pay*, Q-38 – 39, *available at* http://www.irs.gov/newsroom/article/0,,id=129833,00.html.

employer. Jeanette has a total of $50,000 in gross income for tax year 2005, but the IRS only withholds tax from the $25,000 of military pay. When she files her 2005 income tax return, Jeanette owes $4,962 in taxes.[13]

RECOMMENDATION

Amend the Code to require a former employer to provide a taxpayer the option of having federal income tax withheld from his or her differential pay. If a taxpayer makes this election, the former employer is required to withhold federal income tax from the taxpayer's differential pay.[14]

[13] Jeanette had gross income for 2005 of $50,000 and withholding on the $25,000 of military pay of $2,159. Her total tax liability for the year is $7,121, bringing the amount Jeanette owes to $4,962. The calculation was made assuming the taxpayer files single, has no additional income, takes the standard deduction, is not entitled to any other deductions or credits for tax year 2006, and was not overwithheld from on the $25,000 of military pay.

[14] IRC § 3402(p)(3) authorizes the Secretary to provide for withholding "from any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of this chapter, if the employer and the employee, or the person making and the person receiving such other type of payment, agree to such withholding." This legislative proposal goes beyond the scope of the authority provided in § 3402(p)(3) by *mandating* withholding if the military member requests it.

AMEND IRC § 6511 TO ALLOW REFUND CLAIMS PAST THE RSED WHEN EXCESS COLLECTION IS DUE TO IRS ERROR

PROBLEM

The IRS sometimes levies on taxpayer accounts in excess of the tax liability owed and does not notify the taxpayer of the excess collection. If the taxpayer does not file a refund claim within the statutorily-permitted time, the IRS will not honor the claim. Under Internal Revenue Code (IRC) § 6511(a), a taxpayer who files a claim for refund or credit of tax generally must do so no later than three years after filing the return or two years after paying the tax.

It is the IRS's position that there is no statutory authority to allow the IRS to refund the amounts improperly levied upon if the refund claim is not timely, even if the mistake is attributable solely to the IRS and the taxpayer did not learn of the error prior to the refund statute expiration date (RSED). That the levy should have been but was not timely released by the IRS does not override the mandates of IRC § 6511.

EXAMPLE

Jane Doe is a retired widow whose sole source of income is a $900 monthly Social Security benefit. She owns a house and a car, but has no other assets of value. In April 1999, the IRS assessed $3,000 against a joint return filed by Ms. Doe and her deceased husband, and now seeks to recover this amount via levy. The IRS issues a continuous levy on the Social Security benefits for unpaid balances due, and the Social Security Administration transfers a portion of Ms. Doe's benefits directly to the IRS.

The underlying liability was fully paid in June 2001. However, the IRS negligently continued to levy the taxpayer's Social Security benefits until June 2004, when the IRS discovered its error. Because the IRS did not notify the taxpayer of the excess collection until June 2006 (after the RSED has lapsed), she has no way to recover the funds that the IRS improperly levied.

RECOMMENDATION

The National Taxpayer Advocate recommends that the IRS be required to send out annual statements to taxpayers under continuous levy showing payments received, penalties assessed, and interest charged, along with a detailed breakout of the application of such payments to tax, penalties, and interest for all relevant tax years. Taxpayers receive this type of itemized statement from the IRS when they enter into an installment agreement under IRC § 6159[1] and from creditors in the private sector (*e.g.*, mortgage

[1] Section 3506 of the IRS Restructuring and Reform Act of 1998 provides that each taxpayer who has an installment agreement be given an annual statement setting forth the initial balance at the beginning of the year, the payments made during the year, and the remaining balance as of the end of the year. Pub. L. No. 105-206, 112 Stat. 685, 771-72 (1998). *See also* IRM 3.17.46.7.6.

lenders). This annual statement is necessary since taxpayers who discover errors have a limited window of time to request refunds of overpayments.

Alternatively, the National Taxpayer Advocate recommends that IRC § 6511 be amended to allow taxpayers two years from the date they learn of the excess collection to make refund claims if the excess collection is due to IRS negligence. This legislative recommendation would provide relief to taxpayers where the excess collection is due to IRS negligence.

FEDERAL OVERSIGHT OF RETIREMENT PLANS OF QUASI-GOVERNMENTAL ENTITIES

PROBLEM

In 1974, Congress enacted the Employee Retirement Income Security Act (ERISA), which created minimum standards for most voluntarily established employee benefit plans.[1] Section 2(b) of ERISA sets forth Congress' objectives in enacting the law, stating that:

> [I]t is the policy of this Act to protect…the interests of participants of employee benefit plans and their beneficiaries…by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies.[2]

Title I of ERISA contains rules for reporting and disclosure, vesting, participation, funding, fiduciary conduct, and civil enforcement, and is administered by the Department of Labor's Employee Benefits Security Administration (EBSA, formerly the Pension and Welfare Benefits Administration).[3] EBSA requires administrators of private pension and welfare plans to provide participants with easily understandable summaries of their plans. These summaries are filed with EBSA, along with annual reports on the financial operations of the plans and on the bonding of persons charged with handling plan funds and assets. Plan administrators must also meet strict fiduciary responsibility standards, which the EBSA enforces.

The enforcement provisions contained in Title I of ERISA, however, are available to private-sector plan participants only. The Department of Labor has no oversight responsibility for governmental plans (defined as plans "established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof") or quasi-governmental[4] plans. These plans are specifically exempt from Title I of ERISA.[5]

The Office of Personnel Management (OPM) came into existence on January 1, 1979, and took over many of the functions of the former United States Civil Service Commission.[6] The duties and authority of the OPM are specified in the Civil Service Reform Act of 1978.[7] The OPM has statutory authority to oversee the two primary

1 Pub. L. No. 93-406, 88 Stat. 829, September 2, 1974.

2 29 USC § 1001(b).

3 *See* 29 USC § 1001.

4 Quasi-governmental entities are hybrid organizations established to implement public policy functions traditionally assigned to executive departments and agencies.

5 29 USC § 1003(b)(1).

6 *See* Executive Order 12107 of December 28, 1978 (43 FR 36037, 92 Stat. 3783).

7 *See* 5 USC 1101.

plans providing benefits to federal employees – the Civil Service Retirement System (CSRS)[8] and the Federal Employees Retirement System (FERS).[9]

Neither EBSA nor the OPM has the statutory responsibility for oversight of retirement plans administered by quasi-governmental entities. One rationale for exempting governmental plans from federal oversight was to respect the principle of comity, by which the federal government gives deference to the laws or decisions of the states on the presumption that state courts are equally capable of addressing federal law. While this explanation may make sense for retirement plans administered by state government agencies, the principle of comity does not apply to retirement plans administered by quasi-federal governmental agencies.

EXAMPLE

Jane Doe has been employed by the XYZ Agency, a quasi-governmental entity, for 20 years. In May 2006, she becomes disabled and is unable to perform her duties as a receptionist. Ms. Doe timely files an application for disability benefits in accordance with the provisions of her pension plan, but the plan administrator denies the application. Ms. Doe would like to contest this decision, but the plan does not allow participants to appeal a denial of benefits.

Because the XYZ Agency is not a private entity, the Department of Labor has no jurisdiction over the administration of this plan. The OPM does not have oversight responsibility because Ms. Doe is not a participant in CSRS or FERS. And because this plan is not state-administered, there is no designated state agency with oversight authority. With no avenue for administrative relief, Ms. Doe must undertake litigation, a costly and timely endeavor, if she wishes to challenge the XYZ Agency's decision to deny her application for disability benefits.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress appoint a federal agency (*e.g.*, the Department of Labor's EBSA or the OPM) to maintain oversight responsibility for ensuring that quasi-governmental retirement plans carry out their fiduciary duties. This legislative recommendation would provide relief to participants in retirement plans administered by quasi-governmental entities who currently have no avenue for administrative relief when there is a dispute with the plan administrator.

[8] *See* 5 USC 8347.

[9] *See* 5 USC 8461.

COLLECTION DUE PROCESS AND UNECONOMICAL LEVIES

PROBLEM

Internal Revenue Code § 6331(j) requires the IRS to conduct a thorough investigation of the status of any property or right to property which is to be levied upon and sold under IRC § 6335. This investigation shall include (1) a verification of the taxpayer's liability; (2) an analysis of whether the expenses of levy and sale would exceed the fair market value of the property at the time of the levy; (3) a determination that there is sufficient equity in the property to yield net sale proceeds to apply to the tax liability; and (4) a thorough consideration of alternative collection methods.[1]

Appeals Officers conducting Collection Due Process hearings under IRC § 6330 (Notice and Opportunity for Hearing Before Levy) are required to obtain verification from the IRS that that the requirements of any applicable law or administrative procedure have been met.[2] Moreover, in making the determination about whether the IRS may proceed with the proposed levy action, the Appeals hearing officer shall take into consideration "whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."[3]

Recent court decisions have held that the Appeals hearing officer need not verify that the IRS conducted the IRC § 6331(j) review prior to proposing a levy action that triggers the CDP hearing.[4] Courts have also held that the Appeals hearing officer is not required to take into account the uneconomical nature of the levy under the CDP "balancing" of the government's interests versus the intrusiveness of the action from the taxpayer's perspective.[5]

The failure to investigate and determine the uneconomical nature of a proposed levy action prior to a CDP hearing on the appropriateness of the levy action renders that hearing meaningless. The failure to investigate the economic feasibility of the levy is contrary to the oversight of IRS collection activity that Congress intended and that should be required.

1 IRC § 6331(j)(2)(A)-(D).

2 IRC § 6330(c)(1).

3 IRC § 6330(c)(3)(C).

4 In *Living Care Alternatives of Utica, Inc.*, 411 F.3d 621 (6th Cir. 2005), the court agreed with the Commissioner's reasoning that "[a]ll that the statute requires is that the IRS investigate the equity in a property prior to levying on it, not prior to the collection due process hearing." *Id.* at 628-29. *See also, Medlock v. U.S.*, 325 F.Supp.2d 1064 (C.D. Cal. 2003), stating "According to the plain language of the relevant statutory sections [6331(f) and 6331(j)] these actions must be taken before a taxpayer's property may be levied upon by the IRS but are prematurely raised at this stage of the collection process." *Id.* at 1079.

5 "[T]here is not requirement that the government consider in its balancing analysis whether it will receive any revenue from a levy and sale, or whether the business will have to close down due to the levy and sale." *Living Care Alternatives of Utica, Inc.*, 411 F.3d 621, 628 (6th Cir. 2005).

EXAMPLE

The taxpayer, a nursing home, sought to raise in its CDP hearing on a proposed levy action that the IRS's attempt to levy upon property would cause lienholders to levy on the property first, thereby generating no revenue for the government, since the existing debt to the senior lienholders exceeded the value of the property. The Appeals hearing officer did not require the IRS to conduct an investigation and make a determination whether there would be any net sale proceeds to apply toward tax debt, since under current case law the IRS does not have to conduct that investigation prior to the CDP hearing; nor is it an abuse of discretion for the Appeals hearing officer to consider the uneconomical nature of the levy in the CDP hearing.

RECOMMENDATION

Amend IRC §§ 6330(c) to clarify that the Appeals hearing officer, prior to making his determination under IRC § 6330(c)(3), must verify that the IRS conducted the required analysis under IRC § 6331(j), and must also consider that analysis in balancing the government's interest in efficient tax collection with the taxpayer's legitimate concern about the intrusiveness of the proposed levy action.

MOST LITIGATED ISSUES: INTRODUCTION

Internal Revenue Code § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts, classified by type of taxpayer affected. Through analysis of these issues, the National Taxpayer Advocate will, if appropriate, make recommendations designed to mitigate disputes that result in litigation. The recommendations included in this analysis could minimize some of the litigation covered in this section.

Taxpayer Advocate Service (TAS) analysts and attorney-advisors utilized commercial legal research databases to identify the ten most litigated issues (Most Litigated Issues) in federal courts from June 1, 2005 through May 31, 2006.[1] For purposes of this section of the Annual Report to Congress, the term "litigated" means cases in which the court issued an opinion.[2] This year's ten Most Litigated Issues are:

- Appeals From Collection Due Process hearings under IRC §§ 6320 and 6330;
- Gross income under IRC § 61 and related Code sections;
- Summons enforcement under IRC § 7604;
- Accuracy-related penalty under IRC § 6662(b)(1) and (2);
- Failure to file penalty under § 6651(a)(1) and failure to pay estimated tax penalty under IRC § 6654;
- Frivolous issues penalty under IRC § 6673 and related appellate-level sanctions;
- Trade or business expenses under IRC § 162(a) and related Code sections;
- Relief for joint and several liability for spouses, under IRC § 6015;
- Family status issues under IRC §§ 2, 21, 24, 32, and 151; and
- Charitable contribution deduction issues under IRC § 170.

The ten Most Litigated Issues are substantially similar to those identified in 2005, with one exception.[3] This year, charitable contribution deduction issues made the top ten list, taking the place of last year's tenth most litigated issue: trust fund recovery penalties under IRC § 6672.[4] While the other nine issues remained substantially the same, there was a reordering of the top ten issues caused mainly by substantial increases in both IRS summons enforcement litigation and negligence and substantial underpayment

1 Federal tax cases are tried in the United States Tax Court, the United States District Courts, the United States Court of Federal Claims, the United States bankruptcy courts, United States Courts of Appeals and the United States Supreme Court.

2 We recognize that many cases are resolved before the court issues an opinion. Some taxpayers reach a settlement with the IRS before trial while the court dismisses other taxpayer cases for a variety of reasons including lack of jurisdiction and lack of prosecution. Additionally, courts can also issue less formal "bench opinions," which are not published or precedential.

3 *See* National Taxpayer Advocate 2005 Annual Report to Congress 471.

4 *Id.*

penalty litigation.[5] This increase may be due, in part, to the IRS's increased emphasis on enforcement.[6]

Once the top ten issues were identified, TAS personnel provided analysis for each issue in four sections: summary of findings, description of present law, analysis of the litigated case, and conclusion. Each case analyzed is listed in Appendix 3. Cases are categorized by type of taxpayer (*i.e.*, individual or business). Appendix 3 also provides the citation for each case, indicates whether the taxpayer in each case was represented at trial or argued the case *pro se*, and lists the court's decision in each case.[7]

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Taxpayers generally have access to four different tribunals in which to initially litigate a tax matter: the United States Tax Court, United States district courts, the United States Court of Federal Claims, and the United States bankruptcy courts. With limited exceptions, taxpayers have an automatic right of appeal from decisions of the trial court.[8]

The Tax Court is generally a "prepayment" forum. In other words, taxpayers have access to the Tax Court without having to pay the disputed tax in advance. The Tax Court has jurisdiction over a variety of issues, including deficiencies, certain declaratory judgment actions, collection due process, and relief from joint and several liability.[9]

The federal district courts and Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,[10] and (2) the taxpayer has filed an administrative claim for refund.[11] The federal district courts are the only forums in which a taxpayer can receive a jury trial. Bankruptcy courts can adjudicate tax matters that were not previously adjudicated before the initiation of a bankruptcy case.[12]

5 Litigated summons enforcement cases increased from 44 in 2005 to 101 in 2006 (130 percent) and litigated negligence and substantial underpayment penalty cases increased from 57 in 2005 to 92 in 2006 (61 percent). *See* National Taxpayer Advocate 2005 Annual Report to Congress, 473.

6 Beginning in 2002, the IRS identified the increased use of summonses as part of the overall shift in audit priorities toward abusive schemes and promoter investigations. IRS News Release, IRS Sets New Priorities (Sept. 2002).

7 For purposes of this analysis, we considered the court's decision with respect to the issue analyzed only. A "split" decision is defined as a partial allowance on the specific issue analyzed.

8 *See* IRC § 7482, which provides that United States Courts of Appeals have jurisdiction to review the decisions of the Tax Court. There are exceptions to this general rule. For example, IRC § 7463 provides special procedures for small Tax Court cases (where the amount of deficiency or claimed overpayment totals $50,000 or less) from which appellate review is not available. *See also* 28 U.S.C. § 1294, which provides that appeals from district court are to the appropriate Court of Appeals, and 28 U.S.C. § 1295, providing that appeals from the Court of Federal Claims are heard in the Court of Appeals for the Federal Circuit.

9 IRC §§ 6214, 7476-7479, 6330, and 6015.

10 28 U.S.C. § 1346(a)(1). *See Flora v. United States*, 362 U.S. 145 (1960).

11 IRC § 7422(a).

12 *See* 11 U.S.C.A. §§ 505(a)(1) and (a)(2)(A).

ANALYSIS OF *PRO SE* LITIGATION

As in previous years, our analysis indicated that many taxpayers represented themselves before the courts *pro se*.[13] Table 3.1-01 lists the most litigated tax issues for the period June 1, 2005 through May 31, 2006, and identifies the number of cases in which taxpayers represented themselves.

TABLE 3.1-01, *PRO SE* CASES BY ISSUE

Most Litigated Issue	Total Number of Litigated Cases Reviewed	*Pro Se* Litigation	Percentage of *Pro Se* Cases
Collection Due Process	195	143	73%
Gross Income	106	77	73%
Summons Enforcement	101	70	69%
Frivolous Issues Penalty	98	97	99%
Accuracy-Related Penalty	92	51	55%
Failure to File and Failure to Pay Estimated Income Tax Penalties	78	62	79%
Trade or Business Expense	68	47	69%
Joint and Several Liability	51	26	51%
Family Status Issues	46	44	96%
Charitable Deduction Issues	26	17	65%
Total	**861**	**634**	**74%**

Table 3.1-02 demonstrates that overall, taxpayers have a higher chance of prevailing in litigation if they are represented.

TABLE 3.1-02, OUTCOMES FOR *PRO SE* AND REPRESENTED TAXPAYERS

	Pro Se Taxpayers			*Represented Taxpayers*		
Most Litigated Issue	Total Cases	Taxpayer Prevailed in whole or in part	Percent	Total Cases	Taxpayer Prevailed in whole or in part	Percent
Collection Due Process	143	11	8%	52	8	15%
Gross Income	77	3	4%	29	6	21%
Summons Enforcement	70	3	4%	31	5	16%
Frivolous Issues Penalty	97	14	14%	1	0	0%
Negligence and Substantial Understatement Penalties	51	13	25%	41	16	39%
Failure to File and Failure to Pay Estimated Income Tax Penalties	62	2	3%	16	1	6%
Trade or Business Expense	47	10	21%	21	7	33%
Joint and Several Liability	26	6	23%	25	6	24%
Family Status Issues	44	7	16%	2	1	50%
Charitable Deduction Issues	17	6	35%	9	1	11%
Totals	**634**	**75**	**12%**	**227**	**51**	**22%**

[13] *"Pro Se"* means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* 1236-37 (7th ed. 1999).

LITIGATED ISSUE #1 — APPEALS FROM COLLECTION DUE PROCESS (CDP) HEARINGS UNDER INTERNAL REVENUE CODE SECTIONS 6320 AND 6330

SUMMARY

Collection Due Process (CDP) hearings were created by the IRS Restructuring and Reform Act of 1998 (RRA 98).[1] These hearings provide taxpayers an impartial review by the Office of Appeals (Appeals) of the IRS's decision to file a lien or its proposal to undertake a levy action. At the CDP hearing, the taxpayer has the statutory right to raise any relevant issue relating to the unpaid tax or the lien or proposed levy, including the appropriateness of collection actions, collection alternatives, spousal defenses, and under certain limited circumstances, the underlying tax liability.[2]

Taxpayers have the right to judicial review of Appeals' determination, provided that they timely request the CDP hearing and timely petition the court.[3] Generally, collection action is stayed during the CDP hearing process and any judicial review that may follow.[4]

Since 2003, Collection Due Process has been the most frequently litigated tax issue in the federal courts during the annual periods analyzed for the Annual Report to Congress. This year is no exception, with the courts issuing at least 195 opinions from June 1, 2005, through May 31, 2006. In the past, some commentators decried the CDP hearing process as a poorly designed hindrance to the IRS collection process and a vehicle for taxpayers to raise frivolous arguments. In contrast, the National Taxpayer Advocate predicted that the courts would find ways to deal with frivolous CDP litigation and that over time, the true value of CDP judicial review would emerge.

This year's cases prove the National Taxpayer Advocate's point. Although some taxpayers continue to raise frivolous issues, the courts are striking a balance between giving these taxpayers an opportunity to raise nonfrivolous issues for consideration, and then imposing appropriate sanctions where taxpayers continue to proffer frivolous arguments.[5] On the other hand, taxpayers and the IRS are now presenting the courts with significant issues pertaining to the scope of judicial review – including the standard of

[1] Internal Revenue Service Restructuring and Reform Act of 1998, Pub.L. No. 105-206, § 3401, 112 Stat. 685 (1998).

[2] IRC §§ 6320(c) and 6330(c).

[3] IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B) set forth the time requirements for requesting a CDP hearing and IRC §§ 6320(c) and 6330(d) set forth the time requirements for obtaining judicial review of Appeals' determination.

[4] IRC § 6330(e)(1) provides that in general there is a suspension of levy actions during the CDP process (along with a corresponding suspension in the running of the statutory limitations period for collecting the tax). However, IRC § 6330(e)(2) allows the IRS to resume levy actions during judicial review upon a showing of "good cause," if the underlying tax liability is not at issue.

[5] In a number of cases, the courts imposed monetary sanctions under IRC § 6673. *See, e.g., Call v. Comm'r,* T.C. Memo. 2005-289; *Florance v. Comm'r*, 97 A.F.T.R.2d (RIA) 1742 (5th Cir. 2006); *Parker II v. Comm'r*, T.C. Memo. 2005-231; *Raft v. Comm'r,* 95 A.F.T.R.2d (RIA) 2652 (6th Cir. 2005); *Winterroth v. Comm'r*, 97 A.F.T.R.2d (RIA) 1746 (9th Cir. 2006).

review, the application of administrative law and the Administrative Procedure Act to CDP review, and the admissibility of evidence beyond the administrative record. Each of these cases brings IRS collection practices, and the attendant judicial oversight, within established administrative law and practice. This year's cases clearly demonstrate that CDP litigation provides lessons for the IRS and taxpayers about how tax can be effectively and efficiently collected without undermining taxpayer rights.

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a Notice of Federal Tax Lien filed by the IRS[6] or a proposed levy action.[7] The purpose of CDP rights is to give taxpayers adequate notice of collection activity and a meaningful hearing *before* the IRS deprives them of property.[8] The hearing allows the taxpayer an opportunity to raise issues relating to the collection of the subject tax, including:

- Appropriateness of collection actions;[9]
- Collection alternatives such as installment agreement, offer in compromise, posting a bond or substitution of other assets;[10]
- Appropriate spousal defenses;[11]
- The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability;[12] and
- Any other relevant issue relating to the unpaid tax, the lien or the proposed levy.[13]

A taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing if the individual participated meaningfully in the prior hearing or proceeding.[14]

Procedurally, the IRS must provide notice to the taxpayer of the lien filing and its intent to levy. The IRS must provide the Notice of Federal Tax Lien to the taxpayer not more than five business days after the day of filing notice of the lien.[15] The IRS must provide

6 IRC § 6320.

7 IRC § 6330.

8 Prior to the enactment of RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing was sufficient to satisfy due process concerns in the tax collection arena. *See Phillips v. Comm'r*, 283 U.S. 589, 595 – 601 (1931).

9 IRC §§ 6330(c)(2)(A)(ii) and 6320(c).

10 IRC §§ 6330(c)(2)(A)(iii) and 6320(c).

11 IRC §§ 6330(c)(2)(A)(i) and 6320(c).

12 IRC §§ 6330(c)(2)(B) and 6320(c).

13 IRC § 6330(c)(2)(A) and 6320(c).

14 IRC §§ 6330(c)(4) and 6320(c).

15 IRC 6320(a)(2). The Notice of Federal Tax Lien can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address.

the Notice of Intent to Levy to taxpayers at least 30 days before the day of the levy.[16] Further, the IRS must notify the taxpayer of his or her right to a CDP hearing after the filing of the Notice of Federal Tax Lien (NFTL) and before any levy action can take place. In the case of a lien, the CDP hearing notice must be provided to the taxpayer not more than five business days after the filing of the NFTL, and must inform the taxpayer of his or her right to request a CDP hearing within the 30-day period that begins on the expiration of the fifth business day after the filing of the NFTL.[17] In the case of a levy, the CDP hearing notice must be provided to the taxpayer no fewer than 30 days before the first levy and must inform the taxpayer of his or her right to request a hearing within 30 days from the date that the notice is sent.[18]

Under both lien and levy procedures, the taxpayer must return a signed, written request for a CDP hearing within the applicable period for requesting a hearing.[19] Taxpayers who request a CDP hearing after this time period (generally, 30 days from the date of the notice) will receive an "equivalent hearing," which is similar to a CDP hearing except there is no judicial review of an equivalent hearing.[20] Recently issued final regulations require the taxpayer to put the reasons for the CDP hearing in writing (preferably using Form 12153, Request For a Collection Due Process Hearing), and the failure to provide the basis for hearing may result in a denial of a face-to-face hearing.[21] The final regulations also eliminate the availability for equivalent hearings if the taxpayer does not make a request for a hearing within a certain time period. The time period for filing a request for an equivalent hearing after the filing of an NFTL is one year from the end of the five-business-day period following the filing of the NFTL.[22] The time period for filing a request for an equivalent hearing prior to levy is one year from the date of issuance of the CDP notice.[23]

[16] IRC § 6331(d)(2). The Notice of Intent to Levy can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address.

[17] IRC § 6320(a)(2) and 6320(a)(3)(B).

[18] IRC § 6330(a)(2) and 6330(a)(3)(B). The CDP hearing notice can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or can be sent by certified or registered mail (return receipt requested) to the taxpayer's last known address.

[19] IRC §§ 6330(a)(3)(B) and 6330 (a)(3)(B); Treas. Reg. §§ 301.6320-1(c) and 301.6330-1(c).

[20] Treas. Reg. §§ 301.6320-1(i) and 301.6330-1(i).

[21] Treas. Reg. §§ 301.6320-1(c)(2) Q&A-C1, 301.6320(d)(2) Q&A-D8, 301.6330-1(c)(2) Q&A-C1, and 301.6330-1(d)(2) Q&A-D8. The regulations require the IRS to provide the taxpayer an opportunity to "cure" any defect in a timely filed hearing request, including providing a reason for the hearing. In conjunction with issuing the regulations, the IRS revised Form 12153 to include space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider. The new form also includes a description of common alternatives so taxpayers can apply them to the specific facts of their cases. *See* Form 12153, Request For Collection Due Process or Equivalent Hearing (Rev. 11-2006).

[22] Treas. Reg. § 301.6320-1(i)(2) Q&A-I7

[23] Treas. Reg. § 301.6330-1(i)(2) Q&A-I7.

When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the IRS Appeals officer will attempt to conduct one hearing.[24] The IRS will suspend collection action throughout the hearing process, unless it determines that the collection of the tax is in jeopardy or the collection resulted from a levy on a state tax refund.[25] Collection activity is also suspended throughout any judicial review of Appeals' determination, unless the underlying tax liability is not at issue and the IRS can demonstrate to the court good cause to resume collection activity.[26]

Collection Due Process hearings are informal. The Office of Appeals presumptively establishes telephonic CDP hearings, and it is incumbent on the taxpayer to request a face-to-face hearing.[27] Courts have determined that, depending on the circumstances, a CDP hearing need not be face-to-face with the Appeals officer, but can take place by telephone,[28] or by an exchange of correspondence.[29] The hearing is to be held by an impartial officer from the Appeals function of the IRS, who is barred from engaging in *ex parte* communications with IRS personnel regarding the substance of the case.[30]

In addition to the issues described above that the taxpayer is permitted to address in the CDP hearing, the Appeals officer must obtain verification that the requirements of all applicable laws and administrative procedures have been satisfied for the IRS to proceed with collection activity.[31] In making its determination, Appeals must weigh the issues raised by the taxpayer and determine whether the proposed collection action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer

[24] IRC § 6320(b)(4).

[25] IRC § 6330(e)(1) provides the general rule for suspending collection activity, and IRC § 6330(f) provides that if collection of the tax is deemed in jeopardy or the collection resulted from a levy on a state tax refund, section 6330 does not apply, except to provide the opportunity for a CDP hearing within a reasonable time after the levy. *See Clark v. Comm'r*, 125 T.C. 108, 110 (2005) (citing *Dorn v. Comm'r*, 119 T.C. 356 (2002)).

[26] IRC §§ 6330(e)(1) and 6330(e)(2).

[27] Appeals Letter 3855 schedules a conference call, but provides information on the availability of a face-to-face conference. *See also* Treas. Reg. §§ 301.6320-1(d)(2) Q&A-D6, D8 and 301.6330-1(d)(2) Q&A-D6, D8. For a detailed discussion of issues relating to face-to-face and local office hearings before the Office of Appeals, see Most Serious Problem, Concerns with the IRS Office of Appeals, *supra.*

[28] *Katz v. Comm'r*, 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and Appeals Officer constituted a hearing as provided in IRC § 6320(b)); *Ho v. Comm'r*, T.C. Memo. 2006-41(stating that a CDP hearing may be conducted by telephone or correspondence); *but see Garage v. U.S.*, 96 A.F.T.R.2d (RIA) 7201 (D. N.J. 2005) (remanding case for a face-to-face hearing when taxpayer was denied a face-to-face hearing and taxpayer was not told that the telephone conversation constituted a face-to-face hearing).

[29] *Ho v. Comm'r*, T.C. Memo. 2006-41(stating that a CDP hearing may be conducted by telephone or correspondence); *Little v. U.S.*, 96 A.F.T.R.2d (RIA) 7086 , 7090-91 (M.D. N.C. 2005), *aff'd.*, 97 A.F.T.R.2d (RIA) 2227 (4th Cir. 2006); *Turner v. U.S.*, 372 F. Supp. 2d 1053, 1058 (S.D. Ohio 2005) (holding that written documentation, an offer for a telephone hearing, and an opportunity for an in-person hearing to raise relevant issues pertaining to the tax penalty did not violate taxpayer's right to a hearing under IRC § 6330.).

[30] IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1), and 6330(b)(3). *See* Rev. Proc. 2000-43, 2000-2 C.B. 404.

[31] IRC §§ 6330(c)(1) and 6320(c).

that any collection action be no more intrusive than necessary.[32] Within 30 days of the appeals determination, the taxpayer may petition the United States Tax Court for judicial review of Appeals' determination.[33]

Where the validity of the tax liability is properly at issue in the CDP hearing, the amount of the tax liability will be reviewed by the court on a *de novo* basis.[34] Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.[35]

ANALYSIS OF LITIGATED CASES

Collection Due Process was the most litigated tax issue in the federal court system between June 1, 2005, and May 31, 2006. One hundred and ninety-five (195) CDP court opinions were reviewed. Excluding unpublished Tax Court orders that were not included in most prior years' statistics, this represents a one percent decrease from the 197 CDP cases from last year's analysis, and a seven percent increase from the 182 CDP cases reported in 2004. The 195 decided cases do not reflect the full measure of CDP litigation involving taxpayers and the IRS during the review period. Not all CDP cases result in decisions for or against taxpayers. Some cases are resolved through negotiated settlements while other taxpayers do not pursue litigation after filing a petition with the court, resulting in dismissal of the action prior to the court issuing an opinion. Others are disposed of by unpublished order. Nevertheless, the 195 cases in which opinions were issued and published provide useful insight into the costs and benefits of CDP by shedding light on the situations of taxpayers utilizing CDP and the IRS interactions with these taxpayers. Table 1 in Appendix 3 provides a detailed listing of CDP opinions, including specific information about the types of taxpayers involved.

LITIGATION SUCCESS RATE

Taxpayers prevailed in 15 of the 195 cases reviewed (or approximately 7 percent),[36] and prevailed in part in an additional four cases.[37] In five of the 15 cases in which taxpayers prevailed (approximately 33 percent), courts either remanded the case to Appeals

[32] IRC §§ 6330(c)(3)(C) and 6320(c).

[33] IRC §§ 6330(d)(1) and 6320(c). Prior to October 17, 2006, the taxpayer could also petition the district court where the Tax Court did not have jurisdiction over the underlying tax liability.

[34] The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the IRS's administrative CDP determinations. H.R. Rep. No. 105-599 at 266 (Conf. Rep.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

[35] *Cox v. Commissioner*, 126 T.C. 237, 246 (2006) (quoting *Sego v. Comm'r*, 114 T.C. 604, 610 (2000)). *See also* the discussion of standard of review, *infra*.

[36] *Clark v. Comm'r*, 125 T.C. 108 (2005) is included in the number of prevailing cases, as it resulted in a pro-taxpayer ruling. In *Clark*, the court raised the issue of jurisdiction sua sponte, holding that it had jurisdiction to review CDP determinations when the CDP hearing was requested after a levy of a taxpayer's state tax refund. Neither the Commissioner nor the taxpayer contested jurisdiction.

[37] *Bennett v. Comm'r*, T.C. Summ. Op. 2005-84; *Lites v. Comm'r*, T.C. Memo. 2005-206; *Pineda v. Comm'r*, T.C. Summ. Op. 2006-35; *Plumb v. Comm'r*, 96 A.F.T.R.2d (RIA) 5872 (S.D. Fla. 2005).

because issues of material fact remained, or ruled that the IRS abused its discretion.[38] Of the remaining ten cases where taxpayers prevailed, seven involved the existence or amount of underlying liability or application of the relief from joint and several liability under the provisions of IRC § 6015,[39] and two cases involved procedural rulings.[40] In one case, the court barred the IRS from proceeding with collection as a matter of law.[41] Table 3.1.1 below compares litigation success rates in CDP cases for the 2003, 2004, and 2005 Annual Reports to Congress.[42]

TABLE 3.1.1, SUCCESS RATES IN CDP CASES

Court Decisions	2003 Percentage	2004 Percentage	2005 Percentage	2006 Percentage
Decided for IRS	96%	95%	89%	90%
Decided for Taxpayer	1%	4%	8%	8%
Split Decision[43]	3%	1%	3%	2%

ISSUES LITIGATED

The cases discussed in this section are those which the National Taxpayer Advocate believes are significant for tax administration or instructive to Congress, IRS, and taxpayers. In many ways, each of the 195 cases decided during the period under review tells an important story. Because the filing of a lien and levying upon property are some of the most intrusive actions the IRS can take against a taxpayer, each case provides information about how taxpayers and the IRS behave and how problems can be avoided.

Appeals Impartiality

Internal Revenue Code §§ 6320(b)(3) and 6330(b)(3) require CDP hearings to be conducted by an "impartial" Appeals officer or employee – one "who has had no prior involvement with respect to the unpaid tax" before the first CDP lien or levy hearing. Taxpayers may waive the impartiality requirement.

[38] *Crawford v. U.S.*, 422 F.Supp.2d 1209 (D. Nev. 2006); *Drake v. Comm'r*, 125 T.C. 201 (2005); *Garage v. U.S.*, 96 A.F.T.R.2d (RIA) 7201 (D. N.J. 2005); *Sampson v. Comm'r*, T.C. Summ. Op. 2006-75; *Zapara v. Comm'r*, 126 T.C. 215 (2006).

[39] *Butti v. Comm'r*, T.C. Memo. 2006-66; *Creel v. Comm'r*, 419 F.3d 1135 (11th Cir. 2005); *Clark v. Comm'r*, T.C. Summ. Op. 2005-95; *Freije v. Comm'r*, 125 T.C. 14 (2005); *Norris v. Comm'r*, T.C. Memo. 2005-237; *Richard v. Comm'r*, T.C. Summ. Op. 2005-151; *Sherer v. Comm'r*, T.C. Memo. 2006-29.

[40] *Clark v. Comm'r*, 125 T.C. 108 (2005); *Mandody v. Comm'r*, 126 T.C. 195 (2006).

[41] *Manko v. Comm'r*, 126 T.C. 195 (2006).

[42] See *National Taxpayer Advocate 2005 Annual Report to Congress 479, Table 3.1.1* (Most Litigated Issue: Collection Due Process (CDP) Hearings) for 2002, 2003, and 2004 statistics.

[43] A "split" decision refers to a case with multiple issues where both the IRS and the taxpayer prevail on one or more substantive issues.

Cox v. Commissioner

The Appeals Officer in *Cox v. Commissioner*[44] conducted a CDP hearing and issued an adverse determination letter with respect to one tax year of the taxpayer. Later, this same Appeals Officer was assigned a CDP case for two other tax years of the same taxpayer. The taxpayer objected to the Appeals Officer's involvement in the second CDP hearing as prohibited "prior involvement" under IRC § 6330(b)(3).

The Tax Court found that this situation did not demonstrate the type of harm Congress meant to guard against, for three reasons. First, the later years were not the subject of a proceeding before the IRS. The court found that "[p]rior involvement contemplates a situation where the specific year or years were the explicit target of an administrative proceeding."[45] Second, the statute provides for combining lien and levy hearings before the same Appeals Officer, and the court found that as a practical matter, there would be no harm if the later period was first informally considered during the CDP hearing relating to another period. Third, the court took into consideration the "practical realities" of the hearings, noting that the information relevant to both hearings would be much the same.

The court noted, however, that even if, in theory, the arrangement did not violate the impartiality requirement, it still must look at the general requirement of impartiality in terms of the specific conduct of the Appeals Officer. Here, the court found that the administrative record did not show any bias or a "closed mind," noting the Appeals Officer's careful review of records and evidence, and his willingness to meet the taxpayer's scheduling needs.[46]

Drake v. Commissioner

In *Drake v. Commissioner*,[47] the Appeals Settlement Officer, upon receipt of the CDP case, conferred with an IRS Insolvency Unit Advisor and received a copy of the Advisor's memorandum to IRS Counsel, discussing the taxpayers' bankruptcy case. In that memorandum, the Advisor questioned whether the taxpayer and the taxpayer's attorney used the bankruptcy court to "defeat a Federal Tax Lien allowing a Debtor to walk away with the proceeds" and further commented on the conduct of the taxpayers' bankruptcy attorney. The Appeals Officer did not tell the taxpayer about his communications with the Insolvency Unit Advisor.

The Tax Court held that it was an abuse of discretion by the Appeals employee, who did not follow the requirements of IRS guidance with respect to *ex parte* communications. The court cited Revenue Procedure 2000-43, which specifically states that Appeals employees cannot engage in discussions of strengths or weaknesses of case issues that

[44] *Cox v. Comm'r*, 126 T.C. 237 (2006).

[45] *Id.* at 252 (2006).

[46] *Id.* at 253-55.

[47] *Drake v. Comm'r*, 125 T.C. 201 (2005).

appear to compromise Appeals' independence.[48] The guidance also requires the Appeals employee to give the taxpayer the opportunity to participate in any discussions involving "matters that are not ministerial, administrative or procedural."[49] The court noted that the guidance specifically prohibited *ex parte* communications of the "originating function's perception of the demeanor or credibility of the taxpayer or the taxpayer's representative."[50]

The court found that the *ex parte* communication with the Insolvency Unit Advisor was neither ministerial, administrative, nor procedural, nor did the Appeals employee provide the taxpayer with the opportunity to participate in the communication. Therefore, the court held, because the *ex parte* communication may have damaged the taxpayer's credibility, the Appeals employee abused his discretion. The court remanded the case for a new hearing before an independent Appeals Officer who has had no communication about the credibility of the taxpayer or the taxpayer's representative.

Face-to-Face Hearing

As discussed elsewhere in this report, the National Taxpayer Advocate is concerned that the IRS Office of Appeals' increasing trend to centralize activity at its remote campus operations, and the subsequent reductions in local office staffing, reduce the opportunities to obtain a face-to-face hearing. The following case is instructive as to how difficult it can be for some taxpayers to receive a face-to-face hearing.

Garage v. U.S.

Garage v. U.S. involved the collection of a Trust Fund Recovery Penalty (TFRP) under IRC § 6672, for payment of withholding taxes attributable to a defunct corporation.[51] The taxpayer received two CDP final notices and timely submitted two hearing requests. The taxpayer's representatives held several phone conversations with the Appeals Officer, during which the representatives requested a face-to-face hearing. The Appeals Officer did not conduct a face-to-face hearing, and instead continued with telephone conferences. Although the taxpayer asserted that all taxes were paid, the Appeals Officer determined that IRS could proceed with collection.

In his submissions to the court, the taxpayer advanced seven grounds for redetermination. The court addressed only one position – the taxpayer's request for a face-to-face hearing. The court noted that the IRS regulations favor, if not mandate, a face-to-face hearing,[52] but also observed that the Tax Court does not remand cases for face-to-face

[48] Rev. Proc. 2000-43, 2000-2 C.B. 404.

[49] *Id.*, Q&A 6, at 406.

[50] *Drake v. Comm'r*, 125 T.C. 201, 209 (2005), *citing* Rev. Proc. 2000-43, Q&A 5, 2000-2 C.B. 404, 405-06.

[51] *Garage v. U.S.*, 96 A.F.T.R.3d (RIA) 7201 (D. N.J. 2005). IRC § 6672 authorizes the Secretary to assess a civil penalty equal to 100 percent of the trust fund portion of payroll taxes not remitted against a person responsible for withholding and remitting taxes who willfully avoided paying those taxes.

[52] *Garage v. U.S.*, 96 A.F.T.R.3d (RIA) 7201 (D. N.J. 2005), citing Treas. Reg. 301.6330-1(d)(2)(Q&A-D6).

hearings where such a hearing would be futile because the taxpayer's positions are frivolous. Here, the court was "troubled" by the taxpayer's uncontested assertion that the Appeals Officer did not tell the taxpayer's representative that the telephone calls constituted the CDP hearing. Concluding that the taxpayer's positions were not frivolous, the court held that the Appeals Officer abused his discretion in not granting a face-to-face conference.[53] The court remanded the case for a face-to-face hearing and consideration of the seven grounds for relief asserted by the taxpayer.

Standard of Review and the Administrative Record

The most significant group of cases during this period involved the standard for judicial review and the scope of the record upon which such review will be conducted. The leading cases are discussed below in chronological order, because they evidence an evolving understanding of both the uniqueness of Collection Due Process hearings and the application of general principles of administrative law to these hearings.

Living Care Alternatives of Utica, Inc.

In Living Care Alternatives of Utica, Inc., v. U.S.,[54] the Sixth Circuit discussed the background to CDP hearings, and noted that prior to RRA 98, the IRS was able to levy on taxpayer property without providing any pre-deprivation hearing or procedural due process. The court noted that while Congress enacted RRA 98 to provide taxpayers with some additional protections before IRS action, these protections must be interpreted in the historical context of IRS collection. "Tax liens and levies are not typical collection actions; the IRS has much greater latitude and leeway than a normal creditor."[55] The court further noted that since the CDP process was grafted onto a system that historically had very little judicial oversight, there were no formal hearings or official records. "Since normal review of administrative decisions requires the existence of a record, … Congress must have been contemplating a more deferential review of these tax appeals than of more formal agency decisions."[56]

Commenting on the requirement of a balancing test in IRC § 6330(c), the court further noted that "[t]his final balancing factor is novel in American tax law and injects into the calculus an equitable consideration for the taxpayer and his concerns."[57] Here, the

[53] The court stated that the remand remedies the procedurally unfair result brought about when an IRS appeals officer ignores a taxpayer's requests for a face-to-face hearing, determines that a particular telephone conversation constitutes the CDP hearing but fails to inform the taxpayer of this fact, and later, after the taxpayer has filed an appeal to the district court, takes the position that the taxpayer has waived the majority of his arguments because he failed to raise them in the CDP hearing. *Garage v. U.S.*, 96 A.F.T.R.2d (RIA) 9201, slip op. at 6 (D. N.J. 2005).

[54] *Living Care Alternatives of Utica, Inc., v. U.S.*, 411 F.3d 621 (6th Cir. 2005).

[55] *Id.* at 624.

[56] *Id.* at 625.

[57] *Id.* at 625. IRC § 6330(c)(3)(C) requires the Appeals Officer to make a determination that the "proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."

taxpayer argued that the Appeals Officer did not meet the balancing test by failing to consider the effect of senior creditors on the amount collected, and that by proceeding with the levy, the IRS would effectively shut down the business, a nursing home. The court agreed that under IRC § 6331(j)(2)(C), prior to executing a levy, the IRS must investigate the existence of liens and determine that there is sufficient equity in the property to yield net sale proceeds to apply against the taxpayer's liability. The court held, however, that this statutory duty does not yet arise at the time of the CDP hearing, *i.e.*, the investigation of equity in the property must occur prior to the levy but not prior to the CDP hearing, and thus the Appeals Officer did not violate his duty to conduct a balancing analysis.

In discussing the application of the abuse of discretion standard, the court noted that the lack of "a formal record and conventional administrative review" makes application of the abuse of discretion standard difficult. The court denied the taxpayer's request for a remand for additional investigation, noting that "without a clear abuse of discretion in the sense of clear taxpayer abuse and unfairness by the IRS, as contemplated by Congress, the judiciary will inevitably become involved on a daily basis with tax enforcement details that judges are neither qualified, nor have the time, to administer."[58]

Olsen v. U.S.

The First Circuit cited approvingly *Living Care Alternatives'* analysis of CDP's historical context and the standard of review in *Olsen v. U.S.*[59] In *Olsen*, the court noted that "it must be borne in mind that taxpayers have further recourse, besides the CDP hearing, to post-deprivation procedures. While Congress clearly wanted to prevent mere bureaucratic harassment, we do not understand it to have intended to strip the IRS of effective and reasonable tax collection procedures."

In its analysis of the taxpayer's allegation that the district court erred by denying the taxpayer's motion to conduct discovery and thereby supplement the administrative record, the court noted the Supreme Court's longstanding position that review of administrative decisions is usually limited to the agency's decision-making and the evidence on which such decision-making is based (citing *United States v. Carlo Bianchi & Co.*, 373 U.S. 709, 714-15 (1963)). The court further noted that the Supreme Court has extended the "record rule" to informal agency adjudications such as Collection Due Process hearings (citing *Florida Power & Light Co. v Lorion*, 470 U.S. 729, at 744 (1985)). Although there are limited exceptions to the record rule where there is "a strong showing of bad faith or improper behavior" (citing *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402 (1971), overruled on other grounds by *Califano v. Sanders*, 430 U.S. 99 (1977)) on the part of the agency decision-maker, or where the record fails to explain the basis of the agency's action such that there can be no effective judicial review, the court found the

[58] *Living Care Alternatives of Utica, Inc., v. U.S.*, 631 F.3d 621 (6th Cir. 2005).

[59] *Olsen v. U.S.*, 414 F.3d 144, 150-51 (1st Cir. 2005).

record in the instant case adequate for judicial review and found no evidence of improper behavior.

Murphy v. Commissioner

In *Murphy v. Commissioner*,[60] the United States Tax Court discussed the record rule and its 2004 decision in *Robinette v. Commissioner*.[61] Murphy sought to introduce testimony at trial about the special circumstances that limited his ability to pay his entire tax liability. The Commissioner objected to the introduction of this evidence on the ground of relevancy, complaining that this information was not provided at the CDP hearing.

In *Robinette*, the taxpayer sought to admit into evidence testimony and documents, outside of the administrative record, that were relevant to the issue of whether the Appeals Officer abused his discretion in determining the IRS could proceed with collection. The taxpayer asserted such evidence was germane to whether the Appeals Officer "had a closed mind to the arguments presented on petitioner's behalf" and "failed to consider the facts and circumstances of this case."[62]

The court declined to overrule *Robinette*, but sustained the Commissioner's objection to the admission of certain testimony in all but one instance. The court noted that in *Robinette* it required the non-record testimony and documents to be related to issues raised at the CDP hearing and to be relevant and admissible under the Federal Rules of Evidence. The court found that Murphy's trial testimony about the special circumstances relating to his ability to pay was related to the collection alternative considered at the CDP hearing, namely, an offer-in-compromise.[63] However, the court also found that this testimony was not relevant to whether the Appeals Officer abused her discretion in not granting an offer, on two grounds. First, the Appeals Officer determined that the taxpayer was not eligible for an "Effective Tax Administration" offer because he could not pay his liability in full. Second, the Appeals Officer could not abuse her discretion with respect to a "doubt as to collectibility with special circumstances" offer where she did not consider information that the taxpayer failed to provide her within a reasonable period of time.

The court did admit trial testimony by the Appeals Officer as to certain "unexplained notations and abbreviations" in the record, in order to explain those items. The court reasoned as follows:

> An irregularity in the conduct of the hearing or of some defect in the record may not be apparent until after the hearing is concluded and the taxpayer receives notice of the resulting determination. The circumstances may justify allowing

[60] *Murphy v. Comm'r,* 125 T.C. 301 (2005).

[61] *Robinette v. Comm'r*, 123 T.C. 85 (2004), rev'd, 439 F.3d 455 (8th Cir. 2006).

[62] *Id.* at 107.

[63] Offers in compromise are provided for in IRC § 7122 and allow the IRS to compromise the taxpayer's liability based on doubt as to liability, doubt as to collectibility, and effective tax administration. Treas. Reg. § 301.7122-1(b).

> the taxpayer to raise the issue at trial and introduce evidence notwithstanding the taxpayer's failure to raise the issue at the section 6330 hearing.[64]

Robinette v. Commissioner

Finally, in *Robinette v. Commissioner*,[65] the Eighth Circuit reversed the Tax Court and held that the Appeals Officer here did not abuse his discretion in allowing collection to proceed. Prior to the CDP hearing, the IRS had accepted an offer in compromise from Robinette, on which he subsequently defaulted by failing to timely file a tax return. At the CDP hearing, Robinette disputed whether he owed the reinstated liability, stating he had timely filed the return that the IRS claimed it did not have. The Appeals Officer determined that the return was not timely filed and that since the taxpayer proposed no new offer or other collection alternative, collection could proceed. The Tax Court, considering evidence not contained in the administrative record, determined that although the tax return was not timely filed, the breach of the offer conditions was immaterial and therefore the offer should not have been defaulted. The Tax Court held that the Appeals Officer had abused his discretion in allowing collection to proceed.

The Eighth Circuit found that the Tax Court's decision "was based in part on what we conclude was an erroneous application of administrative law and contract law."[66] The court noted a significant dispute over the scope of the record on which the court would conduct its "deferential judicial review." The court reasoned that both the Administrative Procedure Act and general principles of administrative law "limit the scope of judicial review to the administrative record," and that the Supreme Court has held that "exemptions from the APA are 'not lightly to be presumed.'" (Citing *Marcello v. Bonds*, 349 U.S. 302, 310 (1955).) The court observed the absence of any express intent by Congress to grant *de novo* review of CDP determinations where the underlying liability is not at issue, and cited legislative history in support of the application of the abuse of discretion standard, which in turn limits review to the administrative record. The court also discussed exceptions to the record rule, noting that where an informal proceeding such as CDP does not "adequately disclose the basis for the agency's decision," the reviewing court may receive evidence about what happened at the agency proceeding. But even in these instances, the court noted that this evidentiary proceeding is not a trial *de novo* (citing *Camp v. Pitts*, 411 U.S. 138, 143 (1973) (per curiam)).

Having concluded that it must limit its review to the information contained in the administrative record, the court held that the Appeals Officer did not abuse his discretion in allowing collection to proceed. The court analyzed the contractual terms of the offer in compromise, and found that the Tax Court erred by considering the materiality of the breach before determining whether the taxpayer's return-filing requirement (the compliance clause) was an express condition on the government's performance under

[64] *Murphy v. Comm'r*, 125 T.C. 301, 316-17 (2005), referencing *Olsen v. U.S.*, 414 F.3d 144, 155 (1st Cir. 2005).

[65] *Robinette v. Comm'r*, 439 F.3d 455 (8th Cir. 2006), rev'g 123 T.C. 85 (2004).

[66] *Id.* at 464.

the contract. Under the Eighth Circuit's analysis, Robinette's obligation to timely file his tax returns was an express condition on the government's performance, and he breached that condition. The court only then considered the materiality of the breach and found that Robinette presented no evidence at the hearing of immateriality or that enforcement of the condition would cause "disproportionate forfeiture." (Citing Restatement (Second) of Contracts section 229 (1981).)[67]

Procedural Rulings

Several CDP cases involved issues of first impression or procedural import that may never have received judicial review but for the existence of the CDP hearing. In some instances, refund litigation may be available, but the *Flora* pre-payment rule may have barred the taxpayers from bringing a refund suit.[68] Thus, judicial review of agency determinations in CDP hearings provides an important check on agency action.

Manko v. Commissioner

The issue before the Tax Court in *Manko v. Commissioner*[69] was whether the Commissioner can proceed with collection without first issuing a Notice of Deficiency where the parties execute a closing agreement under IRC § 7121 on Form 906. Here, the taxpayers and the IRS entered into a closing agreement for certain partnership adjustments, and agreed to those adjustments on Form 906, Closing Agreement on Final Determination Covering Specific Matters. The closing agreement specifically stated that the agreement does not prevent the Commissioner from making other adjustments (non-partnership) for the years at issue.

Several years later the IRS sent the taxpayer, for the years under the closing agreement, multiple reports titled "Income Tax Examination Changes" and marked "Copy – Information Only." The IRS then assessed the deficiencies without issuing any Notices

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[67] The Eighth Circuit also disagreed with the Tax Court's holding that the Appeals Officer abused his discretion by not "hav[ing] an open mind regarding reinstatement." 123 T.C. 85, 112. The appeals court found that the Internal Revenue Manual was silent on whether the Appeals Officer could reinstate the offer during a CDP hearing, and that the Appeals Officer was instructed by the "National Office" that the offer could not be reinstated unless the IRS erred in declaring a default. Thus, the court found that the Appeals Officer did not his abuse his discretion in failing to reinstate the offer. IRM 8.7.2.3.8 (Rev. 12-01-2006) now states that defaulted OICs will not be reinstated; however, a taxpayer may submit another OIC, which will be considered. The National Taxpayer Advocate believes that this policy is misguided and will advocate for reinstatement of defaulted OICs in certain circumstances.

[68] A taxpayer must generally fully pay the assessed tax for a taxable period to file a suit for refund. If the assessment is not fully paid, the district court or Federal Court of Claims will not have jurisdiction. *See Flora v. United States*, 362 U.S. 145 (1960).

[69] *Manko v. Comm'r*, 126 T.C. 195 (2006).

of Deficiency.[70] After the IRS issued a Final Notice of Intent to Levy and Your Right to a Hearing , the taxpayer timely filed a request for a CDP hearing. The taxpayers argued that they had never received a deficiency notice, had certain net operating losses that would decrease the amount of the liability, and had made payments toward the liability for the years at issue. The Appeals Officer sustained the levy action, relying on legal opinions of IRS counsel in the file.

The court first noted that it had jurisdiction to hear the case under IRC § 6330(d). It next determined that since the case presented a question of law, its decision in the case did not depend on a standard of review, but instead the court must reject erroneous views of law.[71] The court agreed that closing agreements are final and conclusive, and bind the parties as to the terms agreed upon.[72] Form 906 closing agreements, however, bind the parties as to specific matters and do not ultimately determine the tax liability for the year. The court noted that the Commissioner, in fact, made additional adjustments to those years, beyond the scope of the adjustments agreed to in Form 906.

The Tax Court then rejected the Commissioner's argument that the IRS merely computed the liability per the closing agreement's terms. The court found that the taxpayers were never allowed to challenge the Commissioner's computations: "Respondent deprived petitioners of the opportunity of filing a deficiency suit to dispute these computations."[73] Thus, the court held that the Commissioner could not proceed with collection. The court noted that its holding did not alter the terms of the closing agreement and therefore did not "frustrate the purpose" of the agreement.

Zapara v. Commissioner

In *Zapara v. Commissioner* (Zapara II),[74] the Commissioner moved for reconsideration of the Tax Court's decision in *Zapara v. Commissioner*, (Zapara I).[75] The IRS in Zapara I issued a jeopardy levy on certain shares of stock. The IRS did not promptly sell the stock. During the subsequent CDP hearing, the taxpayers, concerned about the stocks' declining value, requested in writing to the Appeals Officer that the IRS sell the stock immediately.

70 Generally, when the IRS determines that there is a deficiency in tax, the IRS must send a deficiency notice to the taxpayer prior to assessing the tax. The taxpayer has 90 days (150 days if the notice is addressed outside of the United States) to petition the Tax Court for redetermination of the deficiency. The IRS may assess the tax at the end of the 90-day or 150-day period if the taxpayer fails to petition the Tax Court. If the taxpayer petitions the Tax Court, the IRS may not assess the tax until the decision of the Tax Court has become final. I.R.C. § 6213(a). There are limited exceptions to the notice of deficiency requirement, such as assessments arising from mathematical or clerical errors, tentative carryback or refund adjustments, and assessments of amounts already paid. I.R.C. § 6213(b). Additionally, a taxpayer may waive this restriction on assessment. I.R.C. § 6213(d).

71 *Manko v. Comm'r,* 126 T.C. 195, 199 (2006).

72 *Id.* at 201, citing IRC § 7121(b).

73 *Id.* at 203 (2006).

74 *Zapara v. Comm'r*, 126 T.C. 215 (2006).

75 *Zapara v. Comm'r*, 124 T.C. 223 (2005).

The Zapara I court found that the IRS violated IRC § 6335(f), which provides taxpayers some protection if the IRS does not publish a notice of sale "as soon as practicable" after it seizes property.[76] Under IRC § 6335(f), the taxpayer may request a sale within 60 days if the IRS takes too long to publish a notice of sale. The statute requires the Secretary to comply with the taxpayer's request for sale unless the Secretary determines that it is not in the best interests of the United States and notifies the taxpayer within 60 days of the request. Since the IRS did not comply with the taxpayer's request for sale or provide the required notice within 60 days of the request, the Tax Court remanded the case and ordered the Appeals Officer to credit against the taxpayers' liability the value of the stock as of 60 days from the request for sale.

In Zapara II, the Commissioner moved for reconsideration on several grounds, including a challenge to the Tax Court's authority to grant relief in the case. The Commissioner asserted that the taxpayers' sole avenue for relief is an action for damages in the United States District Court under IRC § 7433(a). The Tax Court agreed that it does lack jurisdiction to award damages, but pointed out that the relief ordered in Zapara I was not "damages" but rather a "specific remedy." The court stated that it did not determine whether the taxpayer suffered any loss in Zapara I, but instead "ordered specific relief that attempts to give petitioners the credit to which they would have been entitled had respondent complied with their request to sell the stock as required by section 6335(f)." The court reasoned that its authority to order such relief was within its inherent equitable powers that are exercised within its "statutorily defined sphere." (Citing *Estate of Branson v. Commissioner*, 264 F.3d 904, 908 (9th Cir. 2001), *affg.* 113 T.C. 6 (1999)).[77]

The "What Were They Thinking?" Category of Cases

In past years' reports on CDP litigation, we have noted the relatively large number of cases involving frivolous issues, in which taxpayers insist on attempting to litigate the correctness of the underlying liability pursuant to dubious theories of tax law or procedure. We note that the courts have not been reticent in ordering monetary sanctions against these taxpayers, particularly when the court has earlier warned the taxpayer of the consequences of persisting with their frivolous positions. Frequently, when reviewing the cases, the reader's response is, "What were they [the taxpayers] thinking?" On the other hand, sometimes one wonders why a particular case or issue ever made it all the way to litigation without being settled at an earlier stage. The cases discussed below put a different slant on our question, namely, "What was the IRS thinking?"

[76] IRC § 6335(b).

[77] The Tax Court further noted that the equitable remedy in Zapara I was appropriate because by not selling the stock as requested, the IRS had "thwarted" taxpayers' statutory remedy under IRC § 6335(f), which was "tantamount to Respondent's exercising dominion and control" over the property, and resulted in the risk of loss being assumed by the IRS. The court also noted that relief under IRC § 7433 is based on the IRS's negligence or other bad acts, but that violations of IRC § 6335(f) do not require any culpability. Therefore, the court reasoned that Congress did not intend to eliminate equitable remedies under IRC § 6335(f) by enacting IRC § 7433.

Crawford v. U.S.

In *Crawford v. United States,*[78] the taxpayer's divorce decree provided for the taxpayer's ex-husband to pay the tax liability attributable to their joint return. The agreement provided for the transfer of a specific property to the ex-husband, who was required to sell it and apply the proceeds to the tax debt. Taxpayer transferred the property to her ex-husband in accordance with the agreement, but her ex-husband did not sell the property. In her CDP hearing, the taxpayer proposed that the IRS suspend collection against her while the IRS sought to collect from the property of the ex-husband. The taxpayer also agreed to enter into an installment agreement for any amount that was not paid off as a result of IRS collection against her ex-husband. The Appeals Officer determined that the IRS could proceed with collection against the taxpayer on the ground that the taxpayer's request to suspend collection against her and proceed against her former spouse was not a "collection alternative."

The court held that the IRS abused its discretion by not considering the taxpayer's proposed collection alternative and weighing it. The court found that both the statute and the regulations thereunder contemplate just such an approach where joint and several liability is a factor.[79] The court remanded the case for further consideration of the taxpayer's proposed collection alternative.

Sherer v. Commissioner

The taxpayer in *Sherer v. Commissioner*[80] failed to file his tax returns and the IRS subsequently prepared a "substitute for return" under IRC § 6020(b). The IRS then issued a notice of deficiency to the taxpayer's last known address as required under IRC § 6212(b), and later mailed a duplicate notice of deficiency to an address provided by U.S. Postal Service records. Both notices of deficiency were returned to the IRS as "unclaimed." The IRS filed a Notice of Federal Tax Lien and issued a CDP Final Notice. In the subsequent CDP hearing, the taxpayer contested the underlying liability, and showed that he did not reside at either address and never received the notices of deficiency. At the hearing, the Appeals Officer requested that the taxpayer file income tax returns for several years, including the year at issue in the CDP hearing. Instead of filing the returns, the taxpayer mailed several information statements, including brokerage and mortgage interest statements and investment firm account summaries showing the cost basis of the stock sold. The Appeals Officer still requested a tax return, and ultimately issued a notice of determination, citing the taxpayer's failure to file a tax return as grounds for letting stand the "substitute for return" assessment.

[78] *Crawford v. U.S.*, 422 F.Supp.2d 1209 (D. Nev. 2006).

[79] The court found that the collection alternatives set forth in 6330(c)(2)(A)(iii) is not an exclusive list, and that Treas. Reg. 301.6330-1(e)(3) (Q&A-E6) defines a collection alternative to include "a proposal to withhold the proposed or future collection action in circumstances that will facilitate the collection of the tax liability."

[80] *Sherer v. Comm'r,* T.C. Memo. 2006-29.

The Tax Court held that the taxpayer was entitled to raise the underlying liability at trial because he had shown that he didn't live at the address on the notices of deficiency and did not deliberately refuse delivery of the notices. Moreover, the court noted that it can receive information about a deficiency even if the taxpayer did not file a tax return. Under a *de novo* standard of review, the court found that the taxpayer submitted credible evidence as to basis in the stock sold, as well as of entitlement to a mortgage interest deduction. The court held that the taxpayer had no liability for the year in question and thus did not sustain the IRS's proposed collection action.

Sampson v. Commissioner

In *Sampson v. Commissioner*,[81] the taxpayer had been a college student for several years, and sporadically employed before that time. In one year, the taxpayer won a car in a contest, sold it, reported the income from the award, but did not pay the resulting tax liability. The taxpayer submitted an offer in compromise (OIC), based on doubt as to collectibility, in the CDP hearing subsequent to the IRS filing a Notice of Federal Tax Lien. The Appeals Officer imputed "foregone" income to the taxpayer, based on the fact that the taxpayer had "chosen" to be a student rather than a worker,[82] and calculated the taxpayer's reasonable collection potential by averaging the foregone income based on the year in which the taxpayer received the automobile prize. The Appeals Officer then rejected the OIC on the ground that the taxpayer could fully pay the tax debt. When the taxpayer pointed out that the year in which he won a car was an aberrational year in terms of income, the Appeals Officer did not revise the calculation of reasonable collection potential.

In its summary opinion, the Tax Court reviewed IRS guidance about how to calculate future income in circumstances such as Sampson's. Where the taxpayer is temporarily unemployed or underemployed, the IRS calculates future income as if the taxpayer were fully employed. Where the taxpayer has a sporadic employment history or fluctuating income, the IRS calculates the average income over several prior years.[83] The court then found that Sampson qualified for income averaging because of his history of sporadic employment and that his average income was close to zero.

The court next discussed the "future income collateral agreement" provisions in the Internal Revenue Manual, and found that one example in the IRM, involving an offer in compromise submitted by a current medical student with prospects of higher future income, shows that IRS contemplated that a taxpayer could qualify for an OIC even

[81] *Sampson v. Comm'r*, T.C. Summ. Op. 2006-75.

[82] In correspondence to the taxpayer, the Appeals Officer wrote:

> Part of the process of evaluating an offer from a person who is unemployed is to consider what that person would earn if they [sic] were working. Usually that is done by looking at previous income history. In your case, that is problematical because of your history, but it seems clear that were you to find employment you would be able to pay the tax liability for 2002. The fact that you have chosen to go to school rather than work is not really relevant.

[83] IRM § 5.8.5.5(5) (Nov. 15, 2004).

though currently a student.[84] The court further noted that the future income calculation in Sampson's case did not take into account that Sampson did not know what employment he could find after graduation, nor did it consider that Sampson's expenses after graduation might increase (*e.g.*, he would have an obligation to repay student loans). Thus, the court held that the Appeals Officer abused his discretion in rejecting the offer on the ground that the taxpayer could fully pay the liability. The court remanded the case for reconsideration of the offer.

PRO SE ANALYSIS

One hundred and forty-three (or 73 percent) of the 195 cases litigated were brought before the courts by the taxpayer *pro se*, or without benefit of counsel. This is a modest decrease from 79 percent in the previous year.85 Table 3.1.2 shows the breakdown of *pro se* and represented taxpayer cases and the decisions rendered by the court, indicating that approximately eight percent of *pro se* taxpayers receive some relief on judicial review while 15 percent of represented taxpayers received full or partial relief from their CDP appeals.

TABLE 3.1.2, *PRO SE* AND REPRESENTED TAXPAYER CASES AND DECISIONS

Court Decisions	Taxpayer *Pro Se*		Representative	
	Volume	Percentage of Total	Volume	Percentage of Total
Decided for IRS	132	92%	44	85%
Decided for Taxpayer	9	6%	6	11%
Split Decisions	2	2%	2	4%
Totals:	143	100%	52	100%

CONCLUSION

By the end of May 2006, we can say that CDP is an informal hearing, that the "record rule" applies to judicial review of these hearings, that there are narrow evidentiary exceptions to the record rule, that the appellate courts grant significant deference to the IRS's determinations that collection may proceed, and that courts other than the Tax Court are loathe to involve themselves in the daily minutiae of tax enforcement details.

These rulings demonstrate the overriding importance of developing a complete and comprehensive administrative record. Since that record is in the control of the IRS, taxpayers will have to be vigilant in submitting evidence, raising issues, and corresponding in writing during the course of the CDP hearing. Given the large number of *pro se* taxpayers electing these hearings, taxpayers bear a great risk of being harmed if the IRS designs or implements its procedures in a manner that is not taxpayer-friendly. The National Taxpayer Advocate is very concerned that Appeals' reluctance to grant

[84] IRM § 5.8.5.5(6) (Nov. 15, 2004).

[85] National Taxpayer Advocate 2005 Annual Report to Congress 487.

face-to-face and local office hearings increases the likelihood that taxpayers will not develop the administrative record in such a way that courts will be able to conduct proper judicial review.

We have also identified two areas for improvement, one administrative and one legislative. Administratively, the National Taxpayer Advocate shall work with the IRS to clarify and expand the circumstances in which a defaulted offer can be reinstated.[86] Legislatively, the National Taxpayer Advocate is recommending in this report that Congress amend IRC § 6330 to require the Appeals Officer to make the investigation under IRC § 6331(j)(2)(C) as to whether there are other liens on the property and whether there are sufficient net sale proceeds to apply against the taxpayer's liability, *before* issuing a notice of determination in the CDP hearing.[87]

The question remains whether the IRS and taxpayers will learn from these cases. Do Appeals Officers, including Appeals personnel in campus locations who conduct these hearings, read these cases and learn how the courts view CDP hearings? How will taxpayers be educated about the requirements for an administrative record? Regardless of a case's outcome – whether it be for the taxpayer or for the IRS or a split decision – many of the cases identify an opportunity for the IRS to improve procedures, correspondence or communications with the taxpayer, or training for its employees.

86 *See* discussion of *Robinette v. Comm'r, supra.*

87 See Additional Legislative Recommendation, *Collection Due Process and Uneconomical Levies, supra; see also*, discussion of *Living Care Alternatives of Utica, Inc., supra.*

LITIGATED ISSUE #2 GROSS INCOME UNDER INTERNAL REVENUE CODE SECTION 61 AND RELATED SECTIONS

SUMMARY

Taxpayers, when preparing their tax returns, must first determine the amount of gross income they received for that taxable year. This determination is necessary for the computation of their taxable income and the amount of tax that must be paid. Gross income under IRC § 61 has been included in the Most Litigated Issues section of each of the National Taxpayer Advocate's Annual Reports to Congress. The cases reviewed for this report can be separated into two major categories: (1) Income includible in gross income and (2) income specifically excluded from gross income by statute. Some of the statutory exclusions frequently addressed in the reviewed cases include the following:

- Awards and settlements;
- Disability and Social Security benefits; and
- Discharge of indebtedness income.

PRESENT LAW

IRC § 61 broadly defines gross income as "all income from whatever source derived."[1] The United States Supreme Court has broadly described gross income as any accession of wealth.[2] However, as the Internal Revenue Code has evolved, Congress has carved out numerous exceptions and exclusions to this broad definition of income.[3]

ANALYSIS OF LITIGATED CASES

We analyzed 106 cases where gross income was an issue that were decided in the federal court system between June 1, 2005, and May 31, 2006.[4] As stated in previous Annual Reports to Congress, the issues most commonly litigated in gross income cases are what is includible under IRC § 61 and what is excludible from gross income under other statutory provisions.[5] Table 2 in Appendix 3 provides a detailed listing of the cases analyzed for this report. Of the 106 cases, 53 (50 percent) involved taxpayers who failed to report items of gross income.

The following are issues that were commonly raised in unreported income cases and exclusions from gross income cases. While a significant portion (44 percent) of the

1 IRC § 61(a).

2 *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955).

3 *See, e.g.*, IRC §§ 104, 105, and 108.

4 For purposes of our analysis, we reviewed federal cases involving IRC § 61 where the issue was whether the taxpayer had an item of unreported income or whether the taxpayer was entitled to exclude the item from gross income.

5 National Taxpayer Advocate 2001 Annual Report to Congress 259; National Taxpayer Advocate 2002 Annual Report to Congress 258-71; National Taxpayer Advocate 2003 Annual Report to Congress 332-51; National Taxpayer Advocate 2004 Annual Report to Congress 515-22; and National Taxpayer Advocate 2005 Annual Report to Congress 488-97.

cases we identified during our review were "S" cases with no precedential value, they are nonetheless illustrative of the confusion surrounding the concept of gross income.

Unreported Income

Gambling Wages

In four cases, taxpayers did not include their earnings from gambling in their gross income.[6] The taxpayers appeared *pro se* before the U.S. Tax Court and the IRS prevailed in all four cases. The court repeatedly held that a taxpayer is required to report income from gambling, even if the taxpayer is gambling only for recreational purposes and not as a professional gambler.

Alimony

Taxpayers also disputed the inclusion of alimony payments in their gross income. Alimony is includible in gross income under IRC § 71, which characterizes alimony or separate maintenance payments as gross income as long as the payments are not required anytime after the death of the payee spouse.[7] For example, when two married taxpayers divorced and failed to specify in the divorce settlement agreement what should happen to payments upon the death of the payee spouse, the Tax Court concluded such payments were properly includible in the payee spouse's gross income under IRC § 71.[8] Similarly, in *Arias v. Commissioner*, the monthly payments paid to the taxpayer were alimony includible in gross income because the taxpayer's former spouse had no liability to make any payments for any period after the death of the taxpayer.[9]

Exclusions From Gross Income

Awards and Settlements

Taxation of awards and settlements remains one of the most frequently litigated issues related to gross income.[10] The central dispute in 19 cases was whether the award, or a portion of the award, should be excluded from gross income as an amount received "on account of personal physical injuries or physical sickness."[11] Under IRC § 104(a)(2), any award, other than punitive damages, is excludible from gross income if the award is compensation for damages resulting from a physical injury or physical sickness.[12] The exclusion applies regardless of whether the award is received by lawsuit or by agreement, or whether the award comes in a lump sum or by periodic payments.

[6] *Lange v. Comm'r*, T.C. Memo. 2005-176; *McQuarrie v. Comm'r*, T.C. Memo. 2006-93.

[7] IRC § 71.

[8] *Johanson v. Comm'r*, T.C. Memo. 2006-105.

[9] *Arias v. Comm'r*, T.C. Summ. Op. 2006-20.

[10] *Allum v. Comm'r*, T.C. Memo. 2005-177; *Benavides v. U.S.*, 97 A.F.T.R.2d (RIA) 1512 (S.D. Tex. 2006).

[11] IRC § 104(a)(2).

[12] *Id.*

Courts interpret IRC § 104(a)(2) narrowly. Before an award can be excluded under IRC § 104(a)(2), a taxpayer must establish: (1) prosecution or settlement of the claim is based on tort or tort-type rights, and (2) the award was received on account of personal physical injuries or physical sickness.[13] The taxpayer must be able to show a clear causal connection between the award and the taxpayer's physical injury or physical sickness. Making this connection is difficult, as taxpayers successfully argued that some portion of the damages awarded was eligible for the IRC § 104(a)(2) exclusion in only two of the 19 cases we reviewed. For example, in *Lindsey v. Commissioner*, the taxpayer received a $2 million payment in settlement of his claims for tortious interference with contract negotiations.[14] The taxpayer asserted, and had his physician testify, that he suffered from hypertension and stress-related symptoms during contract negotiations. In holding that the settlement payment was related to emotional distress and not physical sickness, the court noted that the payor of the award was never made aware that the taxpayer was suffering any physical sickness, "thereby belying the existence of a direct causal link between any physical sickness. . . and damages paid."[15]

The constitutionality of IRC § 104(a)(2) has recently been called into question by the United States Court of Appeals for the District of Columbia Circuit in *Murphy v. IRS*.[16] In that case, Ms. Murphy sued the New York National Guard for employment discrimination. Ms. Murphy provided medical testimony that she experienced physical, somatic,[17] and emotional injuries, including teeth grinding, due to the stress of the discrimination. Later Ms. Murphy settled the case, and the agreement allocated $45,000 of the $70,000 award to "emotional distress and mental anguish" and the remaining $25,000 for "injury to professional reputation."[18] On their joint return, Mr. and Mrs. Murphy included the entire $70,000 award in gross income and then later filed a claim for refund and instituted a refund suit in the U.S. District Court for the District of Columbia.[19] The district court ruled in the government's favor, and the taxpayers subsequently appealed. Although the Court of Appeals agreed Ms. Murphy's award was not received on account of personal physical injuries or physical sickness within the meaning of IRC § 104(a)(2), the court determined the award was not gross income. The court held that IRC § 104(a)(2) was "unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation," as "damages received solely in compensation for a personal injury are not income within the meaning of that

[13] *Comm'r v. Schleier*, 515 U.S. 323 (1995).

[14] *Lindsey v. Comm'r*, 422 F.3d 684 (8th Cir. 2005).

[15] *Id.* at 689.

[16] *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006), judgment vacated and scheduled for oral argument, No. 05-5139 (D.C. Cir. Dec. 22, 2006).

[17] Quoting the American Heritage Dictionary, the Court of Appeals for the District of Columbia Circuit defined "somatic" as relating to, or affecting the body, especially as distinguished from a body part, the mind, or the environment." *Murphy*, 460 F.3d at 83.

[18] *Id.* at 81.

[19] *See Murphy v. IRS*, 362 F.Supp.2d 206 (D. D.C. 2005).

term in the Sixteenth Amendment."[20] While this case was not decided during the period covered by this report and the opinion is not yet final, the ultimate outcome of this case will impact future litigation of IRC § 104(a)(2) claims.[21]

Contingent Attorney's Fees

In addition to disputing whether an award or a portion of an award qualifies for exclusion from gross income under IRC § 104(a)(2), taxpayers disputed whether the attorney's fees portion of the award was includible in gross income.[22] The Supreme Court resolved the issue of whether the attorney's fees portion of the award is also includible in gross income in *Commissioner v. Banks*, holding that the contingent attorney's fees portion of the award was taxable income to the plaintiff under the anticipatory assignment of income doctrine, which bars the taxpayer from excluding an economic gain from gross income when gain is assigned in advance to another party.[23]

In *Banks* and its companion case, *Commissioner v. Banaitis*, the taxpayers received settlement awards and their attorneys received a portion of those awards as contingency fees.[24] The taxpayers argued that even though the settlement awards were not excludible under IRC § 104(a)(2), they should not have to include the attorney's contingency fee portion of the award in gross income because applicable state law granted the attorneys a property interest in that portion of the award. The Supreme Court rejected that argument, holding the amounts representing the contingent fees were includible in gross income because the arrangement was an anticipatory assignment of income.[25]

In 2004, while the *Banks* and *Banaitis* cases were pending, Congress passed legislation to allow taxpayers to take an "above the line" deduction from gross income for the attorney's fees paid in connection with any action involving a claim of unlawful discrimination.[26] Taxpayers who receive taxable awards or settlements in contingency fee cases not alleging unlawful discrimination, do not, however, get the benefit of an "above the line" deduction from gross income for the attorney's fees paid; those taxpayers can only

[20] *Murphy*, 460 F.3d at 92. The Sixteenth Amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

[21] This case was decided on August 22, 2006. On October 5, 2006, the United States filed a petition for rehearing en banc to the D.C. Circuit. On October 31, 2006, the Murphys filed their opposition to the petition for rehearing. On December 22, 2006, the D.C. Court of Appeals vacated the August 22, 2006 decision and ordered new briefing and oral argument. The D.C. Court of Appeals issued a second order on December 22, 2006, dismissing as moot the government's petition for rehearing en banc but providing that a new period for petitioning en banc will begin to run following the entry of a new panel judgment.

[22] *Allum v. Comm'r,* T.C. Memo. 2005-177; *Goode v. Comm'r*, T.C. Memo. 2006-48.

[23] *Comm'r v. Banks*, 543 U.S. 426 (2005).

[24] *Id.; Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003). In *Banaitis v. Commissioner*, an Oregon case, the court ruled that the state law afforded a property interest in the settlement and therefore the portion of the settlement paid directly for attorney's fees was excluded from income.

[25] *Comm'r v. Banks*, 543 U.S. at 434-36.

[26] Pub. L. No. 108-357, § 703, amended the definition of adjusted gross income in section 62(a). *See* IRC § 62(a)(20) ("costs involving discrimination suits, etc.").

deduct the attorney's fees paid on Schedule A as miscellaneous itemized deductions and are therefore subject to the two percent floor of IRC § 67.[27]

Therefore, in general, a taxpayer must include the portion of recovery paid to the attorney as a contingent fee in gross income. The taxpayer may be able to deduct attorney fees from gross income as a miscellaneous itemized deduction, but this deduction must be added back when computing alternative minimum taxable income.[28] Consequently, if a taxpayer argues unsuccessfully that an award is excludible under IRC § 104(a)(2), the taxpayer must also include the portion of the settlement paid as attorney's fees in gross income. Moreover, even if the taxpayer is able to claim a miscellaneous itemized deduction for the attorney's fees, the taxpayer may be subject to the alternative minimum tax.

Social Security and Disability Benefits

The characterization of payments as Social Security or other types of disability benefits is often litigated because portions of these benefits may be excludible from gross income. For instance, in *Burnham v. Commissioner*, the taxpayer argued his disability pension was excludible under IRC § 105(c), which provides that amounts received by an employee through health or accident insurance for personal injuries or sickness will be included in gross income unless the payments are compensation for the loss of a member or function of the taxpayer's body, or permanent disfigurement, and computed according to the nature of the injury without consideration of the period of time the taxpayer is absent from work.[29] In *Burnham*, the amount the taxpayer received was based on the amount of time the taxpayer was absent from work, rather than the severity of the injury. Therefore, the payments were includible in the taxpayer's gross income.[30]

For tax purposes, Social Security benefits are treated one of three ways: entirely excluded from gross income, 50 percent excluded from gross income, or 85 percent excluded from gross income.[31] The treatment of a taxpayer's Social Security benefits will depend on the taxpayer's adjusted gross income and filing status.[32] It is not surprising that this complexity leads to disputes between the IRS and taxpayers. Moreover, the similarities between various types of benefits can lead taxpayers into thinking they are entitled to exclude the benefits from gross income under one of the provisions as in IRC § 104. For example, in *Green v. Commissioner*, the taxpayer received Social Security benefits but

[27] IRC § 67(a) provides that individuals are allowed miscellaneous itemized deductions only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income, where IRC § 62 defines adjusted gross income.

[28] IRC § 56.

[29] *Burnham v. Comm'r*, T.C. Summ. Op. 2006-8.

[30] *Id.*

[31] IRC § 86.

[32] *Id.*

did not report them in gross income.[33] The taxpayer claimed the benefits were in the nature of workmen's compensation and therefore excludible from gross income under IRC § 104(a)(1).[34] Although the taxpayer was injured on the job and received benefits as a result of those injuries, the Tax Court emphasized that the Social Security Act under which the benefits were paid is not in the nature of a workmen's compensation act.

Discharge of Indebtedness

There were ten cases where the taxpayer was disputing the IRS's determination that the taxpayer received income from the cancellation of indebtedness. In three of the cases, the taxpayer prevailed, while one case resulted in a split decision. Generally, a taxpayer must include cancellation of indebtedness in gross income.[35] However, IRC § 108(a)(1)(B) permits the taxpayer to exclude cancellation of indebtedness from gross income if the discharge occurs when the taxpayer is insolvent.[36] In the Tax Court, the burden of proving insolvency is generally placed on the taxpayer.[37] For example, in *Coppertino v. Commissioner*, the taxpayer argued that cancellation of a debt by the Securities and Exchange Commission was excludible because she was insolvent. The taxpayer testified she did not own a home or any other property, and her only asset was a car with very minimal monetary value. In fact, the taxpayer testified she virtually lived out of her car. Moreover, the IRS was unable to provide the court with any evidence disputing the taxpayer's testimony.[38] Therefore, the taxpayer was considered insolvent and could exclude the cancellation of indebtedness from gross income.

CONCLUSION

Although no clear patterns emerged from the cases, it is clear that gross income is an area of confusion and contention between taxpayers and the IRS. This year, taxpayers prevailed in only seven of the 106 cases, and two cases resulted in a split decision. Taxpayers appeared *pro se* in 75 cases (70 percent), and only prevailed in whole or in part in three of the 75 cases.

Because 50 percent of the cases involved unreported income, it is clear that some taxpayers will search out ways to avoid reporting taxable income, and the IRS needs to be diligent to ensure adherence to the law and proper tax collection.[39] In the other 50 percent of the cases we analyzed, however, many taxpayers raised legitimate issues

[33] *Green v. Comm'r*, T.C. Memo. 2006-39.

[34] IRC § 104(a)(1) provides that gross income does not include "amounts received under workmen's compensation acts as compensation for personal injuries or sickness."

[35] IRC § 61(a)(12).

[36] IRC § 108(a)(1)(B).

[37] U.S. Tax Court Rules of Practice and Procedure, Rule 142(a); *Traci v. Comm'r*, T.C. Memo. 1992-708.

[38] *Coppertino v. Comm'r*, T.C. Summ. Op. 2006-87.

[39] Unreported income is the single largest component of the "tax gap," accounting for roughly 80 percent of the tax gap (approximately $285 billion per year). *See* updated estimates for the overall gap for tax year 2001 at www.irs.gov/pub/irs-news/tax_gap_figures.pdf.

regarding gross income, such as when to exclude settlement awards and Social Security benefits. The complexity of Social Security and disability benefits suggests that the taxability of these types of payments will continue to confuse taxpayers and create contention with the IRS. Moreover, even with the D.C. Circuit's unusual move in vacating its earlier decision in *Murphy v. IRS*, the analysis employed by the court in the earlier decision leaves open the possibility that substantial physical problems caused by emotional distress could be considered physical injuries or physical sickness that would permit a taxpayer to exclude an award for those problems depending on the terms of the award.[40] Thus, *Murphy v. IRS* is a significant case that demonstrates how the law may evolve with modern medical science's understanding of the connection between mind and body, and the biological and neurological basis of mental problems.

[40] The court concluded that "Murphy no doubt suffered from certain physical manifestations of emotional distress," but nonetheless did not find that Murphy's award was excludible under IRC § 104(a)(2) "on account of personal physical injuries or physical sickness" because her award was characterized as compensation for mental pain and anguish and for injury to professional reputation. *Murphy*, 460 F.3d at 84.

LITIGATED ISSUE #3 SUMMONS ENFORCEMENT UNDER INTERNAL REVENUE CODE SECTIONS 7602(A), 7604(A), AND 7609(A)

SUMMARY

We reviewed 101 federal court opinions on issues related to IRS summons enforcement during the 12 months from June 1, 2005, through May 31, 2006.[1] The IRS has the authority to summon the production of books, records, or testimony from witnesses when investigating either a civil or criminal tax liability.[2] This information can be obtained from the person who is the subject of the investigation by serving a summons directly on that person.[3] The IRS can also obtain this information from third-party record keepers who are holding records relating to that person by serving summonses upon those record keepers, and providing notice of the summons to the person identified in the summons.[4]

When a summons is served upon the person who is the subject of the investigation, that person may contest the legality of the summons by waiting until the IRS brings a proceeding to enforce the summons and raising appropriate arguments at that time.[5] When a summons is served upon a third-party record keeper, a person identified in the summons can challenge the legality of a summons by intervening in a proceeding or by bringing a proceeding to quash the summons.[6] Generally, the burden on the IRS to demonstrate the validity of the summons is minimal and the burden upon the taxpayer to demonstrate the illegality of the summons is formidable.[7] The taxpayer prevailed in only three of the 101 cases.[8]

PRESENT LAW

The IRS has broad authority under IRC § 7602 to issue summonses for the examination of a taxpayer's books and records or to direct testimony under oath.[9] The IRS has the authority to enforce a summons under IRC § 7604 by bringing suit in the appropriate United States District Court. The IRS also has the authority to obtain information

[1] A summons is a document notifying the person to whom it is directed that he must appear on the day designated and answer claims or give testimony or produce certain books, papers or other data. *Albachten v. Corbett*, 156 F. Supp. 863 (S.D. Cal. 1957).

[2] IRC § 7602; Treas. Reg. § 301.7602-1.

[3] IRC §§ 7602(a) and 7603(a).

[4] IRC §§ 7603(b) and 7609(a).

[5] IRC § 7609; *see e.g., U.S. v. Davis*, 636 F.2d 1028, 1034 (5th Cir. 1981).

[6] IRC § 7609(a) requires that anyone identified in a third-party summons (other than the person summoned) must be given notice of the summons. IRC § 7609(b) provides that those persons who are entitled to notice can intervene in a proceeding regarding the summons and can initiate a proceeding to quash the summons.

[7] *Connor v. U.S.*, 434 F.3d 676 (4th Cir. 2006), aff'g 94 A.F.T.R.2d (RIA) 7287 (W.D. Va. 2004). The burden upon the government is slight for the statute must be read broadly in order to ensure that the enforcement powers of the IRS are not unduly restricted. *U.S. v. Powell*, 9 U.S. 48, 53 (1968).

[8] *Investor Communications Int'l, Inc. v. U.S.*, 97 A.F.T.R.2d (RIA) 1293 (W.D. Wash. 2006); *Reiserer v. U.S.*, 96 A.F.T.R.2d (RIA) 5437 (W.D. Wash. 2005); *U.S. v. Monumental Life Insurance Co.*, 440 F.3d 729 (6th Cir. 2006).

[9] *LaMura v. U.S.*, 765 F.2d 974, 979, *citing U.S. v. Bisceglia*, 420 U.S. 141, 145 -146 (1975).

related to an investigation from third-party record keepers pursuant to IRC § 7609, provided that notice is given to those identified in the summons so they have the opportunity to contest the summons. A summons can be contested on the grounds that the IRS has failed to satisfy the threshold requirements for issuing a summons, as set forth by the Supreme Court in *United States v. Powell*:

- The investigation must be conducted for a legitimate purpose;
- The inquiry must be relevant to that purpose;
- The IRS must not already possess the information; and
- All required administrative steps must have been taken.[10]

The IRS initially has the burden in a summons enforcement proceeding to show that the Powell requirements are satisfied. The burden shifts to the person attempting to quash the summons to demonstrate that the Powell requirements were not met or enforcement of the summons would be an abuse of process.[11] As noted above, the IRS's burden in satisfying the Powell requirements is minimal, while the taxpayer's burden to demonstrate that one of the factors has not been satisfied is heavy.[12]

There are other limitations on the issuance of a summons, including the restriction against issuing a summons after an IRS recommendation to the Department of Justice for criminal prosecution.[13] Additionally, the IRS may not obtain information protected by a statutory or common law privilege, such as:

- Attorney-client privilege;[14]
- Work product privilege;[15] or
- Tax practitioner privilege.[16]

10 *United States v. Powell*, 379 U.S. 48, 58-59 (1964).

11 *La Mura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985).

12 The IRS burden can generally be satisfied by presenting the sworn affidavit of the agent who issued the summons attesting to the necessary facts. *Id.*

13 IRC § 7602(d)(1).

14 The attorney-client privilege generally provides protection from discovery of information where: (1) legal advice of any kind is sought, (2) from a professional legal advisor in his or her capacity as such, (3) the communication is related to this purpose, (4) made in confidence, (5) by the client, (6) and at the client's insistence protected, (7) from disclosure by the client or the legal advisor, (8) except where the privilege is waived. U.S. v. Evans, 113 F.3d 1457 (7th Cir. 1997), *citing* John Henry Wigmore, Evidence in Trials at Common Law § 2292 (John T. McNaughten rev. 1961).

15 The work product doctrine protects against the discovery of documents and other tangible things prepared in anticipation of litigation. Fed. R. Civ. P. 26.

16 IRC § 7525 extends the protection of the common law attorney-client privilege to federally authorized tax practitioners. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525 (a)(2) and (b). The tax practitioner privilege is interpreted based on the common law rules of the attorney-client privilege. *U.S. v. BDO Seidman*, LLP, 337 F.3d 802, 810 – 812 (7th Cir. 2003).

There are also limitations to these privileges. For example, they extend to "tax advice" but not to tax return preparation materials.[17] Further, the identities of clients are not generally considered privileged information, except in rare cases where so much of the actual confidential communication has been disclosed that merely identifying the client would effectively disclose that communication.[18] Another limitation is the so-called "crime-fraud" exception, which permits discovery of communications between an attorney and client that are in furtherance or perpetration of a fraud.[19]

When the IRS serves a summons on a third-party recordkeeper, the IRS is required to give notice of the summons to any person identified in the description of the books and records contained in the summons in order that the person(s) can contest the summons.[20] The IRS must provide notice to the person within three days of the day on which the summons is served to the recordkeeper, but no later than the 23rd day before the day fixed on the summons on which the records will be reviewed.[21] Persons entitled to notice under IRC § 7609(a)(2) may bring a proceeding to quash a third-party summons in the appropriate federal district court. These proceedings must be brought within 20 days after notice of the summons is served.[22]

Several exceptions apply to the IRC § 7609 notice procedures. Summonses issued "in aid of collection" of an assessed liability or judgment rendered against a person whose liability is at issue are generally exempt from IRC § 7609 notice procedures.[23] In other words, the IRS is not required to give notice to persons identified in the summons where the purpose is to aid the collection of a liability. However, the courts have interpreted the "aid of collection" exception to apply only where the taxpayer upon whose liability the summons is issued owns a legally identifiable interest in the account or other property for which records are summoned.[24] In addition, summonses issued by the IRS in connection with a criminal investigation are also generally exempt from IRC § 7609 procedures. However, the exemption only applies if the summons is not issued to a third-party recordkeeper.[25]

17 *U.S. v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

18 *U.S. v. Blackman*, 72 F.3d 1418, 1424 (9th Cir. 1995).

19 *U.S. v. Zolin*, 491 U.S. 554 (1989).

20 IRC § 7609(a); Treas. Reg. § 301.7609-3(a); *see also Ip v. U.S.*, 205 F.3d 1168,1172 (9th Cir. 2000) (stating "The purpose of the notice provision is to allow people to assert defenses, such as attorney-client privilege or relevancy objections, that would be unavailable to them in the absence of notice.").

21 IRC § 7609(a)(1).

22 IRC § 7609(b)(2)(A).

23 IRC §7609(c)(2)(D); Treas. Reg. § 301.7609-4(a).

24 *Ip v. U.S.*, 205 F.3d 1168,1172-1176 (9th Cir. 2000)

25 IRC § 7609(c)(2)(E).

ANALYSIS OF LITIGATED CASES

This is the second year that summons enforcement has appeared in the National Taxpayer Advocate's Annual Report to Congress as a Most Litigated Issue. In the 2005 Annual Report, we reviewed 44 cases with primary issues related to summons enforcement, and predicted the number of cases would increase as the IRS became more aggressive in its enforcement initiatives. The number of summons enforcement cases not only increased, as expected, but more than doubled in the 12 months following the period covered by the last Annual Report.

A detailed listing of this year's cases can be found in Table 3 in Appendix III. Summons enforcement is the primary issue in all of these cases. The court ruled in favor of the IRS in 93 of the 101 cases, while taxpayers prevailed in three cases and five cases ended in split decisions. Attorneys represented taxpayers in 31 cases, while 70 cases involved taxpayers who were *pro se, i.e.*, without counsel. Arguments raised by litigants against the IRS summons generally fell into the following categories:

- ***Powell* Requirements:** Only two of the litigants prevailed when attacking IRS summonses based on satisfaction of the *Powell* requirements.[26] The burden on the IRS is "slight" while the burden on those challenging the summons is significant.[27] Courts found the taxpayers failed to prove that revenue agents' tactics amounted to abuse of process or lack of good faith.[28] Likewise, the IRS generally defeated taxpayers' claims that the agency already possessed the information by providing affidavits to the contrary from the agents who issued the summonses.[29] Further, many taxpayers raised the generally unsuccessful argument that the IRS requested documents that were not relevant to the investigation.[30]

  The third-party recordkeeper in *U.S. v. Monumental Life Insurance Co.* successfully petitioned to quash the summons by challenging the satisfaction of the Powell requirements. The IRS issued a third-party summons to the insurance company in connection with an investigation of a client. The company proved the IRS already possessed much of the requested information about insurance products

[26] *U.S. v. Monumental Life Insurance Co.*, 440 F.3d 729 (6th Cir. 2006), *rev'g* 345 F. Supp.2d 712 (W.D. Ky. 2004); *The Frost National Bank v. U.S.*, 97 A.F.T.R.2d (RIA) 2769 (W.D. Tex. 2006), *adopting* 97 A.F.T.R.2d (RIA) 2771 (W.D. Tex. 2005).

[27] *U.S. v. Kis*, 658 F.2d 526, 535-37 (7th Cir. 1981).

[28] *See, e.g., U.S. v. Holu*, 96 A.F.T.R.2d (RIA) 5843 (D. Haw. 2005).

[29] *See, e.g., Conner v. U.S.* 434 F.3d 676 (4th Cir. 2006), *aff'g* 94 A.F.T.R.2d (RIA) 7287 (W.D. Va. 2004); *Boelter v. U.S.* 96 A.F.T.R.2d (RIA) 5968 (W.D. Wash. 2005); *Jordon v. U.S.*, 97 A.F.T.R.2d (RIA) 2919 (M.D. Ala. 2006); *U.S. v. Geary*, 96 A.F.T.R.2d (RIA) 5839 (D. Haw. 2005); *U.S. v. Trenholm*, 96 A.F.T.R.2d (RIA) 5856 (D. Haw. 2005) (Availability of information through discovery of ongoing Tax Court proceeding did not render summonses unenforceable), adopting 2005 WL 3200080 (D. Haw. 2005); *but see U.S. v. Monumental Life Ins. Co.*, 440 F.3d 729 (6th Cir. 2006), *rev'g* 345 F. Supp. 2d 712 (W. D. Ky. 2004); *Reiserer v. U.S.*, 96 A.F.T.R.2d (RIA) 5437 (W.D. Wash. 2005).

[30] *See, e.g., Beaumont Key Services, L.L.C. v. U.S.*, 96 A.F.T.R.2d (RIA) 5828 (N.D. Tex. 2005); *O'Doherty v. U.S.*, 97 A.F.T.R.2d (RIA) 322 (N.D. Ill. 2005); *Martini v. U.S.*, 97 A.F.T.R.2d (RIA) 2592 (D. Nev. 2006), *clarifying* 2006 WL 240803 (D. Nev. 2006); *Wilde v. U.S.*, 385 F.Supp.2d 966 (D. Ariz. 2005).

from a completely unrelated case heard before the United States Tax Court. The IRS countered by claiming that IRC § 6103 prevented it from using the information received in one case for an unrelated case. However, the court stated internal use for an investigation of another taxpayer did not violate IRC § 6103. Further, the IRS failed to show the documents were inaccessible merely because they were locked away in a file somewhere. The court also agreed that the requested information was too broad in scope and not relevant to the investigation. Accordingly, the court denied enforcement of the summons.[31]

- **Notice:** Both taxpayers and the IRS raised the issue of insufficient notice. Taxpayers raised the issue in several cases in an attempt to invalidate summonses.[32] Also, because entitlement to notice confers standing to challenge a summons issued to a third-party recordkeeper under IRC § 7609(b), the IRS also raised entitlement to notice as a means to argue that litigants did not have standing to contest the summons. Generally, the IRS is not required to give notice of a summons in aid of collection, provided the taxpayer who is the subject of the investigation has a legally significant interest in the account or other property for which records are sought.[33] Further, notice is not required where the summons is issued in connection with a criminal investigation and is not issued to a third-party recordkeeper.[34]

  The district court in *Stewart v. U.S.*[35] held the IRS was not required to give the taxpayer's spouse notice of the summons because the summons did not identify the spouse. In *Stewart*, notice to the spouse was not even required when the IRS sought records relating to joint accounts owned by both the taxpayer and the spouse.

- **Criminal Referral:** Taxpayers also raised IRC § 7602(d) to invalidate summonses where taxpayers perceived an impending referral to the Department of Justice (DOJ) for criminal prosecution. The IRS is prohibited from issuing a summons or beginning an enforcement proceeding on a summons if a referral to the DOJ is in effect.[36] Courts generally accept the testimony of the IRS agent who issued the summons that no criminal referral has been made, unless the person contesting the summons can provide direct evidence to the contrary.[37]

31 *U.S. v. Monumental Life Insurance Co.*, 440 F.3d 729 (6th Cir. 2006), *rev'g* 345 F. Supp.2d 712 (W.D. Ky. 2004).

32 *Cox v. U.S.*, 97 A.F.T.R.2d (RIA) 1121 (E.D. Cal. 2006), *adopting* 97 A.F.T.R.2d (RIA) 1121 (E.D. Cal. 2006); *Jordon v. U.S.*, 97 A.F.T.R.2d (RIA) 2919 (M.D. Ala. 2006).

33 *Ip v. U.S.*, 205 F.3d 1168,1176 (9th Cir. 2000); *Holland v. U.S.*, 96 A.F.T.R.2d (RIA) 5667 (N.D. Okla. 2005); *Remedios v. Wells Fargo Bank*, 97 A.F.T.R.2d (RIA) 2468 (E.D. Cal. 2006).

34 *Dirr v. U.S.*, 97 A.F.T.R.2d (RIA) 1784 (E.D. Tenn. 2006); *O'Doherty v. U.S.*, 97 A.F.T.R.2d (RIA) 322 (N.D. Ill. 2005).

35 *Stewart v. U.S.*, 96 A.F.T.R.2d (RIA) 6877, 6879 ((D. Or. 2005), *adopting* 96 A.F.T.R.2d (RIA) 6877 (D. Or. 2005).

36 IRC § 7602(d).

37 *Huston v. U.S.*, 96 A.F.T.R.2d (RIA) 6228 (D. Del. 2005); *Travis v. Miki*, 394 F. Supp.2d 1277 (D. Haw. 2005).

- **Constitutional Arguments:** Taxpayers also raised several constitutional arguments. Some claimed summonses were too broad in violation of the Fourth Amendment's restrictions against unreasonable searches and seizures. However, courts have ruled a summons is not overly broad for constitutional purposes if it satisfies the *Powell* requirements.[38] Taxpayers also raised Fifth Amendment protections but succeeded in only one instance, where there was a substantial and real hazard of self-incrimination and the matter could have turned into a criminal investigation.[39] Although the Fifth Amendment privilege may be applicable in summons cases, it is inapplicable where the summons seeks only nontestimonial data and the requested material would not harm the taxpayer.[40] In addition, the Fifth Amendment does not protect individuals against the forced production of records of entities that happen to be in the possession of the individual.[41]
- **Privilege:** Taxpayers unsuccessfully argued privilege as a bar to disclosure of the summoned information.[42] In general, work product protection is waived when the requested documents are shared with an adverse party. Similarly, the attorney-client privilege protection is waived when the requested documents are shared with a third party.[43] The IRS prevailed where the taxpayers or their consultants asserted that the identities of taxpayers were within the attorney-client or tax practitioner privilege.[44]
- **Timeliness of Taxpayer's Petition or Notice and the Doctrine of Equitable Tolling:** Courts dismissed taxpayers' petitions to quash the summons where the taxpayer either failed to file the petition in a timely manner[45] or failed to send notice of the petition to the IRS in accordance with IRC § 7609(b)(2).[46] Courts also

[38] *U.S. v. Back to Health Chiropractic*, 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005), *adopting* 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005); *U.S. v. Hopper*, 96 A.F.T.R.2d (RIA) 6899 (E.D. N.Y. 2005); *Johnson v. U.S.*, 96 A.F.T.R.2d (RIA) 7314 (W.D. Pa. 2005); *U.S. v. Norwood*, 420 F.3d 888 (8th Cir. 2005), *aff'g* 343 F. Supp.2d 860 (D. N.D. 2004).

[39] *U.S. v. Back to Health Chiropractic*, 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005), *adopting* 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005).

[40] *U.S. v. Elliott*, 96 A.F.T.R.2d (RIA) 5503 (W.D. N.C. 2005); *U.S. v. Gippetti*, 96 A.F.T.R.2d (RIA) 6978 (3d Cir. 2005), *vacating and remanding* 94 A.F.T.R.2d (RIA) 6093 (D. N.J. 2004); *U.S. v. Hopper*, 96 A.F.T.R.2d (RIA) 6899 (E.D. N.Y. 2005); *U.S. v. Marra*, 96 A.F.T.R.2d (RIA) 6471 (D. N.J. 2005); *U.S. v. Norwood*, 420 F.3d 888 (8th Cir. 2005), *aff'g* 343 F. Supp.2d 860 (D. N.D. 2004).

[41] *Travis v. Miki*, 394 F.Supp.2d 1277 (D. Haw. 2005); *Johnson v. U.S.*, 96 A.F.T.R.2d (RIA) 7314 (W.D. Pa. 2005);.

[42] *Jordan v. U.S.*, 97 A.F.T.R.2d (RIA) 2919 (M.D. Ala. 2006); *U.S. v. Holmes*, 98 A.F.T.R.2d (RIA) 5559 (D. Ariz. 2006).

[43] *Unocal v. U.S.*, 97 A.F.T.R.2d (RIA) 522 (N.D. Cal. 2005).

[44] *U.S. v. BDO Seidman, LLP*, 337 F.3d 802 (7th Cir. 2003); *Boelter v. U.S.*, 96 A.F.T.R.2d (RIA) 5968 (W.D. Wash. 2005).

[45] *Capstick v. U.S.*, 96 A.F.T.R.2d (RIA) 5657 (W.D. Wash. 2005); *but see Investor Communications Int'l, Inc. v. U.S.*, 97 A.F.T.R.2d (RIA) 1293 (W.D. Wash. 2006); *Linstruth v. U.S.*, 97 A.F.T.R.2d (RIA) 2231 (S.D. Ohio 2005); *Schulz v. U.S.*, 97 A.F.T.R.2d (RIA) 859 (E.D. N.Y. 2005).

[46] *Justin v. U.S.*, 97 A.F.T.R.2d (RIA) 966 (W.D. N.C. 2006), *adopting* 97 A.F.T.R.2d (RIA) 966 (W.D. N.C. 2006); *Bharose v. U.S.*, 96 A.F.T.R.2d (RIA) 6779 (E.D. Cal. 2005); *Environmental Sound Solutions v. Chynoweth*, 2006 WL 1409635 (E.D. Cal. 2006); *Marks v. U.S.*, 97 A.F.T.R.2d (RIA) 433 (S.D. N.Y. 2006).

refused to apply the doctrine of equitable tolling to extend the statutory deadlines under IRC § 7609.[47]

- **Contempt of Court Charges:** In several cases, the courts recommended the taxpayers face contempt of court charges. Generally, where the government petitions for a civil contempt finding, it must establish by clear and convincing evidence that the summoned party violated the court's order. Once a prima facie showing is made to enforce the summons, the burden shifts to the summoned party to show why he or she cannot comply with the order. Unavailability of the documents will not satisfy the burden of production. The taxpayer must show that he has made in good faith all reasonable efforts to comply.[48]
- **No Protection Under Right to Financial Privacy Act:** Several taxpayers unsuccessfully claimed that enforcement of the summons would violate the Right to Financial Privacy Act.[49] However, the courts uniformly dismissed this argument. Congress expressly exempted requests for information under the Internal Revenue Code from the Act's requirements.[50]

CONCLUSION

The IRS may issue a summons to obtain information needed to determine the correctness of a return, determine if a tax return should have been filed, determine a taxpayer's tax liability, or to collect a taxpayer's liability.[51] For these purposes, the IRS may summon documentation from taxpayers who have failed to voluntarily provide that information to the IRS. It appears that as the IRS continues its aggressive enforcement policy, it will continue to heavily rely on the summons enforcement tool, and we expect the courts will continue to see increased numbers of these cases.

[47] *Capstick v. U.S.*, 96 A.F.T.R.2d (RIA) 5657 (W.D. Wash. 2005) (dicta); *Nelson v. U.S.*, 96 A.F.T.R.2d (RIA) 5633 (W.D. Wash. 2005).

[48] *U.S. v. Koehler*, 96 A.F.T.R.2d (RIA) 6528 (M.D. Fla. 2005), *adopting* 96 A.F.T.R.2d (RIA) 6129 (M.D. Fla. 2005); *U.S. v. Montgomery Global Advisors V LLC*, 96 A.F.T.R.2d (RIA) 5849 (N.D. Cal. 2005); *U.S. v. Rose*, 97 A.F.T.R.2d (RIA) 2668 (S.D. Cal. 2006).

[49] 12 U.S.C. § 3401 *et seq.*

[50] 12 U.S.C. § 3413(c). *Kernan v. IRS*, 97 A.F.T.R.2d (RIA) 1636 (D. Ariz. 2006); *Johnson v. U.S.*, 96 A.F.T.R.2d (RIA) 7314 (W.D. Pa. 2005).

[51] IRC § 7602(a).

LITIGATED ISSUE #4 ACCURACY-RELATED PENALTY UNDER INTERNAL REVENUE CODE SECTION 6662(B)(1) AND (2)

SUMMARY

Taxpayers who underpay the required amount of income tax are subject to an accuracy-related penalty if the underpayment is attributable to the taxpayers' negligence or a substantial understatement of tax.[1] While the IRS is authorized to impose other accuracy-related penalties as well, these other issues are not litigated with the same frequency as the negligence and substantial understatement penalty issues, and therefore are not addressed in this analysis.[2] During the review period for this report (June 1, 2005 through May 31, 2006), we identified 92 cases where IRC § 6662(b)(1) and (2) penalties were in dispute. The taxpayers fully prevailed in 26 of those cases, the IRS in 63, and there were three split decisions in which the court ruled partially in favor of each party on the accuracy-related penalty issue.

PRESENT LAW

The amount of the accuracy-related penalty equals 20 percent of the portion of the underpayment[3] attributable to negligence or the substantial understatement of income tax.[4] The IRS can assert more than one of the accuracy-related penalties if applicable; however, the total penalty amount generally cannot exceed 20 percent of the underpayment of tax.[5] The standards for whether taxpayers have been negligent and whether taxpayers have substantially understated their income tax liabilities are very different, but both components of the accuracy-related penalty provide that taxpayers can avoid penalties if they can show there was reasonable cause for the underpayment.

Negligence

The penalty under IRC § 6662(b)(1) is imposed if the taxpayer's underpayment is occasioned by taxpayer's negligence or disregard of the rules or regulations. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax law, including any failure by the taxpayer to keep adequate books and records or to substantiate items that gave rise to the underpayment.[6] Negligence is strongly indicated where a taxpayer fails to include on a tax return income that was reflected on an information return, or where the taxpayer fails to make a reasonable attempt to ascertain

[1] IRC § 6662(b)(1) applies to negligence and IRC § 6662(b)(2) applies to substantial understatements.

[2] IRC § 6662(b)(3) imposes a penalty for substantial valuation misstatement for income taxes; IRC § 6662(b)(4) imposes a penalty for substantial overstatement of pension liabilities; and IRC § 6662(b)(5) imposes a penalty for substantial estate or gift tax valuation understatements.

[3] For IRC § 6662(b) to apply, there must be an underpayment of tax. *See Coburn v. Comm'r*, T.C. Memo. 2005-283 (court found in taxpayer's favor on the issue of whether there was a deficiency in tax, and, therefore, there was no underpayment of tax on which a penalty could be imposed).

[4] IRC § 6662(a).

[5] Treas. Reg. § 1.6662-2(c). The penalty is increased to 40 percent if any portion of the underpayment is due to a gross valuation misstatement. *See* IRC § 6662(h)(1).

[6] Treas. Reg. § 1.6662-3(b)(1).

the correctness of a deduction, credit, or exclusion on a return.[7] The IRS considers various other factors in its determination as to whether negligence was causally related to the underpayment of tax.[8]

Substantial Understatement

In general, an "understatement" is the difference between (1) the correct amount of tax, and (2) the amount of tax which the taxpayer reported on the return reduced by any rebate.[9] The understatement of tax is substantial if it exceeds the greater of $5,000 or ten percent of the tax required to be shown on the return.[10]

Reasonable Cause

The IRC § 6662(a) penalty is not imposed with respect to any portion of the underpayment as to which the taxpayer acted with reasonable cause and in good faith.[11] Thus, while the IRS may propose assessment of the accuracy-related penalty, a taxpayer may be able to demonstrate to the IRS or to a court that the taxpayer had reasonable cause for the underpayment. The decision as to whether a taxpayer acted with reasonable cause and in good faith is made by taking into account all of the pertinent facts and circumstances.[12] Generally, the most important factor is the extent of the taxpayer's effort to determine the proper tax liability.[13] Reliance upon the advice or opinion of a tax professional can constitute reasonable cause if: (1) the adviser is a competent professional who has sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment.[14]

Penalty Assessment and Litigation Process

The accuracy-related penalty is generally proposed as part of the IRS examination process.[15] With the exception of penalties automatically calculated through electronic means, the IRS may not assess a penalty unless managerial approval is made in writing

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7 Treas. Reg. § 1.6662-3(b)(1)(i), (ii).

8 These factors include the taxpayer's history of non-compliance, failure to maintain adequate books and records, actions taken by the taxpayer to ensure the tax as reported was correct and underreported income coupled with an inadequate explanation by the taxpayer. IRM 4.10.6.2.1.

9 IRC § 6662(d)(2)(A).

10 IRC § 6662(d)(1)(A)(i), (ii). There is a special rule for corporations (other than S corporations or personal holding companies) such that an understatement is substantial if it exceeds the lesser of 10 percent of the tax required to be shown on the return or $10,000,000. IRC § 6662(d)(1)(B)(i), (ii).

11 IRC § 6664(c)(1).

12 Treas. Reg. § 1.6664-4(b)(1).

13 *Id.*

14 *Neonatology Associates, P.A. v. Comm'r*, 115 T.C. 43, 99 (2000) (citations omitted).

15 IRM 20.1.5.3.

before the initial determination is made to assess the penalty.[16] Once it determines that the accuracy-related penalty is appropriate, the IRS must follow the same deficiency procedures (*i.e.*, §§ 6211-6213) it follows with other proposed adjustments in the examination process.[17] Deficiency procedures require the IRS to send a notice of deficiency with the proposed adjustments informing the taxpayer of the right to protest the deficiency in the U.S. Tax Court by timely filing a petition.[18] Before a taxpayer receives a notice of deficiency, a taxpayer may have other opportunities to engage the IRS on the merits of the penalty.[19] There are also two other avenues through which taxpayers can litigate the accuracy-related penalty: refund litigation,[20] and in Collection Due Process hearings under certain circumstances.[21]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production as to the accuracy-related penalty, which means the IRS must come forward with evidence to demonstrate that imposition of the penalty is warranted.[22] The taxpayer bears the burden of proof as to any exception to the accuracy-related penalty, such as reasonable cause.[23]

ANALYSIS OF LITIGATED CASES

In prior reports, we have analyzed only the negligence penalty cases under IRC § 6662(b)(1) and have not included the substantial understatement penalty cases under IRC § 6662(b)(2), generally due to the higher number of negligence cases.[24] However,

[16] IRC § 6751(b). However, when a taxpayer responds to the proposed assessment of the accuracy-related penalty, the IRS must consider whether the penalty is appropriate. IRM 20.1.5.1.3(4).

[17] IRC § 6665(a)(1).

[18] IRC § 6213(a).

[19] For example, when the IRS proposes to adjust a taxpayer's liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice ("30 day letter") of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to the return during which time the taxpayer can raise issues related to the deficiency including the reasonable cause exception. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency to the taxpayer. IRM 4.31.6.2.5.

[20] Taxpayers may also litigate the accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346; IRC § 7422(a); *Flora v. U.S.*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a precondition to district court jurisdiction for refund litigation).

[21] IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer can raise a variety of issues including the underlying liability, provided the taxpayer did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC § 6330(c)(2).

[22] IRC § 7491(c) provides that "the Secretary shall have the initial burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title."

[23] *Id.*

[24] *See* Table 4 in Appendix 3 for a listing of IRC § 6662(b)(1) and (2) cases. Of the 92 cases listed in the table, there were 45 in which the courts addressed the negligence penalty alone and 36 cases addressing the substantial understatement penalty alone. In six cases, multiple accuracy-related penalties were at issue, and in five cases it was not possible to determine which of the accuracy-related penalties were at issue.

the IRS can assert either or both penalties for the same underpayment of tax, provided the total penalty does not exceed 20 percent of the underpayment.[25] Further, the IRC § 6662(b)(1) and (b)(2) penalties are frequently litigated in the same cases. Courts do not always specify the particular accuracy-related penalty being sustained, and will in some cases rule that the accuracy-related penalty either applies or does not apply, without specifying under which subsection. Therefore, in this report, we will report on both IRC § 6662(b)(1) and IRC § 6662(b)(2) cases together.

Issues Litigated

In 20 of the 92 cases, taxpayers presented no evidence of reasonable cause or other defenses to the IRS's imposition of the accuracy-related penalty for negligence and substantial understatement of income tax. In the majority of cases, however, taxpayers either argued that the underlying income was not taxable and therefore the penalty was inapplicable, or they presented evidence in support of their claims that the IRS should abate the penalty based on reasonable cause.

Underlying Liability

The accuracy-related penalty cases often involved the issue of whether the income that gave rise to the underpayment penalty was taxable. For example, in five cases, the income at issue was cancellation of indebtedness (COD) income.[26] While the courts did not always agree with the taxpayer about whether the taxpayer had COD income, the courts did agree in each case that the taxpayer was not liable for the accuracy-related penalty.[27] In four of the cases, the U.S. Tax Court held that the IRS failed to prove the elements necessary to hold the taxpayers liable for COD income, and in one case, the Tax Court held there was reasonable cause for the taxpayer to believe the income was not taxable, and, therefore, the penalty was abated.

Taxpayer's Subjective Belief as Reasonable Cause

The most important factor in determining whether a taxpayer has demonstrated reasonable cause is the extent to which the taxpayer attempted to determine his or her correct tax.[28] An honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge, and education of the taxpayer may indicate reasonable cause

[25] Treas. Reg. § 1.6662-2(c).

[26] IRC § 61(a)(12) provides that gross income includes cancellation of indebtedness income. To the extent that a taxpayer has been released from indebtedness, the taxpayer has realized an accession to income that is taxable because the cancellation of indebtedness effects a freeing of assets previously offset by the liability arising from such indebtedness. *U.S. v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931). There are various exclusions from gross income for COD income, including the circumstance where the taxpayer is insolvent at the time the debt was forgiven. IRC § 108(a)(1)(B).

[27] *See, e.g., Coburn v. Comm'r*, T.C. Memo. 2005-283 (holding that loan was non-recourse to the taxpayer and therefore, income could not be COD income); *Tabrezi v. Comm'r*, T.C. Memo. 2006-61 (holding IRS could not demonstrate that taxpayer was solvent prior to the debt cancellation).

[28] Treas. Reg. § 1.6664-4(b)(1).

and good faith or the lack thereof.[29] Thus, an attorney's claim of honest belief about the tax-free nature of retirement distributions was not deemed to be reasonable cause because of his educational background and level of sophistication.[30] In contrast, when a taxpayer makes concerted efforts to determine whether he should have received Forms 1099, U.S. Information Return, for owning education accounts, including contacting the bank where the accounts were established, consulting a financial adviser, and contacting his former spouse, the totality of the circumstances led the Tax Court to conclude the taxpayer had reasonable cause and had acted in good faith.[31]

In four cases, the accuracy-related penalty was litigated in conjunction with the issue of whether settlement proceeds were taxable and whether there was reasonable cause for taxpayers to believe that the proceeds were not taxable. Settlement proceeds received for a tort-type injury that compensate for physical injury or illness are not taxable.[32] Where the evidence demonstrated that the taxpayer had made a reasonable effort to determine the correct amount of tax liability, the Tax Court found reasonable cause.[33] However, where there appeared to be an attempt to manipulate a settlement agreement for tax purposes, courts were unwilling to find reasonable cause.[34]

Thus, the cases demonstrate that where taxpayers make a reasonable effort to ascertain the correct amount of tax, courts are willing to find reasonable cause. However, where taxpayers engage in manipulation, fail to investigate the tax consequences of their income, or ignore important facts, courts decline to conclude reasonable cause exists.

Reliance on Advice of Tax Professional as Reasonable Cause

In 25 cases, taxpayers asserted reliance upon a tax professional as a basis to avoid the accuracy-related penalty; however, only eight taxpayers could meet the necessary burden

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[29] Treas. Reg. § 1.6664-4(b)(1).

[30] *Sadberry v. Comm'r*, 96 A.F.T.R.2d (RIA) 7119 (5th Cir. 2005).

[31] *Monte v. Comm'r*, T.C. Summ. Op. 2005-77.

[32] Two independent requirements must be met before proceeds from a settlement may be excluded under section 104(a)(2). First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is based upon tort or tort type rights. *Comm'r v. Schleier*, 515 U.S. 323, 337 (1995); *see* Treas. Reg. § 1.104-1(c). Second, the taxpayer must show that the damages were received on account of personal physical injuries or physical sickness. *Schleier*, 515 U.S. at 337; *see* IRC § 104(a)(2). *See* Most Litigated Issue, *Gross Income,* supra.

[33] *Kenton v. Comm'r*, T.C. Memo. 2006-13 (holding that taxpayer made reasonable inquiry into the applicable law when excluding contingent legal fees from gross income, as the Supreme Court had only recently concluded that legal fees incurred by taxpayers under contingent fee agreements could not be excluded from gross income).

[34] *Goode v. Comm'r*, T.C. Memo. 2006-48 (holding that reliance on allocation in settlement agreement was not in good faith where allocation of damages to physical injury was suspect); *Tamberella v. Comm'r*, 96 A.F.T.R.2d (RIA) 5311 (2d Cir. 2005) (where taxpayer ignored allocations to non-physical damages in settlement agreement and failed to demonstrate that mental illness contributed to failure to report the income); *Green v. Comm'r*, T.C. Memo. 2005-250 (where taxpayer knew he had received taxable punitive damages but did not report the income).

of proof.[35] Courts ruling against taxpayers in these cases did so for a variety of reasons, including:

- Reliance on the tax adviser was unreasonable in light of taxpayer's prior knowledge that the adviser had previously been convicted of tax fraud;[36]
- Reliance on adviser could not be a defense to a negligence penalty where the negligence was the taxpayer's failure to substantiate his deductions;[37]
- Reliance on tax shelter promoters and tax advisers referred by promoters is not reasonable because their advice is biased;[38] and
- Reliance is unreasonable where the adviser is not provided all necessary documentation.[39]

Reliance on Other Factors as Reasonable Cause

Taxpayers also argued with varying degrees of success that there was reasonable cause to excuse their underpayment of tax based upon reliance on other factors. For example, relying on a Treasury Regulation that conflicts with the statute is not reasonable cause for omitting income where the taxpayer was placed on notice by his employer and the IRS as to the taxable nature of income.[40] On the other hand, reliance on IRS determinations on charitable deductions from audits in previous tax years was reasonable for purposes of abating the accuracy-related penalty.[41] Similarly, when the IRS did not disallow deductions for expenses related to lemon farming in an earlier audit, the Tax Court concluded the taxpayer's reliance on the tax treatment in that earlier audit was reasonable cause for deducting the same expenses in a subsequent year, and the penalty was abated.[42]

Taxpayers also argued that the absence of certain information can constitute reasonable cause and were met with limited success. For example, a taxpayer may not rely on the absence of substantiating documentation in support of a reasonable cause finding.[43] Additionally, taxpayers cannot rely on the absence of Forms 1099 to establish reasonable

[35] *See, e.g., Facq v. Comm'r*, T.C. Memo. 2006-111 (reliance on tax professional was reasonable cause for taxpayer's improper exclusion of gain); *Teymourian v. Comm'r*, T.C. Memo. 2005-232 (reliance on tax professional was reasonable cause for the incorrect tax treatment of constructive dividends and rental income).

[36] *Egan v. Comm'r*, T.C. Memo. 2005-234.

[37] *Lee v. Comm'r*, T.C. Memo. 2006-70.

[38] *Van Scoten v. Comm'r*, 439 F.3d 1243 (10th Cir. 2006); *Mortensen v. Comm'r*, 440 F.3d 375 (6th Cir. 2006).

[39] *King v. Comm'r*, T.C. Memo. 2006-112; *Jackson v. Comm'r*, T.C. Memo. 2005-159.

[40] *Smith v. Comm'r*, T.C. Memo. 2006-51 (taxpayer had no reasonable basis for omitting income by relying on Treas. Reg. § 1.931-1 (which erroneously included Johnston Island as a territory from which income earned is not taxable) when IRC § 931 provided otherwise and the IRS and taxpayer's employer notified taxpayer that the income was taxable).

[41] *Sklar v. Comm'r*, 125 T.C. 281 (2005), *appeal docketed*, No. 06-72961 (9th Cir. June 8, 2006).

[42] *Bangs v. Comm'r*, T.C. Memo. 2006-83.

[43] *Maxfield v. Comm'r*, T.C. Summ. Op. 2006-27; *Kolbeck v. Comm'r*, T.C. Memo. 2005-253.

cause for failing to report income.[44] A taxpayer was, however, able to provide oral testimony rather than books and records to substantiate deductions.[45]

Pro Se Analysis

Taxpayers were *pro se*, or representing themselves, in 51 (or 55 percent) of the cases. These taxpayers fully prevailed in 12 cases and received partial relief in one other. Thus, of the 29 cases in which taxpayers prevailed in full or in part, taxpayers were unrepresented in almost half of the cases.

CONCLUSION

The accuracy-related penalty cases demonstrate that courts are willing to find reasonable cause where taxpayers make a reasonable attempt to determine the correct amount of tax. In finding reasonable cause, courts assessed the effort of taxpayers and their sophistication, as well as the complexity of the legal issues. Where taxpayers knew or should have known facts that would have led to a determination that the income was taxable, courts did not find reasonable cause to abate the accuracy-related penalty.

[44] *PK Ventures, Inc. v. Comm'r*, T.C. Memo. 2006-36; *Snyder v. Comm'r*, T.C. Memo. 2006-92.

[45] *Allemeier v. Comm'r*, T.C. Memo. 2005-207.

LITIGATED ISSUE #5 FAILURE TO FILE PENALTY UNDER INTERNAL REVENUE CODE SECTION 6651(A)(1) AND ESTIMATED TAX PENALTY UNDER INTERNAL REVENUE CODE SECTION 6654

SUMMARY

We reviewed 78 decisions regarding the addition to tax under IRC § 6651(a)(1) for failure to file a timely tax return or the addition to tax under IRC § 6654 for failure to pay estimated income tax that were issued by the federal court system from June 1, 2005, to May 31, 2006, the period which this report covers.[1] The phrase "addition to tax" is commonly referred to as a penalty. We will refer to these two additions to tax as the failure to file penalty and the estimated tax penalty. The IRS prevailed in all but two cases;[2] one other case resulted in a split decision.[3] Of the 78 cases, 43 involved the estimated tax penalty being imposed in conjunction with the failure to file penalty, while only one involved the estimated tax penalty without the failure to file penalty being imposed.

The failure to file penalty is mandatory unless the taxpayer can demonstrate that the failure to timely file a tax return is a result of reasonable cause and not due to willful neglect.[4] The penalty for failure to pay estimated taxes is also mandatory unless the taxpayer can meet one of the exceptions listed in the statute.[5] In the cases analyzed, it was very difficult for the taxpayer to avoid the failure to file penalty based on reasonable cause or the estimated tax penalty based on any of the statutory exceptions.

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer who fails to file a tax return before its due date (including extensions) will be subject to a five percent penalty for each month or partial month the return is late.[6] This penalty generally accumulates for each month the return is not filed up to a maximum of 25 percent.[7] The penalty is based on the amount of tax due, minus any credit the taxpayer is entitled to receive or payment made by the due date.[8] The failure to file penalty applies to income, estate, gift, and certain excise tax returns.[9] IRC § 6698 provides for a penalty for failure to file partnership returns, which is based on different criteria but also carries a reasonable cause component.[10]

1 IRC § 6651(a)(2) and (a)(3) also impose additions to tax for failure to pay taxes; however, only a small number of cases involved these penalties, and therefore, we have not included them in our analysis.

2 *Doudney v. Comm'r*, T.C. Memo. 2005-267; *McManus v. Comm'r*, T.C. Memo. 2006-57.

3 *Leggett v. Comm'r*, T.C. Memo. 2005-185.

4 IRC § 6651(a)(1).

5 IRC § 6654(e).

6 IRC § 6651(a)(1).

7 *Id.* The penalty is increased to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. IRC § 6651(f).

8 IRC § 6651(b).

9 IRC § 6651(a)(1).

10 IRC § 6698.

IRC § 6654 imposes a penalty for failure to pay estimated income tax where prepayments of tax, either through withholding or by making estimated quarterly tax payments during the course of a year, do not equal the percentage of total liability required. In general, the amount required to be paid through each such estimated quarterly payment is 25 percent of the "required annual payment," where the "required annual payment" is the lesser of 90 percent of the tax shown on the return for that year or 100 percent of the tax shown on the return of the individual for the preceding taxable year.[11] The amount of the penalty will be determined by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the period of the underpayment.[12] The penalty for failure to pay estimated tax applies to income tax returns of individuals and certain estates and trusts.[13]

The IRS has the burden of production in any court proceeding with respect to the liability of any individual for the IRC § 6651(a) penalty and the IRC § 6654(a) penalty.[14] The IRS must produce sufficient evidence indicating that it is appropriate to impose the relevant penalty.[15] It is very unusual for the IRS not to meet this burden. Once the IRS does so, the taxpayer must come forward with evidence sufficient to persuade a court that the IRS's determination is incorrect.[16]

The taxpayer also bears the burden of proof with regard to issues of reasonable cause.[17] To prove reasonable cause and avoid the IRC § 6651 penalty, a taxpayer must show that he or she exercised ordinary business care and prudence, but was still unable to file by the due date.[18] As discussed in greater detail below, however, there is only a limited reasonable cause exception to the IRC § 6654 penalty; generally the imposition of the IRC § 6654 penalty is mandatory where the estimated payments do not equal the statutorily required percentage.

ANALYSIS OF LITIGATED CASES

We analyzed 78 opinions issued between June 1, 2005, and May 31, 2006, where the failure to file penalty or the estimated tax penalty was in dispute. All but seven of these cases were litigated in the United States Tax Court. A detailed listing of these cases

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11 IRC § 6654(d).

12 IRC § 6654(a)(1) – (3).

13 IRC §§ 6654(a); 6654(l).

14 IRC § 7491(c). An exception to this rule alleviates the IRS from this initial burden where the taxpayer's petition fails to state a claim for relief from the penalty, such as where the taxpayer only makes frivolous arguments. *Funk v. Comm'r*, 123 T.C. 213 (2004).

15 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001).

16 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) at 447.

17 *Id.*

18 Treas. Reg. § 301.6651-1(c)(1).

appears in Table 5 in Appendix 3.[19] Taxpayers were represented by attorneys in only 16 cases. Of the 62 cases in which taxpayers appeared *pro se*, only one case was resolved in the taxpayer's favor and one other case resulted in a split decision. Thus, taxpayers were unrepresented in the vast majority of cases decided in the IRS's favor.

Failure to File Penalty

A common basis for the courts ruling against taxpayers in the cases we analyzed was the lack of any evidence offered to show that the failure to file was due to reasonable cause.[20] In fact, in more than 50 percent of the cases, the taxpayer did not present any evidence of reasonable cause.

In cases where taxpayers did present evidence of reasonable cause in defense of their failures to file timely (or at all), the arguments included the following:

- **Medical Illness:** Depending on the facts and circumstances, a medical illness may establish reasonable cause for failing to file a tax return timely.[21] However, medical illness did not establish reasonable cause when the illness did not prevent the taxpayer from functioning in other aspects of life, such as work.[22] Similarly, health issues of one spouse did not constitute reasonable cause for the late filing of a joint return when those health issues did not prevent the other spouse from tending to the return.[23]
- **Unavailability of Records:** Generally, the unavailability of records does not constitute reasonable cause.[24] However, taxpayers who use ordinary business care and prudence to obtain the records may be able to demonstrate reasonable cause for not timely filing.[25] When taxpayers (husband and wife) raised the unavailability of records due to a subpoena issued for their bankruptcy proceeding as a basis for determining reasonable cause, the Tax Court rejected this argument, noting that although the records were unavailable, taxpayers should have made an attempt to file a return reporting income and expenses as accurately as they could.[26]

[19] Sixty-nine cases involved individual taxpayers, and nine involved businesses (including individuals engaged in self-employment or partnerships).

[20] *Barrett v. Comm'r*, T.C. Summ. Op. 2006-42; *Ferguson v. Comm'r*, T.C. Memo. 2006-32; *Howard v. Comm'r*, T.C. Memo. 2005-144.

[21] *Harbour v. Comm'r*, T.C. Memo. 1991-532. In *Harbour*, the taxpayer was in a coma during the month before his tax return was due. Clearly, he was not able to work during this time or participate in any other life activities. Therefore, the Tax Court determined this medical condition was a reasonable cause for failure to timely file his tax return.

[22] *Gropper v. U.S.*, 96 A.F.T.R.2d (RIA) 7133 (E.D. Pa. 2005); *Jordan v. Comm'r*, T.C. Memo. 2005-266.

[23] *Lites v. Comm'r*, T.C. Memo. 2005-206.

[24] *Crocker v. Comm'r*, 92 T.C. 899, 913 (1989) (citation omitted).

[25] *Haley v. Comm'r*, T.C. Memo. 1977-348.

[26] *Ferguson v. Comm'r*, T.C. Memo. 2006-32.

- **Reliance on Tax Professional:** Some taxpayers argued that reliance upon a professional to timely file the return was a defense to the failure to file penalty.[27] However, the Supreme Court has made clear in *United States v. Boyle* that taxpayers have a non-delegable duty to file a return on time, and the taxpayer's reliance on an agent does not excuse the failure.[28]
- **Reliance on Spouse or Other Agent:** The *Boyle* rule against reliance on third parties to file tax returns also applies to reliance on family members. A taxpayer was unable to rely on her spouse to file a return.[29] Similarly, reliance on the advice of others regarding the obligation to file or the date for filing did not constitute reasonable cause.[30]
- **"Zero Return" Filers/Returns Filed Under Protest, Disclaiming Liability:** Under the longstanding decision in *Beard v. Commissioner*, a return must be signed under penalties of perjury, purport to be a return, and represent an honest and reasonable attempt to satisfy the requirements of the tax laws.[31] Some taxpayers protested their obligation to pay taxes by filing tax returns with zeroes on every line of the tax return.[32] These taxpayers argued unsuccessfully that because they filed a tax return, they should not be assessed a failure to file penalty; a "zero return" does not, however, constitute a tax return for purposes of IRC § 6651.

  Similarly, where a taxpayer attached a cover page to each of his returns indicating he was filing the returns under protest and also wrote "under protest" in the jurat / signature box on the return, the Tax Court held that such returns did not satisfy the test for a valid return enunciated in *Beard*.[33]

The one constant theme throughout these different types of cases is that the existence of reasonable cause in any given case depends on all the facts and circumstances of the case.[34] Moreover, to the extent that the Tax Court finds that a taxpayer's argument for

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27 *Thibodeaux v. Comm'r*, T.C. Summ. Op. 2005-105.

28 *United States v. Boyle*, 469 U.S. 241, 252 (1985) ("It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under § 6651(a)(1).").

29 *Bennett v. Comm'r*, T.C. Summ. Op. 2005-84.

30 *Martella v. Comm'r*, T.C. Memo. 2005-216 (taxpayer relied on advice available on the internet from unofficial non-governmental third parties regarding the obligation to file); *Welch v. U.S.*, 97 A.F.T.R.2d (RIA) 2453 (D.N.J. 2006) (taxpayer relied on oral advice of IRS employee regarding extended due date).

31 *Beard v. Commissioner*, 82 T.C. 766, 777 (1986) (citation omitted), *aff'd*, 793 f.2d 139 (6th Cir. 1986).

32 *Bonaccorso v. Comm'r*, T.C. Memo. 2005-278; *Coulton v. Comm'r*, T.C. Memo. 2005-199.

33 *Lange v. Commissioner*, T.C. Memo. 2005-200; *Lange v. Commissioner*, T.C. Memo. 2005-176.

34 IRM 20.1.1.3.1(1).

reasonable cause is frivolous or groundless, the Tax Court may require a taxpayer to pay a penalty under IRC § 6673 of up to $25,000.[35]

Failure to Pay Estimated Tax

When the estimated tax penalty under IRC § 6654(a) is imposed, it is almost always imposed in conjunction with IRC § 6651(a)(1). In fact, in 43 of the 78 cases we reviewed, The IRC § 6654(a) penalty was imposed in conjunction with the IRC § 6651(a)(1) penalty. Although these two code sections are often applied in conjunction with one another, the analysis under IRC § 6654(a) is different than the analysis under IRC § 6651(a)(1). One of the most significant differences is IRC § 6654(a) does not provide for a broadly applicable reasonable cause exception. To avoid the estimated tax penalty, the taxpayer has the burden of proving one of the following exceptions:

- The tax is a small amount;[36]
- There is no tax liability for the preceding year;[37]
- The Secretary determines that by reason of casualty, disaster, or other unusual circumstances the imposition of the penalty would be against equity and good conscience;[38] or
- The taxpayer retired after reaching the age of 62 or became disabled in the taxable year for which estimated payments were required to be made or in the taxable year preceding such year and the underpayment was due to reasonable cause and not willful neglect.[39]

The first three exceptions are fairly straightforward, but the last exception depends more on the facts and circumstances of the case. It is often as difficult for taxpayers to meet the retired or disabled reasonable cause exception as it is for them to meet the broader reasonable cause exception under IRC § 6651. For example, a taxpayer who was disabled because of a detached retina did not have reasonable cause for failing to timely make estimated tax payments, and therefore, was liable for the addition to tax for failure to pay estimated tax.[40] Again, the existence of reasonable cause depends on the specific facts and circumstances of each particular case.

In the only two cases where the taxpayers prevailed on the estimated tax penalty, the taxpayers' success was as a result of the IRS failing to meet its burden of production

35 *Holmes v. Commissioner*, T.C. Memo. 2006-80 (taxpayer subject to $2,000 penalty for frivolous argument that filing returns is voluntary); *Wheeler v. Commissioner*, T.C. Memo. 2006-109 (taxpayer subject to $3,000 penalty for frivolous arguments that he had no obligation to file).

36 IRC § 6654(e)(1).

37 IRC § 6654(e)(2).

38 IRC § 6654(e)(3)(A).

39 IRC § 6654(e)(3)(B).

40 *Cooksey v. Comm'r*, T.C. Summ. Op. 2006-84.

regarding the appropriateness of the penalty.[41] In order for the IRS to meet the burden of production, it must produce sufficient evidence indicating that it is appropriate to impose the relevant penalty.[42] In the context of the estimated tax penalty, the IRS must show that the taxpayer did not make estimated tax payments for that tax year. These two cases are noteworthy because it is very unusual for the IRS not to meet the burden of production.

CONCLUSION

The United States tax system relies on taxpayers' willingness to voluntarily and accurately report their income, file returns, and pay taxes. Penalties encourage this type of compliance and deter noncompliance, while also attempting to establish fairness in the system by imposing an additional cost on the noncompliant taxpayer. The penalties for failure to file and failure to pay estimated tax were designed to encourage compliance and make it clear that noncompliance would not be tolerated.[43] Further, both penalties seek to establish fairness by penalizing those taxpayers who do not comply with the filing deadline and tax payment responsibilities.

In regards to the failure to file penalty, the IRS should determine whether this penalty positively influences compliance as intended. Congress should again consider the National Taxpayer Advocate's recommendation of a one-time abatement of the penalty for taxpayers who comply with their filing obligations, but in an untimely manner.[44] This proposal would both broaden the definition of reasonable cause, providing the IRS the authority to abate a late filing penalty for inadvertent taxpayer mistakes, while still encouraging the IRS's goal of voluntary compliance.

41 *Leggett v. Comm'r*, T.C. Memo. 2005-185; *McManus v. Comm'r*, T.C. Memo. 2006-57.

42 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001).

43 *See* Policy Statement P-1-18 dated April 27, 1992, IRM 1.2.1.2.3.

44 National Taxpayer Advocate 2001 Annual Report To Congress 188. This provision was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. *See* H.R. 1528, 108th Cong. § 106 (2003).

LITIGATED ISSUE #6 FRIVOLOUS ISSUES PENALTY UNDER INTERNAL REVENUE CODE SECTION 6673 AND RELATED APPELLATE-LEVEL SANCTIONS

SUMMARY

During the 12 months between June 1, 2005, and May 31, 2006, the federal court system issued decisions in at least 73 cases involving the IRC § 6673 penalty and at least 25 cases involving an analogous penalty at the appellate level.[1] These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, or unreasonably failing to pursue administrative remedies.[2] In 24 of the 73 cases involving IRC § 6673, the U.S. Tax Court decided not to impose the penalty but warned taxpayers that sanctions may be imposed in the future if they engaged in similar conduct.[3] Nonetheless, we included these cases in our analysis to help illustrate what conduct will and will not be tolerated by the courts.

PRESENT LAW

The Tax Court is authorized to impose a penalty against a taxpayer if the taxpayer institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.[4] The maximum penalty is $25,000.[5] In some cases, the IRS requests that the Tax Court impose the penalty; in other cases, the court may exercise its discretion, *sua sponte*,[6] to impose the penalty.

Taxpayers who institute an action pursuant to IRC § 7433[7] in a United States district court for damages against the United States could be subject to a maximum penalty of $10,000 if the court determines that the taxpayer‘s position in the proceedings is frivolous or groundless.[8]

[1] In 11 cases, the U.S. Court of Appeals both affirmed the imposition of the IRC § 6673 penalty by the U.S. Tax Court and imposed an additional sanction against the taxpayer for filing a frivolous appeal. Thus, the total number of cases we have identified involving frivolous claims is 87.

[2] The Tax Court generally imposes the penalty under IRC § 6673(a)(1). U.S. Courts of Appeals generally impose sanctions under IRC § 7482(c)(4), 28 U.S.C. § 1927, or Rule 38 of the Federal Rules of Appellate Procedure, although some appellate-level penalties may be imposed under other authorities.

[3] *See, e.g., Balice v. Comm'r*, T.C. Memo. 2005-161.

[4] IRC § 6673(a)(1)(A), (B), (C).

[5] IRC § 6673(a)(1).

[6] "Sua sponte" is a term that means without prompting or suggestion. Thus, for conduct that the Tax Court finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested that the penalty be imposed. *See, e.g., Call v. Comm'r*, T.C. Memo. 2005-289 (Tax Court imposed $5,000 penalty without being asked to do so where taxpayer presented frivolous arguments to delay collection proceedings).

[7] IRC § 7433(a) allows taxpayers a cause of action against the IRS, as follows:

> If, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the Internal Revenue Service recklessly or intentionally, or by reason of negligence, disregards any provision of this title, or any regulation promulgated under this title, such taxpayer may bring a civil action for damages against the United States in a district court of the United States. Except as provided in section 7432, such civil action shall be the exclusive remedy for recovering damages resulting from such actions.

[8] IRC § 6673(b)(1).

In addition, IRC § 7482(c)(4),[9] § 1927 of Title 28 of the U.S. Code,[10] and Rule 38 of the Federal Rules of Appellate Procedure[11] (among other laws and rules of procedure) authorize Federal courts to impose penalties against taxpayers for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in non-tax cases, this report focuses primarily on the IRC § 6673 penalty. However, the table of cases presented in Table 6 of Appendix 3 lists 25 cases we identified in which U.S. Courts of Appeals considered the imposition of appellate-level sanctions under other authorities. It imposed such sanctions in 22 of those cases.

ANALYSIS OF LITIGATED CASES

We analyzed 73 opinions issued between June 1, 2005 and May 31, 2006, where the IRC § 6673 penalty was addressed. Fifty-five of these opinions were issued by the Tax Court, one was issued by a U.S. District Court, and 17 were issued by U.S. Courts of Appeals on appeals brought by taxpayers who sought review of the Tax Court's imposition of the penalty. Notably, the Courts of Appeals sustained the Tax Court's imposition of the penalty in each of the 17 cases it decided. A detailed listing of all cases is presented in Table 6 of Appendix 3. We identified only 8 cases that unambiguously involved business taxpayers (which includes a taxpayer filing a Form 1040 with a Schedule C, E, or F), and the status of a taxpayer as either an individual filer or a business filer was unclear in at least 12 other cases. With the exception of one unusual case,[12] no taxpayer was represented by an attorney; thus, all taxpayers except in that case appeared *pro se*. In the 42 cases where either the IRS sought the imposition of the IRC § 6673 penalty or the Tax Court imposed it *sua sponte*, the taxpayer prevailed in only 10 cases. Therefore, taxpayers were unrepresented in virtually all IRC § 6673 penalty cases, and the IRS was successful in obtaining the penalty about 75 percent of the time.

The taxpayers in these cases presented a wide variety of arguments that generally have been rejected by the courts on numerous occasions. In summarizing the nature of frivolous taxpayer claims, one U.S. Court of Appeals has observed:

> Some people believe with great fervor preposterous things that just happen to coincide with their self-interest. 'Tax protesters' have convinced them-

[9] IRC § 7482(c)(4) provides that the United States Courts of Appeals and the United States Supreme Court have the authority to impose a penalty in any case where the Tax Court's decision is affirmed if the appeal was instituted or maintained primarily for delay or the taxpayer's position in the appeal was frivolous or groundless.

[10] 28 U.S.C.§ 1927 authorizes federal courts to sanction an attorney or any other person admitted to practice before any court of the United States or any Territory thereof for unreasonably and vexatiously multiplying proceedings.

[11] Federal Rule of Appellate Procedure 38 provides that if a United States Court of Appeals determines an appeal is frivolous, the court may award damages and single or double costs of the appellee.

[12] *Dixon v. Comm'r*, T.C. Memo. 2006-67, *appeal docketed*, No. 06-74649 (9th Cir. Sept. 26, 2006).

> selves that wages are not income, that only gold is money, that the Sixteenth Amendment is unconstitutional, and so on.[13]

Among the cases we reviewed, taxpayers raised the following arguments that the Tax Court has deemed frivolous and groundless and consequently were subject to a penalty under IRC § 6673(a)(1) (or, in some cases, were warned that such arguments were frivolous and could lead to a penalty in the future if the same frivolous positions were maintained):

- **The income tax is unconstitutional:** Constitutional objections to the income tax are varied. In *Lewis v. Commissioner*, the taxpayer argued that the assessment of tax violates "most basic 'DUE PROCESS' protections as provided by [the] 4th, 5th, 6th and 7th Amendments."[14] In *Taylor v. Commissioner*, the taxpayer argued that requiring individuals to file and sign tax returns violates the 5th Amendment protection against self-incrimination.[15] In *Stallard v. Commissioner*, the taxpayer argued that the income tax constitutes a "taking of property without due process of law, in violation of the 5th Amendment."[16] In *Forrest v. Commissioner*, the taxpayer challenged the validity of the 16th Amendment, which authorizes a direct tax on income.[17]
- **No statute imposes liability for tax:** The majority of taxpayers in the cases we reviewed did not dispute the constitutionality of the income tax. Several argued simply that no law authorizes the imposition of income tax.[18]
- **IRS forms do not display a valid OMB control number:** One taxpayer argued that he was not required to file tax returns because IRS forms do not display a valid control number issued by the Office of Management and Budget, in violation of the Paperwork Reduction Act of 1980.[19] Similarly, the Tax Court rejected an argument that a notice of deficiency was invalid without an OMB control number.[20]
- **The payment of tax is voluntary:** This argument, presumably a corollary to the argument that the payment of tax is not required by law, was made in several cases.[21]
- **Texas residents are not subject to the income tax:** Taxpayers who reside in Texas have advanced several arguments in opposition to the assessment or collection of

[13] *Coleman v. Comm'r*, 791 F.2d 68, 69 (7th Cir. 1986).

[14] T.C. Memo. 2006-73.

[15] T.C. Memo. 2006-67.

[16] T.C. Memo. 2006-42, *appeal docketed*, No. 06-1190 (D.C. Cir. June 1, 2006).

[17] T.C. Memo. 2005-228.

[18] *See, e.g., Horowitz v. Comm'r*, T.C. Memo. 2006-91 (taxpayer stated he could not find any "statute or regulation making [me] liable for an income tax."); *Bonaccorso v. Comm'r*, T.C. Memo. 2005-278 (taxpayer received compensation exceeding $90,000 in each year at issue yet contended, "I found no code section that made me liable for any income tax.").

[19] *Saxon v. Comm'r*, T.C. Memo. 2006-52.

[20] *Holliday v. Comm'r*, T.C. Memo. 2005-240.

[21] *See, e.g., Holmes v. Comm'r*, T.C. Memo. 2006-80; *Crow v. Comm'r*, T.C. Summ. Op. 2005-124.

income tax against them. In *Holmes v. Commissioner*, the taxpayer asserted that his domicile is outside the United States because he lived in the "compact state of Texas state republic."[22] In *Hennard v. Commissioner*, the taxpayer argued that the IRS is not authorized to practice law in Texas.[23]

- **Private sector wages are not subject to the income tax:** In *Lange v. Commissioner*, the taxpayer argued that the income tax properly applies only to wages received from the government – not to wages received from private sector employers.[24]
- **Notices of deficiency are not properly signed:** At least one taxpayer argued that a notice of deficiency was invalid because the person sending it lacked sufficient authority to sign the notice.[25]
- **Income earned is not described in IRC § 861:** Taxpayers sometimes argue that compensation for services is not subject to tax because it is not listed in IRC § 861 as one of the "items of gross income [that] shall be treated as income from sources within the United States." [26] The Internal Revenue Code is clear, however, that compensation for services is subject to tax under IRC § 61(a)(1).

While many of the cases we reviewed involved the penalty under IRC § 6673(a)(1)(B) against taxpayers for taking a frivolous or groundless position in a Tax Court proceeding, the Tax Court also imposed the penalty under IRC § 6673(a)(1)(A) against taxpayers for instituting or maintaining proceedings primarily for delay:

- **Collection Due Process (CDP) claims were maintained to delay collection of tax:** When the IRS is proposing to impose a levy, the taxpayer has a right to a Collection Due Process hearing with the IRS Office of Appeals.[27] The taxpayer may appeal an adverse administrative determination to the Tax Court. These rights were established by Congress, and the National Taxpayer Advocate believes that CDP reviews are critical to ensuring the protection of taxpayer rights in the collection process. In the nine CDP cases where the Tax Court imposed the IRC § 6673 penalty, however, the court generally concluded that the taxpayer had abused the CDP process to delay collection.[28]

In only one case we reviewed did taxpayers ask the Tax Court to sanction the IRS's attorney. In *Dixon v. Comm'r*, a group of taxpayers who had engaged in a tax-shelter

[22] T.C. Memo. 2006-80.

[23] T.C. Memo. 2005-275.

[24] T.C. Memo. 2005-200, *appeal docketed*, No. 06-1116 (6th Cir. Jan. 25, 2006).

[25] *Lewis v. Comm'r*, T.C. Memo. 2006-73.

[26] *See, e.g., Woods v. Comm'r*, T.C. Memo. 2006-38.

[27] IRC § 6330(a)(3)(B).

[28] *See, e.g., Carrillo v. Comm'r*, T.C. Memo. 2005-290; *Quigley v. Comm'r*, T.C. Memo. 2005-153.

transaction sought sanctions against the IRS under IRC § 6673(a)(2)(B)[29] for its conduct before the U.S. Court of Appeals for the Ninth Circuit. The Court of Appeals for the Ninth Circuit found that IRS attorneys had perpetrated a fraud on the court and remanded the consolidated cases to the Tax Court to determine whether the taxpayers were entitled to attorneys' fees and expenses.[30] The Tax Court concluded that an award of attorneys' fees was appropriate under IRC § 7430 but not under § 6673.[31]

CONCLUSION

Taxpayers did not raise genuine issues in virtually any of the cases we analyzed. These taxpayers raised frivolous arguments, which have been repeatedly litigated and rejected in the past. The courts have consistently stated that these boilerplate arguments are frivolous and without merit. The message of these cases is clear: Where taxpayers assert frivolous arguments to impede or delay the collection of tax, the IRS often will seek the imposition of a penalty under IRC § 6673 (in addition to tax, interest, and other penalties that may apply), and the Tax Court in most cases will impose the penalty. Moreover, even if the IRS does not request a penalty, taxpayers may face sanctions if the Tax Court concludes their conduct falls within the conduct that Congress made subject to IRC § 6673. Finally, U.S. Courts of Appeals almost invariably will sustain the Tax Court's imposition of the IRC § 6673 penalty and will generally impose further sanctions on taxpayers who pursue frivolous appeals.

[29] IRC § 6673(a)(2)(B) provides that if the Tax Court finds that an attorney appearing on behalf of the Commissioner of Internal Revenue multiplied the proceedings unreasonably and vexatiously, the Tax Court may require that the United States pay the excess costs, expenses, and attorneys' fees.

[30] *See Dixon v. Comm'r*, 316 F.3d 1041 (9th Cir. 2003).

[31] *Dixon v. Comm'r*, T.C. Memo. 2006-97, *appeal docketed*, No. 06-74649 (9th Cir. Sept. 26, 2006).

LITIGATED ISSUE #7 TRADE OR BUSINESS EXPENSES UNDER INTERNAL REVENUE CODE SECTION 162 AND RELATED SECTIONS

SUMMARY

The deductibility of trade or business expenses is perennially one of the ten most litigated tax issues in the federal courts. We identified 68 cases that included a trade or business expense issue and were litigated between June 1, 2005 and May 31, 2006. The courts affirmed the IRS position in 75 percent of the cases, while taxpayers prevailed less than five percent of the time.[1] The remaining cases resulted in split decisions.

PRESENT LAW

Internal Revenue Code (IRC, or the "Code") § 162 allows deductions for ordinary and necessary trade or business expenses paid or incurred during a taxpayer's taxable year. Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance. The IRS, the Department of the Treasury, Congress, and the courts continue to provide legal guidelines about whether a taxpayer is entitled to certain trade or business expense deductions. The litigated cases analyzed for this report reveal that this process is ongoing. When a taxpayer seeks judicial review of the IRS's determination of a tax liability stemming from the deductibility of a particular trade or business expense, the courts must often address a series of questions, including those discussed below.

What is a trade or business expense under IRC § 162?

Although "trade or business" is one of the most widely used terms in the IRC, neither the Code nor the Treasury Regulations provide a definition.[2] The definition of "trade of business" comes from the common law of federal income tax, where the concepts have been developed and refined by the courts.[3] The Supreme Court has interpreted "trade or business" for purposes of IRC § 162 to mean an activity conducted "with continuity and regularity" and with the primary purpose of making income or a profit.[4]

What is an ordinary and necessary expense?

IRC § 162(a) requires a trade or business expense to be both "ordinary and necessary" in order to be deductible. The expense must be ordinary and necessary in relation to the taxpayer's trade or business. In *Welch v. Helvering*, the Supreme Court stated that the words "ordinary" and "necessary" have different meanings, and both must be satisfied for a taxpayer to benefit from the deduction.[5] The Supreme Court describes an

[1] The IRS prevailed in 51 of 68 cases, while taxpayers prevailed in only three.

[2] In 1986 the term "trade or business" appeared in at least 492 subsections of the Code and 664 Treasury Regulation provisions. F. Ladson Boyle, *What is a Trade or Business?* 39 Tax Law. 737 (Summer 1986).

[3] Carol Duane Olson, *Toward a Neutral Definition of "Trade of Business" in the Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

[4] *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).

[5] 290 U.S. 111, 113 (1933).

"ordinary" expense as customary or usual and of common occurrence in the taxpayer's trade or business.[6] The Court describes a "necessary" expense as one that is appropriate and helpful for development of the business.[7]

In addition to being ordinary and necessary, common law also requires that the amount of the expense be reasonable in order for the expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held that "… the element of reasonableness is inherent in the phrase 'ordinary and necessary.' Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in unlimited amount."[8]

When is an expense paid or incurred during the taxable year?

IRC § 162(a) requires an expense to be "paid or incurred during the taxable year" in order to be deductible. The Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits – including adequate records to substantiate deductions claimed as trade or business expenses.[9] If a taxpayer is unable to substantiate deductions by documentary evidence (*e.g.*, invoice, paid bill, or canceled check) but can establish that he or she had some deductible business expenditures, the courts may opt to employ the Cohan rule to grant the taxpayer a reasonable amount of deductions.

The *Cohan* rule is a rule of "indulgence" established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.[10] In *Cohan*, the court held that the taxpayer's business expense deductions were not adequately substantiated, but "… the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent."[11]

The *Cohan* rule may not be utilized in situations where IRC § 274(d) applies. Section 274(d) provides that unless a taxpayer complies with strict substantiation rules, no deduction is allowable for (1) traveling expenses, (2) entertainment expenses, (3) gifts, or (4) certain "listed property."[12] A taxpayer is required to substantiate a claimed IRC §

6 *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940).

7 *Comm'r v. Tellier*, 383 U.S. 687, 679 (1996) (citations omitted).

8 *Comm'r v. Lincoln Elec. Co.*, 176 F.2d 815, 817 (6th Cir. 1949) (citation omitted).

9 IRC § 6001. *See also* Treas. Reg. § 1.6001-1 and Treas. Reg. § 1.446-1(a)(4).

10 39 F.2d 540 (2nd Cir. 1930).

11 *Cohan v. Comm'r*, 39 F.2d 540, 544 (2nd Cir. 1930).

12 "Listed property" includes any property used as a means of transportation; any property of a type generally used for purposes of entertainment, recreation, or amusement; computer or peripheral equipment (except when used exclusively at a regular business establishment); cell phones; or other property specified in regulations. IRC § 280F(d)(4)(A) and (B).

274(d) expense with adequate records or sufficient evidence corroborating the taxpayer's statement establishing the amount, time, place, and business purpose of the expense.[13]

Who has the burden of proof in a substantiation case?

Generally, a taxpayer bears the burden of proving entitlement to the business expense deductions and that the IRS's proposed determination of tax liability is incorrect.[14] Section 7491(a) provides that the burden of proof shifts to the IRS when a taxpayer:

- Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability;
- Complies with the requirements to substantiate deductions;
- Maintains all records required under the Code; and
- Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.[15]

ANALYSIS OF LITIGATED CASES

Trade or business expense cases have been one of the ten most litigated tax issues in the federal courts since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.[16] We reviewed 68 cases involving various trade or business expense issues that were litigated in federal courts from June 1, 2005, through May 31, 2006. Table 7 in Appendix 3 contains a detailed listing of those cases.

Table 3.7.1 categorizes the main trade or business expense issues raised by taxpayers. Cases involving more than one issue are included in more than one category. In *Her v. Commissioner*,[17] for example, the taxpayer raised three distinct trade or business expense issues, so *Her* is included in three categories in Table 3.7.1.

[13] Treas. Reg. § 1.274-5T(b).

[14] *See Welch v. Helvering*, 290 U.S. 111, 115 (1933) and Tax Court Rule 142(a).

[15] IRC § 7491(a)(1) applies to a court proceeding in which the examination started after July 22, 1998, and if there is no examination, to the taxable period or events which started or occurred after July 22, 1998.

[16] National Taxpayer Advocate 1998-2005 Annual Reports to Congress.

[17] T.C. Summ. Op. 2005-187.

TABLE 3.7.1, TRADE OR BUSINESS EXPENSE CASES AND ISSUES

Issue	Type of Taxpayer	
	Individual	Business (including sole-proprietors)
Substantiation of Expenses [18]	9	28
Profit Objective [19]	2	13
Ordinary and Necessary Trade or Business Expenses [20]	6	10
Personal vs. Business Expenses [21]	3	6
Travel Expenses [22]	2	3
Compensation Expense Issues [23]	0	4
Education Expenses [24]	2	0

TABLE 3.7.2, PREVAILING PARTY IN TRADE OR BUSINESS EXPENSE COURT DECISIONS, PRO SE TAXPAYER VERSUS TAXPAYERS WITH REPRESENTATION

Type of Taxpayer	IRS	Taxpayer	Split	Total
Pro Se	37	1	9	47
Represented	14	2	5	21
Totals	**51**	**3**	**14**	**68**

Over two-thirds of the taxpayers litigating trade or business deduction issues represented themselves *(pro se)*. In terms of percentage, represented taxpayers fared somewhat better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in one-third of litigated cases (seven of 21), while *pro se* taxpayers received relief in 21 percent of litigated cases (ten of 47).[25] In terms of the number of cases, however,

[18] IRC § 6001 and Treas. Reg. § 1.6001 require a taxpayer to maintain books and records that substantiate income, deductions, and credits. Treasury Regulation § 1.162-17 provides guidance regarding maintaining adequate records to substantiate deductions claimed as trade or business expenses.

[19] IRC § 183(a) provides that no deduction attributable to an activity shall be allowed if such activity is not engaged in for profit.

[20] IRC § 162(a) allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.

[21] IRC § 262(a) provides that generally, personal, living and family expenses are not deductible.

[22] IRC § 162(a)(2) allows a trade or business expense deduction for traveling expenses incurred "away from home in the pursuit of a trade or business." A taxpayer's "home" for purposes of IRC § 162(a)(2) is his or her principal place of business. *Kroll v. Commissioner*, 49 T.C. 557, 561-562 (1968).

[23] IRC § 162(a)(1) allows a trade or business expense deduction for a "reasonable allowance for salaries or other compensation for personal services actually rendered."

[24] Treas. Reg. § 1.162-5(a) provides that a taxpayer may deduct educational expenses under IRC § 162(a) if the education maintains or improves skills required by the individual in his or her employment or other trade or business or meets the express requirements of the individual's employer.

[25] Only one pro se taxpayer received full relief. *Castagnetta v. Comm'r*, T.C. Summ. Op. 2006-24. *Castagnetta* is particularly notable because the taxpayer not only received full relief representing himself, but he was able to prevail on the difficult issue of whether gambling activities constituted a trade or business.

pro se taxpayers fared better. *Pro se* taxpayers received full or partial relief in ten cases, compared to seven cases for represented taxpayers.

COURT DECISIONS

Table 3.7.3 reflects the disposition of court decisions in each category of cases.

TABLE 3.7.3, PREVAILING PARTY IN TRADE OR BUSINESS EXPENSE COURT DECISIONS, INDIVIDUAL VERSUS BUSINESS.[26]

Type of Taxpayer	IRS	Taxpayer	Split	Total
Individual	11	1	5	17
Business	40	2	9	51
Totals	**51**	**3**	**14**	**68**

INDIVIDUALS

Seventeen of the 68 cases analyzed were litigated by individual taxpayers. The most prevalent issue in these cases was the substantiation of the claimed trade or business expense deductions. For example, in *Joseph v. Commissioner*,[27] the taxpayer was denied $33,785 in deductions claimed for travel expenses incurred while traveling to England to attend English literature courses at Worcester College at Oxford. The taxpayer was a high school English teacher working in Chicago, Illinois. The IRS denied the taxpayer's deductions for several reasons, including the taxpayer's failure to adequately substantiate the travel expenses as required under IRC § 274(d). At trial, the taxpayer produced only one "Copy Statement" showing lodging costs in the United Kingdom.[28] The court believed that the Copy Statement was "requested in anticipation of litigation" and that taxpayer's trial testimony was self serving. Therefore, the court sustained the IRS's denial of taxpayer's travel expense deductions because (among other reasons) the taxpayer had failed to adequately substantiate these expenses.

BUSINESS TAXPAYERS

Fifty-one of the 68 litigated trade or business expense cases involved business taxpayers. These taxpayers had slightly less success than individual taxpayers in receiving a favorable outcome. Business taxpayers received full or partial relief in 22 percent of cases (11 of 51) compared to 35 percent for individual taxpayers (six of 17).

As with individual taxpayers, substantiation of expenses was also the most prevalent issue in the business taxpayer trade or business deduction cases. For example, in

[26] Business taxpayers include any business entity and individual taxpayers filing either Form 1040 Schedules C or F (*i.e.*, sole proprietors).

[27] T.C. Memo. 2005-169.

[28] The Copy Statement reflected rental costs of £4,556.

Christensen v. Commissioner,[29] the IRS denied the taxpayer's business expense deductions for his 1998-2001 tax years because of the taxpayer's failure to substantiate his expenses. The taxpayer provided no substantiation at trial, but testified that all substantiating documents were destroyed in "hard disk crashes," or lost while moving. The court did not find the taxpayer's testimony regarding his business expenses persuasive, and because the taxpayer provided no documentary evidence the court was unable to estimate the taxpayer's expenses under *Cohan*. Thus, the court sustained the IRS's position and did not allow the taxpayer's unsubstantiated business expense deductions.

Another prevalent issue litigated by business taxpayers was the question of whether the taxpayers' business expense deductions were attributable to a legitimate "for profit" activity constituting an actual trade or business. Three such cases involved tax advice given by a group known as "Renaissance TTP, Inc." or "The Tax People."[30] The Tax People developed and promoted a multi-level marketing program called, "The Tax Relief System" (TRS). The Tax People marketed TRS primarily to taxpayers operating home-based businesses and claimed that it would "turn most of your everyday expenses into business expenses." The Tax People also guaranteed that taxpayers using TRS would generate at least $5,000 in federal income tax deductions for the first 12 months the taxpayer operated his or her home business. TRS participants would purchase the TRS materials with a down payment (typically $300) and monthly payments of $100, and would then attempt to sell the TRS materials to other taxpayers by recruiting them as "downline" distributors. The participants would then claim trade or business expense deductions for numerous items, such as automobile expenses, office expenses, advertising, etc. The IRS denied these deductions in all three TRS cases on the grounds that participation in TRS did not constitute a trade or business for purposes of IRC § 162(a). The Tax Court sustained the IRS in all three cases. In the Abloso case, the court stated, "In essence, petitioner did little more than pay a monthly membership fee to TRS for generally misleading or ill-advised tax products and services. Petitioner's participation

[29] T.C. Memo. 2006-62.

[30] *Abloso v. Commissioner*, T.C. Summ. Op. 2006-60; *Sears v. Commissioner*, T.C. Summ. Op. 2006-47; and *Her v. Commissioner*, T.C. Summ. Op. 2005-187.

in the TRS program hardly constitutes a trade or business within the meaning of section 162(a)."[31]

CONCLUSION

As in previous years, taxpayers continued to challenge IRS denials of trade or business expense deductions, and represented taxpayers fared better than their *pro se* counterparts. While the IRS generally prevailed in these cases, the courts did not always favor the IRS's application of the law to the taxpayers' facts and circumstances. Thus, the definition of an allowable trade or business expense is open to interpretation.

Many of the cases analyzed demonstrate taxpayer confusion over legal requirements. The Renaissance / Tax People cases in particular show not only that taxpayers misunderstand the rules, but also how taxpayers can be harmed when unscrupulous individuals exploit this lack of understanding. Thus, the IRS can minimize litigation by providing clear guidance on the deductibility of trade or business expenses. In the Renaissance / Tax People cases, the IRS helped educate and alert taxpayers to these types of scams by prosecuting the people responsible. Through education, outreach, and partnering with stakeholders, the IRS can help taxpayers understand what trade or business expense deductions are allowable, how to substantiate those expenses, and how to avoid participating in schemes that advertise business expense deductions that appear "too good to be true."[32] The IRS should proactively reach out to educate taxpayers about this issue – particularly self-employed and small business taxpayers.[33] By helping these taxpayers understand the requirements for deducting trade or business expenses, the IRS will encourage compliance and minimize litigation.

[31] *Abloso v. Commissioner*, T.C. Summ. Op. 2006-60, 8. The United States government prosecuted the individuals behind the Renaissance/Tax People scheme, for numerous cases of fraud including tax, mail and wire fraud. At least 50,000 people participated in the Renaissance/Tax People scam. *See* United States Department of Justice News Release, *Tax Scheme Founder Arrested while Crossing Border into United States*, Oct. 26, 2004, and David Cay Johnston, *Judge Closes Down Tax-Advice Company*, N.Y. Times, May 16, 2001, C4. On May 16, 2001, the United States District Court in Kansas ruled that the Renaissance/Tax People company was an illegal pyramid scheme where investors had no chance of making a profit. David Cay Johnston, *Judge Closes Down Tax-Advice Company*, N.Y. Times, May 16, 2001, C4. In August 2004, a federal grand jury returned a 148-count indictment against the founder of the Renaissance/Tax People company that included tax fraud charges. In October 2004, the company's founder was arrested crossing the border from Mexico into the United States. United States Department of Justice News Release, *Tax Scheme Founder Arrested while Crossing Border into United States*, Oct. 26, 2004. The people responsible for the Renaissance/Tax People scheme are scheduled to be tried for tax fraud and other offenses in November 2006. *A Tune up on Corporate Tax Issues: What's going on under the Hood?*, *Hearing before the Senate Comm. on Finance*, (written statement of Eileen J. O'Connor, Assistant Attorney General, Tax Division, U.S. Dept. of Justice, June 13, 2006) (available at http://finance.senate.gov/hearings/testimony/2005test/061306testeo.pdf).

[32] The Taxpayer Advocate Service is sponsoring research conducted by the Office of Program Evaluation and Risk Analysis (OPERA) to identify and potentially supplement what the IRS is doing to detect and combat emerging abusive tax schemes. *See* National Taxpayer Advocate's Report to Congress, Fiscal Year 2007 Objectives, 10-11, and *The Tax Gap and Tax Shelters: Hearing Before the Senate Comm. on Finance*, 108th Cong. (Jul. 21, 2004)(testimony of Nina E. Olson, National Taxpayer Advocate).

[33] *See* Most Serious Problem, *Small Business Outreach*, supra.

LITIGATED
ISSUE #8 RELIEF FROM JOINT AND SEVERAL LIABILITY UNDER INTERNAL REVENUE CODE SECTION 6015

SUMMARY

Married persons may elect to file their income tax returns jointly or separately. Spouses filing joint federal tax returns are jointly and severally liable for any deficiency or tax due.[1] Joint and several liability enables the IRS to collect the entire amount due from either taxpayer.

IRC § 6015 provides three avenues for relief from joint and several liability. Section 6015(b) provides "traditional" relief for deficiencies and is similar to the innocent spouse relief formerly provided in section 6013(e). Section 6015(c) also provides relief for deficiencies for certain divorced or separated spouses; this section allocates the liability to each spouse. Section 6015(f) provides "equitable" relief from deficiencies and underpayments, but it only applies if a taxpayer is not eligible for relief under IRC § 6015(b) or (c). A taxpayer generally files Form 8857, Request for Innocent Spouse Relief, to request relief.

We reviewed 51 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2005 and May 31, 2006. The jurisdiction of the court and the taxpayer's knowledge or constructive knowledge were frequent subjects of litigation. The National Taxpayer Advocate has proposed legislation to address both of these issues.[2]

PRESENT LAW

Traditional Innocent Spouse Relief Under IRC § 6015(b)

IRC § 6015(b) provides full or partial relief from joint and several liability if the requesting spouse can demonstrate that:

1. A joint return was filed;
2. There was an understatement of tax attributable to erroneous items of the non-requesting spouse;
3. Upon signing the return, the requesting spouse did not know or have reason to know of the understatement;

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[1] IRC § 6013(d)(3). We use the terms "deficiency" and "understatement" interchangeably for purposes of this discussion and the case table.

[2] The National Taxpayer Advocate has proposed legislation in this report to restore the Tax Court's jurisdiction in certain cases. *See* National Taxpayer Advocate 2006 Annual Report to Congress, infra/supra (Key Legislative Recommendation: Innocent Spouse Relief). The National Taxpayer Advocate has also proposed to eliminate joint and several liability on certain returns. *See* National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse). Thus, the proposal would virtually eliminate the need for innocent spouse relief and the need to inquire about one spouse's knowledge.

4. Taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable; and
5. The requesting spouse elected relief within two years after the IRS began collection activities with respect to him or her.

Allocation of Liability Under IRC § 6015(c)

IRC § 6015(c) relieves the requesting spouse of liability for deficiencies allocable solely to the nonrequesting spouse. To obtain relief under this section, the requesting spouse must demonstrate that:

1. A joint return was filed;
2. At the time relief is elected, the joint filers are unmarried, legally separated, or have not lived in the same household for the 12 months immediately preceding the election; and
3. The election was made within two years after the IRS began collection activities with respect to the requesting spouse.

This election allocates to each joint filer that portion of the deficiency on the joint return attributable to each joint filer as calculated under the allocation provisions of IRC § 6015(d).

A taxpayer is ineligible to make an election under IRC § 6015(c) if the IRS demonstrates that, at the time the return was signed, the requesting taxpayer had "actual knowledge" of any item giving rise to the deficiency. Additionally, relief is denied for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.[3]

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides equitable relief from both deficiencies and underpayments for taxpayers who can demonstrate that:

1. Relief under IRC § 6015(b) or (c) is unavailable; and
2. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency.

[3] IRC § 6015(c)(4); IRC § 6015(d)(3)(C).

Revenue Procedure 2003-61 lists some of the factors the IRS considers in determining whether equitable relief is appropriate.[4] These factors include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, compliance with income tax laws, and abuse.

Unlike IRC § 6015(b) and (c), which relieve taxpayers from deficiencies in tax, equitable relief under IRC § 6015(f) is available for both deficiencies and underpayments.

Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*. After reviewing the request, the IRS issues a Notice of Determination granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails the notice to file a petition with the U.S. Tax Court.[5] The taxpayer may also petition the Tax Court if he or she does not receive a determination within six months of filing Form 8857.[6] The taxpayer may also raise relief from joint and several liability in a Collection Due Process proceeding,[7] a deficiency proceeding,[8] a bankruptcy proceeding,[9] or a refund suit.

Intervention by Nonrequesting Spouse

When a spouse requests innocent spouse relief, the IRS must notify the nonrequesting spouse and give him or her an opportunity to submit relevant information.[10] Upon request of either spouse, the IRS will generally share with one spouse the information

[4] Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447. Section 4.01 of this revenue procedure sets out seven threshold conditions that must be met by the taxpayer to be eligible for relief under IRC § 6015(f). The seven threshold conditions are: the requesting spouse filed a joint return for the taxable year in question; the relief is not available to the requesting spouse under IRC § 6015(b) or (c); the requesting spouse applies for relief no later than two years after the date of the IRS's first collection activity; no assets were transferred between the spouses as part of a fraudulent scheme; the nonrequesting spouse did not transfer disqualified assets to the requesting spouse; the requesting spouse did not file, or failed to file, with a fraudulent intent; and the income tax liability from which the relief is sought is attributable to the nonrequesting spouse. Section 4.02 establishes three elements the taxpayer can prove to qualify for relief from liability for an underpayment: spouses are no longer married, are legally separated, or not members of the same household for the last 12 months; the requesting spouse had no knowledge, or reason to know, that the nonrequesting spouse would not pay the income tax liability; and the requesting spouse will suffer economic hardship if the IRS does not provide relief. Finally, if the taxpayer satisfies the threshold conditions, but fails to prove the section 4.02 elements, section 4.03 provides the nonexclusive factors the IRS considers in determining whether equitable relief is appropriate.

[5] IRC § 6015(e)(1)(A)(ii).

[6] IRC § 6015(e)(1)(A)(i)(II).

[7] IRC § 6320(c); § 6330(c)(2)(A)(i).

[8] IRC § 6213; *Corson v. Comm'r*, 114 T.C. 354, 363 (2000).

[9] 11 USCA § 505(a)(1).

[10] IRC § 6015(h)(2); Treas. Reg. § 1.6015-6.

submitted by the other spouse.[11] Additionally, the IRS must notify the nonrequesting spouse of the preliminary and final determination of the requesting spouse's claim for relief.[12] The nonrequesting spouse may not petition from the final determination of relief[13], but has the opportunity to become a party to any innocent spouse proceeding in the Tax Court.[14]

ANALYSIS OF LITIGATED CASES

We analyzed 51 opinions issued between June 1, 2005, and May 31, 2006. Seventy- five percent (38 out of 51) were decided in the Tax Court, 16 percent (eight out of 51) in courts of appeals, six percent (three out of 51) in district courts, and four percent (two out of 51) in bankruptcy courts. Seventy-six percent (39 out of 51) were decided in favor of the IRS, 20 percent (ten out of 51) in favor of the taxpayer, and four percent (two out of 51) were split decisions. In about 51 percent (26 out of 51) of the cases the taxpayers appeared *pro se* (*i.e.*, they represented themselves). The nonrequesting spouse intervened in approximately 14 percent of the cases (seven out of 51).[15]

Only about 65 percent of the cases (33 out of the 51) involved an analysis of whether to grant relief. The other 35 percent (18 cases) involved procedural issues. Of the cases involving procedural issues, 72 percent (13 out of 18) were decided in favor of the IRS, 22 percent (four out of 18) in favor of the taxpayer, and six percent (one out of 18) were split decisions. Of the 33 cases decided on the merits, 79 percent (26 out of 33) were decided in favor of the IRS, 18 percent (six out of 33) in favor of the taxpayer (including one case where only the intervenor opposed granting relief), and three percent (one out of 33) were split decisions. See Table 8 in Appendix 3 for a detailed breakdown of the decided cases.

Procedural Issues

Uncertainty associated with procedural issues was a significant subject of litigation. As noted above, 35 percent of the cases (18 out of 51) involved procedural issues such as

[11] Treas. Reg. § 1.6015-6(a)(1). In cases of alleged spousal abuse, the IRS will not share the requesting spouse's contact information with the nonrequesting spouse. IRM 25.15.3.3.1 (Sept. 1, 2006).

[12] Treas. Reg. § 1.6015-6(a)(2).

[13] *Maier v. Comm'r*, 119 T.C. 267, 276 (2002), aff'd, 360 F.3d 361, 365 (2d Cir. 2004).

[14] IRC § 6015(e)(4); *King v. Commissioner*, 115 T.C. 118 (2000).

[15] The nonrequesting spouse only intervened in cases decided on the merits. Only 33 of the cases that we reviewed were decided on the merits. The nonrequesting spouse intervened in 18 percent (6 out of 33) of these cases.

whether the court had jurisdiction,[16] whether the taxpayer properly requested relief,[17] and the consequences of the decision to grant relief.[18] Perhaps the most important procedural issues involved the availability of judicial review of IRS determinations under IRC § 6015, as illustrated by the following cases.

Commissioner v. Ewing[19]

The taxpayer filed a joint return in 1995 that reflected an underpayment of estimated tax attributable to the husband's business. In 1999, the taxpayer sought relief from the unpaid 1995 tax liability under IRC § 6015(f). The IRS denied relief and the taxpayer petitioned the Tax Court. In two separate opinions, the Tax Court determined it had jurisdiction under IRC § 6015(e) to review the IRS's determination and granted the taxpayer's request for relief. The Ninth Circuit Court of Appeals reversed, holding that the Tax Court had no jurisdiction to review the IRS's decision.

The Ninth Circuit based its decision on the text of IRC § 6015(e)(1), which provides for Tax Court jurisdiction "[i]n the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply." The Ninth Circuit reasoned the Tax Court did not have jurisdiction because the IRS had not asserted a deficiency. It did not reach the issue of whether jurisdiction might also fail on the basis that the taxpayer sought relief solely under IRC § 6015(f) (*i.e.*, did not elect relief under IRC § 6015(b) or IRC § 6015(c)).

Both the Eighth Circuit Court of Appeals and Tax Court recently decided to follow the Ninth Circuit's holding in *Ewing*.[20] As a result, the IRS will now routinely file a motion to dismiss for lack of jurisdiction in cases under IRC § 6015(f) where the IRS has not

16 *See, e.g., Bartman v. Comm'r*, 446 F.3d 785 (8th Cir. 2006), vacating 122 T.C. 32 (2004) (no jurisdiction to review IRC § 6015(f) underpayment cases); *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *aff'g in part and vacating in part* T.C. Memo. 2004-93 (no jurisdiction to review IRC § 6015(f) underpayment cases); *Sjodin v. Comm'r*, 97 A.F.T.R.2d (RIA) 2622 (8th Cir. 2006) (no jurisdiction to review IRC § 6015(f) underpayment cases); *Christensen v. Comm'r*, T.C. Memo. 2005-299 (no jurisdiction over IRC § 66(c) or IRC § 6013(e) claims); *Parlin v. Comm'r*, T.C. Memo. 2006-18 (no jurisdiction because petition was not timely filed).

17 *See, e.g., U.S. v. Feda*, 97 A.F.T.R.2d (RIA) 1985 (N.D. Ill. 2006) (district court not the proper forum to apply for relief when not requested administratively first); *Clark v. Comm'r*, T.C. Summ. Op. 2005-95 and *Ferris v. Comm'r*, T.C. Summ. Op. 2005-131 (application for relief was timely even though received by the IRS after the two-year limitation period expired because the IRS failed to send the notice required by RRA 98).

18 *See, e.g., Ordlock v. Comm'r*, 126 T.C. 47 (2006) (discussing the consequences of granting relief to taxpayers in community property jurisdictions); *Estate of Capehart v. Comm'r*, 125 T.C. 211 (2005) (discussing consequences of granting relief under 6015(c) and how to allocate liability under 6015(d)); *Dennard v. Comm'r*, T.C. Summ. Op. 2005-115 (discussing why no refund was due even though relief was granted).

19 *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *rev'g Ewing v. Comm'r*, 118 T.C. 494 (2002).

20 *Bartman v. Comm'r*, 446 F.3d 785 (8th Cir. 2006) (following the Ninth Circuit's decision in Ewing); *Sjodin v. Comm'r*, 97 A.F.T.R.2d (RIA) 2622 (8th Cir. 2006) (same); *Billings v. Commissioner*, 127 T.C. No. 2 (July 25, 2006) (same). *Billings* is not included in the case table because it was decided after May 31, 2006.

asserted a deficiency.[21] The National Taxpayer Advocate has proposed legislation to restore the Tax Court's jurisdiction to review such cases.[22]

Forty eight percent (16 of 33) of the cases decided on the merits involved requests for relief from liability for underpayments under IRC § 6015(f) (*i.e.*, where a joint tax liability was properly reported on the return, but not paid). The IRS's decision not to grant underpayment relief under IRC § 6015(f) was the most frequent subject of litigation. Thus, absent legislation, litigation is likely to decline significantly in the future, not because factual determinations are becoming easier or the law is becoming more settled, but rather because the Tax Court now lacks jurisdiction to review such decisions.

Nonetheless, in several other cases courts rejected various arguments that would have deprived the taxpayer of the ability to obtain administrative or judicial review of the request for relief.[23] *In re Drake* provides an example.[24]

In re Drake

The taxpayer requested relief under IRC § 6015 prior to filing bankruptcy. The IRS issued a notice of determination denying the taxpayer's request for relief during the bankruptcy process. The taxpayer filed a petition in Tax Court for review of the IRS's determination, but the court held it did not have jurisdiction because bankruptcy law imposes a "stay" that prevents the taxpayer from filing a Tax Court petition during the bankruptcy process.[25] If the taxpayer had not filed a petition, the time for filing would have expired without any opportunity for judicial review.[26] The taxpayer filed a motion with the bankruptcy court to review the IRS's determination and redetermine her liability. The bankruptcy court held that the IRS violated the stay when it issued a notice of determination denying her request for relief. As a consequence of that violation, the

[21] Notice CC-2006-020 (Aug. 25, 2006).

[22] *See* National Taxpayer Advocate 2001 Annual Report to Congress 159-165 (proposing to grant Tax Court jurisdiction to review determinations under IRC § 6015(f)) and National Taxpayer Advocate 2006 Annual Report to Congress, *supra.* Similar proposals were recently introduced in the House (H.R. 6111) and the Senate (S. 3523). The House bill passed both houses of Congress and was referred to the President on December 9, 2006.

[23] The court decided in favor of the taxpayer in the following cases involving procedural issues. *In re Drake*, 336 B.R. 155 (Bankr. D. Mass. 2006), *motion for reconsideration denied* 97 A.F.T.R.2d (RIA) 2491 (Bankr. D. Mass. 2006) (Notice of Determination violated bankruptcy stay and was void; request for relief remained in Appeals); *United States v. Battersby*, 398 F.Supp.2d 865 (N.D. Ohio 2005) (court stayed foreclosure pending the outcome of taxpayer's request for relief under IRC § 6015); *Clark v. Comm'r*, T.C. Summ. Op. 2005-95 (taxpayer's request for relief was timely and should have been considered on the merits); *Ferris v. Comm'r*, T.C. Summ. Op. 2005-131; *Thomas v. Comm'r*, T.C. Summ. Op. 2005-102 (petitioner not barred by res judicata). In each of these cases, except *Battersby*, the court's decision preserved the taxpayer's right to judicial review of the IRS's determination.

[24] *In re Drake*, 336 B.R. 155 (Bankr. D. Mass. 2006).

[25] The Tax Court suggested that the taxpayer might seek review of the IRS's determination by the bankruptcy court. *Drake v. Comm'r*, 123 T.C. 320, n.4 (2004).

[26] The National Taxpayer Advocate recommended a legislative change in her 2004 Annual Report to Congress to create a tolling provision in IRC § 6015, which would toll the period for filing in the Tax Court until the automatic bankruptcy stay lapses. *See* National Taxpayer Advocate 2004 Annual Report to Congress 490.

notice was void and the relationship between the taxpayer and the IRS was the same as it was the day before the IRS issued it, *i.e.*, the request for relief remained with Appeals. The bankruptcy court further held that the automatic stay was no longer a bar to issuing a notice of determination, from which the taxpayer could petition the Tax Court.

Although availability of judicial review was a very important procedural issue, a number of other important cases addressed the consequences flowing from the decision to grant relief, such as *Ordlock v. Commissioner*, discussed below.[27]

Ordlock v. Commissioner

The IRS granted the taxpayer's request for innocent spouse relief under IRC § 6015(b). By the time the IRS granted relief, the taxpayer had paid much of the liability with community property. She sought a refund of this community property.

The IRS argued that pursuant to IRC § 6321, a lien attaches to the entire amount of the community property, and thus, no refund of community property could be granted. However, IRC § 6015(a) provides "[a]ny determination under this section shall be made without regard to community property laws." IRC § 6015(g)(1) further provides that "notwithstanding any other law or rule of law ... credit or refund shall be allowed or made to the extent attributable to the application of this section." The taxpayer argued that a plain reading of the statutory language entitled her to a refund of certain community property assets used to pay her spouse's tax liability.

The Tax Court held that the taxpayer was not entitled to a refund of overpayments attributable to community property. The court reasoned that the "determination" referenced in IRC § 6015(a) refers only to a determination of whether a taxpayer is entitled to relief under IRC § 6015, not a determination of whether the IRS could retain community property under state law to satisfy the separate liability of one spouse. The court explained that the language in IRC § 6015(g)(1), which purports to apply "notwithstanding any other law," should not be read to ignore state law for purposes of defining property interests subject to a federal tax lien under IRC § 6321.[28]

Review on the Merits

While the courts considered many factors in determining the appropriateness of relief on the merits under IRC § 6015, the most significant was whether the requesting taxpayer had actual or constructive knowledge of the tax deficiency. All three avenues for relief contain a knowledge element or factor, making it the linchpin in most of the

[27] *Ordlock v. Comm'r*, 126 T.C. 47 (2006). *See also, Estate of Capehart v. Comm'r*, 125 T.C. 211 (2005) (discussing consequences of granting relief under 6015(c) and how to allocate liability under 6015(d)); *Dennard v. Comm'r*, T.C. Summ. Op. 2005-115 (discussing why no refund was due even though relief was granted).

[28] The National Taxpayer Advocate's 2005 legislative proposal would require the IRS to exhaust reasonable collection efforts against a liable spouse before pursuing collection from a nonliable spouse. *See* National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse).

courts' analyses.[29] Taxpayers generally were not successful if they could not show a lack of actual or constructive knowledge in IRC § 6015(b) or (f) cases.[30]

Proving actual knowledge under IRC § 6015(c) was an issue in each of the nine cases involving IRC § 6015(c) that were decided on the merits. In such cases, the IRS has the burden of proving actual knowledge. The IRS prevailed in eight of the nine cases in which actual knowledge under IRC § 6015(c) was litigated.[31] In the ninth case, the IRS conceded that the requesting spouse did not have actual knowledge, but the intervenor disagreed.[32] Frequent litigation involving the actual knowledge requirement under IRC § 6015(c) was also noted in last year's Annual Report to Congress. In that report we noted that this issue was litigated in 14 cases and the IRS was unable to prove actual knowledge in four of those cases.[33]

The National Taxpayer Advocate has proposed legislation that would tax each spouse on only his or her own income, reducing or eliminating the need for innocent spouse relief.[34] While retaining married-filing-jointly status, this proposal would reduce or eliminate the need to inquire about one spouse's knowledge.

CONCLUSION

Inclusion as one of the "most litigated issues" suggests that an issue either involves unsettled areas of law or difficult factual determinations, and the issue could potentially benefit from legislative attention. A decrease in litigation involving relief under IRC § 6015(f) should not be taken as a sign that IRC § 6015 is not in need of legislative attention. Such a reduction would be the logical result of recent cases holding that the Tax Court no longer has jurisdiction to review certain controversies arising under IRC § 6015(f). In fact, the cases reviewed for this report suggest that determining what a taxpayer knew or should have known generates a significant amount of controversy and will likely continue to do so even if courts are unable to review many of the IRS's determinations under IRC § 6015.

29 *See* IRC § 6015(b)(1)(C); IRC § 6015(c)(3)(C); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.02(1)(b), § 4.03(2)(a)(iii).

30 Revisions to IRS guidance in 2003 place less emphasis on knowledge in section 6015(f) determinations. *See* Rev. Proc. 2003-61, 2003-2 C.B. 296.

31 *See Clark v. Comm'r*, T.C. Summ. Op. 2006-34; *Elias v. Comm'r*, T.C. Summ.Op. 2005-67; *Glenn v. Comm'r*, T.C. Summ. Op. 2005-127; *Packer v. Comm'r*, T.C. Summ. Op. 2006-22; *Stringham v. Comm'r*, T.C. Summ. Op. 2006-44; *Sylve v. Comm'r*, T.C. Summ. Op. 2005-137; *Thomas v. Comm'r*, T.C. Summ. Op. 2005-100; *Young v. Comm'r*, T.C. Summ. Op. 2005-135.

32 *See Vasquez v. Comm'r*, T.C. Summ. Op. 2005-133.

33 National Taxpayer Advocate 2005 Annual Report to Congress 531, 533, 593 (Most Litigated Issue: Relief From Joint and Several Liability).

34 National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse).

LITIGATED

ISSUE #9 FAMILY STATUS ISSUES UNDER INTERNAL REVENUE CODE SECTIONS 2, 21, 24, 32, AND 151

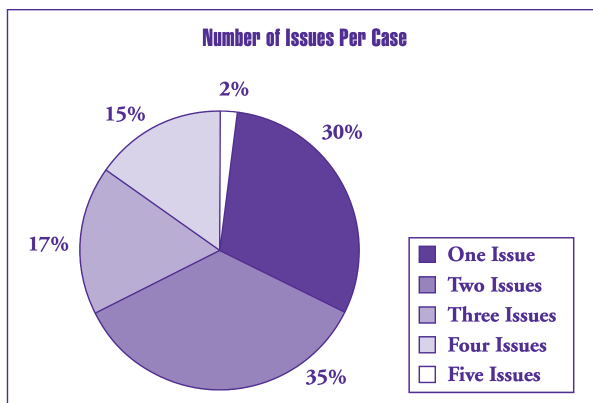
SUMMARY

Family status issues involve exemptions, credits, and filing status claimed by taxpayers when they prepare their federal tax returns. Litigated cases often include multiple family status issues with similar factual determinations. This report combines the following issues into a single "family status" category:

- Head of household filing status;[1]
- Child and dependent care credit;[2]
- Child tax credit;[3]
- Earned income tax credit (EITC);[4] and
- Dependency exemption.[5]

We reviewed 46 federal court opinions issued between June 1, 2005, and May 31, 2006. More than two-thirds of these cases dealt with multiple family status issues, with the determination of one issue often affecting others. For example, a denial of the dependency exemption will result in the summary denial of the child tax credit, and may jeopardize eligibility for head of household filing status and the child and dependent care credit. The chart below illustrates the extent to which these claims were litigated together.

TABLE 3.9.1, FAMILY STATUS ISSUES PER CASE



1 IRC § 2(b).

2 IRC § 21.

3 IRC § 24.

4 IRC § 32.

5 IRC § 151.

PRESENT LAW

Uniform Definition of Qualifying Child

Prior to 2005, there were six definitions of a "child" for purposes of the most basic provisions of the Internal Revenue Code.[6] These family status provisions potentially affect 81 million taxpayers and 79 million children.[7] The Working Families Tax Relief Act (WFTRA)[8] introduced a uniform definition of a qualifying child (UDOC) that changed five of the family status definitions, effective for tax years beginning after December 31, 2004. The intent of the UDOC legislation was to bring about some uniformity for the vast majority of taxpayers who had to meet multiple tests just to determine whether they were eligible to claim an exemption, credit, or filing status under the basic family status provisions.[9]

Under UDOC, a dependent must be either a "qualifying child" or a "qualifying relative."[10] The other family status provisions incorporate the definition of a qualifying child, but retain rules specific to each code section (such as age and income restrictions).

Qualifying Child

In general, four tests must be met to claim someone as a qualifying child under UDOC.

1. **Relationship Test.** The child must be the taxpayer's child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or descendent of one of these relatives. An adopted child includes a child lawfully placed with a taxpayer for legal adoption even if the adoption is not final. An eligible foster child is any child placed with a taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.[11]
2. **Residency Test.** The child must live with the taxpayer for more than half of the tax year. Exceptions apply for temporary absences for special circumstances: children who were born or died during the year, children of divorced or separated parents, and kidnapped children.[12]

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6 IRC § 2(b) (Head of Household); IRC § 21 (Child and Dependent Care Credit); IRC § 24 (Child Tax Credit); IRC § 32 (Earned Income Tax Credit); IRC § 151 (Dependency Exemption). IRC § 7703(b) provides an exception to the general determination of whether an individual is married and states that certain married persons who are living apart from their spouses may be treated as unmarried. Although the new uniform definition did not alter the rules in § 7703(b), there is a proposal in the 2007 budget that will improve upon the current rules. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2007 Revenue Proposals* (Feb. 2006), 58-61.

7 IRS Compliance Data Warehouse, *Tax Year 2004 Individual Return Transaction File*.

8 The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166 (2004).

9 Nina E. Olson, *Uniform Qualifying Child Definition: Uniformity for Most Taxpayers*, 111 Tax Notes 225 (Apr. 10, 2006). *See also* Additional Legislative Recommendation, *Uniform Definition of Qualifying Child Fixes, supra*.

10 IRC § 152(a).

11 IRC §§ 152(c)(1)(A), 152(c)(2), and 152(f)(1).

12 IRC §§ 152(c)(1)(B) and 152(f)(6); Treas. Reg. § 1.152-2(a)(2)(ii).

3. **Age Test.** The child must be under a certain age, depending on the tax benefit claimed, to be a qualifying child.[13]
4. **Support Test.** The child cannot provide more than half of his or her own support during the year.[14]

Qualifying Relative

If an individual does not meet the requirements for a qualifying child, he or she may be eligible as a dependent if the individual meets the requirements for a qualifying relative. In general, four tests must be met to claim someone as a qualifying relative.

1. **Relationship Test.** The individual must be a child or a descendant of a child; a brother, sister, stepbrother, or stepsister; the father or mother, or an ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister of the taxpayer; a brother or sister of the father or mother of the taxpayer; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or an individual (other than the spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.[15]
2. **Gross Income Test.** A qualifying relative must have gross income below the exemption amount for the taxable year.[16]
3. **Support Test.** The taxpayer must provide more than one-half of the individual's support for the calendar year in which the taxable year begins.[17]
4. **Not a Qualifying Child.** A qualifying relative may not be a qualifying child of such taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which the taxable year begins.[18]

Tie-Breaker Rule

Sometimes a child meets the tests to be a qualifying child of more than one person. However, only one person can treat the child as a qualifying child. If the taxpayers have the same qualifying child, they may decide among themselves who will claim the child. If they cannot agree and more than one taxpayer files a return claiming the same child, the IRS will use the tie-breaker rules explained in the following table to determine which taxpayer will be allowed to claim the child.[19] In the past, these tiebreaker rules applied

[13] IRC § 152(c)(1)(C).

[14] IRC § 152(c)(1)(D).

[15] IRC §§ 152(d)(1)(A) and 152(d)(2). However, IRC § 152(f)(3) provides that an individual shall not be treated as a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

[16] IRC § 152(d)(1)(B).

[17] IRC § 152(d)(1)(C).

[18] IRC § 152(d)(1)(D).

[19] IRC § 152(c)(4).

only to a qualifying child for the EITC. Beginning in 2005, these rules apply to five family status provisions. Other taxpayers generally cannot take any of the five tax benefits unless he or she has a different qualifying child – that is, taxpayers may not "split the baby" to divide the benefits.[20]

TABLE 3.9.2, TIE-BREAKER RULE

When More Than One Person Files a Return Claiming the Same Qualifying Child	
IF . . .	**THEN the child will be treated as the qualifying child of the. . .**
Only one of the persons is the child's parent,	Parent.
Both persons are the child's parent,	Parent with whom the child lived for the longer period of time. If the child lived with each parent for the same amount of time, then the child will be treated as the qualifying child of the parent with the highest adjusted gross income (AGI).
None of the persons is the child's parent,	Person with the highest AGI.

Special Rule for Divorced or Separated Parents

A child will be treated as being the qualifying child or qualifying relative of his or her noncustodial parent if all the following apply:

- The parents are divorced or legally separated or lived apart at all times during the last six months of the year;
- The child received over half of his or her support from the parents;
- The child is in custody of one or both of the parents for more than half the year; and
- The custodial parent signs a written statement that he or she will not claim the child as a dependent.[21]

A custodial parent is the parent having custody of the child for the greater part of the year.[22] The noncustodial parent is the parent who is not the custodial parent.[23] The special rule for divorced or separated parents enables the custodial parent to transfer the dependency exemption and child tax credit to the noncustodial parent; it does not enable the noncustodial parent to claim head of household filing status, the credit for child and dependent care expenses, or the EITC.

[20] CC Notice 2006-86, 2006-41 I.R.B. 680. There is an exception to the "split the baby" rule for divorced or separated parents, discussed below.

[21] IRC § 152(e). *See also* Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents (used to transfer the dependency exemption to the noncustodial parent). The custodial parent may use a similar written statement that meets the requirements of the form in lieu of using the Form 8332.

[22] IRC § 152(e)(4)(A).

[23] IRC § 152(e)(4)(B).

MOST LITIGATED

MOST LITIGATED TAX ISSUES

ANALYSIS OF LITIGATED CASES

The opinions discussed below are based on law in effect for tax years prior to the effective date of UDOC. There is no discussion of the UDOC (primarily because the cases did not include sufficient facts to determine whether UDOC would have changed the result) or other novel issues of law in the cases examined for this report. The opinions discussed factual disputes and clarified misconceptions regarding the law. Therefore, the discussion focuses on typical contested issues, rather than novel issues of law. A majority of the cases litigated during this period were small tax cases.[24]

Pro Se Analysis

Taxpayers were represented by counsel in only two of the 46 cases litigated this year,[25] even though many of the cases were highly fact-specific and involved a complicated web of statutory provisions. It appeared that many of the taxpayers did not understand either the law or how to present relevant evidence. The assistance of counsel might have made a difference in the outcome of these cases. A detailed listing of all family status cases analyzed appears in Table 9 in Appendix 3.

Head of Household Filing Status – IRC § 2(b)

We reviewed 19 cases involving head of household status during the reporting period, with two taxpayers prevailing on their claims.[26]

In *Lozoya v. Commissioner*,[27] the taxpayer's wife left him and their two dependent children in 2001. The IRS determined the taxpayer must file as married filing separately because he was married and his wife did not sign a joint return with him. IRC § 7703(b), however, allows a married taxpayer to file as unmarried when the taxpayer:

a. Files a separate return;

b. Pays over half the cost of maintaining the household during the year; and

c. Uses that household as the principal place of abode together with at least one dependent child; if

d. During the last six months of the taxable year, such individual's spouse is not a member of such household.

The parties disagreed only about whether the taxpayer and his wife shared the same household for the last six months of 2001. The taxpayer and his son testified that the taxpayer's wife left the household in June 2001. The court found their testimony to be

[24] In certain tax disputes involving $50,000 or less, taxpayers may elect to have their case conducted under the simplified small tax case procedure. Trials in small tax cases generally are less formal and result in a speedier disposition. However, decisions entered pursuant to small tax case procedures may not be appealed or cited as precedent. *See* IRC § 7463.

[25] *Melton v. Comm'r*, T.C. Summ. Op. 2005-152; *Omans v. Comm'r*, T.C. Summ. Op. 2005-110.

[26] *Lozoya v. Comm'r*, T.C. Summ. Op. 2005-73; *Washington v. Comm'r*, T.C. Summ. Op. 2006-81.

[27] T.C. Summ. Op. 2005-73.

credible and held that the taxpayer qualified for head of household filing status for the 2001 tax year.

In *Washington v. Commissioner*,[28] the taxpayer claimed head of household filing status for the 2003 tax year. During the period in question, the taxpayer resided in Louisiana with a live-in girlfriend and her 14 year old daughter. Although the taxpayer considered his live-in girlfriend his "common law wife," the state of Louisiana does not recognize the doctrine of common law marriage. Therefore, the taxpayer met the first prong of the head of household test – that he must be unmarried at the end of the taxable year.[29] With respect to the second prong (that the taxpayer must maintain a household that is the principal place of abode of an individual for whom the taxpayer is entitled to a dependency exemption under IRC § 151[30]), the IRS conceded the taxpayer's entitlement to the dependency exemption for the girlfriend's child. The U.S. Tax Court held that the taxpayer satisfied the requirements of IRC § 2(b) and qualified for head of household filing status for the 2003 tax year.

Child Tax Credit – IRC § 24

We reviewed 21 cases involving the child tax credit during the reporting period. Before 2005, one of the requirements for a taxpayer to claim the child tax credit was for a taxpayer to be able to claim a dependency exemption for the child. Because qualifying for the dependency exemption was required to claim the child tax credit, the child tax credit was often summarily denied where the dependency exemption was denied. In the three cases where the taxpayer prevailed, the Tax Court held the taxpayers were entitled to claim the child tax credit because they were entitled to dependency exemption deductions under § 151.[31]

Earned Income Tax Credit – IRC § 32

Introduction

We analyzed 24 cases involving the EITC during the reporting period. The taxpayers prevailed in three of those cases.[32]

In *Beckford v. Commissioner*,[33] the taxpayer claimed EITC for his niece in the 2003 tax year. The IRS denied the EITC claim because the niece did not meet the relationship requirement and the taxpayer did not show that he cared for the niece as his own child

[28] T.C. Summ. Op. 2006-81.

[29] IRC § 2(b)(1).

[30] IRC § 2(b)(1).

[31] *Litton v. Comm'r*, T.C. Summ. Op. 2006-56; *Manzueta v. Comm'r*, T.C. Summ. Op. 2005-185; *Omans v. Comm'r*, T.C. Summ. Op. 2005-110.

[32] *Beckford v. Comm'r*, T.C. Summ. Op. 2006-80; *Lozoya v. Comm'r*, T.C. Summ. Op. 2005-73; *Vogt v. Comm'r*, T.C. Summ. Op. 2005-107.

[33] T.C. Summ. Op. 2006-80.

(this "cares for" rule was in place in 2003, but was eliminated by the uniform definition of a qualifying child for returns beginning after December 31, 2004).[34] Although the taxpayer was not eligible to claim EITC under IRC § 32(c)(1)(A)(i) for a qualifying child, the court held that the taxpayer was an "eligible individual" under IRC § 32(c)(1)(A)(ii), which does not require any qualifying children. For 2003, a taxpayer was eligible under this subsection only if his adjusted gross income was less than $11,230; the taxpayer's adjusted gross income was $11,132.

As discussed above, the taxpayer's wife in *Lozoya v. Commissioner*[35] moved out of the home in June 2001. The Tax Court held that under IRC § 7703(b), the wife is not considered a member of the taxpayer's household and determined that the taxpayer qualified for head of household filing status for the 2001 tax year. The court further held that since the taxpayer qualified for that filing status, it follows that he also qualified for the EITC for his two children.

In Vogt v. Commissioner,[36] the sole issue for EITC eligibility was whether the taxpayer's adjusted gross income exceeded the income limitation for the 2001 tax year. The IRS stated at trial that the EITC is not available for taxpayers with income in excess of $11,610. The court explained that in 2001, the EITC phase-out range for taxpayers with two dependents began at $13,090 and the EITC was phased out completely when taxpayers' adjusted gross income reached $32,121. Because the taxpayers here had adjusted gross income of less than $32,121 for the tax year 2001, the court held they were entitled to a portion of the EITC.

Dependency Exemption – IRC § 151

We analyzed 38 cases involving the dependency exemption, with taxpayers prevailing in only three of them.[37]

In *Hartfield v. Commissioner*,[38] the taxpayer lived with his girlfriend and her minor child for the entire year in 2003. During that time, the taxpayer paid the full costs of supporting the child, including housing, clothing, food, personal hygiene, transportation, and school supplies. To qualify as a dependent under the law in effect at that time, an indi-

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[34] Under the prior rules, IRC § 32(c)(3)(B)(i)(II) required that a taxpayer claiming as a qualifying child a brother, sister, stepbrother, or stepsister, or a descendant of any such individual must care for the child as the taxpayer's own child. There was a great deal of uncertainty on the part of taxpayers as to what constituted "caring for" the child as one's own child. *See Gilmore v. Commissioner*, T.C. Summ. Op. 2004-38; *Barajas v. Commissioner*, T.C. Summ. Op. 2002-59. Because the "cares for" test was vague and hard to administer, and introduced a type of support test into the EITC definition of qualifying child because it will require a showing of activities such as purchasing food, clothing, medical care, and other items, Congress eliminated the "cares for" requirement when it passed the UDOC rules.

[35] T.C. Summ. Op. 2005-73.

[36] T.C. Summ. Op. 2005-10 7.

[37] *Hartfield v. Comm'r*, T.C. Summ. Op. 2006-77; *Litton v. Comm'r*, T.C. Summ. Op. 2006-56; *Omans v. Comm'r*, T.C. Summ. Op. 2005-110.

[38] T.C. Summ. Op. 2006-77.

vidual must have received over half his or her support from the taxpayer, have had the same principal place of abode as the taxpayer, and have been a member of the taxpayer's household.[39] The court was satisfied that the taxpayer met all of these requirements, and held the taxpayer was entitled to a dependency exemption deduction for the 2003 tax year.

In *Litton v. Commissioner*,[40] the taxpayer and her ex-husband had joint custody of their children. In the case of a child of divorced parents, if a child receives over half of his support during the year from one or both his parents and is in the custody of one or both parents for more than half of the year, then the child shall be treated as receiving over half of his support during the year from the parent having physical custody for a greater portion of the year.[41] That parent is referred to as the "custodial parent." The issue in question was which parent had physical custody and was the custodial parent. The taxpayer contended she was the custodial parent because the children were in her physical custody for more than half of the year. In support of her contention, the taxpayer presented into evidence a day planner showing she had physical custody of the children for 195 days in 2003, which is more than half of the year. However, the husband disputed the taxpayer's method of counting "days," arguing that the children spent the night with him on many of the Sundays included in the taxpayer's calculation of 195 days. On balance, and in light of the facts and circumstances of this case, the Tax Court concluded the children spent more than 50 percent of the time with the taxpayer. Accordingly, the court held that the taxpayer was entitled to dependency exemption deductions for her son and daughter in the taxable year 2003.

In *Omans v. Commissioner*,[42] the taxpayer and his wife divorced in 1993. The divorce decree awarded the wife physical custody of their two minor children. A noncustodial parent may be entitled to dependency exemption deductions if one of the exceptions in IRC § 152(e) is satisfied. IRC § 152(e)(2) provides that a child shall be treated as having received over half of his or her support from the noncustodial parent if the custodial parent signs a written declaration that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year, and the noncustodial parent attaches such written declaration to the noncustodial parent's return for the taxable year beginning during such calendar year.[43] The settlement agreement attached to the taxpayer's 1998 return contains the names of the two children, the custodial parent's signature as witnessed by a notary's certification, the date of her signature, and taxpayer's name.

[39] IRC § 151.

[40] T.C. Summ. Op. 2006-56.

[41] IRC § 152(e)(1). Under UDOC, custodial parent is the parent having custody for the greater portion of the calendar year. IRC § 152(e)(4)(n).

[42] T.C. Summ. Op. 2005-110.

[43] Under UDOC, the noncustodial parent may still claim the child as a dependent if certain requiremenrts are met under IRC § 152(e)(2).

Although the settlement agreement did not list each and every year to which the taxpayer's entitlement to the dependency exemption deductions was to apply, the court found that it clearly refers to the separate returns of the taxpayer and his ex-wife "for the 1992 tax year and for each year thereafter," thus including the year at issue. The IRS contended that the custodial parent's signature failed to signify her intent to not claim the dependency exemption deductions, due to the absence of the language "will not claim" from the settlement agreement. The Tax Court found the custodial parent's notarized signature indicated more than a mere acknowledgment of the form of the settlement agreement, and that it signified the custodial parent's sworn agreement to the settlement agreement's contents, including the taxpayer's entitlement to the dependency exemption deductions.

CONCLUSION

Family status provisions are fundamental components of the tax code, and yet they have complicated and sometimes conflicting eligibility standards. Because of this complexity, tax filing can be a difficult and confusing exercise for low and middle income families. Taxpayers who wish to claim the family status credits and deductions often do not understand the qualification requirements or how to properly satisfy them. Further, such taxpayers often lack legal representation when they go before the courts, which may affect the outcomes of their cases.

The changes to family status provisions made by the Working Families Tax Relief Act may ease the burden of proving eligibility somewhat through UDOC. Under the old rules, support was the key element in determining whether a taxpayer qualified for dependency exemptions, which in turn affected eligibility for other related provisions. The uniform definition of child replaced the support test with the residency test, which may be easier for a taxpayer to prove. The court often looked to custody agreements, calendars or planners, and testimony as evidence of where the child resided on various days. Because the family status provisions incorporating the uniform definition of child were not effective until tax year 2005, it may be several years before courts issue opinions involving these provisions.

LITIGATED ISSUE #10 CHARITABLE DEDUCTIONS UNDER INTERNAL REVENUE CODE SECTION 170

SUMMARY

Subject to certain limitations, taxpayers can take a deduction from their adjusted gross income for contributions of cash or other property to charitable organizations.[1] Taxpayers must contribute to certain qualifying organizations,[2] and are required to substantiate contributions of $250 or more.[3] Litigation generally arises over one of four issues:

- Whether the organization to which a contribution is made is charitable in nature;
- Whether the property that is contributed qualifies as a charitable contribution;
- Whether the amount deducted equals the fair market value of the property contributed; and
- The extent to which the taxpayer has substantiated the contribution.

For this report, we reviewed 26 cases with charitable deductions as a contested issue. The government prevailed in 19 cases and there were seven split decisions, *i.e.*, the court ruled partially in favor of the taxpayer and partially in favor of the government.

PRESENT LAW

Taxpayers can generally take a deduction for charitable contributions made within the taxable year.[4] Deductions of charitable contributions for individuals are generally limited to 50 percent of the taxpayer's contribution base (which is adjusted gross income computed without regard to any net operating loss carryback to the taxable year under IRC § 172).[5] However, subject to certain limitations, individual taxpayers are permitted to carry forward unused charitable contributions in excess of the 50 percent contribution base for up to five years.[6] Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income.[7] No deduction is allowed for services that taxpayers offer to charitable organizations;[8] however, expenditures made incident to

1 IRC § 170.

2 To claim a charitable contributions deduction, a taxpayer must establish that a gift was made to a qualified entity organized and operated exclusively for an exempt purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual. IRC § 170(c)(2).

3 IRC § 170(f)(8).

4 IRC § 170(a)(1).

5 IRC § 170(b)(1)(A), (F).

6 IRC § 170(d)(1).

7 IRC § 170(b)(2).

8 Treas. Reg. § 1.170A-1(g).

the rendition of services to a charitable organization and which are not reimbursed may constitute a deductible contribution.[9]

Substantiation

Deductions for charitable contributions of $250 or more are disallowed in the absence of a contemporaneous written receipt from the recipient of the contribution.[10] For cash contributions, taxpayers are required to maintain receipts from the charitable organization, copies of cancelled checks, or other reliable records showing the name of the organization and the date and amount contributed.[11] For charitable contributions of property other than money, taxpayers generally must maintain for each contribution a receipt from the recipient of the contribution showing the following information: (1) the name of the recipient; (2) the date and location of the contribution; and (3) a description of the property.[12] When property other than money is contributed, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.[13]

***Cohan** Doctrine*

In cases where taxpayers have provided credible evidence of having made a charitable contribution but have difficulty substantiating the precise amount of the payment, a judicial doctrine has evolved that allows courts to determine, based on the best evidence at hand, the amount of the charitable contribution.[14] The Cohan doctrine does not relieve the taxpayer of the responsibility of substantiating his or her charitable contribution, although it can assist taxpayers who can demonstrate that contributions were made but have not kept records of the precise amounts contributed.[15]

ANALYSIS OF LITIGATED CASES

Of the 26 charitable deduction cases we reviewed, three involved the issue of whether the recipient was a qualified charitable organization, six cases involved a dispute over

[9] *Id.* Meal expenditures in conjunction with offering services to qualifying organizations are not deductible unless the expenditures are away from the taxpayer's home. *Id.; see also Work v. Comm'r*, T.C. Memo. 2005-259 (holding taxpayer did not substantiate fact that meal expenses associated with volunteer efforts were incurred away from home). Likewise, travel expenses associated with contribution are not deductible if there is a significant element of personal pleasure involved with the travel. IRC § 170(j).

[10] IRC § 170(f)(8); see also Treas. Reg. § 1.170A-13(f).

[11] Treas. Reg. § 1.170A-13(a)(1).

[12] Treas. Reg. § 1.170A-13(b)(1).

[13] Treas. Reg. § 1.170A-1(c)(1). Note that the fair market value must be reduced for certain contributions of ordinary income and capital gain property. *See* IRC § 170(e).

[14] *Cohan v. Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930). In *Cohan*, a theatrical production manager claimed unsubstantiated deductions for the entertainment of actors, employees, and dramatic critics. He did not maintain records of these expenses, but knew that they were substantial sums. The Second Circuit determined that the Board of Tax Appeals was authorized to estimate unsubstantiated taxpayer expenses when it is certain that expenses were incurred, but the amount could not be quantified. *Id.* at 543.

[15] *See, e.g., Robinette v. Comm'r*, T.C. Summ. Op. 2006-69; *Finch v. Comm'r*, T.C. Summ. Op. 2006-54.

the valuation of the property, five involved the issue of whether the property contributed qualified as a deductible contribution, and 15 cases involved the taxpayers' substantiation (or lack thereof) of the claimed contributions.[16]

Qualifying Charitable Organization

To be deductible, a charitable contribution must be made to a qualifying charitable organization.[17] In three cases, taxpayers' deductions were rejected for failing to meet this threshold test. In one case, the U.S. Tax Court held that contributions to one's sick family members, while laudable, do not constitute contributions to a qualifying organization.[18] In another case, the Tax Court held that a Christian center may not be a qualifying organization where the taxpayer fails to demonstrate that it is operated exclusively for religious purposes.[19] In a third case, the taxpayers (husband and wife) made a variety of payments for which they claimed charitable deductions.[20] The Tax Court concluded that only a contribution to the American Heart Association was legitimate, as "[n]othing establishes that any [of the other deductions] were made to qualified donees."[21]

Qualified Contribution

To constitute a qualified contribution for purposes of IRC § 170, the donor-taxpayer must possess a transferable property interest in the property and intend to irrevocably relinquish all rights, title and interest to the property without an expectation of some benefit in return.[22] Thus, a charitable deduction for the non-renewal of grazing rights failed because the taxpayer had no transferable property interest in the grazing license, and the government received no benefit from the taxpayer's waiver of the renewal of that license.[23] Likewise, where the transfer of real property from the taxpayer to the charitable organization does not satisfy all legal requirements before the year's end, the

16 Some cases contained one or more of these issues, which explains a total of greater than 26. *See, e.g., Haas v. Comm'r*, T.C. Summ. Op. 2006-9 (involving substantiation and valuation of the contribution).

17 Qualifying charitable organizations include: (1) federal, state or local governments, and (2) corporations, trusts or funds organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of a private individual or shareholder. See IRC § 170(c) for a full description of qualifying organizations.

18 *Westbrook v. Comm'r*, T.C. Summ. Op. 2006-3.

19 *Triplett v. Comm'r*, T.C. Summ. Op. 2005-148 (holding the failure to provide a list of members or to demonstrate that the center performed religious services demonstrated that the organization was not operated exclusively for religious purposes).

20 *Deihl v. Comm'r*, T.C. Memo. 2005-287.

21 *Id.*

22 IRC § 170(f)(3) requires that taxpayers relinquish all rights, title and interest in property contributed. *See Sklar v. Comm'r*, 125 T.C. 281 (2005) (holding payments for private tuition were made in expectation of a return benefit, *i.e.*, education, and therefore were not deductible as charitable contributions), *appeal docketed*, No. 06-72961 (9th Cir. June 8, 2006); *see also Rev. Rul.* 67-246, 1967-2 C.B. 104.

23 *Bischel v. U.S.*, 415 F. Supp. 2d 1211 (D. Nev. 2005).

taxpayer's deduction will be denied for that year.[24] The existence of personal benefit from the transfer also determined the outcome in two cases. A charitable deduction for payment of tuition to a private school failed because the taxpayer received a substantial benefit in return for the contribution, *i.e.*, a private education for his children, in return for the payment.[25] Similarly, where a taxpayer expends travel costs while contributing services to a charitable organization, the taxpayer may not take a deduction for those expenses when there is a significant personal benefit associated with those expenses.[26]

A taxpayer may make a charitable contribution of an interest in realty that is less than all of all the taxpayer's right, title, and interest to the property, provided that the contribution satisfies the IRC § 170(h) definition of a qualified conservation contribution.[27] However, as the Tax Court held, the grant of a conservation easement that limits development to a specified number of lots is not a qualified contribution if the existence of a circumstance (such as a floodplain) would have precluded additional development regardless of whether the conservation easement had been granted.[28] Likewise, preserving land from development does not satisfy qualified conservation purpose requirements unless a historic structure or historically important land area is being preserved.[29]

Valuation

Six cases involved disputes between the IRS and taxpayers as to the value of property contributed. When taxpayers contribute non-cash items, they must determine the fair market value of the property as of the date of the contribution.[30] Fair market value is the price at which the property would change hands between a willing buyer and a willing seller,[31] thus the price paid by taxpayer for the property is more persuasive as to fair market value than expert appraisals.[32] Determining the fair market value of non-cash property with precision can be difficult for taxpayers. Consequently, if taxpayers can

[24] *Kaplan v. Comm'r*, T.C. Memo. 2006-16.

[25] *Sklar v. Comm'r*, 125 T.C. 281 (2005), *appeal docketed*, No. 06-72961 (9th Cir. June 8, 2006)..

[26] *Field v. Comm'r*, T.C. Summ. Op. 2005-184.

[27] A qualified conservation contribution requires that the contribution be of a "qualified real property interest" (*i.e.*, the entire interest of the donor other than a qualified mineral interest, a remainder interest or a restriction on the use that can be made of the property, IRC § 170(h)(2)), to a "qualified organization" (*i.e.*, generally organizations that qualify under IRC § 501(c)(3), IRC § 170(h)(3)), and exclusively for conservation purposes (*i.e.*, the preservation of land areas for outdoor recreation by or education of the general public, the protection of wildlife, the preservation of open spaces or the preservation of historic structures, IRC § 170(h)(4)(A)–(B)). The conservation purpose must be protected in perpetuity. IRC § 170(h)(5)(A).

[28] *Turner v. Comm'r*, 126 T.C. 299, 314 (2006).

[29] *Id*. at 316 (holding there was no actual historic structure on the land and the easement's limitation on development on land near the historic structure does not preserve the historic structure).

[30] Treas. Reg. § 1.170A-1(c)(1).

[31] Treas. Reg. § 1.170A-1(c)(2).

[32] *Wortmann v. Comm'r*, T.C. Memo. 2005-227.

demonstrate that they donated property, courts are willing to apply the *Cohan* doctrine to arrive at a reasonable fair market value.[33]

Substantiation

Fifteen cases involved the issue of taxpayers' substantiation of deductions for charitable contributions, with the IRS fully prevailing in ten cases and split decisions resulting in the other five. In the cases in which the IRS fully prevailed, there was no particular finding of lack of credibility on the part of the taxpayers; rather, the decisions reflect that the substantiation requirement is a prerequisite to the charitable deduction. In the cases where taxpayers were allowed a partial deduction, the courts generally applied the *Cohan* doctrine when taxpayers were able to demonstrate that contributions were made but were unable to demonstrate the precise amounts.[34] However, as the Tax Court noted in several cases: "[We] may estimate the amount of the deductible expense, bearing heavily against the taxpayer whose inexactitude in substantiating the amount of the expense is of his own making."[35]

***Pro Se* Analysis**

In 17 of the 26 cases we reviewed, taxpayers were *pro se, i.e.*, representing themselves. None of the taxpayers who appeared *pro se* were entitled to a charitable deduction in full, but six of the seven taxpayers who received partial relief from the courts in these cases were *pro se*. The fact that unrepresented taxpayers were able to obtain some relief in six of these seven cases may reflect the fact that courts are willing to apply the *Cohan* doctrine in taxpayers' favor, provided the taxpayers can demonstrate credible evidence that charitable contributions were made.

CONCLUSION

Internal Revenue Code § 170 and the applicable Treasury Regulations provide detailed requirements as to what constitutes adequate substantiation for the charitable deduction. These cases demonstrate that courts apply the *Cohan* doctrine to provide some relief to taxpayers who can demonstrate that a contribution has been made; however, on balance, these cases reflect that the courts strictly interpret IRC § 170 and its accompanying regulations.

[33] *Ritchie v. Comm'r*, T.C. Summ. Op. 2005-181.

[34] *Robinette v. Comm'r*, T.C. Summ. Op. 2006-69; *Finch v. Comm'r*, T.C. Summ. Op. 2006-54; *Haas v. Comm'r*, T.C. Summ. Op. 2006-9; *Brown v. Comm'r*, T.C. Summ. Op. 2005-85; *Kendrix v. Comm'r*, T.C. Memo. 2006-9, *appeal docketed*, No. 06-72814 (9th Cir. June 1, 2006), *appeal dismissed* (July 21, 2006), *motion to reconsider filed* (Aug. 3, 2006).

[35] *See, e.g., Robinette v. Comm'r*, T.C. Summ. Op. 2006-69 (citation omitted) ; *Finch v. Comm'r*, T.C. Summ. Op. 2006-54 (citation omitted).

CASE ADVOCACY

Introduction

Internal Revenue Code (IRC) § 7803 requires the National Taxpayer Advocate to report to Congress annually on the activities of the Office of the Taxpayer Advocate.[1] Fiscal year 2006 presented several challenges for Taxpayer Advocate Service case advocacy due to increasing case levels influenced by IRS activities and external factors (*e.g.*, new legislation, natural disasters, and the general economic environment).[2] As Table 4.1 illustrates, most (nearly 47 percent) TAS cases are referred to us by the IRS business operating divisions (BODs).

TABLE 4.1, FY 2006 TAS CASE INTAKE

How TAS Received Each Case	Function Refers to TAS	NTA Toll-Free	Taxpayer Comes Directly to TAS	Total[3] Receipts
Servicewide	**112,709**	**64,779**	**64,685**	**242,173**
Wage & Investment	65,750	44,233	27,190	137,173
Small Business/Self Employed	45,341	19,780	34,954	100,075
Large/Mid-Size Business	604	260	619	1,483
Tax Exempt/Government Entities	1,023	491	1,897	3,411

TABLE 4.2, FY 2006 TAS CASE INTAKE PERCENTAGES

How TAS Received Each Case	Function Refers to TAS	NTA Toll-Free	Taxpayer Comes Directly to TAS
Servicewide	**46.5%**	**26.7%**	**26.7%**
Wage & Investment	47.9%	32.2%	19.8%
Small Business/Self Employed	45.3%	19.8%	34.9%
Large/Mid-Size Business	40.7%	17.5%	41.7%
Tax Exempt/Government Entities	30.0%	14.4%	55.6%

[1] IRC § 7803(c)(2)(B)(ii).

[2] Nina E. Olson, *Common Sense and Good Judgment In Case Processing II* memorandum (Oct.4, 2006) http://www.irs.gov/pub/foia/ig/tas/tas-13-1006-005.pdf. This memorandum will be incorporated into the next revision of IRM 13.

[3] Business operating division (BOD) total receipts will not total to servicewide receipts. The Taxpayer Advocate Management Information System (TAMIS) is a dynamic system, and the statistics gathered for this chart were not compiled on the same date. The servicewide receipt data was retrieved on October 4, 2006. The BOD receipt data was obtained on November 16, 2006.

In addition to working individual taxpayer issues, TAS continually examines taxpayer needs to ensure TAS awareness and accessibility. Changes to IRS policies and procedures continue to dramatically impact taxpayers' need for TAS intervention, thus causing a downstream impact on our workload. TAS took the initiative to reach out to and assist taxpayers, including clarifying TAS acceptance criteria, and offering a public interface through marketing and outreach campaigns.

Case Criteria

TAS clarified its case acceptance criteria[4] to make certain TAS successfully fulfills its mission,[5] protects taxpayer rights, prevents burden, and ensures the equitable treatment of taxpayers. TAS case acceptance criteria fall into four main categories:

- Economic Burden;
- Systemic Burden;
- Best Interest of the Taxpayer; and
- Public Policy.

TAS implemented the clarified case criteria on January 8, 2006.[6] In October 2006, the National Taxpayer Advocate issued a memorandum[7] providing additional guidance to TAS case advocates, IRS employees, and taxpayers explaining when a case qualifies for acceptance in TAS, and qualifies for issuance of a Taxpayer Assistance Order under IRC § 7811.

4 IRC § 7803(c)(2)(c)(ii) authorizes the National Taxpayer Advocate to develop guidance for all IRS employees outlining the criteria for referring taxpayer inquiries to TAS.

5 The TAS mission statement says that, "As an independent organization within the IRS, we help taxpayers resolve problems with the IRS and recommend changes to prevent the problems."

6 National Taxpayer Advocate 2007 Objectives Report to Congress 33.

7 Nina E. Olson, *Common Sense and Good Judgment In Case Processing II* memorandum (Oct.4, 2006) http://www.irs.gov/pub/foia/ig/tas/tas-13-1006-005.pdf. This memorandum will be incorporated into the next revision of IRM 13, Taxpayer Advocate Service.

CHART 4.3, TAS CASE ACCEPTANCE CRITERIA

Economic Burden Case Receipts for FY 2006

Criteria Code	Description	Number of Cases	Percentage of Cases
1	The taxpayer is experiencing economic harm or is about to suffer economic harm.	46,173	19.0%
2	The taxpayer is facing an immediate threat of adverse action.	14,708	6.0%
3	The taxpayer will incur significant costs if relief is not granted (including fees for professional representation).	5,475	2.0%
4	The taxpayer will suffer irreparable injury or long-term adverse impact if relief is not granted.	6,107	3.0%
Total Economic Burden Case Receipts		**72,463**	**29.9%**

Systemic Burden Case Receipts for FY 2006

Criteria Code	Description	Number of Cases	Percentage of Cases
5	The taxpayer has experienced a delay of more than 30 days to resolve a tax account problem.	48,558	20.0%
6	The taxpayer has not received a response or resolution to their problem or inquiry by the date promised.	38,019	16.0%
7	A system or procedure has either failed to operate as intended, or failed to resolve the taxpayer's problem or dispute within the IRS.	82,621	34.0%
Total System Burden Case Receipts		**169,198**	**69.9%**

Best Interest of the Taxpayer Case Receipts for FY 2006

Criteria Code	Description	Number of Cases	Percentage of Cases
8	The manner in which the tax laws are being administered raise considerations of equity, or have impaired or will impair taxpayers' rights.	273	0.1%

Public Policy Case Receipts for FY 2006

Criteria Code	Description	Number of Cases	Percentage of Cases
9	The National Taxpayer Advocate determines compelling public policy warrants special assistance to an individual or group of taxpayers.	239	0.1%
Total Case Receipts		**242,173**	**100%**

Case Receipts

TAS continues to experience an upward trend in receipts coupled with a progressively more complex workload. Chart 4.4 below illustrates how TAS receipts have risen since the beginning of fiscal year 2003, while the number of case advocates needed to work these cases steadily declined. TAS hired a significant number of case advocates in FY 2006,[8] but unfortunately this hiring could not keep pace with either attrition or increasing workload.[9]

CHART 4.4, MONTHLY TAS CASE RECEIPTS AND THE NUMBER OF CASE ADVOCATES FROM OCTOBER 2002 TO SEPTEMBER 2006

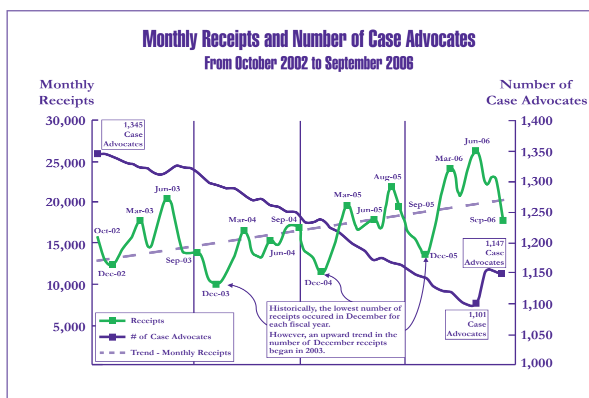
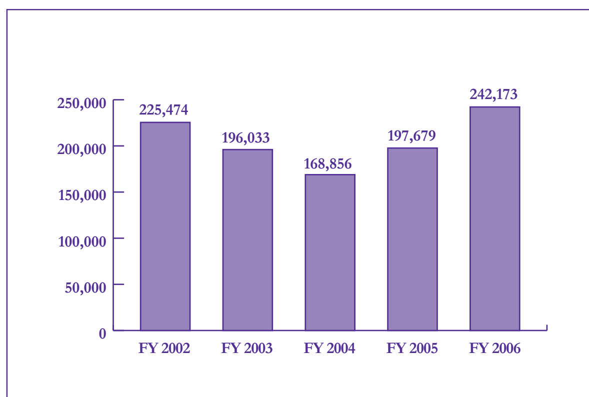


CHART 4.5, TAS TOTAL CASE RECEIPTS



Economic Burden

The percentage of economic burden case receipts has increased for the past several years primarily due to IRS compliance and enforcement activities. TAS procedures require

[8] TAS hired 67 case advocates and 35 intake advocates during FY 2006.

[9] As of December 31, 2006, 119 case advocates were eligible for retirement. An additional 66 case advocates will be eligible for retirement by December 31, 2007. HR Connect (IRS intranet), *Create a Retirement Projection Statistical Report*, (Nov. 9, 2006).

case advocates to respond immediately to the taxpayer's request for assistance in economic burden cases.[10] Even as TAS resources decline, the growing trend of requests for relief from economic burden will likely continue as the IRS steps up enforcement and if taxpayers fail to maintain adequate personal savings to pay unexpected tax debts.[11]

CHART 4.6, TAS ECONOMIC BURDEN CASE RECEIPTS

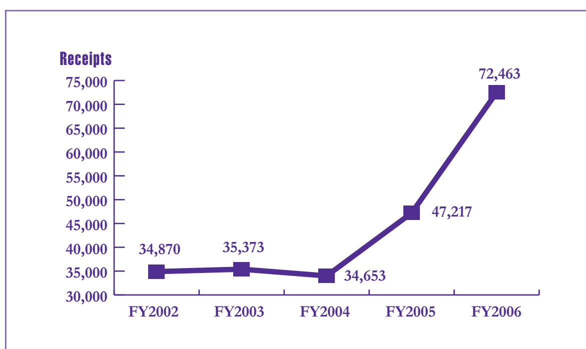
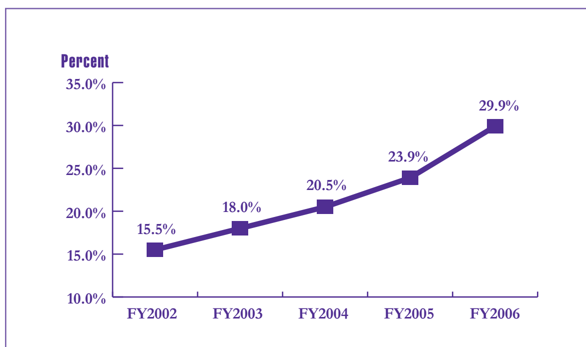


CHART 4.7, TAS ECONOMIC BURDEN RECEIPTS AS A PERCENTAGE OF TOTAL RECEIPTS



Systemic Burden

The majority of taxpayers who contact TAS do so because they are experiencing a systemic burden caused by a process, procedure, or system within the IRS that either failed to operate as intended or failed to resolve the taxpayer's problem. As shown in Chart 4.8, systemic burden case receipts are on the rise. It is notable that the systemic burden cases have decreased in relationship to TAS's total case inventory as shown in Chart 4.9.

[10] Initial contact with taxpayers and actions to resolve cases involving economic burden (TAS Case Acceptance Criteria 1-4) must be initiated within three workdays of the date TAS receives the taxpayer's inquiry.

[11] Personal saving as a percentage of disposable personal income was a negative 0.7 percent in September 2006. Saving for current income may be near zero or negative when outlays are financed by borrowing (including borrowing financed through credit cards or home equity loans), by selling investments or other assets, or by using savings from pervious periods. Bureau of Economic Analysis, U.S. Department of Commerce, BEA 06-52, *Personal Income and Outlays: October 2006* (Nov. 30, 2006).

CHART 4.8, SYSTEMIC BURDEN CASE RECEIPTS

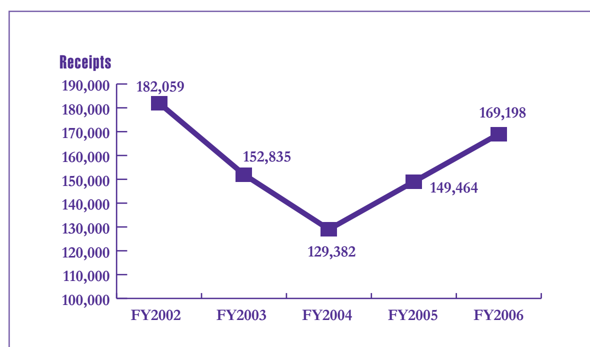
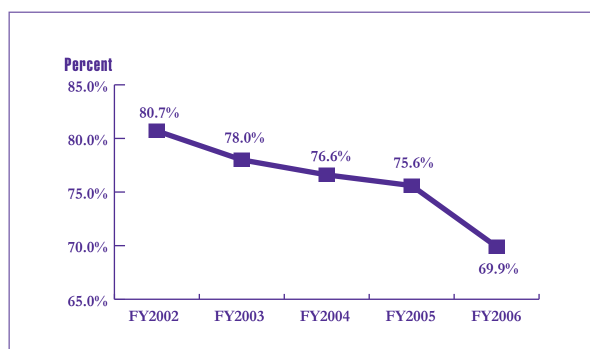


CHART 4.9, SYSTEMIC BURDEN RECEIPTS AS A PERCENTAGE OF TOTAL RECEIPTS



Best Interest of the Taxpayer

TAS accepts cases in situations where the manner in which the tax laws are being administered raise considerations of equity, or has or will impair taxpayer rights. Acceptance of these cases ensures taxpayers receive fair and equitable treatment and protects their rights in situations where no other TAS case acceptance criteria is applicable. TAS received 273 cases in this category in FY 2006. The majority, 67 percent, involved issues related to IRS compliance and enforcement activities, for example, issues related to audits, criminal investigations, levies, liens, and offers in compromise.

Public Policy

TAS accepts cases under this category when the National Taxpayer Advocate determines compelling public policy warrants assistance to an individual or group of taxpayers that may arise due to the implementation of new tax programs or initiatives. TAS accepts cases under Public Policy criteria only when the taxpayer's situation does not fall under any other case acceptance criteria. In FY 2006, the National Taxpayer Advocate designated cases related to the IRS's Private Debt Collection Initiative as warranting assistance under public policy criteria.[12]

[12] *See* Most Serious Problem, *True Costs and Benefits Of Private Debt Collection, supra.*

Sources of TAS Casework

TAS uses primary and secondary issue codes to identify and track issues that lead taxpayers to seek TAS assistance. These issues are often indicators of the downstream impact of IRS initiatives. Chart 4.10 illustrates the top 15 issues taxpayers face when seeking TAS assistance. For example, TAS is experiencing significant increases in enforcement issues such as taxpayer delinquency investigations and levies.[13]

TABLE 4.10, TOP 15 ISSUES RECEIVED IN TAS (FY 2006)

Rank	Description of the Issue	Number of Cases		% Change
		FY 2005	FY 2006	
1	Criminal Investigation	28,639	21,395[14]	-25.29%
2	Levies (including the Federal Payment Levy Program)	11,477	18,800	63.81%
3	Processing amended returns	12,338	17,140[15]	38.92%
4	Earned Income Tax Credit (EITC) – Revenue Protection Strategy Claims	12,836	12,769	-0.52%
5	Injured spouse claim	6,285	11,599	84.55%
6	Processing original returns	9,288	10,398	11.95%
7	Expedite refund requests	6,903	10,070	45.88%
8	Reconsideration of Substitute for Return under IRC §6020(b)[16] and Audits[17]	7,406	10,005	35.09%
9	Automated Underreporter Examination[18] Completed	5,978	7,706	28.91%
10	Open audit	9,288	6,934	-25.34%
11	Liens (including original filing, release, withdrawal, subordination, and discharge)	5,474	6,065	10.80%
12	Copies of Returns, Transcript of Account, Audit Reports, or Information Requested under the Freedom of Information Act	5,677	5,753	1.34%
13	Other document processing issues	3,314	5,619	69.55%
14	Taxpayer Delinquency Investigation - Substitute for Return under IRC §6020(b)[19]	2,173	5,083	133.92%
15	Automated Underreporter Examination In Process	2,963	4,718	59.23%

[13] For a detailed discussion of levies, see Most Serious Problem, *Levies, supra.*

[14] *See* Status Update, *Major Improvements In the Questionable Refund Program And Some Continuing Concerns, supra.*

[15] *See* Most Serious Problem, *Correspondence Delays, supra.*

[16] IRC § 6020(b): If any person fails to make any return required by any internal revenue law or regulation made there under at the time prescribed therefore, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

[17] Reconsideration of a tax assessment resulting from an IRS examination, or an income or employment tax return prepared by the IRS under IRC § 6020(b).

[18] The Automated Underreporter (AUR)program matches taxpayer income and deductions submitted by third parties against amounts reported on the individual income tax return.

[19] TDI is an IRS program to determine whether a taxpayer has filed a required return.

Trends in Case Advocacy

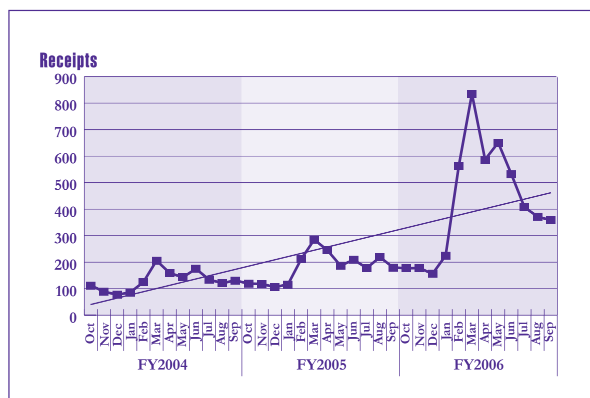
TAS workload volumes are a function of many variables, including new IRS initiatives, changes in legislation or IRS practices, and increases or decreases in staffing components within IRS operating divisions. The following issues exemplify the downstream effect on TAS receipts created by changes in other IRS functions.

Effect of the Delinquent Refund Hold Program on TAS Case Receipts

The Delinquent Return Refund Hold (RH) program delays issuing a taxpayer's refund while the IRS investigates a return delinquency.[20] When the IRS secures the delinquent return, it uses the refund to offset any balance due amounts. In March 2006, the Wage & Investment (W&I) division issued new guidelines for processing RH cases, which included lowering the dollar threshold for freezing taxpayer refunds associated with unfiled returns. The IRS consolidated the program at one campus in January 2006, but expanded it to two others in March.

The impact of the RH program on TAS case receipts is illustrated in Chart 4.11, TAS Case Receipts Resulting from Taxpayer Delinquency Investigations[21] and Substitute for Return under IRC § 6020(b). TAS experienced a 182 percent increase in these receipts in February and March 2006 compared to 2005.

CHART 4.11, TAS CASE RECEIPTS RESULTING FROM TAXPAYER DELINQUENCY INVESTIGATIONS AND SUBSTITUTE FOR RETURN UNDER IRC § 6020(B)



In addition to the significant upturn in receipts in these two months, TAS receipts for the remainder of FY 2006 remained higher than in the two previous years. As illustrated in Chart 4.12, the IRS reported a reduction in TDI inventory, but the FY 2006 overage TDI inventory has increased by more than 90 percent, contributing to the continued increase in TAS TDI receipts.

[20] IRM 25.12.1.1(2) (10-01-2005).

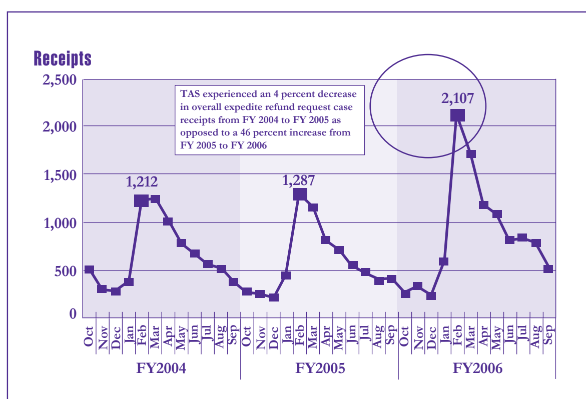
[21] TDI is an IRS program to determine whether a taxpayer has filed a required return.

CHART 4.12, COMPARISON OF TDI INVENTORY AND OVERAGE INVENTORY (ENTITY)[22]

	FY 2004	FY 2005	Percentage Change from FY 2004 to 2005	FY 2006	Percentage Change from FY 2005 to 2006
ACS TDI Ending Inventory	1,274,175	1,223,025	-4.01%	1,122,418	-8.23%
ACS TDI Overage Inventory	151,201	113,486	-24.94%	217,634	91.77%
Field Collection TDI Ending Inventory	91,290	120,921	32.46%	100,352	-17.01%
Field Collection TDI Overage Inventory	6,057	4,358	-28.05%	8,308	90.64%

Expedite refund requests is another issue where the RH program impacts TAS case receipts with a significant (46 percent) increase for FY 2006. While these requests normally increase in February and March, during the tax filing season, Chart 4.13 shows that they rose by 63 percent in February of 2006.

CHART 4.13, TAS EXPEDITE REFUND REQUEST CASE RECEIPTS FOR FY 2004 - 2006



W&I reviewed the RH program after receiving an increased number of Operations Assistance Requests (OARs)[23] and Taxpayer Assistance Orders (TAOs)[24] from TAS. The objective of the review was to determine how the IRS could release refunds more quickly, especially if the delinquent returns are likely to result in refunds.[25] Working together, W&I and TAS have identified improvements to the Refund Hold Program to ensure

[22] IRS, *Business Measures DataMart, Enterprise Director, Collection Report Monthly Comparison, Enterprise ACS Commissioner's Report Monthly Comparison, September 2004, 2005, and 2006*, at http://irbizmart.enterprise.irs.gov/P120.asp?url=/start_bal_ind.asp. Entity refers to the amount of taxpayers affected as opposed to the tax modules affected (which includes multiple years for the same taxpayer).

[23] IRM 13.1.7.7(1) (Oct. 31, 2004). An OAR is used by TAS to request assistance from an operating division or function to complete an action on a TAS case when TAS does not have the delegated or statutory authority to take the required action.

[24] A Taxpayer Assistance Order (TAO) may require an IRS unit to take an action, cease an action, or refrain from taking an action. A TAO may expedite consideration of a taxpayer's case, review and reconsider its own determination, or review the determination at a higher level in that unit.

[25] Wage & Investment, *Business Performance Review 25* (Nov. 1, 2006).

cases are worked and resolved promptly and have issued guidance to their employees on handling these cases.

Effects of Customer Account Support (CAS) Operations on TAS Case Receipts

Customer Account Support (CAS), a function within W&I, is responsible for processing all individual and business returns (paper and electronic), and answering automated and assistor calls.[26] TAS case receipts most significantly impacted by this operation are amended returns processing,[27] injured spouse claims,[28] and math error notices,[29] all processes that W&I considers adjustments work.[30] W&I reported that as of September 30, 2006, the Individual Adjustments inventory (IMF) stood at 381,010, significantly higher than the 282,582 for last year.[31] IMF overage was approximately 40 percent of the total inventory, compared to approximately 20 percent last year.[32] This increase was caused by the need to maintain 15 hours of daily service in the toll-free operation coupled with high telephone traffic experienced during the timeframe normally devoted to adjustments work.[33]

As shown in Charts 4.14, 4.15, and 4.16, TAS normally experiences an increase in amended return processing, Injured Spouse Claim and Math Error receipts during May, June, and July. The downstream impact caused by IRS's overage inventory is readily apparent. TAS Amended Return case receipts increased 51.5 percent, Injured Spouse receipts rose 129.5 percent, and Math Error receipts went up 91.1 percent from June 2005 to June 2006.[34]

At the request of the IRS Oversight Board, TAS and W&I developed a new efficiency measure to document progress in reducing systemic problems. TAS and W&I selected amended return processing to test the process, and in FY 2007 will conduct root cause analysis, take corrective actions, and monitor case inventories for improvements.

[26] Wage & Investment, *Strategy & Program Plan FY 2007 – 2008*, 7 (Sept. 2006 revision).

[27] For further discussion of processing claims for refund, see National Taxpayer Advocate 2002 Annual Report to Congress 42-46.

[28] *See* Most Serious Problem, *Injured Spouse Allocations*, *supra*

[29] *See* Most Serious Problem, *IRS Implementation of Math Error Authority Impairs Taxpayer Rights, supra*. For further discussion on Math Error Authority, see National Taxpayer Advocate 2003 Annual Report to Congress 113-121.

[30] IRM 21.5.1.2 (Oct. 1, 2003). General adjustments are changes made at the request of the taxpayer on Individual [IMF], Business [BMF], and International tax accounts and Internal Transcripts. Adjustments may be required because of processing errors on returns; missing schedules; claims; amended returns; or internal transcripts.

[31] Wage & Investment, *Business Performance Review* 16 (Nov. 1, 2006).

[32] *Id.*

[33] *Id.* at 14.

[34] Amended Return case receipts increased 88.0 percent from July 2005 to July 2006. Math error case receipts include Math Error, Math Error IRS Individual Taxpayer Identification Number (ITIN), Invalid Dependent Social Security Number (SSN) or name, and Invalid Spouse or Dependent ITIN.

ADVOCACY

CHART 4.14, PROCESSING AMENDED RETURNS CASE RECEIPTS

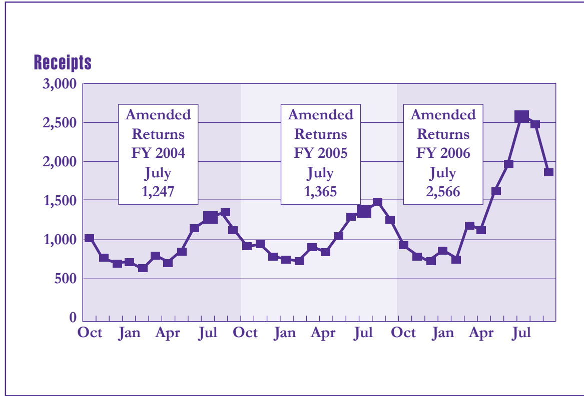


CHART 4.15, PROCESSING INJURED SPOUSE CLAIM CASE RECEIPTS

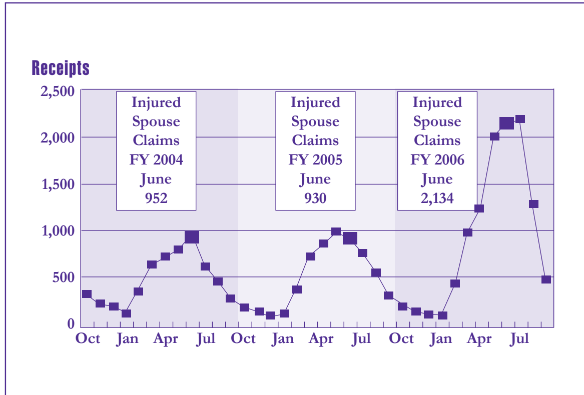
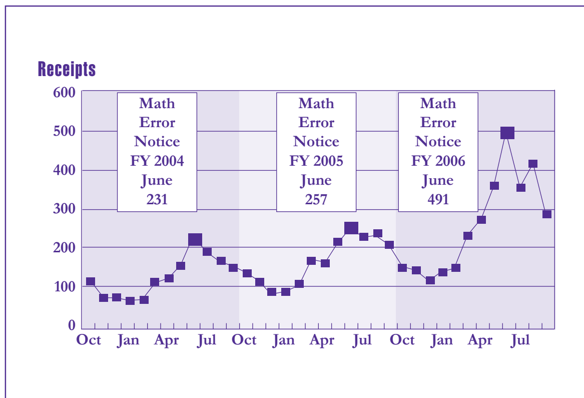


CHART 4.16, MATH ERROR NOTICE CASE RECEIPTS



Effect of Criminal Investigation Cases on TAS Case Receipts

The National Taxpayer Advocate published a study of the problems taxpayers were experiencing with the IRS's Questionable Refund Program (QRP) in her 2005 Annual Report to Congress.[35] The program freezes taxpayers' refunds when the IRS Criminal Investigation (CI) division makes a determination that the refund claim may be fraudulent. In the majority of cases, taxpayers were not notified of the IRS's determination to freeze the refund or given an opportunity to provide information to support their claims. As a result, TAS case receipts involving CI issues increased dramatically, from 5,509 cases in FY 2002 to 28,639 in FY 2005 as taxpayers turned to TAS for assistance in obtaining their refunds.

The IRS agreed to implement significant changes to the QRP program for tax returns processed during the 2006 tax filing season. These changes included notifying taxpayers when the IRS places a refund in freeze status, providing taxpayers with the opportunity to submit information to support their refund claim, and affording taxpayers appeal rights if the information submitted is not sufficient to substantiate the claim.[36]

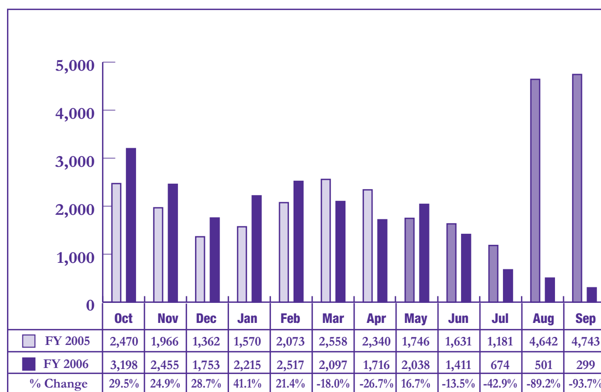
In March 2006, the IRS implemented the first phase of the program reforms when it began issuing notices to taxpayers to advise them of the delays in issuing their refunds and the reasons for the delays. The notice also gave taxpayers a timeframe when they could expect to receive their refund or additional contact from the IRS. If the IRS determined the refund claim was questionable, it sent taxpayers a second notice giving them the opportunity to substantiate their claim. As illustrated in the following chart, the new procedures led to a dramatic decrease in TAS cases related to the QRP in FY 2006 compared to FY 2005. More importantly, this systemic improvement afforded taxpayers equitable treatment and appeal rights.[37]

35 National Taxpayer Advocate 2005 Annual Report to Congress 25-54.

36 National Taxpayer Advocate's 2007 Objectives Report to Congress 17-19.

37 For a complete assessment of the CI program changes, see Status Update, *Major Improvements In the Questionable Refund Program And Some Continuing Concerns, supra.*

CHART 4.17, TAS QUESTIONABLE REFUND PROGRAM CASE RECEIPTS FOR FY 2005 – FY 2006

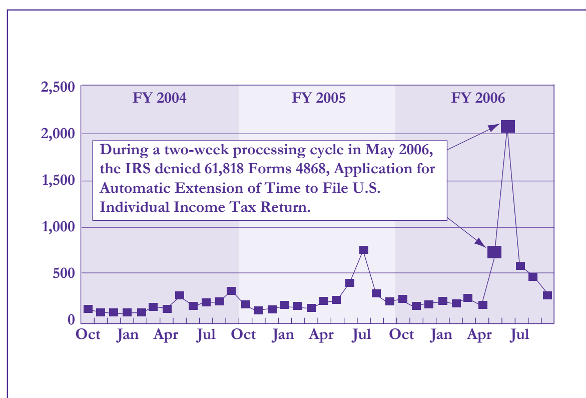


	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
FY 2005	2,470	1,966	1,362	1,570	2,073	2,558	2,340	1,746	1,631	1,181	4,642	4,743
FY 2006	3,198	2,455	1,753	2,215	2,517	2,097	1,716	2,038	1,411	674	501	299
% Change	29.5%	24.9%	28.7%	41.1%	21.4%	-18.0%	-26.7%	16.7%	-13.5%	-42.9%	-89.2%	-93.7%

Other Document Processing Issues

In May 2006, TAS and W&I collaborated to resolve the erroneous denial of a large number of Forms 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. This error caused increases of 201.6 percent and 379.5 percent in Other Document Processing Issue case receipts for May and June of FY 2006, respectively, compared to the prior year. This is an example of a systemic issue identified by case advocates that created a large volume of TAS cases. TAS worked to resolve the systemic issue with the operating division, and issued guidance to assist case advocates in processing individual cases.[38]

TABLE 4.18, TAS CASE RECEIPTS – OTHER DOCUMENT PROCESSING ISSUES, MONTHLY FOR FY 2004 – FY 2006[39]



38 A communication with interim guidance was issued to all TAS employees on June 9, 2006.

39 IRS Alert, AM/SP IRM W 06276, *Erroneously Denied Requests for Extensions of Time to File* (June 2, 2006).

Congressional Casework

TAS is responsible for independently reviewing all tax account inquiries sent to the IRS by members of Congress. TAS received 10,873 such inquiries in FY 2006. Table 4.19 below highlights the top ten issues in Congressional cases.

TABLE 4.19, TOP TEN ISSUES IN CONGRESSIONAL CASES

Issue	Number
Levies (including the Federal Payment Levy Program)	1,015
Application for Exempt Status (Form 1023/1024)	693
Account/Notice Inquiry	440
Liens (including original filing, release, withdrawal, subordination, and discharge)	439
Failure to File Penalty (FTF)/ Failure to Pay Penalty (FTP)	420
Copies of Returns/Transcripts/Reports/Requests under the Freedom of Information Act (FOIA)	400
Open Audit (Not Revenue Protection Strategy or Earned Income Tax Credit)	396
Automated Underreporter Examination in Process	373
Reconsideration of Substitute for Return under IRC §6020(b)[40] and Audits[41]	331
Offer in Compromise (includes Doubt as to Collectibility and Effective Tax Administration)	318

Case Closures

In FY 2006, TAS closed 234,630 cases received in the 2006 fiscal year or prior years, providing full or partial relief to the taxpayer in 63.8 percent of these cases. Closures increased 23.4 percent over FY 2005, largely because of the overall growth (22.5 percent) in case receipts. Table 4.20 details the disposition of cases closed in FY 2006.

[40] IRC § 6020(b): If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefore, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

[41] Reconsideration of a tax assessment resulting from an IRS examination, or an income or employment tax return prepared by the IRS under IRC § 6020(b).

TABLE 4.20, TAS CASE DISPOSITIONS FOR FY 2006

Type of Relief	Number	%
Relief Provided to Taxpayer	**165,085**	**70.36%**
Full relief	152,260	64.89%
Partial relief	12,797	5.45%
TAO Issued - IRS Complied	28	0.01%
TAO Issued - IRS Appealed; TAO Sustained	0	0.00%
TAO Issued - IRS Appealed; TAO Modified	0	0.00%
No Relief Provided to Taxpayer	**69,545**	**29.64%**
TAO Issued - IRS Appealed; TAO Rescinded	5	0.00%
No relief (no response from taxpayer)	30,077	12.82%
Advocate does not deem relief appropriate	16,980	7.24%
Relief provided prior to Taxpayer Advocate Service Intervention	13,924	5.93%
Relief not required (taxpayer rescinded request)	3,276	1.40%
No relief (hardship not validated)	1,410	0.60%
Relief not required (hardship not related to internal revenue laws)	1,383	0.59%
No relief (tax law precluded relief)	1,471	0.63%
Other	1,019	0.43%
Total TAS Cases Closed	**234,630**	**100.00%**
Taxpayer Assistance Orders (TAO) Issued	46	0.02%

Operations Assistance Requests (OARs)

TAS uses Operations Assistance Requests (OARs) to obtain assistance from an IRS operating division or function to complete an action. An OAR is needed when TAS does not have the statutory or delegated authority to take the action(s) required to resolve taxpayers' problems. Table 4.21 highlights the OARs issued and closed during FY 2006 and the average number of days it took the IRS to complete the requested action(s).

TABLE 4.21, OAR ACTIVITY FOR FY 2006

Operating Division/Function	OARs Issued	OARs Rejected[43]	OARs Completed[44]	Average Age (Days)[45]
Appeals	1,888	459	1,500	56.4
Criminal Investigation	28,557	696	31,458	22.3
Large/Mid-Size Business	117	12	90	37.0
Small Business/Self-Employed	75,155	13,465	60,935	18.8
Tax Exempt/Government Entities	1,093	136	911	32.2
Wage & Investment	83,619	11,167	70,650	19.2
Total	**190,429**	**25,935**	**165,544**	**20.0**

[42] Thirteen TAOs remained open at the end of FY 2006 pending resolution.

[43] An OAR may be rejected for more than one reason. Examples include OARs routed to the wrong IRS function or location, incomplete OARs, OARs lacking sufficient documentation to support the recommended action, the recommended action is not clear or the IRS disagrees with the recommended action.

[44] Completed OARs do not include OARs that were rejected.

[45] The Average Age is the number of days to close an OAR divided by the number of OARs closed.

Taxpayer Assistance Orders

IRC § 7811 authorizes the National Taxpayer Advocate to issue a Taxpayer Assistance Order (TAO) when a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the tax laws are being administered. A TAO may be issued to direct the IRS to take an action, cease an action, or refrain from taking an action in a case.[46] A TAO may also be issued to order the IRS to expedite consideration of a taxpayer's case, reconsider its determination in a case, or review the case at a higher level of the organization.

Upon receipt of a TAO, the responsible IRS official can either agree to take the action directed or appeal the order. During FY 2006, TAS issued 46 TAOs compared to 20 in FY 2005. The following table summarizes the issues:

TABLE 4.22, TAXPAYER ASSISTANCE ORDERS ISSUED IN FY 2006

Issue Description	Number
Levies	8
Taxpayer Delinquent Investigation	8
Open Audit	6
Application for Tax Exempt Status	5
Processing Amended Return	3
Request for Reconsideration of Audit/Substitute for Return or IRC § 6020(b) Assessment	3
Offer in Compromise - Doubt as to Collectibility	3
Lost or Stolen Refund	1
Expedite Refund Request	1
IRS Offset of Refund to Other Debt	1
Application for Individual Taxpayer Identification Number	1
Claim for Earned Income Tax Credit	1
Other Examination Issues	1
Bankruptcy	1
Offer in Compromise - Effective Tax Administration	1
Request for Interest Abatement	1
Account or Notice Inquiry	1

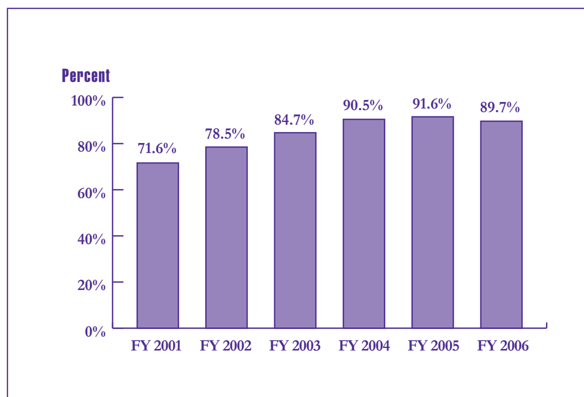
The IRS complied with 28 of the TAOs. TAS rescinded five TAOs after negotiating further with the IRS to resolve the taxpayer's problem. Thirteen TAOs remained open and pending resolution as of the end of FY 2006.

[46] The terms of a TAO may require the Secretary within a specified time period to release property of the taxpayer levied upon, or to cease any action, take any action as permitted by law, or refrain from taking any action, with respect to the taxpayer under chapter 64 (relating to collection), subchapter B of chapter 70 (relating to bankruptcy and receiverships), chapter 78 (relating to discovery of liability and enforcement of title), or any other provision of law which is specifically described by the National Taxpayer Advocate in such order.

Case Quality and Timeliness

TAS has measured the case quality and timeliness of the assistance it provides to taxpayers since the organization began operating in FY 2001.[47] Because TAS is the last resort for many taxpayers, it maintains extremely high quality standards and goals for its employees. Chart 4.23 below shows TAS case quality improved significantly from FY 2001 through FY 2005. In FY 2006, TAS's cumulative quality rate remained very high at 89.7 percent; however, the measure fell below the FY 2006 goal of 91.5 percent. TAS also experienced a decline in quality standards 1 through 3, which measure the timeliness of responses to taxpayers, as depicted in Chart 4.24.

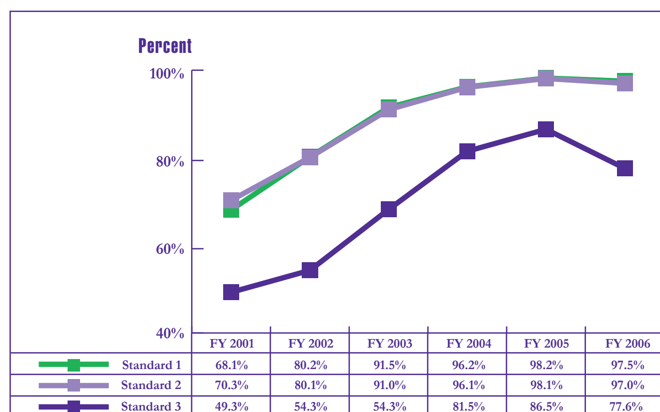
CHART 4.23, TAS CASE QUALITY – FY 2001 THROUGH 2006



[47] TAS Quality Standards are:

1. Did TAS make timely contact with the taxpayer?
2. Did TAS take initial action/request information within the specified timeframe?
3. Did TAS take all subsequent actions timely from the time action could have been taken?
4. Did TAS resolve all taxpayer issues?
5. Did TAS address all related issues?
6. Were all actions taken by TAS and the IRS operations/functional divisions technically and procedurally correct?
7. Did TAS give the taxpayer a clear, complete, correct explanation at closing?
8. Did TAS educate the taxpayer regarding any of his/her actions that contributed to the problem?

CHART 4.24, TAS QUALITY TIMELINESS STANDARDS



	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Standard 1	68.1%	80.2%	91.5%	96.2%	98.2%	97.5%
Standard 2	70.3%	80.1%	91.0%	96.1%	98.1%	97.0%
Standard 3	49.3%	54.3%	54.3%	81.5%	86.5%	77.6%

Several factors contributed to the decline in the case quality index, particularly TAS's timeliness standards, which occurred in spite of TAS's continued focus on improving the quality and timeliness of responses to taxpayers. Rising receipts, higher per employee inventory levels, and the growing complexity of case issues have made it difficult for TAS to maintain and improve its level of quality. Receipts increased 22.5 percent, from 197,679 in FY 2005 to 242,173 in FY 2006, and open inventory levels have risen 18.6 percent, from 40,648 at the end of FY 2005 to 48,198 at the end of FY 2006. Further, TAS has experienced steady attrition among the case advocates who handle taxpayer inquiries, with the number falling from 1,345 to 1,147 between FY 2002 and September 2006. The average daily inventory for FY 2006 was 42 cases per case advocate. TAS casework has also become more complex. Cases involving economic burden (TAS Case Acceptance Criteria 1-4), which have stringent timeframes for timely contact and resolution,[48] increased 53.5 percent.[49] Cases involving compliance and enforcement issues, which are considered more complex and take longer to resolve, increased 19.9 percent from the prior year and represent 64.2 percent of TAS's case receipts in FY 2006.

In FY 2006, TAS completed a study to determine the complexity of each case and identify a method of tracking the factors that contribute to complexity. TAS is implementing most of the recommendations from the study and will use the information to identify and support future staffing and resource needs.

TAS hired 67 case advocates and 35 intake advocates in June 2006, and is waiting for final action on the FY 2007 federal budget to determine if further hiring will be possible in 2007.

[48] Initial contact with taxpayers and actions to resolve cases involving economic burden (TAS Case Acceptance Criteria 1-4) must be initiated within 3 workdays of the date TAS receives the taxpayer's inquiry.

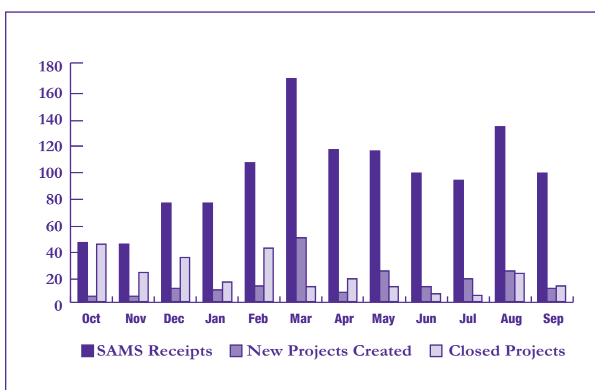
[49] TAS economic burden case receipts increased from 47,217 in FY 2005 to 72,463 in FY 2006.

SYSTEMIC ADVOCACY RECEIPTS AND PROJECTS

The TAS Office of Systemic Advocacy reviews, assigns, and tracks advocacy work through the Systemic Advocacy Management System (SAMS), a web-based application available to IRS employees and the public.[50] Systemic Advocacy employees review and evaluate all issue submissions and apply criteria that categorize and develop the issues into projects when appropriate, or assimilate new issues into existing projects.

Table 4.25 illustrates monthly issue receipts, new advocacy projects created from receipts and project closures for fiscal year 2006.

TABLE 4.25, FY 2006 SAMS RECEIPTS, NEW PROJECTS, AND CLOSURES



From October 1, 2005 through September 30, 2006, the Office of Systemic Advocacy received 1,144 issues on SAMS, an increase of 80 percent from the previous fiscal year. Most of the submissions came to TAS during and immediately after the filing season and during the summer months when the majority of TAS's outreach occurred. The public (taxpayers, academics, and tax professionals) submitted approximately 43 percent (487) of all systemic advocacy issues received, an increase from the 17 percent (107) submitted via the public Internet in fiscal year 2005. TAS and other IRS employees submitted the remaining issues directly into SAMS using the IRS intranet.

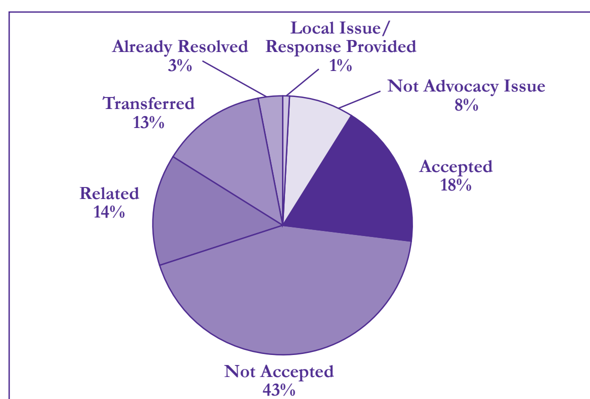
The number of submissions received this past fiscal year is the largest since the Office of Systemic Advocacy put SAMS online in FY 2003. Heightened awareness of Systemic Advocacy and SAMS through internal and external outreach may be responsible for the increase. Additionally, some tax web sites began encouraging taxpayers to submit advocacy issues on specific topics resulting in multiple submissions on the same topic, many

[50] SAMS is a database of advocacy issues submitted to TAS by IRS employees and the public, and the advocacy projects created from issues. The Internet version of SAMS is available through the Systemic Advocacy pages of the TAS public website at http://www.irs.gov/advocate.

with the exact same wording.[51] While submissions of this type do help determine the scope of issues, only one of these related submissions will be evaluated and considered a potential project. Systemic Advocacy closes the rest of these issues on SAMS and designates them as related to the initial submission.

Systemic Advocacy does not consider all advocacy submissions for development into projects. Some SAMS submissions are individual taxpayer account issues, tax law or procedural questions, or issues that have already been or are in the process of being resolved. Systemic Advocacy also receives submissions relating to other government or state taxing agencies. These issues are marked accordingly on SAMS, but are not elevated for project consideration. The following chart illustrates the disposition and percentages of fiscal year 2006 issues.

CHART 4.26, FY 2006 SAMS RECEIPTS AND CLOSING DISPOSITIONS[52]



Systemic Advocacy reviews all issue submissions, using established criteria to prioritize inventory and develop advocacy projects. SAMS Program Managers first rank the issues, then forward their recommendations to the Directors of Immediate Interventions and Advocacy Projects for their concurrence. This three tiered review enhances the probability that Systemic Advocacy is using its resources to work the most important projects. Even

[51] In July, the Internet site http://www.taxmama.com ran an article titled *Tax Mama's Tax Quips – Changing IRS Collection Policy* about the inequity of IRS policy on collecting back taxes from divorced spouses. The following sentence appeared at the end of the article:

> So, please join me in submitting this issue to the Taxpayer Advocate so she can recommend legislation in this area. You can use the link below. Limit your submission to 2000 characters, including spaces. http://www.irs.gov/advocate/article/0,,id=117703,00.html. This is the link to the TAS Systemic Advocacy / SAMS section of the http://www.irs.gov website.

[52] *Related* issues are those for which a project already exists or is under consideration. *Transferred* issues are those that are sent to other TAS departments for consideration and resolution. This category includes taxpayer account issues or TAS casework policy issues. Issues marked as *Already Resolved* are ones for which a procedural fix is in place or a legislative recommendation has already been made by the National Taxpayer Advocate. Issues for which a quick response can be given directing the submitter to the answer to his or her question are designated as *Response Provided*. Issues that are not systemic or lie outside the jurisdiction of TAS or the IRS are marked as *Not Advocacy Issue*.

though most submissions do not become projects, Systemic Advocacy continually assesses all submissions to identify trends and gain a comprehensive understanding of problems.

During fiscal year 2006, Systemic Advocacy developed approximately 16 percent of submissions into new projects.[53] Chart 4.27 presents the top categories of new projects, which account for 84 of the 181 total projects created in FY 2006. Systemic Advocacy closed 238 projects during this period.

CHART 4.27, FY 2006 TOP SYSTEMIC ADVOCACY PROJECT CATEGORIES

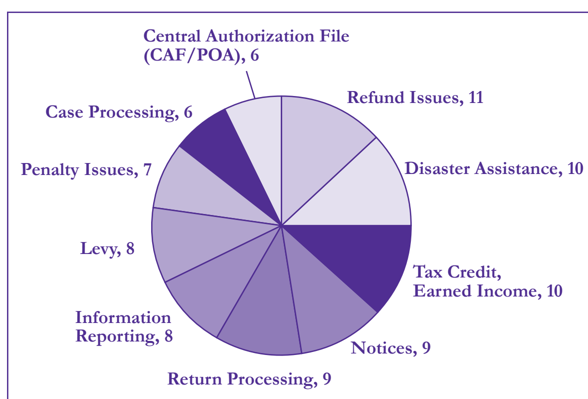


Table 4.28 outlines the Top 25 systemic issue topics in SAMS by major issue (MI) codes that correspond to tracking on TAMIS, the TAS database of individual taxpayer cases. Some of the advocacy issues do not directly match with TAMIS MI Codes because cases usually relate to problems with customer service or problems with taxpayer accounts. For example, no TAMIS MI code exactly matches the SAMS key word Notices, which usually deals with notice clarity. Systemic advocacy issues often address problems with tax law interpretation, lack of published guidance,[54] or difficulty (either by IRS or by taxpayers) in applying tax law.

[53] Some advocacy issues accepted in fiscal year 2006 were not yet developed into projects by the end of the fiscal year resulting in the difference in percentage between accepted issues (18 percent) and projects created (16 percent).

[54] Published guidance includes Treasury Regulations, Revenue Rulings and Procedures and Notices.

TABLE 4.28, TOP 25 ISSUES RECEIVED IN SAMS FOR FY 2006

Core Issue Code	Description	FY06 Advocacy Receipts
000-090	Refund Issues[55]	74
310	Return Processing[56]	54
100	Service	43
N/A	Case Processing	41
N/A	Fringe Benefits	39
200	Payments/Account Credits	39
111	Notices	37
600	Examination Issues	35
700	Collection Issues	28
N/A	Form or Publication Issue	28
390	Information Reporting	28
500	Penalty Issues	28
150	Copies of Tax Returns/ Transcripts	26
190	Employment Tax Issues	26
710	Levy	26
N/A	Navigating the IRS	25
780	Offers in Compromise (OIC)	24
N/A	Central Authorization File (CAF/POA)	23
751	Installment Agreements	23
720	Lien	23
N/A	Free Filing	22
N/A	Income Issues	21
N/A	Instructions	21
340	Injured Spouse	19
N/A	Expenses	18

Eight of the top ten advocacy issues from fiscal year 2005 remain in the top ten this year, including Refund Issues, Return Processing, Service, Case Processing, Payments/Account Credits, Notices, Examination Issues, and Information Reporting. Offer in Compromise and Installment Agreements dropped from the top ten, but remain frequently reported issues at 17th and 18th respectively. These were replaced by Fringe Benefits as the fifth most reported key issue and Collection Issues, Penalty Issues, and Form/Publication Issue all tying for tenth.[57]

[55] All refund issue key words were consolidated and include refund freezes, offsets, and direct deposits. It also includes lost or stolen refunds, erroneous refunds and issues pertaining to the refund statute of limitations (RSED).

[56] Key words "Return Processing" and "Original Return" were combined to create one issue referring to the processing of original tax returns.

[57] All of the submissions on fringe benefits were requesting amendment of IRC § 129 to increase the $5,000 limit employees can currently exclude from gross income for employer-paid dependent care costs. All but one of these submissions was received in December 2005 from external sources.

LOW INCOME TAXPAYER CLINICS

TAS administers and oversees the Low Income Taxpayer Clinic (LITC) Program for the IRS. IRC § 7526 provides for matching grants of up to $100,000 per year for qualifying organizations that represent low income taxpayers involved in controversies with the IRS and for organizations that provide tax education and outreach to taxpayers who speak English as a second language (ESL taxpayers) or who have limited English proficiency (LEP). IRC § 7526 requires clinics to provide services for free or for no more than a nominal fee.

TAS remains committed to achieving maximum access to representation for low income taxpayers under the terms of the LITC Grant Program. In 2006, the LITC Program funded at least one clinic in every state, the District of Columbia, and Puerto Rico. TAS continued to work towards the following goals when awarding the FY 2007 grants:

- Ensure each state (plus the District of Columbia and Puerto Rico) continues to be served by at least one clinic;
- Expand coverage in states that do not have both controversy representation and ESL education and outreach; and
- Ensure grant recipients demonstrate they are serving geographic areas that have sizable populations eligible for and requiring LITC services.

TAS continues to aggressively market the LITC Grant Program in areas where LITC services are underrepresented. For the 2007 grant cycle, TAS received 192 grant applications, including 52 first-time applicants, and for the first time in the history of the LITC Program, TAS received an application from Guam. The LITC Program Office worked with local tax officials in Guam to market the LITC Program and identify qualified organizations who were interested in participation. TAS awarded grants to at least one clinic in the District of Columbia, Puerto Rico, Guam, and every state except Colorado for 2007.

TAS is planning a 2007 supplemental application period, which will focus on Colorado. TAS will contact the congressional offices, accredited law schools, business schools, and 501(c) organizations in Colorado to promote the LITC Program and help identify qualifying organizations.

TAXPAYER ADVOCACY PANEL TOWN HALL MEETINGS

The National Taxpayer Advocate partnered with the Taxpayer Advocacy Panel (TAP) in fiscal year 2006 to give taxpayers a unique opportunity to voice their concerns about taxpayer service. The TAP hosted a series of town hall meetings focusing on current customer service needs and how the IRS should strategically address those needs. The primary objectives of the meetings were to:

- Conduct outreach and educate citizens about the TAP;
- Gather input from taxpayers on change and their future customer service needs;

- Solicit direct grassroots feedback from taxpayers on what service initiatives could be improved; and
- Validate the current level of customer service taxpayers are receiving.

The meetings took place in seven cities across the country in locations designed to attract maximum citizen input, in venues including small college campuses, libraries, and veterans' facilities. As the following table illustrates, TAS and the TAP scheduled the meetings to meet the needs of a diverse population and ensure participation from a cross-section of taxpayers.

TABLE 4.29, TAP TOWN HALL MEETINGS

Location	Date
Philadelphia, PA	December 7, 2005
San Diego, CA	February 1, 2006
Davenport , IA	March 8, 2006
Jackson, MS	March 23, 2006
Fargo, ND	April 26, 2006
Cranston, RI	May 10, 2006
Cincinnati, OH	June 6, 2006

Feedback and attendance were mixed, but the overwhelming response from all attendees was that the IRS should not sacrifice customer service, but rather should continue to improve service. Although the meetings covered a variety of topics in different cities, some issues remained consistent. The key customer service issues raised by taxpayers include:

- Taxpayers' fear of the IRS;
- The need for alternative service locations, including mobile vans and access to service in shopping malls;
- A single point of contact to address account issues;
- Confusing correspondence and notices; and
- Long wait times on customer assistance telephone lines.

The meetings afforded taxpayers an unprecedented opportunity to hold a candid dialogue with the National Taxpayer Advocate about issues that directly impact their tax situations. All meetings featured local TAP members who gave taxpayers an overview of the TAP, the recruitment process, and current success stories. The National Taxpayer Advocate served as the keynote speaker and engaged the participants in a direct conversation focused on customer service. Some attendees also took part in smaller focus group sessions with TAP members that further delved into customer service and taxpayer expectations, and completed exit surveys designed to gather information for potential TAP issues. W&I supported communications and outreach and provided representatives from the Taxpayer Assistance Blueprint (TAB) team for each session.[58]

[58] For a further discussion of the TAB, see Volume II of this report.

TAXPAYER ADVOCATE SERVICE

TOP 25 CASE ADVOCACY ISSUES

TOP 25 CASE ADVOCACY ISSUES FOR FY 2006 IDENTIFIED BY TAMIS RECEIPTS

Core Issue Code	Description	Total
95x	Criminal Investigation	21,395
71x	Levies	18,800
330	Processing amended returns	17,140
63x-640	Earned Income Tax Credit (EITC)	12,769
340	Injured spouse claim	11,599
310	Processing original returns	10,398
020	Expedite refund requests	10,070
620	Recons/SFR/6020b/audit	10,005
670	Closed automated underreporter	7,706
310	Open audit	6,934
72x	Liens	6,065
150	Copies of returns/transcripts/reports/FOIA	5,753
390	Other document processing issues	5,619
760	TDI - SFR/6020b	5,083
660	Open automated underreporter	4,718
090	Other refund inquiries/issues	4,493
210	Missing/incorrect payments	4,287
675	CAWR/FUTA	4,223
520	FTF/FTP penalties	4,190
75x	Installment agreements	3,980
060	IRS offset	3,791
010	Lost or stolen refunds	3,626
790	Other collection issues	3,079
110	Account/notice inquiries	3,075
320	Math error	2,906
	Total: Top 25 Cases	**191,704**
	Total: All FY 2006 TAS Cases	**242,173**

ADVOCACY PORTFOLIOS

Portfolio	LTA Name	State / Office	Phone Number
Abusive Schemes	Zelle, J	MO	314-612-4610
Appeals: Nondocketed Inventory	Logan, A	WY	307-633-0800
Appeals: Nondocketed Inventory (Campus)	Safrey, E	BSC	631-654-6686
Audit Reconsiderations	Keleman, L	CA LA	213-576-3140
Audit Reconsiderations (Audit Recon/ ASFR/ 6020B (620))	Carey, W	ATC	770-936-4500
AUR Exam	Boucher, D	ME	207-622-8528
Backup Withholding	Adams, M	KS	316-352-7506
Bankruptcy Processing Issues	Mettlen, A	PA PITT	412-395-5987
Campus Consistency	Wess, D	MSC	901-395-1900
Carryback/Carryforward Claims	Sherwood, T	CO	303-446-1012
CAWR/FUTA	Blair, C	OSC	801-620-7168
Centralized Lien Filing and Releases	Diehl, M	CSC	859-669-5405
CLG Coordinator	Scott, C	OKL	405-297-4055
Collection Contract Support	Kleckley, F	SC	803-253-3029
Criminal Investigation (CI)/CI Freezes	Sawyer, M	FSC	559-442-6400
CSEDs	Sherwood, T	CO	303-446-1012
EITC: Certification/Precertification	Mings, L	KCC	816-291-9000
EITC: Notice Redesign	Taylor, S	IL CHI	312-566-3800
EITC: Outreach and Education, Financial Literacy	Mapp, T	PA PHIL	215-861-1304
EITC: Recertification	Lewis, C	LA	504-558-3001
EO Applications, Penalties, Education and Outreach	Finnesand, M	SD	605-377-1600
ETA/Electronic Filing	Martin, B	TN	615-250-5000
ETA/Electronic Return Originators	Martin, B	TN	615-250-5000
Examination Strategy	Revel-Addis, B	FL JACK	904-665-1000
Excise Tax	Diehl, M	CSC	859-669-5405
Federal Payment Levy Program (FPLP)	Morris, R	WI	414-231-2390
Filing Season Readiness/SPEC	Douts, K	AK	907-271-6877
FPLP Communication	O'Shaughnessy, M	NH	603-433-0571
Frontline Leader Readiness Program (FLRP)	Kitson, A	NY BKLN	718-488-2080
Government Entities: Tribal Government Issues	Wirth, B	NY BUF	716-686-4850
Health Care Tax Credit (HCTC)	Cummings, L	TX DAL	214-413-6500
Identity Theft	Safrey, E	BSC	631-654-6686
Injured Spouse	Post, T	WV	304-420-8695
Innocent Spouse Relief: IRC § 6015	Adams, C	CA LAGN	949-389-4804
Installment Agreements: Allowable Expenses (Low Cost)	Washington, J	MS	601-292-4800
Installment Agreements: Processing	Tam, J	CA OAK	510-637-2703
Interest Computations: Abatement of Interest	Romano, F	CT	860-756-4555
International Taxpayers	Puig, JC	PR	787-622-8930
IRS Training on Taxpayers Rights	Hickey, M	NE	402-221-4181
ITIN Outreach	Blount, P	MI	313-628-3670
ITIN Processing	Lombardo, L	PSC	215-516-2499
Levy (710) [Hardship determination linked to release of levy]	Polson, R	IA	515-564-6888

ADVOCACY PORTFOLIOS (CONT.)

Portfolio	LTA Name	State / Office	Phone Number
Lien Release, Lien Withdrawal, Lien Subordination, Lien Discharge (721, 722,723, 724)	Lauterbach, L	NJ	973-921-4043
LITC	Lewis, C	LA	504-558-3001
Mentoring	Kobayashi, R	WA	206-220-4356
Mixed and Scrambled TINs (Multiple/Mixed TINs (410))	Murphy, M	AZ	602-207-8240
Nonfiler Strategy	Warren, J	MN	651-312-7999
Notice Clarity (Account/Notice Inquiry Transfer Criteria (110))	Egan, C	RI	401-525-4200
OIC (Field, COIC)	Burns, L	KY	502-582-6030
OIC (Field, ETA, COIC)	Sonnack, B	TX HO	713-209-3660
Outreach and Marketing to Low income TPs	Grant, D	NV	702-868-5179
Outreach to ESL Taxpayers (including ITINs)	Puig, JC	PR	787-622-8930
Penalties: *e.g.* failure to pay, abatements, adjustments, estimated tax, failure to file; CSED	Keating-Jones, J	OR	503-326-2333
Position Management	Wirth, B	NY BUF	716-686-4850
Practitioner Priority Services	Beck, J	WA	206-220-6037
Preparer Penalties	Votta, P	MD	410-962-2082
Returned/Stopped Refunds (40)	Gilchrist, M	AL	205-912-5631
Schedule K-1 Matching	Sheely, K	IN	317-685-7840
Seizure and Sale (730)	Fallacaro, B	MA	617-316-2690
TACs - Rural	Foard, L	ND	701-239-5141
TACs - Urban and Communications	VanHorn, C	OH CIN	513-263-3260
TAS Confidentiality/ IRC 6103	Warren J.	MN	651-312-7999
Tax Exempt Entities: EP Penalties	Blair, C	OSC	801-620-7168
Tax Exempt Entities: EP returns (Forms 5500)	Blair, C	OSC	801-620-7168
Tax Forums	Washington, J	MS	601-292-4800
TIGTA/GAO	Thompson, T	MT	406-441-1022
Tip Reporting	Grant, D	NV	702-868-5179
Transcript Delivery System (Copies of returns, transcripts, reports, FOI (150))	Cooper-Aquilar, S	UT	801-799-6958
Transition of SB Work	Keleman, L	CA LA	213-576-3140
Trust Fund Recovery Penalty	Campbell, M	VA	804-916-3501
US Territories and Possessions	James, G	HI	808-539-2870

TABLE 1
APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330

Case Citation	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (Issues Other Than Business)			
Aaron v. Comm'r, T.C. Summ. Op. 2006-63	Offers in compromise	Yes	IRS
Bailey v. Comm'r, T.C. Memo 2005-241	Inability to challenge underlying liabilities; offer in compromise	Yes	IRS
Balice v. Comm'r, T.C. Memo 2005-161	Frivolous arguments	Yes	IRS
Banks v. Comm'r, T.C. Summ. Op. 2006-38	Inability to challenge underlying liability.	Yes	IRS
Bankson v. Comm'r, T.C. Summ. Op. 2006-83	Offer in compromise	Yes	IRS
Barrett v. Comm'r, T.C. Summ. Op. 2006-42	Underlying liability challenged	Yes	IRS
Bean v. Comm'r, T.C. Memo. 2006-88	Face to face hearing; frivolous arguments; section 6673 penalty	Yes	IRS
Bell v. Comm'r, 126 T.C. 126 (2006)	Inability to challenge underlying liability	Yes	IRS
Bennett v. Comm'r, T.C. Summ. Op. 2005-84	Underlying liability; relief under section 66(c)(3)	Yes	Split
Blocker v. Comm'r, T.C. Memo. 2005-279	Underlying liability; last known address	No	IRS
Boyd v. Comm'r, 124 T.C. 296 (2005)	Tax Court lacks jurisdiction when no CDP hearing requested/determination issued; installment agreement	No	IRS
Brandenburg v. Comm'r, T.C. Memo. 2005-149	Underlying liability; face to face hearing; frivolous arguments	Yes	IRS
Broderick v. U.S., 96 A.F.T.R.2d (RIA) 5383 (D. Ariz. 2005)	District court lacked of jurisdiction over income tax liability; face to face hearing; frivolous arguments	Yes	IRS
Broomfield v. Comm'r, T.C. Memo. 2005-148	Lack of jurisdiction; last known address	Yes	IRS
Brousseau v. U.S., 96 A.F.T.R.2d (RIA) 6279 (M.D.Tenn. 2005)	Frivolous income tax return penalties; frivolous arguments	Yes	IRS
Bullock v. Comm'r, T.C. Memo. 2006-6	Moot - liability satisfied	Yes	IRS
Butti v. Comm'r, T.C. Memo. 2006-66	underlying liability; opportunity to reschedule hearing	Yes	TP
Cahill v. U.S., 96 A.F.T.R.2d (RIA) 7356 (9th Cir. 2005)	Lack of Jurisdiction over income tax liability in district court	Yes	IRS
Call v. Comm'r, T.C. Memo. 2005-289	Inability to challenge underlying liability; right to record hearing; frivolous arguments; section 6673 penalty	Yes	IRS
Carifee v. Comm'r, T.C. Memo. 2005-224	Offer in compromise	Yes	IRS
Carlson v. U.S., 96 A.F.T.R.2d (RIA) 6395 (D. Mass. 2005)	Offer in compromise	No	IRS
Carrillo v. Comm'r, T.C. Memo. 2005-290	Inability to challenge underlying liability; recorded hearing; frivolous arguments; section 6673 penalty	Yes	IRS
Carter v. Comm'r, T.C. Summ. Op. 2006-76	Inability to challenge underlying liability	Yes	IRS
Celestin v. Comm'r, T. C. Summ. Op. 2006-59	Liability not discharged in bankruptcy.	Yes	IRS
Cena v. Kenisky, 95 A.F.T.R.2d (RIA) 2927 (W.D. Tex.)	Lack of jurisdiction; frivolous arguments; face to face hearing	Yes	IRS
Chryson v. Estoll, 97 A.F.T.R.2d (RIA) 2529 (9th Cir. 2006)	District court lack of jurisdiction over income tax liability	Yes	IRS
Clark v. Comm'r, 125 T.C. 108 (2005)	Tax court has jurisdiction to review CDP determination regarding levy on state tax refund	No	TP
Clark v. Comm'r, T. C. Summ. Op. 2005-95	Section 6015(f) claim timely filed; remanded for reconsideration on merits	Yes	TP
Cobin v. U.S., 97 A.F.T.R.2d (RIA) 826 (4th Cir. 2006)	Inability to challenge underlying liability; frivolous arguments; face to face hearing	Yes	IRS
Cooksey v. Comm'r, T.C. Summ. Op. 2006-84	Penalty	Yes	IRS
Cox v. Comm'r, 126 T.C. 237 (2006)	Administrative record; impartiality of appeals officer; offer in compromise; currently not collectible status	No	IRS
Crandall v. Comm'r, T.C. Memo. 2005-286	Face to face hearing; right to record hearing; frivolous arguments; section 6673 penalty	Yes	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Crawford v. U.S., 422 F.Supp.2d 1209 (D. Nev. 2006)	Appeals officer's failure to consider Taxpayer's collection alternative was an abuse of discretion; list of collection alternatives listed in section 6330 is not exclusive (trust fund recovery penalty)	No	T/P
Creel v. Comm'r, 419 F.3d 1135 (11th Cir. 2005)	U.S. Attorney's issuance of satisfaction of judgment & release of lien settled civil tax liability.	No	TP
Deaton v. Comm'r, 440 F.3d 223 (5th Cir. 2006)	Refund limitation period under section 6511.	No	IRS
Delgado v. Comm'r, T.C. Memo. 2005-186	Frivolous arguments; right to record hearing	Yes	IRS
DelVecchio v. Comm'r, 97 A.F.T.R.2d (RIA) 976 (11th Cir. 2006)	Period of limitations on assessment.	Yes	IRS
Demos v. Comm'r, T.C. Summ. Op. 2006-15	Moot - liabilities satisfied	Yes	IRS
Deutsch v. Comm'r, T.C. Memo. 2006-27	Inability to challenge underlying liability	No	IRS
Dostal v. Comm'r, T.C. Memo. 2005-264	Offer in compromise	No	IRS
Dourlain v. U.S., 96 A.F.T.R.2d (RIA) 6529 (N.D. N.Y 2005)	District court lacked jurisdiction over income tax liability and petition not timely filed; frivolous arguments	Yes	IRS
Dowdy v. U.S., 96 A.F.T.R.2d (RIA) 5517 (E.D. Tex. 2005)	Trust fund recovery penalty	No	IRS
Drake v. Comm'r, 125 T.C. 201	Ex parte communications	No	TP
Eash v. U.S., 97 A.F.T.R.2d (RIA) 913 (D. Neb. 2006)	Frivolous return penalties; frivolous arguments	Yes	IRS
Eby v. IRS, 97 A.F.T.R.2d (RIA) 1747 (S.D. Ohio 2006)	Inability to challenge underlying liability when not challenged at CDP hearing; dischargeabilty in bankruptcy; period of limitations on collection	Yes	IRS
Etkin v. Comm'r, T.C. Memo. 2005-245	Installment agreement; relief under section 6015	Yes	IRS
Evan V. Comm'r, T.C. Summ. Op. 2005-163	Inability to challenge underlying liability; offer in compromise; face to face hearing	Yes	IRS
Fargo v. Comm'r, 447 F.3d 706 (9th Cir. 2006)	Offer in compromise	No	IRS
Felder v. Comm'r, T.C. Summ. Op. 2006-89	Inability to challenge underlying liability; frivolous arguments	Yes	IRS
Figler v. Comm'r, T.C. Memo. 2005-230	Inability to challenge underlying liability	Yes	IRS
Florance v. Comm'r, 97 A.F.T.R.2d (RIA) 1742 (5th Cir. 2006)	Frivolous arguments; section 6673 penalty	Yes	IRS
Forbes v. Comm'r, T.C. Memo. 2006-10	Frivolous arguments; section 6673 penalty	Yes	IRS
Ford v. Comm'r, T.C. Memo. 2006-102	Installment agreement	Yes	IRS
Forrest v. Comm'r, T.C. Memo. 2005-228	Frivolous arguments; section 6673 penalty	Yes	IRS
Frazier v. Comm'r, T.C. Memo 2005-229	Inability to challenge underlying liability; installment agreement	Yes	IRS
Freije v. Comm'r, 125 T.C. 14 (2005)	Application of payments; jurisdiction over years at issue allows for consideration of facts from years not at issue, but affecting years at issue; portion of assessed under math error procedures invalid	Yes	TP
Frese v. U.S., 97 A.F.T.R.2d (RIA) 1123 (D. N.J. 2006)	Inability to challenge underlying liability; lack of jurisdiction over underlying liability; frivolous return penalty; frivolous arguments; face to face hearing	Yes	IRS
Garage v. U.S., 96 A.F.T.R.2d (RIA) 7201 (D. N.J. 2005)	Face to face hearing (trust fund recovery penalty)	No	TP
Giragosian v. Comm'r, T.C. Summ. Op. 2005-104	Abatement of interest; inability to raise issue in litigation when issue not raised at hearing	Yes	IRS
Gittinger v. Comm'r, 96 A.F.T.R.2d (RIA) 5006 (5th Cir. 2005)	Frivolous arguments; section 6673 penalty	Yes	IRS
Golden v. Comm'r, T.C. Memo. 2005-170	Periods of limitation on assessment and collection; res judicata	Yes	IRS
Goldman v. Comm'r, T.C. Summ. Op. 2005-165	Penalties	Yes	IRS
Goodin v. Comm'r, T.C. Memo. 2005-158	Frivolous arguments; section 6673 penalty	Yes	IRS
Gori v. Comm'r, T.C. Summ. Op. 2005-79	Face-to-face hearing; frivolous arguments	Yes	IRS
Gorospe v. Comm'r, 451 F.3d 966 (9th Cir. 2006)	Inability to challenge underlying liability	No	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Granger v. U.S., 95 A.F.T.R.2d (RIA) 2849 (E.D. Va. 2005)	Lack of jurisdiction; frivolous arguments; face to face hearing	Yes	IRS
Greene-Thapedi v. Comm'r, 126 T.C. 1	Moot - liability satisfied	Yes	IRS
Griffen v. Comm'r, T.C. Summ. Op. 2005-74	Inability to challenge underlying liability; liability not discharged in bankruptcy	Yes	IRS
Hajiyani v. Comm'r, T.C. Memo. 2005-198	Inability to challenge underlying liability; offer in compromise not reviewed when not submitted in CDP hearing; application of payments and offsets	Yes	IRS
Haley v. IRS, 97 A.F.T.R.2d (RIA) 968 (D. Md. 2006)	Period for assessment (trust fund recovery penalty)	Yes	IRS
Hansen v. Comm'r, T.C. Summ. Op. 2005-75	Underlying liability; penalties; interest abatement	Yes	IRS
Higginbotham v. Comm'r, T.C. Memo. 2005-270	Failure to prosecute	Yes	IRS
Hiner v. IRS, 96 A.F.T.R.2d (RIA) 6246 (D. Ariz. 2005)	Payment plan paying trust fund recovery penalty in full, but not including interest, rejected; interest abatement	Yes	IRS
Ho v. Comm'r, T.C. Memo. 2006-41	Face to face; frivolous arguments; interest	Yes	IRS
Holliday v. Comm'r, T.C.Memo. 2005-132	Frivolous arguments; recording hearing; section 6673 penalty	Yes	IRS
Holliday v. Comm'r, T.C.Memo. 2005-240	Frivolous arguments; recording hearing; section 6673 penalty	Yes	IRS
Homza v. U.S., 97 A.F.T.R.2d (RIA) 2463 (S.D. Ohio 2006)	District court lacks jurisdiction over income tax liability	Yes	IRS
Hoover v. Comm'r, T.C. Memo. 2006-82	Assessment period of limitations; fraud penalties; jeopardy assessment	Yes	IRS
Hudspath v. Comm'r, 97 A.F.T.R.2d (RIA) 2200 (4th Cir. 2006)	Inability to challenge underlying liability	Yes	IRS
Johnston v. Comm'r, 96 A.F.T.R.2d (RIA) 7021 (9th Cir. 2005)	Frivolous arguments	Yes	IRS
Joseph v. Comm'r, T.C. Memo. 2006-20	Installment agreement	Yes	IRS
Kandi v. U.S., 97 A.F.T.R.2d (RIA) 721 (W. D. Wash. 2006)	Retroactive application of regulations; collection of employment tax from sole member of single-member LLC	No	IRS
Kanter, Estate of, v. Comm'r, T.C. Memo. 2006-46	Assessments; stay of proceedings pending determination of liability	No	IRS
Kozack v. Comm'r, T.C. Memo. 2005-246	Face to face hearing; frivolous arguments	Yes	IRS
Kun v. Comm'r, 96 A.F.T.R.2d (RIA) 7109 (9th Cir. 2005)	Underlying liability; offer in compromise	Yes	IRS
Laing v. Comm'r, 96 A.F.T.R.2d (RIA) 5484 (5th Cir. 2005)	Receipt of notice of assessment for trust fund recovery penalty	No	IRS
Lance v. Comm'r, T.C. Summ. Op. 2005-180	Tax Court lacked jurisdiction over preparer penalties	Yes	IRS
Lane v. Comm'r, T.C.Memo. 2005-182	Underlying liability	Yes	IRS
Larson v. U.S., 96 A.F.T.R.2d (RIA) 5480 (W.D. Pa. 2005)	Lack of jurisdiction - petition not timely filed (trust fund recovery penalty)	Yes	IRS
Lemann v. Comm'r, T.C. Memo. 2006-37	Installment agreement; offer in compromise; balancing test	Yes	IRS
Lingwall v. Comm'r, T.C. Summ. Op. 2005-69	Inability to raise relief under section 6015 in CDP hearing when raised previously	Yes	IRS
Lites v. Comm'r, T.C. Memo. 2005-206	Penalties; installment agreement	No	Split
Little v. U.S., 97 A.F.T.R.2d (RIA) 2227 (4th Cir. 2006), *aff'g* 96 A.F.T.R.2d (RIA) 7086 (M.D. N.C. 2005)	Frivolous return penalties; face to face hearing	Yes	IRS
Lobb v. U.S., 96 A.F.T.R.2d (RIA) 7000 (D. Or. 2005), *adopting* 96 A.F.T.R.2d (RIA) 6882 (D. Or. 2005)	District court lacked jurisdiction over income tax liability	Yes	IRS
Loftus v. Comm'r, T.C. Summ. Op. 2005-164	Dischargeability in bankruptcy; abatement of interest, penalties	Yes	IRS
Lorenzen v. U.S., 97 A.F.T.R.2d (RIA) 1366 (D. Wyo. 2006)	District court lacked jurisdiction - petition not timely filed	Yes	IRS
Magee v. Comm'r, T.C. Memo. 2005-263	Validity of joint election; relief under section 6015	Yes	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Maicon v. IRS, 96 A.F.T.R.2d (RIA) 5673 (N.D. Ga. 2005)	Frivolous tax return penalties; frivolous arguments	Yes	IRS
Mandody v. Comm'r, T.C. Memo. 2005-142	Summary judgment not appropriate due to facts in dispute	Yes	TP
Manjourides v. Comm'r, T.C.Memo. 2005-242	Installment agreement; CDP hearing did not close prematurely	No	IRS
Manko v. Comm'r, 126 T.C. 195 (2006)	Specific issue closing agreement did not obviate requirement to issue deficiency notice prior to assessment	No	TP
Mann v. IRS, 97 A.F.T.R.2d (RIA) 1590 (W.D. Okla. 2006)	Frivolous tax return penalty; frivolous arguments	Yes	IRS
Martin v. Comm'r, 436 F.3d 1216 (10th Cir. 2006)	Period of limitations on assessment.	No	IRS
Martin v. Michalski, 97 A.F.T.R.2d (RIA) 2313 (W.D. N.Y 2006)	District court lacked jurisdiction over income tax liability	Yes	IRS
Matthews v. Comm'r, 97 A.F.T.R.2d (RIA) 2170 (D. Md. 2006)	District court lacked jurisdiction over income tax liability	Yes	IRS
McCurdy v. U.S., 95 A.F.T.R.2d (RIA) 2776 (D. Mass. 2005)	Face to face hearing; Fair Debt Collection Act; frivolous return penalties; frivolous arguments	Yes	IRS
McDermott v. Comm'r, T.C. Summ. Op. 2005-162	Frivolous arguments	Yes	IRS
Meeker v. Comm'r, T.C. Memo. 2005-146	Tax Court lacked jurisdiction over frivolous return penalties; frivolous arguments	Yes	IRS
Morlino v. Comm'r, T.C. Memo. 2005-203	CDP hearing did not close prematurely	No	IRS
Muller v. Comm'r, 97 A.F.T.R.2d (RIA) 2239 (D. Vt. 2006)	District court lacked of jurisdiction over income tax liability; frivolous arguments	Yes	IRS
Murphy v. Comm'r, 125 T.C. 301 (2005)	Offer in compromise; CDP hearing did not close prematurely	No	IRS
Negoescu v. Comm'r, T.C. Summ. Op. 2005-161	Relief under section 6015	Yes	IRS
Newell v. Comm'r, T.C. Summ. Op. 2006-7	Installment agreement	Yes	IRS
Newstat v. Comm'r, T.C. Memo. 2005-262	underlying liability; installment agreement	Yes	IRS
Nicklaus v. Comm'r, T.C. Memo. 2005-156	Substitute for returns; collateral estoppel; inability to challenge underlying liability	Yes	IRS
Norris v. Comm'r, T.C. Memo. 2005-237	Interest and penalties	Yes	TP
Olsen v. U.S., 414 F.3d 144 (1st Cir. 2005)	Offer in compromise	No	IRS
Orum v. Comm'r, 412 F.3d 819 (7th Cir. 2005), *aff'g* 123 T.C. 1 (2004)	Installment agreement; lack of jurisdiction - no timely request for CDP hearing	Yes	IRS
Parker II v. Comm'r, T.C. Memo. 2005-231	Lack of Jurisdiction - no timely request for CDP hearing; frivolous arguments; section 6673 penalty	Yes	IRS
Parker v. Comm'r, T.C. Memo. 2005-294	Lack of jurisdiction to review filing of liens prior to effective date of section 6320; validity of lien	No	IRS
Parker v. Comm'r, T.C. Memo. 2006-43	Validity of assessments; bankruptcy; period of limitations on assessment; penalties; abatement of interest; offer in compromise	Yes	IRS
Patrick v. Comm'r, T.C. Summ. Op. 2005-92	Offer in compromise	Yes	IRS
Patridge v. IRS, 97 A.F.T.R.2d (RIA) 434 (C.D. Ill. 2005)	District court lacked jurisdiction over income tax liability	No	IRS
Pineda v. Comm'r, T.C. Summ. Op. 2006-35	Abatement of interest; penalties; installment agreement	Yes	Split
Pirnat v. Comm'r, 96 A.F.T.R.2d (RIA) 6858 (M.D. Fla. 2005)	District court lacked jurisdiction over income tax liability	Yes	IRS
Plumb v. Comm'r, 96 A.F.T.R.2d (RIA) 5872 (S.D. Fla. 2005); 97 A.F.T.R.2d (RIA) 1373 (S.D. Fla. 2006)	Timeliness of petition; inability to challenge underlying liability	No	Split
Poindexter v. Comm'r, 95 A.F.T.R.2d (RIA) 2724 (2nd Cir. 2005)	Underlying liability; inability to raise new issues on appeal	Yes	IRS
Pomerantz v. Comm'r, T.C. Memo. 2005-295	Inability to challenge underlying liability	No	IRS
Pomeranz v. U.S., 96 A.F.T.R.2d (RIA) 6767 (S.D. Fla. 2005)	Frivolous return penalties; frivolous arguments	Yes	IRS
Pragasam v. Comm'r, T. C. Memo. 2006-86	Lack of jurisdiction - inability to petition from an equivalent hearing; last known address	No	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Prakasam v. Comm'r, T.C. Memo. 2006-53	Lack of jurisdiction - inability to petition from an equivalent hearing; last known address	No	IRS
Prusick v. Comm'r, 97 A.F.T.R.2d (RIA) 1196 (9th Cir. 2006)	Underlying liability; face to face hearing	Yes	IRS
Raft v. Comm'r, 95 A.F.T.R.2d (RIA) 2652 (6th Cir. 2005)	Lack of jurisdiction - tp did not timely request CDP hearing; section 6673 penalty	Yes	IRS
Ralidis v. U.S., 97 A.F.T.R.2d (RIA) 1315 (5th Cir. 2006)	Frivolous arguments; section 6673 penalty	Yes	IRS
Ramirez v. Comm'r, T.C. Memo. 2005-179	Penalties	Yes	IRS
Razo v. Comm'r, 95 A.F.T.R.2d (RIA) 2828 (5th Cir. 2005), *aff'g* T.C. Memo. 2004-1.	Offer in compromise	No	IRS
Reese v. Comm'r, T.C.Memo. 2006-21	Penalties	Yes	IRS
Render v. IRS, 96 A.F.T.R.2d (RIA) 6492 (E.D. Mich. 2005)	Inability to challenge underlying liability; installment agreement; offer in compromise	Yes	IRS
Richard v. Comm'r, T.C. Summ. Op. 2005-151	Application of payments; invalid assessment	Yes	TP
Richmond, Jr. v. Comm'r, T.C. Memo. 2005-238	Application of payments; math error; setoff; dischargeability in bankruptcy	Yes	IRS
Robinette v. Comm'r, 439 F.3d 455 (8th Cir. 2006)	Offer in compromise; administrative record	No	IRS
Romano v. Comm'r, T.C. Memo. 2005-193	Inability to challenge underlying liablity;	Yes	IRS
Ross v. IRS, 97 A.F.T.R.2d (RIA) 2199 (D. Minn. 2006)	District court lacked jurisdiction over income tax liability; Taxpayer may not petition from equivalent hearing	Yes	IRS
Royal v. Comm'r, T.C.Memo. 2006-71	Inability to pay	Yes	IRS
Sabath v. Comm'r, T.C. Memo. 2005-222	Inability to challenge underlying liability	No	IRS
Salazar v. Comm'r, T.C. Memo. 2006-7	Tax Court lacked jurisdiction over employment tax liaiblity	No	IRS
Sampson v. Comm'r, T.C. Summ. Op. 2006-75	Offer in compromise	Yes	TP
Sampson-Gray v. Comm'r, T. C. Summ. Op. 2006-19	Moot - liability satisfied	Yes	IRS
Sapp v. Comm'r, T.C. Memo. 2006-104	Ex parte communications; dischargeability in bankruptcy; tax protester designation	Yes	IRS
Schneller v. Comm'r, T.C. Memo. 2006-100	Frivolous arguments; inability to challenge underlying liability	Yes	IRS
Schneller v. Comm'r, T.C. Memo. 2006-99	Frivolous arguments; inability to challenge underlying liability	Yes	IRS
Sherer v. Comm'r, T.C. Memo. 2006-29	Underlying liability	Yes	TP
Sherwood v. Comm'r, T.C. Memo. 2005-268	Tax Court lacked jurisdiction to review frivolous tax return penalty and false withholding information penalty; inability to challenge underlying liability; face to face hearing; frivolous arguments	Yes	IRS
Simmons v. Comm'r, 97 A.F.T.R.2d (RIA) 509 (E.D. Pa. 2005)	Application of payments (trust fund recovery penalty)	No	IRS
Singer V. Comm'r, T.C. Memo. 2005-175	Offer in compromise	Yes	IRS
Stearns v. IRS, 97 A.F.T.R.2d (RIA) 889 (D. Conn. 2006)	Inability to challenge underlying liability (trust fund recovery penalty)	Yes	IRS
Stephens v. Comm'r, T.C. Memo. 2005-183	Frivolous arguments	Yes	IRS
Stone v. Comm'r, T.C. Summ. Op. 2005-186	Abatement of interest; penalties	Yes	IRS
Streiffert v. IRS, 96 A.F.T.R.2d (RIA) 5229 (5th Cir. 2005)	Lack of jurisdiction - untimely petition; frivolous arguments; sanctions	Yes	IRS
Sutton v. Comm'r, 97 A.F.T.R.2d (RIA) 2411 (N.D. N.Y. 2006)	Installment agreement (trust fund recovery penalty)	No	IRS
Swartz v. Comm'r, 96 A.F.T.R.2d (RIA) 6981 (E.D. Mich. 2005)	District court lacked jurisdiction over income tax liability; face to face hearing	No	IRS
Tassielli v. Comm'r, T.C. Summ. Op. 2006-68	Inability to challenge underlying liability;	Yes	IRS
Tinnerman v. IRS, 96 A.F.T.R.2d (RIA) 6885 (11th Cir. 2005)	Frivolous arguments; face to face hearing	Yes	IRS
Torres v. Comm'r, T.C. Summ. Op. 2006-21	Inability to challenge underlying liability	Yes	IRS
Turner-Simmons v. Comm'r, T.C. Memo. 2005-135	Application of payments	Yes	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Ulloa v. U.S., 96 A.F.T.R.2d (RIA) 6784 (N.D. N.Y. 2005)	Lack of jurisdiction - petition not timely filed	Yes	IRS
Van Syoc v. U.S., 96 A.F.T.R.2d (RIA) 6857 (M.D. Fla. 2005)	District court lacked jurisdiction over income tax liability	Yes	IRS
Vierow v. Comm'r, 96 A.F.T.R.2d (RIA) 7435 (9th Cir. 2005)	Administrative record.	Yes	IRS
Wagenknecht v. U.S., 97 A.F.T.R.2d (RIA) 3000 (N.D. Ohio 2006)	Frivolous return penalty; district court lacked jurisdiction over income tax liability	Yes	IRS
Wetzel v. Comm'r, T.C. Memo. 2005-211	Inability to challenge underlying liability; frivolous arguments; 6673 penalty	Yes	IRS
Whitfield v. Comm.'r, T.C. Summ. Op. 2005-141	Application of payments; equitable estoppel	Yes	IRS
Wilcox v. Comm'r, T.C. Memo. 2005-257	Inability to pay	Yes	IRS
Winans v. Comm'r, T.C. Memo. 2005-271	Inability to challenge underlying liability; frivolous arguments; ability to pay; ability to raise issues in litigation not raised at hearing	Yes	IRS
Winterroth v. U.S.,97 A.F.T.R.2d (RIA) 1746 (9th Cir. 2006)	District court lack of jurisdiction over income tax liability; frivolous arguments; section 6673 penalty	Yes	IRS
Woods v. Comm'r, T.C. Memo. 2006-38	ability to raise issues in litigation not raised at hearing; dischargeability in bankruptcy; frivolous arguments; section 6673 penalties	Yes	IRS
Wright v. Comm'r, T.C. Memo. 2005-291	Face to face hearing; frivolous arguments; section 6673 penalty	Yes	IRS
Wrubleski v. Comm'r, 96 A.F.T.R.2d (RIA) 6620 (11th Cir. 2005)	Frivolous arguments	Yes	IRS
Yazzie v. Comm'r, 96 A.F.T.R.2d (RIA) 7020 (9th Cir. 2005)	Inability to challenge underlying liabiltiy; frivolous arguments; section 6673 penalty	Yes	IRS
Zapara v. Comm'r, 126 T.C. 215 (2006)	Inability to challenge underlying liability; value of seized stock	Yes	TP
Business Taxpayers			
Action Employment Resources, Inc. v. U.S., 96 A.F.T.R.2d (RIA) 7376 (9th Cir. 2005)	Installment agreement; release of lien	No	IRS
B&E Wholesale Meats, Inc. v. Comm'r, 96 A.F.T.R.2d (RIA) 5226 (N.D. Ill. 2005)	Under state law, corporation could not challenge lien filing that occurred after corporation dissolved; no settlement agreement when not reduced to writing	No	IRS
Cohen Enterprises v. U.S., 97 A.F.T.R.2d (RIA) 2465 (W.D. Pa. 2006)	Installment agreement	Yes	IRS
Collectors Training Institute Inc. v. U.S., 96 A.F.T.R.2d (RIA) 6522 (N.D. Ill. 2005)	Business lacked standing to challenge trust fund recovery penalties asserted against corporate officers; district court lacked jurisdiction over trust fund recovery penalties asserted against corporate officers; installment agreement	No	IRS
Comfort Plus Health Care, Inc.v. Comm'r, 96 A.F.T.R.2d (RIA) 5277 (D. Minn. 2005)	Lack of jurisdiction - petition not timely filed; impartiality of appeals officer; administrative record; payments properly applied, penalties; offer in compromise; installment agreement; new evidence as to employee embezzlement not allowed	No	IRS
Heartland Automotive Enterprises, Inc. v. U.S., 96 A.F.T.R.2d (RIA) 5351 (M.D. Ga. 2005)	Inability to challenge underlying liability or penalty	No	IRS
Investment Research Associates, Inc. v. Comm'r, 126 T.C. 183 (2006)	Tax Court lacked jurisdiction because Taxpayer did not timely file request for CDP hearing request	No	IRS
Johnson Home Care Services, Inc. v. U.S., 96 A.F.T.R.2d (RIA) 6085 (E.D. N.Y. 2005)	Balancing test met; installment agreement rejected	No	IRS
Living Care Alternatives of Kirkersville, Inc. v. U.S., 96 A.F.T.R.2d (RIA) 6155 (S.D. Ohio 2005)	Balancing test; collateral estoppel	No	IRS
Living Care Alternatives of Utica, Inc. v . U.S., 411 F.3d 621 (6th Cir. 2005)	Offer in compromise	No	IRS
Mars's Contractors, Inc. v. Comm'r, T.C. Memo. 2006-94	Tax Court lacked jurisdiction over employment tax liability	No	IRS
Pediatric Affiliates, P.A. v. U.S., 97 A.F.T.R.2d (RIA) 1329 (D. N.J. 2006)	Underlying liability; judicial estoppel; equitable estoppel	No	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Rupert V. U.S., 97 A.F.T.R.2d (RIA) 976 (D. Idaho 2006)	Automatic stay; installment agreement; issues not raised in hearing may not be raised in litigation	Yes	IRS
Service Employees International Union v. Comm'r, 125 T.C. 63 (2005)	Lack of jurisdiction over IRC 6652(c)(1) penalty - failure to file exempt organization annual return	No	IRS
Taramark Title Co., Inc. v. U.S., 402 F.Supp.2d 323 (D. Mass. 2005)	Offer in compromise; installment agreement; penalties and fees	No	IRS
Walter Transport, Inc. v. U.S., 97 A.F.T.R.2d (RIA) 2104 (D. Mo. 2006)	Installment agreement	No	IRS

TABLE 2
GROSS INCOME UNDER IRC § 61 AND RELATED SECTIONS

Case Citation	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (But not Sole Proprietorships)			
Ackerman v. Comm'r, T.C. Memo. 2006-3	Distribution from nonqualified deferred compensation plan	Yes	IRS
Adams v. Comm'r, T.C. Summ. Op. 2005-120	Unreported wage income	Yes	IRS
Alegria v. Comm'r, T.C. Summ. Op. 2005-147	Discharge of indebtedness income	Yes	IRS
Allen v. Comm'r, T.C. Memo. 2006-11	Unreported compensation from American Indian tribe	Yes	IRS
Allum v. Comm'r, T.C. Memo. 2005-177	Settlement proceeds excludable under IRC § 104(a)(2) or nontaxable return on capital; portion of settlement proceeds paid to attorney as contingent fee excludable	Yes	IRS
Andrew v. Comm'r, T.C. Summ. Op. 2005-158	Social security disability benefits versus IRC § 104(a)(2) benefits	Yes	IRS
Arias v. Comm'r, T.C. Summ. Op. 2006-20	Alimony or separate maintenance payment versus gift	Yes	IRS
Arnett v. Comm'r, 126 T.C. 89 (2006)	Unreported wage income earned in Antarctica excludable under IRC § 911	No	IRS
Askew v. Comm'r, T.C. Summ. Op. 2005-108	Distributions from tax sheltered annuity policies	Yes	IRS
Barrett v. Comm'r, T.C. Summ. Op. 2006-42.	Annuity payments from defined benefit plan	Yes	IRS
Benavides v. U.S., 97 A.F.T.R.2d (RIA) 1512 (S.D. Tex. 2006	Jury award of punitive damages in wrongful death action excludable under IRC § 104(a)(2)	No	IRS
Biyo v. Comm'r, T.C. Summ. Op. 2005-106	Social security disability benefits	Yes	IRS
Bonaccorso v. Comm'r, T.C. Memo. 2005-278	Unreported income	Yes	IRS
Bond v. Comm'r, T.C. Memo. 2005-251	Settlement proceeds excludible under IRC § 104(a)(2)	Yes	IRS
Bothe v. Comm'r, T.C. Summ. Op. 2006-51	Settlement proceeds excludible under IRC § 104(a)(2)	No	IRS
Braden v. Comm'r, T.C. Summ. Op. 2006-78	Settlement proceeds excludible under IRC § 104(a)(2) -- motion for partial summary judgment filed by Government	Yes	TP
Bradley v. Comm'r, T.C. Memo. 2005-223	Settlement proceeds excludible under IRC § 104(a)(2)	Yes	IRS
Bradley v. Comm'r, T.C. Summ. Op. 2006-11	Distributions from retirement plans	Yes	IRS
Burke v. Comm'r, T.C. Memo. 2005-297	Distributive share of partnership income held in escrow	Yes	IRS
Burnham v. Comm'r, T.C. Summ. Op. 2006-8	Disability pension payments under IRC § 105; insurance annuity payments under IRC § 72	Yes	IRS
Carlisle v. U.S., 66 Fed. Cl. 627 (2005)	Back pay for member of Armed Forces excludable under IRC § 112	Yes	IRS
Clark v. Comm'r, T.C. Memo. 2005-292	Unreported income	Yes	IRS
Clemons v. Comm'r, T.C. Summ. Op. 2005-109	Gambling winnings.	Yes	IRS
Coburn v. Comm'r, T.C. Memo. 2005-283	Discharge of indebtedness income for a loan on which TP defaulted	No	TP
Cole v. Comm'r, T.C. Memo. 2006-44	Unreported interest income.	Yes	IRS
Coppertino v. Comm'r, T.C. Summ. Op. 2006-87	Discharge of indebtedness income – whether TP was insolvent at time of cancellation	No	TP
Cronk v. Comm'r, T.C. Summ. Op. 2005-174	Interest income from redemption of savings bonds	Yes	IRS
Crow v. Comm'r, T.C. Summ. Op. 2005-124	Unreported wage income	Yes	IRS
De Shon v. Comm'r, T.C. Summ. Op. 2005-117	Discharge of indebtedness income	Yes	Split
Doby v. Comm'r, T.C. Summ. Op. 2006-90	Annuity payments from pension plan; IRA distributions	Yes	IRS
Doll v. Comm'r, T.C. Memo. 2005-269	Proceeds from sale of partnership interests	Yes	IRS
Dorsey v. Comm'r, T.C. Memo. 2006-50	Unreported compensation for services rendered	Yes	IRS
Earnshaw v. Comm'r, 96 A.F.T.R.2d (RIA) 6226 (10th Cir. 2005)	Discharge of indebtedness income.	Yes	IRS
Ellis v. Comm'r, T.C. Summ. Op. 2005-177	Discharge of indebtedness income	Yes	IRS
Everhart v. Comm'r, T.C. Summ. Op. 2005-81	Unreported wage income	Yes	IRS

TABLE 2: GROSS INCOME UNDER IRC § 61 AND RELATED SECTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Garza v. Comm'r, T.C. Summ. Op. 2005-96	Commissions on life insurance policies	Yes	IRS
George, v. U.S., 420 F.3d 991 (9th Cir. 2005)	Constructive receipt of receivership fees under IRC § 451.	No	IRS
Goode v. Comm'r, T.C. Memo. 2006-48	Settlement proceeds excludable under IRC § 104(a)(2); portion of settlement proceeds designated as attorneys fees excludable.	No	IRS
Green v. Comm'r, T.C. Memo. 2006-39	Social security benefits excludable under IRC § 104(a)(2)	Yes	IRS
Green v. Comm'r, T.C. Memo. 2005-250	Settlement proceeds excludable under IRC § 104(a)(2)	No	IRS
Guthrie v. Comm'r, T.C. Memo. 2005-196	Unreported wage income, interest income, and dividend income.	Yes	IRS
Hajek v. Comm'r, T.C. Summ. Op. 2005179	Compensation for services versus a gift	Yes	IRS
Hawkins v. Comm'r, T.C Memo. 2005-149	Court award excludable under IRC § 104(a)(2)	No	IRS
Hilen v. Comm'r, T.C. Memo. 2005-226	Exercise of nonstatutory stock options.	No	IRS
Hoang v. Comm'r, T.C. Memo. 2006-47	Unreported interest income; IRA distributions	No	IRS
Hodges v. Comm'r, T.C. Memo. 2005-168	Proceeds from sale of securities.	Yes	IRS
Holmes v. Comm'r, T.C. Memo. 2006-80	Unreported wage income, interest income, savings bond incomes, and IRC § 401(k) distribution	Yes	IRS
Huisenfeldt v. Comm'r, T.C. Summ. Op. 2006-5	Unreported tip income.	Yes	IRS
Hurley v. Comm'r, T.C. Summ. Op. 2005-125	Whether 30% disability entitles TP to exclude 30% of wages from gross income	Yes	IRS
Jerose v. Comm'r, T.C. Summ. Op. 2005-132	Disability benefits excludable under IRC § 105	Yes	IRS
Johanson v. Comm'r, T.C. Memo. 2006-105	Alimony or separate maintenance payment versus property settlement or part of guaranteed stream of payments for fixed term	No	IRS
Joseph v. Comm'r, T.C. Memo. 2005-169	IRA distribution	Yes	IRS
Karns Prime and Fancy Food, Ltd. v. Comm'r, T.C. Memo. 2005-233	Payment from supplier as a loan	No	IRS
Kikalos v. Comm'r, 434 F.3d 977 (7th Cir. 2006)	Unreported coupon and buy-down income, promotional income, vendor refunds and reimbursement income, bulk sales income, and insurance reimbursements	No	IRS
Knox v. Comm'r, T.C. Summ. Op. 2006-72	Lump sum payment from deferred compensation plan under IRC § 457	Yes	IRS
Lange v. Comm'r, T.C. Memo. 2005-176	Gambling winnings; pension distributions; social security benefits.	Yes	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2006-12	Unreported wage income.	Yes	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2006-6	Unreported interest income.	Yes	IRS
Lindsey v. Comm'r, 422 F.3d 684 (8th Cir. 2005)	Settlement proceeds excludable under IRC § 104(a)(2)	No	IRS
Major v. Comm'r, T.C. Memo. 2005-141	Unreported compensation, dividends, and interest income	Yes	IRS
Mansel v. Comm'r, T.C. Summ. Op. 2005-157	Commission payments from auto dealership	Yes	IRS
Marretta v. Comm'r, 97 A.F.T.R.2d (RIA) 1206 (3rd Cir. 2006)	Unreported income from Ponzi scheme	No	IRS
Martinez v. Comm'r, T.C. Memo. 2005-213	Unreported wage income.	Yes	IRS
Martins v. Comm'r, T.C. Summ. Op. 2006-43	Discharge of indebtedness income	Yes	IRS
McManus v. Comm'r, T.C. Memo. 2006-68	Unreported commissions from selling life insurance policies	No	IRS
McQuarrie v. Comm'r, T.C. Memo. 2006-93	Gambling winnings; social security benefits	Yes	IRS
Messina v. Comm'r, T.C. Memo. 2006-107	Unreported settlement proceeds on claim for wrongful discharge and back wages; unreported wage income; unreported interest income	Yes	IRS
Millard v. Comm'r, T.C. Memo. 2005-192	Constructive receipt of income when check received even though not cashed for nearly 2 years	Yes	IRS

TABLE 2: GROSS INCOME UNDER IRC § 61 AND RELATED SECTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Moloney v. Comm'r, T.C. Summ. Op. 2006-53	Discharge of student loan indebtedness excludable under IRC § 108(f) versus discharge of indebtedness includible under IRC § 61(a)(12)	Yes	IRS
Montgomery v. Comm'r, T.C. Summ. Op. 2006-18	Social security benefits	Yes	IRS
Mostafa v. Comm'r, T.C. Memo. 2006-106	Unreported wage income and IRA distributions	Yes	IRS
Mullen v. Comm'r, T.C. Summ. Op. 2006-41	Disability annuity payments from Railroad Retirement Board subject to return of capital provisions of IRC § 72(b) or (d)	Yes	IRS
Mumy v. Comm'r, T.C. Summ. Op. 2005-129	Settlement proceeds excludable under IRC § 104(a)(2).	No	IRS
Namyst v. Comm'r, 435 F.3d 910 (8th Cir. 2006)	Reimbursement by TP's employer for expenses as part of an accountable plan versus ordinary income	No	IRS
Nash-Milton v. Comm'r, T.C. Summ. Op. 2005-156	Unemployment compensation	Yes	IRS
Pates v. Comm'r, T.C. Summ. Op. 2005-182	Settlement proceeds excludable under IRC § 104(a)(2)	Yes	IRS
Peck v. Comm'r, T.C. Summ. Op. 2006-86	Settlement proceeds excludable under IRC § 104(a)(2)	Yes	IRS
Peebles v. Comm'r, T.C. Summ. Op. 2006-61	Payment made to avoid lawsuit and embarrassment regarding marital affair as income versus gift	Yes	IRS
Randich v. Comm'r, T.C. Summ. Op. 2005-119	Payments to former spouse as child support versus alimony	Yes	IRS
Reichner v. Comm'r, T.C. Summ. Op. 2006-50	Distribution from retirement plan taxable to distribute under IRC § 72	Yes	IRS
Reimels v. Comm'r, 436 F.3d 344 (2d Cir. 2006)	Social security disability benefits excludable under IRC § 104(a)(4)	No	IRS
Remos v. Comm'r, T.C. Summ. Op. 2005-98	Gambling winnings	Yes	IRS
Rhodes v. Comm'r, 96 A.F.T.R.2d (RIA) 6421 (5th Cir. 2005)	Unreported wage income and investment income	Yes	IRS
Rivera v. Baker West, Inc., 430 F.3d 1253 (9th Cir. 2005)	Settlement proceeds excludable under IRC § 104(a)(2)	No	IRS
Roulac v. U.S., 96 A.F.T.R.2d (RIA) 6348 (N.D. Cal. 2005)	Settlement proceeds excludable under IRC § 104(a)(2)—motion for partial summary judgment filed by Government	No	TP
Royal v. Comm'r, T.C. Memo. 2006-72	Distribution from retirement plan that discharged outstanding loan balance	Yes	IRS
Sam Kong Fashions, Inc. v. Comm'r, T.C. Memo. 2005-157	Constructive dividends	No	IRS
Scott v. Comm'r, T.C. Summ. Op. 2006-16	Discharge of indebtedness income	Yes	IRS
Siron v. Comm'r, T.C. Memo. 2006-64	Unreported wage income.	Yes	IRS
Smith v. Comm'r, 96 A.F.T.R.2d (RIA) 7022 (9th Cir. 2005)	Unreported income	Yes	IRS
Speltz v. Comm'r, T.C. Summ. Op. 2006-25	Medical benefits paid by employer-spouse to employee-spouse as "reimbursements" excludable under IRC § 105(b)	No	TP
Stang v. Comm'r, T.C. Memo. 2005-154	Unreported wage income and nonemployee compensation	Yes	IRS
Tabrezi v. Comm'r, T.C. Memo. 2006-61	Discharge of indebtedness income - whether TP was insolvent at time of cancellation	No	TP
Tamberella v. Comm'r, 96 A.F.T.R.2d (RIA) 5311 (2d Cir. 2005)	Settlement proceeds excludable under IRC § 104(a)(2)	No	IRS
Teymourian v. Comm'r, T.C. Memo. 2005- 232	Unreported rental income; loans versus constructive dividends	No	TP
Veras v. Comm'r, T.C. Summ. Op. 2006-1	Unreported interest income	Yes	IRS
Vogt v. Comm'r, T.C. Summ. Op. 2005-107	Assistance payments paid to TPs (H&W) by State of California, Department of Social Services, to care for TPs' disabled son	Yes	IRS
Watson v. Comm'r, T.C. Summ. Op. 2005-123	Prejudgment interest received in a personal injury lawsuit excludable under IRC § 104(a)(2)	Yes	IRS

TABLE 2: GROSS INCOME UNDER IRC § 61 AND RELATED SECTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Wheeler v. U.S., 96 A.F.T.R.2d (RIA) 6917 (D.Mass. 2005)	Retroactive payment of occupational disability benefits to retired firefighter excludable under IRC § 104(a)(1)	No	IRS
Wolf v. Comm'r, T.C. Summ. Op. 2005-150	Separate maintenance payment includable under IRC § 71	Yes	IRS
Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)			
Ho Ching Cheng v. Comm'r, T.C. Memo. 2006-74	Unreported income	No	IRS
Hoover v. Comm'r, T.C. Memo. 2006-82	Unreported farm and interest income	Yes	Split
Leggett v. Comm'r, T.C. Memo. 2005-185	Unreported income	Yes	IRS
Martella v. Comm'r, T.C. Memo. 2005-216	Unreported income	Yes	IRS
Taylor v. Comm'r, T.C. Memo. 2006-67	Unreported income	Yes	IRS
Young v. Comm'r, T.C. Summ. Op. 2005-76	Earnings from ministry, including parsonage allowance, includable when computing net earnings from self employment	Yes	IRS

TABLE 3
SUMMONS ENFORCEMENT UNDER IRC §§ 7602(A), 7604(A), AND 7609(A)

Case Citation	Issue(s)	*Pro Se*	Decision
Individual TPs (Issues Other Than Business)			
Abell v. Sothen, 97 A.F.T.R2d (RIA) 1804 (D. Colo. 2006)	Lack of jurisdiction over two banks not located in the district; Powell requirements satisfied	Yes	IRS
Anderson v. U.S., 98 A.F.T.R.2d (RIA) 5150 (N.D. Ga. 2006), *adopting* 98 A.F.T.R.2d (RIA) 5147 (N.D. Ga. 2006)	TP not permitted to amend motion to quash to assert new theories; TP presented frivolous arguments	Yes	IRS
Aposhian v. U.S., 98 A.F.T.R.2d (RIA) 5145 (D. Utah 2006), *adopting* 98 A.F.T.R.2d (RIA) 5146 (D. Utah 2006)	TP failed to show cause for noncompliance with summons	Yes	IRS
Benoit v. U.S., 97 A.F.T.R.2d (RIA) 2931 (S.D. Cal. 2006)	Powell requirements satisfied	Yes	IRS
Bharose v. U.S., 96 A.F.T.R.2d (RIA) 6779 (E.D. Cal. 2005)	Petition to quash summons dismissed; TP failed to timely serve government	Yes	IRS
Bishop v. Bahr, 96 A.F.T.R.2d (RIA) 5835 (D. S.C. 2005) *adopting* 96 A.F.T.R.2d (RIA) 5507 (D. S.C. 2005)	Court dismissed IRS, IRS agent, and IRS manager as defendants, substituted U.S; dismissed for lack of jurisdiction	Yes	IRS
Boelter v. U.S., 96 A.F.T.R.2d (RIA) 5968 (W.D. Wash. 2005)	Powell requirements satisfied; Attorney-client privilege not applicable	No	IRS
Booth v. U.S., 2005 U.S. Dist. LEXIS 27307 (E.D. Cal. 2005)	TP failed to provide valid reason for stay; Fifth Amendment cannot be raised prior to appearing before IRS, but must be raised with respect to questions asked or documents sought	Yes	IRS
Buckler v. U.S., 97 A.F.T.R.2d (RIA) 1350 (W.D. Ky. 2006)	Court did not have jurisdiction to quash third-party summonses where TP offered no proof that summoned parties are registered and conducting business within the district	No	IRS
Capstick v. U.S., 96 A.F.T.R.2d (RIA) 5657 (W.D. Wash. 2005)	Court did not allow equitable tolling to extend date to timely file petition	No	IRS
Chapman v. U.S., 96 A.F.T.R.2d (RIA) 7410 (5th Cir. 2005), *aff'g* 98 A.F.T.R.2d 5312 (S.D. Tex. 2004)	Fifth Amendment defense not applicable	Yes	IRS
Christensen v. U.S., 98 A.F.T.R.2d (RIA) 5084 (W.D. Mich. 2006), *adopting* 98 A.F.T.R.2d (RIA) 5053 (W.D. Mich. 2006)	TP failed to meet burden of proving abuse of process	Yes	IRS
Congdon v. U.S., 98 A.F.T.R.2d (RIA) 5279 (N.D. Tex. 2006)	Powell requirements satisfied	No	IRS
Connor v. U.S., 434 F.3d 676 (4th Cir. 2006) *aff'g* 94 A.F.T.R.2d. (RIA) 7287 (W.D. Va. 2004)	Powell requirements satisfied.	No	IRS
Cox v. U.S., 2006 U.S. Dist. LEXIS 7582 (E.D. Cal. 2006), *adopting* 97 A.F.T.R.2d (RIA) 1121 (E.D. Cal. 2006)	Powell requirements satisfied.	Yes	IRS
Cromar v. U.S., 98 A.F.T.R.2d (RIA) 6027 (D.Utah 2006), *adopting* 98 A.F.T.R.2d (RIA) 5860 (D. Utah 2006)	TP failed to show cause why TP should not be compelled to comply with the summons	Yes	IRS
Dillingham v. U.S., 96 A.F.T.R.2d (RIA) 5293 (E.D. Cal. 2005)	Court lacked subject matter jurisdiction	Yes	IRS
Dirr v. U.S., 97 A.F.T.R.2d (RIA) 1784 (E.D. Tenn. 2006)	Summons issued to TP's employer in connection with a criminal investigation not subject to notice requirements	Yes	IRS
Edwards v. U.S., 97 A.F.T.R.2d (RIA) 1646 (10th Cir. 2006), *aff'g* 96 A.F.T.R.2d 6906 (RIA) (D. Wyo. 2005)	Powell requirements satisfied; TP's appeal frivolous; sanctions imposed	Yes	IRS
Elliott v. U.S., 96 A.F.T.R.2d (RIA) 5503 (W.D. N.C. 2005)	Contents and act of producing records not protected by Fifth Amendment	No	IRS
Falgione v. U.S., 395 F.Supp.2d 241 (W.D. Pa. 2005)	Powell requirements satisfied	No	IRS
Garnache v. U.S., 95 A.F.T.R.2d (RIA) 2966 (D. Wash. 2005)	Summons meets three prong Endicott Johnson test	Yes	IRS
Geary v. U.S., 96 A.F.T.R.2d (RIA) 5839 (D. Haw. 2005)	Powell requirements satisfied	No	IRS

TABLE 3: SUMMONS ENFORCEMENT UNDER IRC §§ 7602(A), 7604(A), AND 7609(A) (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Gippetti v. U.S., 96 A.F.T.R.2d (RIA) 6978 (3rd Cir. 2005), *vacating and remanding* 94 A.F.T.R.2d (RIA) 6093 (D. N.J. 2004)	Remanded to determine whether TP had possession or control over the documents; Fifth Amendment defense not applicable	No	Split
Gould v. U.S., 98 A.F.T.R.2d (Ria) 5338 (W.D. Wash. 2006), *adopting* 98 A.F.T.R.2d (RIA) 5336 (W.D. Wash. 2006)	Powell requirements satisfied; Fifth Amendment claims are premature	Yes	IRS
Hargis v. U.S., 97 A.F.T.R.2d (RIA) 320 (9th Cir. 2005), *aff'g* 93 A.F.T.R.2d (RIA) 2739 (C.D. Cal. 2003)	Powell requirements satisfied	No	IRS
Holland v. U.S., 96 A.F.T.R.2d (RIA) 5667 (N.D. Okla. 2005)	Court lacked jurisdiction and TP not entitled to notice of third-party summons because summons issued in aid of collection.	Yes	IRS
Holmes v. U.S., 98 A.F.T.R.2d (RIA) 5559 (D. Ariz. 2006)	Privilege claims unsubstantiated	Yes	IRS
Holoubek v. U.S., 97 A.F.T.R.2d (RIA) 2635 (D. Ariz. 2006)	Powell requirements satisfied and IRS has the authority to issue the summons	Yes	IRS
Hopper v. U.S., 96 A.F.T.R.2d (RIA) 6899 (E.D. N.Y. 2005)	Fourth and Fifth Amendments not violated	Yes	IRS
Huston v. U.S. Penobscot County Federal Credit Union, 97 A.F.T.R.2d (RIA) 503 (D. Me. 2005)	Powell requirements satisfied	Yes	IRS
Huston v. U.S., 96 A.F.T.R.2d (RIA) 6228 (D. Del. 2005)	Powell requirements satisfied	Yes	IRS
Ivie v. U.S., 95 A.F.T.R2d (RIA) 2992 (W.D. Tenn. 2005)	Powell requirements satisfied	Yes	IRS
Jaeger v. U.S., 97 A.F.T.R.2d (RIA) 2158 (D. Conn. 2006)	TP's objections overruled. Judge was not biased or prejudiced and the TP failed to introduce any evidence to counter in personam jurisdiction	Yes	IRS
Jerry v. U.S., 96 A.F.T.R.2d (RIA) 5539 (D. Md. 2005)	TP in contempt of court	Yes	IRS
Johnson v. U.S., 2006 WL 505844 (W.D. Tex. 2006)	Powell requirements satisfied; summons is not overbroad; Title 12 and IRC § 6065 not applicable	Yes	IRS
Johnson v. U.S., 96 A.F.T.R.2d (RIA) 7314 (W.D. Pa. 2005)	Fourth and Fifth Amendments offer no protections; absence of IRS employee signature does not render document defective; Right to Financial Privacy Act does not prohibit disclosure of financial records under Title 26	Yes	IRS
Jordan v. U.S., 97 A.F.T.R.2d (RIA) 2919 (M.D. Ala. 2006)	Powell requirements satisfied; TP failed to prove overbreadth, attorney-client privilege, or second inspection	No	IRS
Justin v. U.S., 2006 U.S. Dist. LEXIS 35773 (W.D. N.C. 2006), *adopting* 97 A.F.T.R.2d (RIA) 966 (W.D. N.C. 2006)	Court did not have jurisdiction to quash third-party summonses where TP failed to timely serve the government and the summoned third parties do not reside within the district	Yes	IRS
Kahre v. U.S., 96 A.F.T.R.2d (RIA) 7434 (9th Cir. 2005)	Motion to quash dismissed as moot	Yes	IRS
Katoa v. U.S., 98 A.F.T.R.2d (RIA) 5857 (D. Utah 2006)	TP failed to show cause for noncompliance with summons	Yes	IRS
Katz v. U.S., 97 A.F.T.R.2d (RIA) 2818 (D. Vt. 2006)	Powell requirements satisfied	Yes	IRS
Kernan v. IRS, 97 A.F.T.R.2d (RIA) 1636 (D. Ariz. 2006)	IRS has authority to seek information about third parties to the investigation; Right to Financial Privacy Act does not prohibit disclosure of financial records under Title 26; investigation not subject to the notice requirements of APA; IRS employee did not act in bad faith	Yes	IRS
Koehler v. U.S., 96 A.F.T.R.2d (RIA) 6528 (M.D. Fla. 2005), *adopting* U.S. v., 96 A.F.T.R.2d (RIA) 6129 (M.D. Fla. 2005); *U.S. v. Koehler*, 97 A.F.T.R.2d (RIA) 2916 (M.D. Fla. 2006)	Powell requirements satisfied; TP in contempt of court; TP fined	No	IRS
Lain v. U.S., 97 A.F.T.R.2d (RIA) 1616 (10th Cir. 2006), *aff'g* 96 A.F.T.R.2d (RIA) 6995 (D. Wyo. 2005)	Powell requirements satisfied; TP's arguments were frivolous	Yes	IRS
Langer v. U.S., 98 A.F.T.R.2d (RIA) 5433 (8th Cir. 2005)	Powell standards satisfied; TP failed to refute prima facie case	Yes	IRS

TABLE 3: SUMMONS ENFORCEMENT UNDER IRC §§ 7602(A), 7604(A), AND 7609(A) (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Leahy v. U.S., 98 A.F.T.R.2d (RIA) 5858 (D. Utah 2006) *adopting U.S. v. Leahy*, 98 A.F.T.R.2d (RIA) 5859 (D. Utah 2006)	TP failed to show cause for noncompliance with summons	Yes	IRS
Linstruth v. U.S., 97 A.F.T.R.2d (RIA) 2332 (S.D. Ohio 2005), *adopting* 97 A.F.T.R.2d (RIA) 2231 (S.D. Ohio 2005)	Petition to quash summons dismissed due to untimeliness	Yes	IRS
Loude v. U.S., 2006 U.S. Dist. LEXIS 19006 (E.D. Mich. 2006)	Emergency motion to stay proceedings denied	Yes	IRS
MacAlpine v. U.S., 97 A.L.F.R.2d (RIA) 2014 (W.D. N.C. 2006)	Lack of jurisdiction to quash third-party summons because TP failed to attach copy of summons and submit proof of mailing copy of petition to summoned third-party; Filing of petition is frivolous	Yes	IRS
Mackey v. U.S., 2005 U.S. Dist. LEXIS 25380 (W.D. Mo. 2005)	TP failed to file objections	Yes	IRS
Markham v. U.S., 2006 U.S. Dist. LEXIS 1011 (W.D. Mo. 2006)	TP failed to file objections	Yes	IRS
Marks v. U.S., 97 A.F.T.R.2d (RIA) 433 (S.D. N.Y. 2006)	Court lacked jurisdiction due to untimely filing of petition and failure to serve notice on the government	Yes	IRS
Marra v. U.S., 96 A.F.T.R.2d (RIA) 6471 (D. N.J. 2005)	No Fifth Amendment privilege when Fifth Amendment not raised with respect to each question posed and each document sought	No	IRS
Martini v. U.S., 97 A.F.T.R.2d (RIA) 2592 (D. Nev. 2006), *clarifying Martini v. U.S.*, 2006 WL 240803 (D. Nev. 2006)	IRS has authority to issue a third-party summons to state agency - no violation of Tenth Amendment; IRS produced requisite proof of service of summons; Powell requirements satisfied	Yes	IRS
Maxwell v. U.S., 96 A.F.T.R.2d (RIA) 6591 (M.D. Tenn. 2005)	Dismissed untimely filed petition	Yes	IRS
Mayer v. U.S., 2005 U.S. Dist. LEXIS 27544 (M.D. Fla. 2005), *adopting U.S. v. Mayer*, 96 A.F.T.R.2d (RIA) 6096 (M.D. Fla. 2005)	Powell requirements satisfied	Yes	IRS
McGugan v. Katzmar, 96 A.F.T.R.2d (RIA) 7182 (D. N.J. 2005)	Untimely petition; frivolous arguments; Powell requirements satisfied	Yes	IRS
McMillian v. U.S., 97 A.F.T.R.2d (RIA) 642 (M.D. Fla. 2006) adopting 97 A.F.T.R.2d (RIA) 631 (M.D. Fla. 2005)	Powell requirements satisfied	Yes	IRS
Murphy v. Murphy, 97 A.F.T.R.2d (RIA) 2209 (D. Utah 2006), *adopting* 97 A.F.T.R.2d (RIA) 2210 (D. Utah 2006)	Powell requirements satisfied	Yes	IRS
Nelson v. U.S., 96 A.F.T.R.2d (RIA) 5633 (W.D. Wash. 2005)	TP did not provide sufficient facts for the court to consider whether equitable tolling could extend the time to file a petition to quash	No	IRS
Norwood v. U.S., 420 F.3d 888 (8th Cir. 2005), *aff'g* 343 F. Supp.2d 860 (D. N.D. 2004)	TP failed to refute prima facie case; Fourth and Fifth Amendment rights not violated	No	IRS
O'Doherty v. U.S., 97 A.F.T.R.2d (RIA) 322 (N.D. Ill. 2005)	TP not entitled to notice of third-party summons because summoned party is not a third-party recordkeeper	No	IRS
Plemons v. U.S., 97 A.F.T.R.2d (RIA) 899 (E.D. Tenn. 2005)	Court denied TPs' frivolous motion to dismiss summons enforcement action	Yes	IRS
Pless v. U.S., 2005 U.S. App. LEXIS 23574 (4th Cir. 2006), *aff'g* 2005 U.S. Dist. LEXIS 43578 (D. S.C. 2005)	Powell requirements met	Yes	IRS
Plum v. U.S., 2006 U.S. Dist. LEXIS 12379 (N.D. Tex. 2006)	Powell requirements satisfied	Yes	IRS
Polinder v. U.S., A69 98 A.F.T.R.2d (RIA) 5319 (W.D. Wash. 2006)	Powell requirements satisfied; Fifth Amendment claim immature at summons enforcement stage	Yes	IRS
Rae v. U.S., 96 A.F.T.R.2d (RIA) 6294 (E.D. Mich. 2005) *adopting* 96 A.F.T.R.2d (RIA) 6294 (E.D. Mich. 2005)	TP failed to show Court's jurisdiction or his entitlement to the relief requested	Yes	IRS
Ramshaw v. U.S., 96 A.F.T.R.2d (RIA) 6275 (E.D. Mo. 2005)	TP failed to send notice of proceeding to summoned party	Yes	IRS

TABLE 3: SUMMONS ENFORCEMENT UNDER IRC §§ 7602(A), 7604(A), AND 7609(A) (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Remedios v. Wells Fargo Bank, 2006 U.S. Dist. LEXIS 35442 (E.D. Cal. 2006), *adopting* 97 A.F.T.R.2d (RIA) 2468 (E.D. Cal. 2006)	TP need not receive notice of a third-party summons issued to collect tax owed by the TP	Yes	IRS
Sarnowski v. U.S., 2005 U.S. Dist. LEXIS 43120 (D. N.J. 2005); *Sarnowski v. U.S.*,96 A.F.T.R.2d (RIA) 6321 (E.D. Va. 2005)	Court lacked subject matter jurisdiction, Powell requirements met; petition to quash summons dismissed due to untimeliness	Yes	IRS
Schulz v. IRS, 413 F.3d 297 (2d Cir. 2005), *clarifying Schultz v. IRS*, 395 F.3d 463; *Schulz v. U.S.*, 97 A.F.T.R.2d (RIA) 859 (E.D.N.Y. 2005)	Judicial review of summons and intervening opportunity to comply with the court order of enforcement is required prior to the imposition of coercive or punitive damages on TP; TP filed petition to quash in an untimely manner	Yes	IRS
Schulz v. U.S., 97 A.F.T.R.2d (RIA) 815 (N.D. Cal. 2005), *aff'g Schulz v. U.S.*, 96 A.F.T.R.2d (RIA) 6554 (N.D. Cal. 2005)	No First Amendment violation; Powell requirements satisfied	Yes	IRS
Stark v. U.S., 97 A.F.T.R.2d (RIA) 2764 (E.D. Cal. 2006)	Powell standards satisfied	Yes	IRS
Stewart v. U.S., 96 A.F.T.R.2d (RIA) 6881 (D. Or. 2005), adopting 96 A.F.T.R.2d (RIA) 6877 (D. Or. 2005)	No jurisdiction over petition to quash summons which is filed by a party not identified in the summons; Error on three summonses resulted in quashed summonses as to the party inadvertently named on the summonses; Powell requirements satisfied on remaining summons	Yes	Split
Storaasli v. IRS, 95 A.F.T.R.2d (RIA) 2939 (9th Cir. 2005)	TP not entitled to quash summons	Yes	IRS
Tilley v. U.S., 97 A.F.T.R.2d (RIA) 2016 (E.D.N.C. 2006)	Powell requirements satisfied	Yes	IRS
Travis v. Miki, 394 F.Supp.2d 1277 (D. Haw. 2005)	Powell requirements satisfied; Fifth Amendment privilege does not apply to the records of entities	No	IRS
Trenholm v. U.S., 96 A.F.T.R.2d (RIA) 5856 (D. Haw. 2005) *adopting* 2005 WL 3200080 (D. Haw. 2005)	Powell requirements satisfied	No	IRS
Turner v. U.S., 98 A.F.T.R.2d (RIA) 6071 (E.D. Cal. 2006) *adopting* 98 A.F.T.R.2d (RIA) 5995 (E.D. Cal. 2006)	Powell requirements satisfied	Yes	IRS
Veith v. Stegemueller, 97 A.F.T.R.2d (RIA) 835 (5th Cir. 2006)	TP arguments are frivolous; sanctions imposed	Yes	IRS
Wessel v. U.S., 96 A.F.T.R.2d (RIA) 6481 (N.D. Cal. 2005) *adopting U.S. v. Wessel*, 96 A.F.T.R.2d (RIA) 6481 (N.D. Cal. 2005)	Powell requirements satisfied	Yes	IRS
Wilde v. U.S., 385 F.Supp.2d 966 (D. Ariz. 2005)	TP does not have standing to challenge service of summons on the third-party recordkeeper	Yes	IRS
Williams v. U.S., 2005 U.S. Dist. LEXIS 25674 (E.D. Tenn. 2005), *adopting Williams v. U.S.*, 96 A.F.T.R.2d (RIA) 6747 (E.D. Tenn. 2005)	Lack of subject matter jurisdiction as to summonses issued to banks without branches in the district; summonses are still enforceable absent attestations	Yes	Split
Wozab v. U.S., 97 A.F.T.R.2d (RIA) 2201 (D. Utah 2006), *adopting U.S. v. Wozab* 97 A.F.T.R.2d (RIA) 2202 (D. Utah 2006)	TP failed to show cause for noncompliance with summons	Yes	IRS
Zarska v. U.S., 142 Fed. Appx. 174 (4th Cir. 2005), *aff'g* 2004 WL 3740906 (N.D. W.Va. 2004).	Order denying motion to quash affirmed due to no reversible error	Yes	IRS
Business TPs (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships, Estates and Trusts)			
Back to Heath Chiropractic v. U.S., 96 A.F.T.R.2d (RIA) 7071, *adopting* 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005)	Fifth Amendment a legally sufficient defense to enforcement of one summons relating to individual TP, but not to the business TP; Fourth Amendment not violated	Yes	Split
Beaumont Key Services, L.L.C. v. U.S., 96 A.F.T.R.2d (RIA) 5828 (N.D. Tex. 2005)	Powell requirements satisfied; TP cannot challenge amount of tax deficiency in petition to quash summons; TP did not show abuse of court process	No	IRS
Benistar 419 Plan Services, Inc. v. U.S., 96 A.F.T.R.2d (RIA) 5794 (2d Cir. 2005)	Powell requirements satisfied	No	IRS
Environmental Sound Solutions v. Chynoweth, 2006 U.S. Dist. LEXIS 32431 (E.D. Cal. 2006)	TP failed to serve petition within 20 days after notice of the summons; Powell requirements satisfied	No	IRS
Holu v. U.S., 96 A.F.T.R.2d (RIA) 5843 (D. Haw. 2005)	Failure to prove abuse of process or lack of institutional good faith	No	IRS

TABLE 3: SUMMONS ENFORCEMENT UNDER IRC §§ 7602(A), 7604(A), AND 7609(A) (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Investor Communications Int'l, Inc. v. U.S., 97 A.F.T.R.2d (RIA) 1293 (W.D. Wash. 2006)	TP met its obligation to properly serve notice of its petition to quash third-party summons	No	TP
Mississippi Gulf Coast Men's Christian Ass'n, Inc., 97 A.F.T.R.2d (RIA) 2934 (S.D. Miss. 2006)	Summoned third party not entitled to notice of petition to quash; court lacks jurisdiction	No	IRS
Mollison v. U.S., 97 A.F.T.R.2d (RIA) 1677 (S.D.N.Y. 2006)	collateral proceedings (deficiency) do not deprive IRS authority to issue summons; summons permitted by agreement between U. S. and Virgin Islands	No	IRS
Montgomery Global Advisors V LLC, et al, v. U.S., 97 A.F.T.R.2d (RIA) 1528 (N.D. Cal. 2006); *U.S. v. Montgomery Global Advisors V LLC*, 97 A.F.T.R.2d (RIA) 838 (N.D. Cal. 2006); *U.S. v. Montgomery Global Advisors V LLC*, 96 A.F.T.R.2d (RIA) 5849 (N.D. Cal. 2005)	Court denied motion to incarcerate TP who began attempting to comply with summons; Court ordered compliance with summons and threatened incarceration; TP in contempt for failure to comply with summons and fined	No	IRS
Monumental Life Ins. Co. v. U.S., 440 F.3d 729 (6th Cir. 2006), *rev'g* 345 F. Supp. 2d 712 (W. D. Ky. 2004)	Summons was overbroad, precluding enforcement in full	No	TP
Reiserer v. U.S., 96 A.F.T.R.2d (RIA) 5437 (W.D. Wash. 2005)	Motion to stay enforcement of summons granted pending appeal of another relevant case	No	TP
Rose v. U.S., 437 F.Supp.2d 1166 (S.D. Cal. 2006)	TP failed to comply with summons and sanctioned with civil contempt of court charges	No	IRS
The Frost National Bank v. U.S., 97 A.F.T.R.2d (RIA) 2769 (W.D. Tex. 2006), *adopting* 97 A.F.T.R.2d (RIA) 2771 (W.D. Tex. 2005)	Noncompliance with administrative steps results in granting motion to quash some of the summons	No	Split
Unocal Corp. v. U.S., 97 A.F.T.R.2d (RIA) 522 (N.D. Cal. 2006)	TP waived the work product doctrine and attorney-client privilege when it shared the documents with an adverse third party	No	IRS
Wallace v. U.S., 2006 WL 1320117 (4th Cir. 2006)	Order denying motion to quash affirmed due to no reversible error	Yes	IRS

TABLE 4
ACCURACY-RELATED PENALTY UNDER IRC § 6662(B)(1) AND (2)

Case Citation	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (Issues Other Than Business)			
Alegria v. Comm'r, T.C. Summ. Op. 2005-147	6662(b)(2) - TP's belief that COD income was not taxable as reasonable cause	Yes	TP
Allemeier v. Comm'r, T.C. Memo. 2005-207	6662(b)(1) - Oral testimony rather than books/records to substantiate deductions	Yes	TP
Allen v. Comm'r, T.C. Memo. 2006-11	6662(b)(2) - No evidence of reasonable cause presented	Yes	IRS
Estate of Amlie v. Comm'r, T.C. Memo. 2006-76	6662(b)(1) - Whether undervaluation of stock gave rise to understatement of tax	No	TP
Askew v. Comm'r, T.C. Summ. Op. 2005-108	6662(b)(2) - No evidence of reasonable cause presented	Yes	IRS
Ayittey v. Comm'r, T.C. Summ. Op. 2006-65	6662(b)(2) - Lack of basis information as reasonable cause when records destroyed by fire	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2005-155	6662(b)(1) - No evidence of reasonable cause presented	Yes	IRS
Coburn v. Comm'r, T.C. Memo. 2005-283	6662(b) - Whether TP's default on a loan gave rise to underpayment of tax	No	TP
Cronk v. Comm'r, T.C. Summ. Op. 2005-174	6662(b)(2) - TP's belief in stepped-up basis theory or reliance on letter from Appeal's officer as reasonable cause	Yes	IRS
De Shon v. Comm'r, T.C. Summ. Op. 2005-117	6662(b)(2) – IRS burden of production	Yes	TP
Ercolino v. Comm'r, T.C. Summ. Op. 2006-92	6662(b)(1) - Whether deduction of child support as alimony was negligent	No	TP
Everhart v. Comm'r, T.C. Summ. Op. 2005-81	6662(b)(1) - No adequate books/records and failure to substantiate	Yes	IRS
Facq v. Comm'r, T.C. Memo. 2006-111	6662(b)(1) – Reliance on tax professionals when excluding gain from stock acquired with third party margin debt as reasonable cause	No	TP
Ferguson v. Comm'r, T.C. Memo. 2006-32	6662(b)(2) – No evidence of reasonable cause presented	Yes	IRS
Garza v. Comm'r, T.C. Summ. Op. 2005-96	6662(b)(2) – No evidence of reasonable cause presented	Yes	IRS
Glenn v. Comm'r, T.C. Summ. Op. 2005-127	6662(b)(2) – Reliance on tax professional to prepare accurate return as reasonable cause when TP unsophisticated as to tax matters	Yes	TP
Goode v. Comm'r, T.C. Memo. 2006-48	6662(b)(2) - Reliance on settlement agreement and lack of receipt of Form 1099 as reasonable cause for excluding proceeds from income	No	IRS
Gran v. U.S., 96 A.F.T.R.2d (RIA) 7468 (N.D. Cal. 2005)	6662(b) - Whether TP filed Form 8275 disclosing position to the IRS	No	IRS
Haas v. Comm'r, T.C. Summ. Op. 2006-9	6662(b)(1) – No evidence of reasonable cause presented	Yes	IRS
Hang v. Comm'r, T.C. Summ. Op. 2006-64	6662(b)(2) – Reliance on tax professional as reasonable cause when TP doesn't provide sufficient information	Yes	IRS
Hanna v. Comm'r, T.C. Summ. Op. 2006-57	6662(b)(2) - Failure to comply with IRC 469 rules due to complexity as reasonable cause	Yes	TP
Hess v. Comm'r, T.C. Summ. Op. 2006-66	6662(b)(2) - Reliance on tax professional as reasonable cause when TP did not review return	Yes	IRS
Horwarth v. Comm'r, 96 A.F.T.R.2d (RIA) 5448 (4th Cir. 2005)	6662(b)(1) - No evidence of reasonable cause presented	Yes	IRS
Huisenfeldt v. Comm'r, T.C. Summ. Op. 2006-5	6662(b)(1) – No evidence of reasonable cause presented	Yes	IRS

TABLE 4: ACCURACY-RELATED PENALTY UNDER IRC § 6662(B)(1) AND (2) (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Hunter v. Comm'r, T.C. Memo. 2005-219	6662(b) - TPs' (H&W) petition failed to state legally sufficient grounds for relief	Yes	IRS
Hurley v. Comm'r, T.C. Summ. Op. 2005-125	6662(b)(1) and (b)(2) - Reliance on tax professional as reasonable cause and full-disclosure of tax position	Yes	TP
Joseph v. Comm'r, T.C. Memo. 2005-169	6662(b)(1) – No adequate books/records and failure to substantiate	Yes	IRS
Kaplan v. Comm'r, T.C. Memo. 2006-16	6662(b)(2) - Reliance on tax professional's advice for charitable contribution deduction as reasonable cause	No	IRS
Kendrix v. Comm'r, T.C. Memo. 2006-9	6662(b)(1) and (b)(2) – No evidence of reasonable cause presented; failure to substantiate	Yes	IRS
Leonard v. Comm'r, T.C. Summ. Op. 2005-114	6662(b)(2) - Oral testimony to demonstrate reliance on tax professional	Yes	IRS
Lindsey v. Comm'r, 422 F.3d 684 (8th Cir. 2005)	6662(b)(2) - Whether exclusion of settlement proceeds gave rise to substantial understatement of tax	No	IRS
Major v. Comm'r, T.C. Memo. 2005-194	6662(b)(1) - No adequate books/records and failure to substantiate	Yes	IRS
Mansel v. Comm'r, T.C. Summ. Op. 2005-157	6662(b)(1) - TP's belief that payments from employer were advances subject to adjustment rather than taxable commissions as reasonable cause	Yes	IRS
Melnik v. Comm'r, T.C. Memo. 2006-25	6662(b)(1) and (b)(2) - Reliance on advice of tax professionals to use foreign trusts to avoid taxes as reasonable cause	No	TP
Monte v. Comm'r, T.C. Summ. Op. 2005-77	6662(b)(2) - Extent of TP's efforts to determine correct tax	Yes	TP
Mullins v. Comm'r, T.C. Summ. Op. 2005-72	6662(b)(1) - Whether failure to report capital gains and pro rata share of S corporation income/deductions was negligent	Yes	IRS
Sadberry v. Comm'r, 96 A.F.T.R.2d (RIA) 7119 (5th Cir. 2005)	6662(b)(2) – Whether TP with significant education, knowledge and experience has reasonable cause	Yes	IRS
Sanders v. Comm'r, T.C. Memo. 2005-163	6662(b)(1) - Whether TP should have known partnership deductions were too good to be true	No	IRS
Sklar v. Comm'r, 125 T.C. 281 (2005), *appeal docketed*, No. 06-72961 (9th Cir. June 8, 2006)	6662(b)(1) – IRS sustained same type of deductions in previous years as reasonable cause	No	TP
Smith v. Comm'r, T.C. Memo. 2006-51	6662(b)(1) - Reliance on Treasury Regulation that conflicts with statute as reasonable cause regarding Johnston Island exemption status	No	IRS
Snyder v. Comm'r, T.C. Memo. 2006-92	6662(b)(2) - Reliance on opinions of friends as to taxable nature of annuity contracts and absence of Form 1099-Rs as reasonable cause	No	IRS
Sylve v. Comm'r, T.C. Summ. Op. 2005-137	6662(b)(2) - Reliance on tax professional as reasonable cause	No	TP
Tabrezi v. Comm'r, T.C. Memo. 2006-61	6662(b) - IRS burden of proof	No	TP
Tamberella v. Comm'r, 96 A.F.T.R.2d (RIA) 5311 (2d Cir. 2005)	6662(b)(1) - Mental illness as reasonable cause for omitting settlement proceeds from income	No	IRS
Teymourian v. Comm'r, T.C. Memo. 2005-232	6662(b)(1) -Reliance on tax professional as to tax treatment of constructive dividends and rental income as reasonable cause	No	TP
Triplett v. Comm'r, T.C. Summ. Op. 2005-148	6662(b)(1) - No evidence of reasonable cause presented	Yes	IRS
Tulay v. Comm'r, T.C. Summ. Op. 2006-70	6662(b)(2) – Reasonableness of payment made to ex-spouse as deductible alimony	Yes	TP

TABLE 4: ACCURACY-RELATED PENALTY UNDER IRC § 6662(B)(1) AND (2) (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Turner v. Comm'r, 126 T.C. 299 (2006)	6662(b)(1) and (b)(2) – Reliance on valuation report as reasonable cause	No	IRS
Westbrook v. Comm'r, T.C. Summ. Op. 2006-3	6662 (b)(1) - IRS burden of production	Yes	TP
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships, and Trust(s)).			
168 Garment, Inc. v. Comm'r, T.C. Memo. 2006-23	6662(b)(2) as an alternative to 6663	Yes	TP
Abdullah v. Comm'r, T.C. Summ. Op. 2006-32	6662(b)(2) – Failure to substantiate	Yes	IRS
Abloso v. Comm'r, T.C. Summ. Op. 2006-60	6662(b)(1) – Reliance on advice from tax promoter as reasonable cause where TPs (H&W) fail to substantiate	Yes	IRS
Arnold v. Comm'r, T.C. Memo. 2005-256	6662(b)(1) – No evidence of reasonable cause presented	Yes	IRS
Bangs v. Comm'r, T.C. Memo. 2006-83	6662(b)(1) – IRS failure to challenge deductions in earlier audit as reasonable cause	No	Split
Booker v. Comm'r, T.C. Summ. Op. 2005-90	6662(b)(1) – Evidence presented of substantiation irrelevant or fabricated	Yes	IRS
Christensen v. Comm'r, T.C. Memo. 2006-62	6662(b)(2) – No evidence of reasonable cause presented	Yes	IRS
Clark v. Comm'r, T.C. Memo. 2005-292	6662(b)(1) - No evidence of reasonable cause presented	Yes	IRS
Coppertino v. Comm'r, T.C. Summ. Op. 2006-87	6662(b)(2) - Whether COD income gave rise to underpayment of tax	No	TP
Cox v. Comm'r, T.C. Memo. 2005-288	6662(b)(1) - Reliance on tax professional as reasonable cause	No	TP
D'Avilar v. Comm'r, T.C. Summ. Op. 2006-52	6662(b)(1) - Whether failure to substantiate deductions on amended return that the IRS never processed constitutes negligence	Yes	TP
Deihl v. Comm'r, T.C. Memo. 2005-287	6662(b)(1) - Reliance on tax professional as reasonable cause	No	IRS
Egan v. Comm'r, T.C. Memo. 2005-234	6662(b)(2) – Reliance on tax professionals as reasonable cause when TP fails to show professionals were competent	No	IRS
Field v. Comm'r, T.C. Summ. Op. 2005-184	6662(b)(2) - No evidence of reasonable cause presented	Yes	IRS
Giles v. Comm'r, T.C. Memo. 2006-15	6662(b)(2) – Reliance on tax professional as reasonable cause	No	TP
Green v. Comm'r, T.C. Memo. 2005-250	6662(b)(1) and (b)(2) - TP's belief that settlement amount was excludable from gross income as reasonable cause	No	IRS
Hawks v. Comm'r, T.C. Memo. 2005-155	6662(b)(1) - No evidence of reasonable cause presented	Yes	IRS
Hudack v. Comm'r, T.C. Summ. Op. 2005-159	6662(b)(2) - Reliance on tax professional as reasonable cause	Yes	TP
Indmar Products Co. v. Comm'r, 444 F.3d 771 (6th Cir. 2006)	6662(b)(2) - Whether corporate payments are equity rather than deductible debt that give rise to an underpayment of tax	No	TP
Jackson v. Comm'r, T.C. Memo. 2005-159	6662(b)(1) - Whether failure to maintain and produce documentation constitutes negligence	Yes	IRS
Kanofsky v. Comm'r, T.C. Memo. 2006-79	6662(b)(1) - Failure to substantiate	Yes	Split
Kenton v. Comm'r, T.C. Memo. 2006-13	6662(b)(2) – Reliance on recent Supreme Court decision resolving divided issue as reasonable cause	No	Split
Kikalos v. Comm'r, 434 F.3d 977 (7th Cir. 2006)	6662(b)(1) - Whether failure to keep records after repeatedly being warned by the IRS to do so constitutes negligence	No	IRS

TABLE 4: ACCURACY-RELATED PENALTY UNDER IRC § 6662(B)(1) AND (2) (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
King v. Comm'r, T.C. Memo. 2006-112	6662(b)(1) - Reliance on tax professional as reasonable cause when TPs (H&W) did not provide all necessary information; record-keeping practices that the IRS approved in prior audit as reasonable cause	No	IRS
Kolbeck v. Comm'r, T.C. Memo. 2005-253	6662(b)(1) – Lack of access to substantiating records as reasonable cause	Yes	IRS
Kovacevich v. Comm'r, 97 A.F.T.R.2d (RIA) 1952 (9th Cir. 2006)	6662(b)(1) - Reliance on tax professional as reasonable cause when TPs (H&W) did not provide all relevant information; proper disclosure of relevant information on Form 8275	Yes	IRS
Lee v. Comm'r, T.C. Memo. 2006-70	6662(b)(2) - Reliance on tax professional as reasonable cause	Yes	IRS
Long-Term Capital Holdings, LP v. U.S., 96 A.F.T.R.2d (RIA) 6344 (2d Cir. 2005)	6662(b)(2) and (b)(3) - Reliance on tax professional as reasonable cause when advice not based on all relevant facts; inclusion of misstatement of basis in the definition of "valuation misstatement"	No	IRS
Lowry v. Comm'r, 97 A.F.T.R.2d (RIA) 1198 (9th Cir. 2006)	6662(b)(2) – No evidence of reasonable cause presented	No	IRS
Maxfield v. Comm'r, T.C. Summ. Op. 2006-27	6662(b)(1) - Whether improper deductions and lack of substantiation prevents finding of reasonable cause or IRC 6662(b)(1) penalty;	Yes	IRS
Megibow v. Comm'r, 96 A.F.T.R.2d (RIA) 7536 (2d Cir. 2005)	6662(b)(1) - No argument on reasonable cause presented to the court	No	IRS
Mortensen v. Comm'r, 440 F.3d 375 (6th Cir. 2006)	6662(b)(1) - Reliance on Tax Court opinion and advice from promoter of investment as reasonable cause	No	IRS
NT, Inc. v. Comm'r, 126 T.C. 191 (2006)	6662(b) - IRS burden of production	No	IRS
NHUSS Trust v. Comm'r, T.C. Memo. 2005-236	6662(b)(1) - Reliance on trust's promoter as reasonable cause	No	IRS
Pchan v. Comm'r, T.C. Summ. Op. 2006-88	6662(b)(2) - Reliance on tax professional as reasonable cause when TP doesn't provide all necessary information	Yes	IRS
PK Ventures, Inc. v. Comm'r, T.C. Memo. 2006-36	6662(b)(2) – Reliance on information returns or advice of tax professionals as reasonable cause	No	IRS
Remler v. Comm'r, T.C. Memo. 2005-265	6662(b)(1) - No evidence of reasonable cause presented	Yes	IRS
Richardson v. Comm'r, T.C. Memo. 2006-69	6662(b)(1) – No evidence of reasonable cause presented	No	IRS
Rogers v. Comm'r, T.C. Memo. 2005-248	6662(b)(1) – Reliance on tax professional as reasonable cause	No	IRS
Sparkman v. Comm'r, T.C. Memo. 2005-136	6662(b)(1) - Whether failing to report income from sham trusts and failing to substantiate deductions constitutes negligence	No	IRS
Taylor v. Comm'r, T.C. Memo. 2006-67	6662(b)(2) - No evidence of reasonable cause or substantial authority presented	Yes	IRS
Van Scoten v. Comm'r, 439 F.3d 1243 (10th Cir. 2006)	6662(b)(1) - Reliance on tax professional as reasonable cause when professional is shelter promoter	No	IRS
Xilinx, Inc. v. Comm'r, 125 T.C. 37 (2005)	6662(b)(1) - Whether failure of corporate TP and foreign subsidiary to share in allocation of costs of stock options gives rise to an underpayment of tax	No	TP

TABLE 5
FAILURE TO FILE PENALTY UNDER IRC § 6651(A)(1) AND FAILURE TO PAY ESTIMATED TAX PENALTY UNDER IRC § 6654

Case Citation	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (But not Sole Proprietorships)			
Adams v. Comm'r, T.C. Summ. Op. 2005-120	Return containing zeroes as a "return"; 6654	Yes	IRS
Andrew v. Comm'r, T.C. Summ. Op. 2005-158	Uncertainty as to tax treatment of social security benefits as reasonable cause	Yes	IRS
Barrett v. Comm'r, T.C. Summ. Op. 2006-42	No evidence of reasonable cause presented; 6654	Yes	IRS
Bennett v. Comm'r, T.C. Summ. Op. 2005-84	Reliance on spouse to file as reasonable cause	Yes	IRS
Berrey v. Comm'r, T.C. Summ. Op. 2005-80	No evidence of reasonable cause presented; 6654	Yes	IRS
Bonaccorso v. Comm'r, T. C. Memo. 2005-278	Return containing zeroes as a "return" and frivolous arguments; 6654	Yes	IRS
Bruce v. Comm'r, T.C. Memo. 2005-139	Nonfiler – claim of no taxable income as willful neglect; 6654	Yes	IRS
Burnham v. Comm'r, T.C. Summ. Op. 2006-8	No evidence of reasonable cause presented	Yes	IRS
Carlo v. Comm'r, T.C. Memo. 2005-165	Nonfiler; case dismissed for lack of prosecution.	Yes	IRS
Clark v. Comm'r, T.C. Memo. 2005-292	No evidence of reasonable cause presented	Yes	IRS
Christensen v. Comm'r, T.C. Memo. 2006-62	No evidence of reasonable cause presented	Yes	IRS
Cooksey v. Comm'r, T.C. Summ. Op. 2006-84	6654	Yes	IRS
Coulton v. Comm'r, T.C. Memo. 2005-199	Return containing zeroes as a "return; no evidence of reasonable cause presented	Yes	IRS
Cronk v. Comm'r, T.C. Summ. Op. 2005-174	No evidence of reasonable cause presented	Yes	IRS
Crow v. Comm'r, T.C. Summ. Op. 2005-124	Return containing zeroes as a "return"; no evidence of reasonable cause presented; 6654	Yes	IRS
Davis v. Comm'r, T.C. Memo. 2005-160	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Ferguson v. Comm'r, T.C. Memo. 2006-32	Bank and tax records unavailable due to a subpoena as reasonable cause	Yes	IRS
Geddis v. Comm'r, T.C. Memo. 2005-191	No evidence of reasonable cause presented	No	IRS
Gillings v. Comm'r, T.C. Memo. 2006-65	TP's belief that her parents would disown her for filing as reasonable cause; 6654	Yes	IRS
Green v. Comm'r, T.C. Memo. 2005-250	No evidence of reasonable cause presented	No	IRS
Gropper v U.S., 96 A.F.T.R.2d (RIA) 7133 (E.D. Pa. 2005)	Inability to perform tax obligations due to medical problems as reasonable cause even though still performing normal business operations	No	IRS
Guthrie v. Comm'r, T.C. Memo. 2006-81	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Guthrie v. Comm'r, T.C. Memo. 2006-89	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Guthrie v. Comm'r, T.C. Memo. 2005-196	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Hansen v. Comm'r, T.C. Summ. Op. 2006-85	Nonfiler; no evidence of reasonable cause presented	Yes	IRS
Hattman v. Comm'r, 96 A.F.T.R.2d (RIA) 6223 (3d Cir. 2005)	Nonfiler with frivolous arguments; 6654.	Yes	IRS
Hennard v. Comm'r, T.C. Memo. 2005-275	Nonfiler with frivolous arguments; 6654.	Yes	IRS
Hess v. Comm'r, T.C. Summ. Op. 2006-66	No evidence of reasonable cause presented	Yes	IRS

TABLE 5: FAILURE TO FILE PENALTY UNDER IRC § 6651(A)(1) AND FAILURE TO PAY ESTIMATED TAX PENALTY UNDER IRC § 6654 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Hodges v. Comm'r, T.C. Memo. 2005-168	Nonfiler with conscious/intentional failure to file; 6654	Yes	IRS
Holmes v. Comm'r, T.C. Memo. 2006-80	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Howard v. Comm'r, T.C. Memo. 2005-144	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Jordan v. Comm'r, T.C. Memo. 2005-266	Medical problems, memory loss, and rehabilitation for drug addiction as reasonable cause	No	IRS
Keenan v. Comm'r, T.C. Memo. 2006-45	Nonfiler— belief that 5th Amendment's self-incrimination provisions protects TP from filing as reasonable cause; 6654	Yes	IRS
Krohn v. Comm'r, T.C. Memo. 2005-145	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Lange v. Comm'r, T.C. Memo. 2005-200	Return filed under protest, disclaiming liability; 6654	Yes	IRS
Lange v. Comm'r, T.C. Memo. 2005-176	Return filed under protest, disclaiming liability; 6654	Yes	IRS
Leggett v. Comm'r, T.C. Memo. 2005-185	Nonfiler; no evidence of reasonable cause presented; IRS burden of production for 6654	Yes	Split (6651 IRS, 6654 TP)
Lewis v. Comm'r, T.C. Memo. 2006-73	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2006-12	No evidence of reasonable cause presented; 6654	Yes	IRS
Lindsey v. Comm'r, 422 F.3d 684 (8th Cir. 2005)	No evidence of reasonable cause presented	No	IRS
Lites v. Comm'r, T.C. Memo. 2005-206	Health issues of one spouse as reasonable cause for late filing of a joint return	No	IRS
Major v. Comm'r, T.C. Memo. 2005-141	No evidence of reasonable cause presented	Yes	IRS
Martella v. Comm'r, T.C. Memo. 2005-216	Nonfiler; reliance on advice of unofficial non-governmental third parties provided on the Internet as reasonable cause; 6654	Yes	IRS
McManus v. Comm'r, T.C. Memo. 2006-68	Nonfiler; no evidence of reasonable cause presented; 6654	No	IRS
McManus v. Comm'r, T.C. Memo. 2006-57	Nonfiler; IRS burden of production for 6651 and 6654	No	TP
Messina v. Comm'r, T.C. Memo. 2006-107	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Mostafa v. Comm'r, T.C. Memo. 2006-106	Nonfiler; mistake as to filing requirement as reasonable cause	Yes	IRS
Mullins v. Comm'r, T.C. Summ. Op. 2005-72	No evidence of reasonable cause	Yes	IRS
Paikowski v. Comm'r, T.C. Summ. Op. 2006-48	Return containing zeroes as a "return"; 6654	Yes	IRS
Pond v. Comm'r, T.C. Memo. 2005-255	Nonfiler; no evidence of reasonable cause; 6654	Yes	IRS
Ramirez V. Comm'r, T.C. Memo. 2005-179	Inability to perform tax obligations due to surgery as reasonable cause even though still performing normal business operations	Yes	IRS
Rappaport v. Comm'r, T.C. Memo. 2006-87	Medical problems as reasonable cause	No	IRS
Rhodes v. Comm'r, T.C. Memo. 2005-184	Return containing zeroes as a "return"; 6654	Yes	IRS
Rhodes v. Comm'r, 96 A.F.T.R.2d (RIA) 6421 (5th Cir. 2005)	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS

TABLE 5: FAILURE TO FILE PENALTY UNDER IRC § 6651(A)(1) AND FAILURE TO PAY ESTIMATED TAX PENALTY UNDER IRC § 6654 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Richardson v. Comm'r, T.C. Memo. 2005-143	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Saxon v. Comm'r, T.C. Memo. 2006-52	Nonfiler with frivolous arguments; 6654	Yes	IRS
Scholet v. Comm'r, T.C. Memo. 2005-140	Nonfiler with frivolous arguments; 6654	No	IRS
Siron v. Comm'r, T.C. Memo. 2006-64.	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Stang v. Comm'r, T.C. Memo. 2005-154	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Stewart v. Comm'r, T.C. Memo. 2005-212	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Suri v. Comm'r, 96 A.F.T.R.2d 6526 (2d Cir. 2005)	No evidence of reasonable cause	Yes	IRS
Sylve v. Comm'r, T.C. Summ. Op. 2005-137	Divorce attorney misplacing return in divorce proceeding as reasonable cause	No	IRS
Tamberella v. Comm'r, 96 A.F.T.R.2d (RIA) 5311 (2d Cir. 2005)	Mental illness as reasonable cause	No	IRS
Thomas v. Comm'r, T.C. Memo. 2005-258	Nonfiler; inability to perform tax obligations due to medical problems as reasonable cause even though still performing normal business operations; 6654	Yes	IRS
Triplett v. Comm'r, T.C. Summ. Op. 2005-148	No evidence of reasonable cause presented	Yes	IRS
Vax v. Comm'r, T.C. Memo. 2005-134	No evidence of reasonable cause presented	Yes	IRS
Welch v. U.S., 97 A.F.T.R.2d (RIA) 2453 (D.N.J. 2006)	Reliance on advice of IRS employee regarding extended due date as reasonable cause	No	IRS
Wheeler v. Comm'r, T.C. Memo. 2006-109	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Zakhem v. Comm'r, T.C. Summ. Op. 2005-171	Nonfiler; no evidence of reasonable cause presented; 6654	Yes	IRS
Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)			
Booker v. Comm'r, T.C. Summ. Op. 2005-90	Late filing based on extension when TP has no proof of requesting extension	Yes	IRS
Braun v. Comm'r, T.C. Memo. 2006-110	No evidence of reasonable cause presented	No	IRS
Brown v. Comm'r, T.C. Summ. Op. 2005-85	Medical problems as reasonable cause	No	IRS
Cooper v. Comm'r, T.C. Summ. Op. 2005-97	No evidence of reasonable cause presented; 6654	Yes	IRS
Doudney v. Comm'r, T.C. Memo. 2005-267	IRS burden of production for 6651	Yes	TP
Hansen v. Comm'r, T.C. Summ. Op. 2005-75	No evidence of reasonable cause presented; 6654	Yes	IRS
Paradiso v. Comm'r, T.C. Memo. 2005-187	Nonfiler; inability to perform tax obligations due to medical problems as reasonable cause even though still performing normal business operations; reliance on someone who is not a tax professional as reasonable cause; 6654	Yes	IRS
Sparkman v. Comm'r, T.C. Memo. 2005-136	Difficulty obtaining bookkeeping and accounting advice as reasonable cause	No	IRS
Thibodeaux v. Comm'r, T.C. Summ. Op. 2005-105	Reliance on accountant to file return as reasonable cause	Yes	IRS

TABLE 6
FRIVOLOUS ISSUES PENALTY UNDER IRC § 6673 AND RELATED APPELLATE-LEVEL SANCTIONS

Case Citation	Issue(s)	*Pro Se*	Decision	Amount
Individual Taxpayers (But not Sole Proprietorships)				
Bean v. Comm'r, T.C. Memo. 2006-88	TP sought review of adverse CDP determination and argued that no law authorizes imposition of income tax	Yes	IRS	1,500
Bonaccorso v. Comm'r, T.C. Memo. 2005-278	TP argued that no law authorizes imposition of income tax	Yes	IRS	10,000
Bruce v. Comm'r, T.C. Memo 2005-139	TP argued income tax is unlawful and refused to answer questions posed by IRS and the court	Yes	IRS	10,000
Call v. Comm'r, T.C. Memo. 2005-289, *appeal docketed*, No. 06-70431 (9th Cir. Jan. 24, 2006)	TP sought review of adverse CDP determination; court found proceeding was instituted primarily to delay collection action	Yes	IRS	5,000
Carrillo v. Comm'r, T.C. Memo. 2005-290	TPs (H&W) sought review of adverse CDP determination; court found proceeding was instituted primarily to delay collection action	Yes	IRS	5,000
Crow v. Comm'r, T.C. Summ. Op. 2005-124	TP argued that payment of income tax is voluntary	Yes	IRS	2,000
Guthrie v. Comm'r, T.C. Memo. 2005-196	TP argued that his wages, interest, and dividends did not constitute income	Yes	IRS	15,000
Hodges v. Comm'r, T.C. Memo. 2005-168	TP argued income tax is unconstitutional despite repeated warnings about likelihood of sanctions	Yes	IRS	15,000
Holmes v. Comm'r, T.C. Memo. 2006-80	TP asserted multiple frivolous arguments, including that the payment of income tax is voluntary	Yes	IRS	2,000
Horowitz v. Comm'r, T.C. Memo. 2006-91	TP argued that no law authorizes the imposition of income tax	Yes	IRS	10,000
Howard v. Comm'r, T.C. Memo. 2005-144	TP asserted frivolous constitutional arguments and had previously been sanctioned by the Tax Court	Yes	IRS	12,500
Lane v. Comm'r, T.C. Memo. 2005-182	TP sought review of adverse CDP determination and refused to obtain SSNs for claimed dependents or comply with other tax requirements on moral or religious grounds	Yes	TP	
Lange v. Comm'r, T.C. Memo. 2005-200, *appeal docketed*, No. 06-1116 (6th Cir. Jan. 25, 2006)	TP asserted frivolous arguments and had been warned repeatedly about likelihood of sanctions	Yes	IRS	5,000
Lewis v. Comm'r, T.C. Memo. 2006-73	TP asserted frivolous arguments but had not been warned previously about possible imposition of sanctions	Yes	TP	
Lewis v. Comm'r, T.C. Summ. Op. 2006-12	TP asserted that wage income is not subject to tax	Yes	IRS	1,000
Quigley v. Comm'r, T.C. Memo 2005-153	TP sought review of adverse CDP determination; court found proceeding was instituted primarily to delay collection action	Yes	IRS	1,000
Rhodes v. Comm'r, T.C. Memo. 2005-184	TP argued that his wages, pension distribution, interest, and dividends did not constitute income	Yes	IRS	5,000
Schneller v. Comm'r, T.C. Memo. 2006-99	TP sought review of adverse CDP determination and asserted frivolous arguments but cooperated in the stipulation process	Yes	TP	
Schneller v. Comm'r, T.C. Memo. 2006-100	TP sought review of adverse CDP determination and asserted frivolous arguments but cooperated in the stipulation process	Yes	TP	
Silver v. Comm'r, T.C. Memo. 2005-281	TP argued his income was not taxable and had been sanctioned in previous proceedings	Yes	IRS	25,000
Siron v. Comm'r, T.C. Memo. 2006-64, *appeal docketed*, No. 06-1605 (4th Cir. May 24, 2006)	TP argued that no law authorizes imposition of income tax	Yes	IRS	1,500
Woods v. Comm'r, T.C. Memo. 2006-38	TP sought review of adverse CDP determination and asserted multiple frivolous arguments, including that he did not have gross income from sources within the United States for purposes of Section 861	Yes	IRS	10,000

TABLE 6: FRIVOLOUS ISSUES PENALTY UNDER IRC § 6673 AND RELATED APPELLATE-LEVEL SANCTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision	Amount
Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships - Schedules C, E, F)				
Guthrie v. Comm'r, T.C. Memo. 2006-89, appeal docketed, No. 06-73680 (9th Cir. July 24, 2006)	TP presented frivolous arguments but also raised legitimate concerns about additions to tax determined by IRS	Yes	TP	
Hansen v. Comm'r, T.C. Summ. Op. 2006-85	TP argued tax requirements violated her religious beliefs	Yes	TP	
Hawks v. Comm'r, T.C. Memo. 2005-155	TPs (H&W) asserted frivolous arguments	Yes	TP	
Leggett v. Comm'r, T.C. Memo. 2005-185	TP argued his income was not taxable and had made same argument in a previous proceeding	Yes	IRS	5,000
Stang v. Comm'r, T.C. Memo. 2005-154	TP argued that filing requirement violates 5th Amdt protection against self-incrimination	Yes	IRS	5,000
Stewart v. Comm'r, T.C. Memo. 2005-212	TP asserted combination of frivolous and valid arguments and IRS sought penalty for first time on brief	Yes	TP	
Taylor v. Comm'r, T.C. Memo. 2006-67	TP argued that filing requirement violates 5th Amdt protection against self-incrimination; court deemed argument frivolous but declined to impose penalty	Yes	TP	
Wetzel v. Comm'r, T.C. Memo. 2005-211	TP was a professional tax return preparer who failed to file return and then denied any liability for income tax	Yes	IRS	15,000
Individual vs. Business Status Unclear from Court Opinion				
Crandall v. Comm'r, T.C. Memo. 2005-286	TP sought review of adverse CDP determination; court found proceeding was instituted primarily to delay collection action	Yes	IRS	3,000
Dixon v. Comm'r, T.C. Memo. 2006-97, *appeal docketed*, No. 06-74649 (9th Cir. Sept. 26, 2006)	TPs sought sanctions against IRS for its conduct at appellate level after a finding by a court of appeals that IRS attorneys had perpetrated a fraud on the court; Tax Court found fees were appropriate under Section 7430 but not under Section 6673	No	Split	
Forbes v. Comm'r, T.C. Memo. 2006-10	TP sought review of adverse CDP determination and asserted frivolous arguments, had history of filing retaliatory liens against IRS employees, and TP had been previously warned by the court	Yes	IRS	20,000
Forrest v. Comm'r, T.C. Memo. 2005-228	TP sought review of adverse CDP determination and argued income tax is unconstitutional	Yes	IRS	2,500
Goodin v. Comm'r, T.C. Memo. 2005-158	TP sought review of adverse CDP determination and argued that no law authorizes imposition of income tax	Yes	IRS	7,000
Holliday v. Comm'r, T.C. Memo. 2005-240	TP sought review of adverse CDP determination and argued notice of deficiency invalid because it doesn't contain OMB control number and TP had been sanctioned in previous proceedings	Yes	IRS	2,500
Parker v. Comm'r, T.C. Memo. 2005-231	TP argued that no law authorizes imposition of income tax	Yes	IRS	1,000
Sapp v. Comm'r, T.C. Memo. 2006-104	TP sought review of adverse CDP determination and asserted frivolous arguments but IRS acknowledged errors in its handling of the case	Yes	TP	
Saxon v. Comm'r, T.C. Memo. 2006-52	TP argued he isn't required to file returns because IRS forms don't carry valid OMB control number and TP had been sanctioned in previous proceedings	Yes	IRS	5,000
Stallard v. Comm'r, T.C. Memo. 2006-42, *appeal docketed*, No. 06-1190 (D.C. Cir. June 1, 2006)	TP argued income tax is unconstitutional taking of property without due process of law and had been sanctioned in previous proceedings	Yes	IRS	25,000
Wheeler v. Comm'r, T.C. Memo. 2006-109	TP argued that no law required him to file a return or pay tax	Yes	IRS	3,000
Wright v. Comm'r, T.C. Memo. 2005-291	TP sought review of adverse CDP determination; court found proceeding was instituted primarily to delay collection action	Yes	IRS	2,500

TABLE 6: FRIVOLOUS ISSUES PENALTY UNDER IRC § 6673 AND RELATED APPELLATE-LEVEL SANCTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision	Amount
Section 6673 Penalty Not Requested or Imposed but Taxpayer Warned To Stop Asserting Frivolous Arguments				
Balice v. Comm'r, T.C. Memo. 2005-161	TP sought review of adverse CDP determination and asserted frivolous arguments	Yes		
Coulton v. Comm'r, T.C. Memo. 2005-199	TP argued that no law authorizes imposition of income tax	Yes		
Delgado v. Comm'r, T.C. Memo. 2005-186	TP sought review of adverse CDP determination and argued that no law authorizes the imposition of income tax	Yes		
Gori v. Comm'r, T.C. Summ. Op. 2005-79	TP asserted frivolous arguments	Yes		
Hennard v. Comm'r, T.C. Memo. 2005-275	TP asserted various frivolous arguments, including that the IRS is not authorized to practice law in Texas	Yes		
Keenan v. Comm'r, T.C. Memo. 2006-45, *appeal docketed*, No. 06-73970 (9th Cir. Aug. 15, 2006)	TP argued payment of income tax is voluntary and filing requirement violates 5th Amdt protection against self-incrimination	Yes		
Little v. U.S., 96 A.F.T.R.2d (RIA) 7086 (M.D.N.C. 2005)	TP sought review of adverse CDP determination; TP asserted frivolous constitutional arguments, including that 16th Amdt doesn't authorize income tax	Yes		
Major v. Comm'r, T.C. Memo. 2005-141, appeal docketed, No. 06-72196 (9th Cir. April 27, 2006)	TPs (H&W) asserted frivolous arguments	Yes		
Martella v. Comm'r, T.C. Memo. 2005-216	TP argued that no law authorizes imposition of income tax	Yes		
Meeker v. Comm'r, T.C. Memo. 2005-146	TP sought review of adverse CDP determination and asserted frivolous arguments, including that he is not subject to jurisdiction of the IRS	Yes		
Nino v. Comm'r, T.C. Memo. 2006-59	TP asserted frivolous arguments	Yes		
Paikowski v. Comm'r, T.C. Summ. Op. 2006-48	TP asserted frivolous arguments	Yes		
Pond v. Comm'r, T.C. Memo. 2005-255, *appeal docketed*, No. 06-9002 (10th Cir. June 6, 2006)	TP raised several groundless contentions	Yes		
Stephens v. Comm'r, T.C. Memo. 2005-183	TP sought review of adverse CDP determination and raised frivolous arguments to delay collection proceedings	Yes		
U.S. Courts of Appeals' Decisions on Appeal of Section 6673 Penalties Imposed by U.S. Tax Court				
Barzeski v. Comm'r, 97 A.F.T.R.2d (RIA) 1703 (3d Cir. 2006)	Penalty affirmed	Yes	IRS	500
Barzeski v. Comm'r, 97 A.F.T.R.2d (RIA) 1738 (3d Cir. 2006)	Penalty affirmed	Yes	IRS	500
Brenner v. Comm'r, 97 A.F.T.R.2d (RIA) 517 (11th Cir. 2006)	Penalty affirmed	Yes	IRS	15,000
Brunner v. Comm'r, 96 A.F.T.R.2d (RIA) 5328 (3d Cir. 2005)	Penalty affirmed	Yes	IRS	1,000
Dexter v. Comm'r, 409 F.3d 877 (7th Cir. 2005)	Tax Court "S" case decisions are not appealable, so Tax Court penalty stands	Yes	IRS	2,500
Florance v. Comm'r, 174 Fed. Appx. 200 (5th Cir. 2006)	Penalty affirmed	Yes	IRS	22,500
Gittinger v. Comm'r, 448 F.3d 831 (5th Cir. 2006)	Penalty affirmed	Yes	IRS	Not Specified
Graves v. Comm'r, 97 A.F.T.R.2d (RIA) 734 (9th Cir. 2006)	Penalty affirmed	Yes	IRS	Not Specified
Malfatti v. Comm'r, 97 A.F.T.R.2d (RIA) 1197 (9th Cir. 2006)	Penalty affirmed	Yes	IRS	15,000
Rhodes v. Comm'r, 96 A.F.T.R.2d (RIA) 6421 (5th Cir. 2005)	Penalty affirmed	Yes	IRS	2,000
Smith v. Comm'r, 96 A.F.T.R.2d (RIA) 7022 (9th Cir. 2005)	Penalty affirmed	Yes	IRS	Not Specified
Stearman v. Comm'r, 436 F.3d 533 (5th Cir. 2006)	Penalty affirmed	Yes	IRS	25,000

TABLE 6: FRIVOLOUS ISSUES PENALTY UNDER IRC § 6673 AND RELATED APPELLATE-LEVEL SANCTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision	Amount
Streiffert v. IRS, 96 A.F.T.R.2d (RIA) 5229 (5th Cir. 2005)	Penalty affirmed	Yes	IRS	5,000
Suri v. Comm'r, 96 A.F.T.R.2d (RIA) 6526 (2d Cir. 2005)	Penalty affirmed	Yes	IRS	1,000
Tello v. Comm'r, 96 A.F.T.R.2d. (RIA) 5284 (5th Cir. 2005)	Penalty affirmed	Yes	IRS	500
Wroblewski v. Comm'r, 96 A.F.T.R.2d (RIA) 6479 (2d Cir. 2005)	Penalty affirmed	Yes	IRS	Not Specified
Yazzie v. Comm'r, 96 A.F.T.R.2d (RIA) 7020 (9th Cir. 2005)	Penalty affirmed	Yes	IRS	2,000
U.S. Courts of Appeals' Decisions on Sanctions Under Section 7482(c)(4), FRAP Rule 38, or Other Authority				
Barzeski v. Comm'r, 97 A.F.T.R.2d (RIA) 1703 (3d Cir. 2006)	TP (W) argued she isn't required to file returns because IRS forms don't carry valid OMB control number	Yes	IRS	1,000
Barzeski v. Comm'r, 97 A.F.T.R.2d (RIA) 1738 (3d Cir. 2006)	TP (H) argued he isn't required to file returns because IRS forms don't carry valid OMB control number	Yes	IRS	1,000
Brenner v. Comm'r, 97 A.F.T.R.2d (RIA) 517 (11th Cir. 2006)	TP asserted deficiency notice is invalid absent a tax return, abused discovery process, and challenged constitutionality of income tax	Yes	IRS	6,000
Chapman v. U.S., 96 A.F.T.R.2d (RIA) 7410 (5th Cir. 2005)	TP argued she is not subject to IRS jurisdiction as a resident of "sovereign state" of Texas	Yes	IRS	3,000
Edwards v. U.S., 97 A.F.T.R.2d (RIA) 1646 (10th Cir. 2006)	TP sought review of adverse CDP determination; court found proceeding was instituted primarily to delay collection action	Yes	IRS	6,000
Florance v. Comm'r, 174 Fed. Appx. 200 (5th Cir. 2006)	TP asserted frivolous arguments, but court denied IRS request for sanctions due to Tax Court penalty and fact that TP appeared pro se	Yes	TP	
Gittinger v. Comm'r, 448 F.3d 831 (5th Cir. 2006)	TP, an attorney, asserted frivolous arguments and had previously been sanctioned	Yes	IRS	6,000
Gittinger v. Comm'r, 96 A.F.T.R.2d (RIA) 5006 (5th Cir. 2005)	TP asserted that wage income is not taxable income	Yes	IRS	6,000
Graves v. Comm'r, 97 A.F.T.R.2d (RIA) 734 (9th Cir. 2006)	TP pursued a frivolous appeal	Yes	IRS	6,000
Jay v. Comm'r, 97 A.F.T.R.2d (RIA) 1201 (9th Cir. 2006)	TP did not assert frivolous arguments, the court found, rejecting IRS claim to the contrary	Yes	TP	
Kyler v. Everson, 442 F.3d 1251 (10th Cir. 2006)	TP argued that IRS Comm'r lacked authority to file federal tax liens and repeatedly accused prosecutors and judges of criminal misconduct	Yes	IRS	8,000
Meyer v. Comm'r, 97 A.F.T.R.2d (RIA) 1200 (9th Cir. 2006)	TP asserted frivolous arguments	Yes	IRS	6,000
Morrison v. Comm'r, 97 A.F.T.R.2d (RIA) 1198 (9th Cir. 2006)	TP asserted arguments that court found were "wholly without merit"	Yes	IRS	2,500
O'Connor v. Comm'r, 97 A.F.T.R.2d (RIA) 539 (9th Cir. 2006)	TP asserted arguments that court found were "wholly without merit"	Yes	IRS	3,000
Poole v. IRS, 97 A.F.T.R.2d (RIA) 2528 (9th Cir. 2006)	TP argued that compensation for labor is not income and payment of tax is voluntary	Yes	IRS	6,000
Raft v. Comm'r, 95 A.F.T.R.2d (RIA) 2652 (6th Cir. 2005)	TP sought review of adverse CDP determination; court found arguments frivolous and held him jointly and severally liable for the penalty with his former attorney	Yes	IRS	2,000
Ralidis v. U.S., 97 A.F.T.R.2d (RIA) 1315 (5th Cir. 2006)	TP, a physician, argued that his income was not taxable	Yes	IRS	6,000
Rhodes v. Comm'r, 96 A.F.T.R.2d (RIA) 6421 (5th Cir. 2005)	TP asserted that wages are not taxable	Yes	IRS	6,000
Schrader v. Comm'r, 96 A.F.T.R.2d (RIA) 7100 (9th Cir. 2005)	TP argued that compensation is not taxable	Yes	IRS	Not Specified
Smith v. Comm'r, 96 A.F.T.R.2d (RIA) 7326 (10th Cir. 2005)	TP asserted frivolous arguments	No	IRS	6,000

TABLE 6: FRIVOLOUS ISSUES PENALTY UNDER IRC § 6673 AND RELATED APPELLATE-LEVEL SANCTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision	Amount
Stearman v. Comm'r, 436 F.3d 533 (5th Cir. 2006)	TP argued Comm'r is not authorized to provide accounting services or practice law in Texas and TP has no "fiduciary obligation" to pay tax; court found TP abused judicial process and doubled penalty requested by IRS	Yes	IRS	12,000
Streiffert v. IRS, 96 A.F.T.R.2d (RIA) 5229 (5th Cir. 2005)	TPs (H&W) argued that IRS has no authority to impose or collect tax	Yes	IRS	3,500
Tello v. Comm'r, 96 A.F.T.R.2d. (RIA) 5284 (5th Cir. 2005)	TP argued Comm'r is not authorized to provide accounting services or practice law in Texas and TP has no "fiduciary obligation" to pay tax	Yes	IRS	2,500
Veith v. Stegemueller, 97 A.F.T.R.2d (RIA) 835 (5th Cir. 2006)	TP disputed authority of U.S. district court to enforce an IRS summons and made other frivolous arguments	Yes	IRS	6,000
Wroblewski v. Comm'r, 96 A.F.T.R.2d (RIA) 6479 (2d Cir. 2005)	TP argued income tax is an excise tax, and court found language in other cases could mislead a pro se litigant on that point	Yes	TP	

TABLE 7
TRADE OR BUSINESS EXPENSES UNDER IRC § 162 AND RELATED SECTIONS

Case Citation	Issue(s)	*Pro Se*	Decision
Abdullah v. Comm'r, T.C. Summ. Op. 2006-32	Deductions denied for expenses not substantiated; deductions allowed for other expenses because the IRS did not meet burden of proof	Yes	Split
Allemeier v. Comm'r, T.C. Memo. 2005-207	Deductions allowed for education expenses but denied for unsubstantiated expenses	Yes	Split
Balino v. Comm'r, T.C. Summ. Op. 2005-134	Deductions denied for expenses not substantiated; deductions allowed for some unreimbursed employee expenses	Yes	Split
Booker v. Comm'r, T.C. Summ. Op. 2005-90	Expenses not substantiated; expenses personal in nature	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2005-155	Expenses not substantiated	Yes	IRS
Finch v. Comm'r, T.C. Summ. Op. 2006-54	Expenses not substantiated and not incurred away from home	Yes	IRS
Galyen v. Comm'r, T.C. Memo. 2006-30	Expenses not ordinary and necessary	No	IRS
Giles v. Comm'r, T.C. Memo. 2006-15	Taxpayer not engaged in a trade or business when not done for profit	No	IRS
Green v. Comm'r, T.C. Memo. 2005-250	Taxpayer not engaged in a trade or business	No	IRS
Hauge v. Comm'r, T.C. Memo. 2005-276	Partnership could deduct portion of legal expenses related to partnership's business, but neither partnership nor partners can deduct legal fees attributable to partner's personal expenses	No	Split
Holladay v. United States, 96 A.F.T.R.2d (RIA) 5804 (Bankr. N.D. Ga. 2005)	IRS Motion for Summ. J. denied; taxpayer allowed to produce records to substantiate expenses	No	TP
Joseph v. Comm'r, T.C. Memo. 2005-169	Expenses not substantiated	Yes	IRS
Rappaport v. Comm'r, T.C. Memo. 2006-87	No deduction for shareholder's personal expenses paid by corporation	No	IRS
Ritchie v. Comm'r, T.C. Summ. Op. 2005-181	No deduction for unreimbursed employee expenses when employee has right to reimbursement; expenses not substantiated	Yes	IRS
Robinette v. Comm'r, T.C. Summ. Op. 2006-69	No employee expense deductions because taxpayer was not away from home	Yes	IRS
Target v. United States, 96 A.F.T.R.2d (RIA) 5649 (W.D. Tenn. 2005), *vacated and amended in part*, 96 A.F.T.R.2d (RIA) 6341 (W.D. Tenn. 2005)	No business deduction for indemnification to employer because expense was not ordinary; deduction allowed for legal fees	No	Split
Westbrook v. Comm'r ,T.C. Summ. Op. 2006-3	Deductions disallowed for voluntary payment of corporate expenses and nonqualified employee education expenses	Yes	IRS
Abloso v. Comm'r, T.C. Summ. Op. 2006-60	Taxpayer not engaged in a trade or business	Yes	IRS
Alley v. Comm'r, T.C. Summ. Op. 2006-4	No Schedule C deductions for unreimbursed employee expense	Yes	IRS
Arnold v. Comm'r, T.C. Memo. 2005-256	Deductions denied for expenses taxpayer did not pay; expenses not substantiated	Yes	IRS
Berge v. Comm'r, T.C. Summ. Op. 2006-29	Deductions allowed for travel expenses when business was the primary reason for travel; deductions denied for personal legal fees	Yes	Split
Boyd v. Comm'r, T.C. Summ. Op. 2006-36	No travel expense deductions because taxpayers had no "tax home"	Yes	IRS
Braun v. Comm'r, T.C. Memo. 2006-110	Expenses not substantiated	No	IRS
Brown v. Comm'r, T.C. Summ. Op. 2005-85	Expenses not substantiated	No	IRS

TABLE 7: TRADE OR BUSINESS EXPENSES UNDER IRC § 162 AND RELATED SECTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Butler v. Comm'r, T.C. Summ. Op. 2006-39	Deductions allowed to extent expenses were substantiated	Yes	Split
Castagnetta v. Comm'r, T.C. Summ. Op. 2006-24	Deductions allowed for gambling expenses because taxpayer's gambling activities constituted a trade or business	Yes	TP
Cavanagh v. Comm'r, T.C. Summ. Op. 2005-113	No Schedule C deductions for unreimbursed employee expenses	Yes	IRS
Chickie's and Pete's, Inc. v. Comm'r, T.C. Memo. 2005-243	No trade or business deductions for expenses that were royalty payments rather than compensation	No	IRS
Christensen v. Comm'r, T.C. Memo. 2006-62	Expenses not substantiated	Yes	IRS
Chrysler Corp. v. Comm'r, 436 F.3d 644 (6th Cir. 2005)	No deduction for warranty claims not submitted during taxable year; no deduction for ESOP liquidation because stock redemptions were not compensatory	No	IRS
Cooper v. Comm'r, T.C. Summ. Op. 2005-97	Taxpayer not engaged in a trade or business when not done for profit	Yes	IRS
Craft v. Comm'r, T.C. Memo. 2005-197	Deductions allowed for unreimbursed employee expenses, office supplies, dues, & subscriptions; deductions denied for legal expenses not related to taxpayer's trade or business	No	Split
D'Avilar v. Comm'r, T.C. Summ. Op. 2006-52	Expenses not substantiated	Yes	IRS
Deihl v. Comm'r, T.C. Memo. 2005-287	Deductions denied for various personal and unsubstantiated expenses. Deductions allowed for substantiated business expenses	No	Split
Doudney v. Comm'r, T.C. Memo. 2005-267	Expenses not substantiated	Yes	IRS
E.J. Harrison & Sons, Inc. v. Comm'r, 96 A.F.T.R.2d (RIA) 5182 (9th Cir. 2005)	Shareholder compensation was excessive, but Tax Court calculations were reversed and remanded	No	Split
Everhart v. Comm'r, T.C. Summ. Op. 2005-81	Court estimated gross income and allowed deductions to extent expenses were substantiated	Yes	Split
Field v. Comm'r, T.C. Summ. Op. 2005-184	Taxpayer not engaged in a trade or business; expenses personal in nature	Yes	IRS
Her v. Comm'r, T.C. Summ. Op. 2005-187	Taxpayer not engaged in a trade or business; expenses not substantiated; expenses personal in nature	Yes	IRS
Hoover v. Comm'r, T.C. Memo. 2006-82	Expenses not substantiated	Yes	IRS
Hough v. Comm'r, T.C. Memo. 2006-58	Deductions allowed for expenses that taxpayer substantiated through evidence and testimony; deductions not allowed for unsubstantiated expenses	Yes	Split
Kanofsky v. Comm'r, T.C. Memo. 2006-79	Taxpayer not engaged in a trade or business	Yes	IRS
Kashama v. Comm'r, T.C. Summ. Op. 2005-144	Expenses not substantiated	Yes	IRS
Kolbeck v. Comm'r, T.C. Memo. 2005-253	Expenses not substantiated	Yes	IRS
Lamb v. Comm'r, T.C. Summ. Op. 2006-13	Expenses personal in nature; no profit objective	Yes	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2006-6	Deductions allowed to extent expenses were substantiated	Yes	Split
Lofstrom v. Comm'r, 125 T.C. 271 (2005)	No deductions for bed and breakfast expenses because bread and breakfast was also taxpayers' residence; other business expenses not substantiated; writing activity not engaged in for profit	No	IRS
Maxfield v. Comm'r, T.C. Summ. Op. 2006-27	Expenses were personal and not substantiated	Yes	IRS
Nash-Milton v. Comm'r, T.C. Summ. Op. 2005-156	Expenses not substantiated	Yes	IRS
Obot v. Comm'r, T.C. Memo. 2005-195	Expenses not substantiated	Yes	IRS

TABLE 7: TRADE OR BUSINESS EXPENSES UNDER IRC § 162 AND RELATED SECTIONS (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Pchan v. Comm'r, T.C. Summ. Op. 2006-88	Expenses not substantiated	Yes	IRS
PK Ventures, Inc. v. Comm'r, T.C. Memo. 2006-36	No deduction for unreasonable compensation	No	IRS
Remler v. Comm'r, T.C. Memo. 2005-265	Taxpayers not engaged in a trade or business when not done for profit	Yes	IRS
Rhodes v. Comm'r, T.C. Summ. Op. 2006-49	Expenses not substantiated	No	IRS
Richardson v. Comm'r, T.C. Memo. 2006-69	Expenses not substantiated	No	IRS
Ryan v. Comm'r, T.C. Summ. Op. 2005-118	Taxpayer not engaged in a trade or business when not done for profit	Yes	IRS
Sam Kong Fashions, Inc. v. Comm'r, T.C. Memo. 2005-157	Expenses not substantiated	No	IRS
Satlin v. Comm'r, T.C. Summ. Op. 2005-143	Shareholder cannot deduct expenses incurred for corporation	Yes	IRS
Sears v. Comm'r, T.C. Summ. Op. 2006-47	Taxpayer not engaged in a trade or business when not done for profit	Yes	IRS
Speltz v. Comm'r, T.C. Summ. Op. 2006-25	Medical benefit expenses paid by employer-spouse to employee-spouse deductible	No	TP
Stewart v. Comm'r, T.C. Memo. 2005-212	Expenses not substantiated	Yes	IRS
Stewart v. Comm'r, T.C. Summ. Op. 2006-37	No deductions for expenses not ordinary and necessary; expenses not substantiated	Yes	IRS
Taye-Channell v. Comm'r, T.C. Memo. 2006-8	Taxpayers not engaged in a trade or business	No	IRS
Taylor v. Comm'r, T.C. Memo. 2006-67	Expenses not substantiated	Yes	IRS
Thibodeaux v. Comm'r, T.C. Summ. Op. 2005-105	Expenses not substantiated and not incurred during year at issue	Yes	IRS
Veras v. Comm'r, T.C. Summ. Op. 2006-1	Deductions allowed for substantiated business expenses and disallowed for expenses not substantiated	Yes	Split
Verity v. Comm'r, T.C. Summ. Op. 2005-70	Deductions for business travel expenses denied because taxpayer had no "tax home"	Yes	IRS
Wood v. Comm'r, 95 A.F.T.R.2d (RIA) 2778 (11th Cir. 2005)	Taxpayer not engaged in a trade or business	Yes	IRS

TABLE 8
RELIEF FROM JOINT AND SEVERAL LIABILITY UNDER IRC § 6015

Case Citation	Issue(s)	*Pro Se*	Intervenor	Decision
Aranda v. Comm'r, 432 F.3d 1140 (10th Cir. 2005), *aff'g* T.C. Memo. 2003-306	6015(b), (f) (understatement); when IRS miscited the type of relief granted in the notice of determination, IRS intent, rather than typo on notice of determination, governed amount and type of relief granted	No	No	IRS
Baranowicz v. Comm'r, T.C. Memo. 2003-274, *appeal dismissed*, 432 F.3d 972 (9th Cir. 2005)	6015(e); Absent showing of concrete harm, court rejected intervenor's argument that the grant of participation rights in the Tax Court under 6015(e)(4) confers standing on intervenor to appeal. Petitioner was not a party to the appeal	No	Yes	IRS
Bartak v. Comm'r, 96 A.F.T.R.2d (RIA) 7356 (9th Cir. 2005), *aff'g* T.C. Memo. 2004-83	6015(b), (f) (understatement)	No	No	IRS
Bartman v. Comm'r, 446 F.3d 785 (8th Cir. 2006), *aff'g in part and rev'g in part*, T.C. Memo. 2004-93	6015(e)	No	No	IRS
Battersby v. United States, 398 F.Supp.2d 865 (N.D. Ohio 2005)	Treas. Reg. 1.6015-7(c)(1); Spouse entitled to stay of foreclosure against jointly owned residence while IRS processed request for relief	No	No	TP
Bright v. Comm'r, T.C. Summ. Op. 2005-145	6015(f) (underpayment)	Yes	No	TP
Campbell v. Comm'r, T.C. Memo. 2006-24	6015(b), (f) (understatement)	No	No	TP
Estate of Capehart v. Comm'r, 125 T.C. 211 (2005), *aff'd*, No. 05-71306, 2006 WL 3222717 (9th Cir. Nov. 7, 2006)	6015(d) (allocation of deficiency)	No	No	Split
Chadwick v. Comm'r, T.C. Summ. Op. 2005-154	6015(f) (underpayment)	No	No	IRS
Christensen v. Comm'r, T.C. Memo. 2005-299	6015(e)	No	No	IRS
Clark v. Comm'r, T.C. Summ. Op. 2005-95	Treas. Reg. § 1.6015-5(b); Period for requesting relief	Yes	No	TP
Clark v. Comm'r, T.C. Summ. Op. 2006-34	6015(b), (c), (f) (understatement)	Yes	No	IRS
Cummings v. United States, 2005 Bankr. Lexis 2040 (S.D. Fla. 2005)	Bankruptcy court had no jurisdiction to review 6015(f) determination, but IRS was equitably estopped from collecting	Yes	No	IRS
Dennard v. Comm'r, T.C. Summ. Op. 2005-115	6015(g) (period for making a claim for refund)	Yes	No	IRS
In re Drake, 336 B.R. 155 (Bankr. D. Mass. 2006), *motion to amend denied*, 97 A.F.T.R.2d (RIA) 2491 (Bankr. D. Mass. 2006)	IRS violated the bankruptcy stay by issuing a notice of determination denying relief under 6015; Prior decision not a manifest error of law	No	No	TP
Elias v. Comm'r, T.C. Summ. Op. 2005-67	6015(b), (c), (f) (understatement)	Yes	No	IRS
Etkin v. Comm'r, T.C. Memo. 2005-245	6015(f) (underpayment); Disqualified asset transfer	Yes	No	IRS
Ewing v. Comm'r, 439 F.3d 1009 (9th Cir. 2006), *rev'g in part and vacating in part*, 118 T.C. 494 (2002) and 122 T.C. 32	6015(e); (g)	No	No	IRS
Feda v. United States, 97 A.F.T.R.2d (RIA) 1985 (N.D. Ill. 2006)	District court was not the proper forum to apply for relief under 6015(f) for the first time	Yes	No	IRS
Feldman v. Comm'r, 96 A.F.T.R.2d (RIA) 6786 (9th Cir. 2005), *aff'g* T.C. Memo. 2003-201	6015(f) (underpayment)	No	No	IRS
Ferris v. Comm'r, T.C. Summ. Op. 2005-131	Treas. Reg. § 1.6015-5(b); Period for requesting relief	Yes	No	TP

TABLE 8: RELIEF FROM JOINT AND SEVERAL LIABILITY UNDER IRC § 6015 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Intervenor	Decision
Fox v. Comm'r, T.C. Memo. 2006-22	6015(f) (underpayment)	Yes	No	IRS
Glenn v. Comm'r, T.C. Summ. Op. 2005-126	6015(f) (understatement)	No	No	IRS
Glenn v. Comm'r, T.C. Summ. Op. 2005-127	6015(b), (c), (f) (understatement)	Yes	No	IRS
Haltom v. Comm'r, T.C. Memo. 2005-209	6015(b), (f) (understatement)	No	No	Split
Krasner v. Comm'r, T.C. Memo. 2006-31	6015(f) (underpayment)	No	Yes	IRS
Lingwall v. Comm'r, T.C. Summ. Op. 2005-69	6015(e); 6330(c)(4); After relief under 6015 denied and not appealed, TP not entitled to raise 6015 issues for a second time in a CDP proceeding	Yes	No	IRS
Madden v. Comm'r, T.C. Memo. 2006-4	6015(f) (underpayment)	No	No	IRS
Magee v. Comm'r, T.C. Memo. 2005-263	6015(f) (underpayment)	Yes	No	IRS
Martin v. Comm'r, T.C. Summ. Op. 2005-128	6015(f) (underpayment)	Yes	No	IRS
Merendino v. Comm'r, T.C. Memo. 2006-2	6015(f) (underpayment)	No	No	IRS
Motsko v. Comm'r, T.C. Memo. 2006-17	6015(f) (underpayment)	No	Yes	IRS
MPM Fin. Group, Inc. v. United States, 97 A.F.T.R.2d (RIA) 1640 (E.D. Ky. 2006)	TP's request for relief was not a reason to revisit a judgment against her spouse's property	No	No	IRS
Neal v. Comm'r, T.C. Memo. 2005-201	6015(f) (underpayment)	No	No	TP
Negoescu v. Comm'r, T.C. Summ. Op. 2005-161	6015(f) (underpayment)	Yes	No	IRS
Ohrman v. Comm'r, 96 A.F.T.R.2d (RIA) 7331 (9th Cir. 2005), *aff'g* T.C. Memo. 2003-301	6015(c); Disqualified asset transfer	No	No	IRS
Ordlock v. Comm'r, 126 T.C. 47 (2006)	6015(a), (g); TP residing in community property jurisdiction granted relief, but not entitled to refund of community property	No	No	IRS
Packer v. Comm'r, T.C. Summ. Op. 2006-22	6015(b), (c), (f) (understatement)	Yes	No	IRS
Parlin v. Comm'r, T.C. Memo. 2006-18	6015(e) (time for filing petition)	No	No	IRS
Puckett v. Comm'r, T.C. Summ. Op. 2006-28	6015(f) (underpayment)	Yes	No	IRS
Richardson v. Comm'r, T.C. Memo. 2006-69	6015(b)	No	No	IRS
Rodriguez v. Comm'r, T.C. Summ. Op. 2006-10	6015(f) (understatement)	Yes	No	IRS
Siddons v. Comm'r, T.C. Summ. Op. 2005-160	6015(f) (underpayment)	Yes	Yes	TP
Simon v. Comm'r, T.C. Memo. 2005-220	6015(f) (underpayment)	No	No	IRS
Sjodin v. Comm'r, 97 A.F.T.R.2d (RIA) 2622 (8th Cir. 2006), *vacating and remanding* T.C. Memo. 2004-205	6015(e)	Yes	No	IRS
Stringham v. Comm'r, T.C. Summ. Op. 2006-44	6015(b), (c), (f) (understatement)	Yes	Yes	IRS
Sylve v. Comm'r, T.C. Summ. Op. 2005-137	6015(b), (c), (f) (understatement); Duress	Yes	Yes	IRS
Thomas v. Comm'r, T.C. Summ. Op. 2005-100	6015(b), (c), (f) (understatement)	Yes	No	IRS
Thomas v. Comm'r, T.C. Summ. Op. 2005-102	6015(g) (res judicata)	Yes	No	TP
Vasquez v. Comm'r, T.C. Summ. Op. 2005-133	6015(c); Intervenor did not prove TP's knowledge	Yes	Yes	TP*

TABLE 8: RELIEF FROM JOINT AND SEVERAL LIABILITY UNDER IRC § 6015 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Intervenor	Decision
Young v. Comm'r, T.C. Summ. Op. 2005-135	6015(b), (c), (f) (understatement)	Yes	No	IRS

*The IRS agreed the TP was entitled to relief; only intervenor was opposed

TABLE 9
FAMILY STATUS ISSUES UNDER IRC §§ 2, 21, 24, 32, AND 151

Case Citation	Issue(s)	*Pro Se*	Decision
Aruai v. Comm'r, T.C. Memo. 2006-98	Child Tax Credit, EITC, Dependency Exemption	Yes	IRS
Baker v. Comm'r, T.C. Memo. 2006-60	Filing Status, Child Tax Credit, EITC, Dependency Exemption	Yes	IRS
Beckford v. Comm'r, T.C. Summ. Op. 2006-80	Child Tax Credit, EITC, Dependency Exemption	Yes	Split
Berry v. Comm'r, T.C. Summ. Op. 2005-153	Child Tax Credit, Dependency Exemption	Yes	IRS
Bland v. Comm'r, T.C. Summ. Op. 2006-17	EITC, Dependency Exemption	Yes	IRS
Bodiford v. Comm'r, T.C. Summ. Op. 2005-149	Filing Status, EITC, Dependency Exemption	Yes	IRS
Booker v. Comm'r, T.C. Summ. Op. 2005-90	Dependency Exemption	Yes	IRS
Burnham v. Comm'r, T.C. Summ. Op. 2006-8	Dependency Exemption	Yes	IRS
Chizer v. Comm'r, T.C. Summ. Op. 2006-73	Filing Status, Child Tax Credit, EITC, Dependency Exemption	Yes	IRS
D'Amours v. Comm'r, T.C. Summ. Op. 2006-26	Dependency Exemption	Yes	IRS
Darton v. Comm'r, T.C. Summ. Op. 2005-188	Dependency Exemption	Yes	IRS
Doudney v. Comm'r, T.C. Memo 2005-267	Dependency Exemption	Yes	IRS
Griffin v. Comm'r, T.C. Summ. Op. 2005-94	EITC	Yes	IRS
Harris v. Comm'r, T.C. Summ. Op. 2005-166	Filing Status, Child Tax Credit, EITC, Dependency Exemption	Yes	IRS
Hartfield v. Comm'r, T.C. Summ. Op. 2006-77	Filing Status, EITC, Dependency Exemption	Yes	Split
Her v. Comm'r, T.C. Summ. Op. 2005-130	Filing Status, Child & Dependent Care Credit, Child Tax Credit, EITC, Dependency Exemption	Yes	IRS
Jordan v. Comm'r, T.C. Memo. 2006-95	Filing Status, Dependency Exemption	Yes	IRS
Lane v. Comm'r, T.C. Memo. 2005-182	Child Tax Credit, Dependency Exemption	Yes	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2006-2	Child Tax Credit, Dependency Exemption	Yes	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2006-6	Child Tax Credit, Dependency Exemption	Yes	IRS
Litton v. Comm'r, T.C. Summ. Op. 2006-56	Child Tax Credit, Dependency Exemption	Yes	TP
Lozoya v. Comm'r, T.C. Summ. Op. 2005-73	Filing Status, EITC, Dependency Exemption	Yes	TP
Mace v. Comm'r, T.C. Summ. Op. 2005-89	Child Tax Credit, Dependency Exemption	Yes	IRS
Major v. Comm'r, T.C. Memo. 2005-194	EITC	Yes	IRS
Manzueta v. Comm'r, T.C. Summ. Op. 2005-185	Filing Status, Child Tax Credit, EITC, Dependency Exemption	Yes	Split
McCullough v. Comm'r, T.C. Summ. Op. 2006-31	Filing Status, EITC	Yes	IRS
Melton v. Comm'r, T.C. Summ. Op. 2005-152	Child Tax Credit, Dependency Exemption	No	IRS
Moore v. Comm'r, T.C. Summ. Op. 2006-79	Filing Status, EITC, Dependency Exemption	Yes	IRS
O'Brien v. Comm'r, T.C. Summ. Op. 2005-111	Dependency Exemption	Yes	IRS
Omans v. Comm'r, T.C. Summ. Op. 2005-110	Child Tax Credit, Dependency Exemption	No	TP
Onorati v. Comm'r, T.C. Summ. Op. 2005-101	Filing Status, Child Tax Credit, Dependency Exemption	Yes	IRS
Pen v. Comm'r, T.C. Summ. Op. 2006-33	Filing Status, EITC, Dependency Exemption	Yes	IRS
Powers v. Comm'r, T.C. Memo. 2005-152	Child Tax Credit, Dependency Exemption	Yes	IRS
Reyes v. Comm'r, T.C. Summ. Op. 2005-142	Filing Status, Child Tax Credit, EITC, Dependency Exemption	Yes	IRS

TABLE 9: FAMILY STATUS ISSUES UNDER IRC §§ 2, 21, 24, 32, AND 151 (CONT.)

Case Citation	Issue(s)	*Pro Se*	Decision
Royal v. Comm'r, T.C. Memo 2006-72	EITC	Yes	IRS
Sarni v. Comm'r, T.C. Summ. Op. 2005-189	Child Tax Credit, Dependency Exemption	Yes	IRS
Schultheiss v. Comm'r, T.C. Summ. Op. 2005-169	Dependency Exemption	Yes	IRS
Shrader v. Comm'r, T.C. Summ. Op. 2005-88	Dependency Exemption	Yes	IRS
Smith v. Comm'r, T.C. Summ. Op. 2005-167	Filing Status, Child Tax Credit, EITC, Dependency Exemption	Yes	IRS
Symonds v. Comm'r, T.C. Summ. Op. 2006-30	Filing Status, Dependency Exemption	Yes	IRS
Vogt v. Comm'r, T.C. Summ. Op. 2005-107	EITC	Yes	TP
Washington v. Comm'r, T.C. Summ. Op. 2006-81	Filing Status, EITC	Yes	Split
White v. Comm'r, T.C. Summ. Op. 2005-140	EITC	Yes	IRS
Wilson v. Comm'r, T.C. Summ. Op. 2005-168	Filing Status, Child Tax Credit, EITC, Dependency Exemption	Yes	IRS
Wilson v. Comm'r, T.C. Summ. Op. 2005-82	Filing Status, EITC	Yes	IRS
Wood v. Comm'r, T.C. Summ. Op. 2006-46	Dependency Exemption	Yes	IRS

TABLE 10
CHARITABLE DEDUCTIONS UNDER IRC § 170

Case Citation	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (Issues Other Than Business)			
Bischel v. U.S., 415 F.Supp.2d 1211 (D. Nev. 2006).	Waiver of grazing permit as charitable contribution	No	IRS
Booker v. Comm'r, T.C. Summ. Op. 2005-90.	Substantiation	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2005-85.	Substantiation	Yes	Split
D'Avanzo v. U.S., 67 Fed. Cl. 39 (2005), *appeal docketed*, No. 05-5174 (Sept. 29, 2005), *appeal dismissed*, 172 Fed. Appx. 319 (Fed. Cir. Feb. 14, 2006), *dismissal order vacated*, 172 Fed. Appx. 324 (Fed. Cir. March 16, 2006).	Substantiation	Yes	IRS
Doudney v. Comm'r, T.C. Memo. 2005-267.	Substantiation	Yes	IRS
Field v. Comm'r, T.C. Summ. Op. 2005-184.	Deductibility of travel expenses incurred in connection with providing charitable services	Yes	IRS
Finch v. Comm'r, T.C. Summ. Op. 2006-54.	Substantiation	Yes	Split
Haas v. Comm'r, T.C. Summ. Op. 2006-9.	Substantiation; value of donated property	Yes	Split
Jackson v. Comm'r, T.C. Memo. 2005-159.	Substantiation	Yes	IRS
Kendrix v. Comm'r, T.C. Memo. 2006-9, *appeal docketed*, No. 06-72814 (9th Cir. June 1, 2006), *appeal dismissed* (July 21, 2006), *motion to reconsider filed* (Aug. 3, 2006).	Substantiation; value of donated property	Yes	Split
Koblick v. Comm'r, T.C. Memo. 2006-63.	Fair market value of corporate stock donated	No	IRS
Lange v. Comm'r, T.C. Memo. 2005-176, *appeal docketed*, No. 05-2592 (Dec. 6, 2005).	Substantiation	Yes	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2006-6.	Substantiation	Yes	IRS
Paradiso v. Comm'r, T.C. Memo. 2005-187.	Substantiation	Yes	IRS
Ritchie v. Comm'r, T.C. Summ. Op. 2005-181.	Value of donated property	Yes	Split
Robinette v. Comm'r, T.C. Summ. Op. 2006-69.	Substantiation	Yes	Split
Scholet v. Comm'r, T.C. Memo. 2005-140.	Substantiation; evidence presented by TP from which court can estimate contributions	No	IRS
Sklar v. Comm'r, 125 T.C. 281 (2005), *appeal docketed*, No. 06-72961 (9th Cir. June 8, 2006).	Tuition/fees paid to school providing religious and secular education as charitable contribution	No	IRS
Triplett v. Comm'r, T.C. Summ. Op. 2005-148.	Qualified donee	Yes	IRS
Turner v. Comm'r, 126 T.C. 299 (2006).	Existence of a qualified conservation contribution	No	IRS
Westbrook v. Comm'r, T.C. Summ. Op. 2006-3.	Qualified donee	Yes	IRS
Work v. Comm'r, T.C. Memo. 2005-259.	Substantiation	Yes	IRS
Wortmann v. Comm'r, T.C. Memo. 2005-227.	Value of donated property	No	IRS
Business Taxpayers (sole proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships, and Trust(s))			
Deihl v. Comm'r, T.C. Memo. 2005-287.	Substantiation; qualified donee	No	Split
Kaplan v. Comm'r, T.C. Memo. 2006-16.	Presence of elements of bona fide inter vivos gift at time of noncash charitable contribution	No	IRS
NHUSS Trust v. Comm'r, T.C. Memo. 2005-236.	Value of donated property	No	IRS

ACRONYM GLOSSARY – ANNUAL REPORT TO CONGRESS 2006

Acronym	Definition
ACDS	Appeals Centralized Database System
ACH	Automated Clearing House
ACS	Automated Collection System
ACTC	Advance Child Tax Credit
ADA	Americans With Disabilities Act
ADR	Alternative Dispute Resolution or Address Research System
AHT	Average Handle Time
AGI	Adjusted Gross Income
AICPA	American Institute of Certified Public Accountants
AIS	Automated Insolvency System
AJCA	American Jobs Creation Act of 2004
AIMS	Audit Information Management System
ALE	Allowable Living Expenses
ALS	Automated Lien System
AM	Accounts Management
AMC	Alternative Media Center
AMS	Accounts Management Services
AMT	Alternative Minimum Tax
ANMF	Automated Non Master File
AOIC	Automated Offer In Compromise
ARC	Annual Report to Congress
AQMS	Appeals Quality Measurement System
ASA	Average Speed of Answer
ASED	Assessment Statute Expiration Date
ASFR	Automated Substitute for Return
ASL	American Sign Language
ATAO	Application for Taxpayer Assistance Order
AUR	Automated Underreporter
AWSS	Agency Wide Shared Services
BMF	Business Master File
BPR	Business Performance Review
BSV	Billing Support Voucher
CACI	Corporate Approach to Collection Inventory
CADE	Customer Account Data Engine
CARE	Customer Assistance, Relationships & Education
CAS	Customer Account Services
CCISO	Cincinatti Campus Innocent Spouse Operations
CCP-LU	Centralized Case Processing Lien Unit
CCR	Central Contractor Registration
CDA	Consolidated Decision Analytics
CDP	Collection Due Process
CDPTS	Collection Due Process Tracking System

ACRONYM GLOSSARY – ANNUAL REPORT TO CONGRESS 2006 (CONT.)

Acronym	Definition
CEX	Consumer Expenditure Survey
CFf	Collection Field Function
CERCA	Council for Electronic Revenue Communication Advancement
CID	Criminal Investigation Division
CIDS	Centralized Inventory Distribution System
CIP	Compliance Initiative Projects
CIS	Correspondence Imaging System
CLD	Communications, Liaison and Disclosure
CLU	Centralized Lien Unit
CNC	Currently Not Collectible
COD	Cancellation Of Indebtedness
COIC	Centralized Offer In Compromise Program
COTR	Contract Officer Technical Representative
CONOPS	Concept of Operations
CP	Computer Paragraph
CPE	Continuing Professional Education
CQMS	Collection Quality Management System
CRIS	Compliance Research Information System
CSAR	Collection Service Activity Report
CSCO	Compliance Services Campus Operation
CSED	Collection Statute Expiration Date
CSI	Campus Specialization Initiative
CSR	Customer Service Representative
CTC	Child Tax Credit
DA	Disclosure Authorization
DAC	Disability Access Credit
DART	Disaster Assistance Review Team
DATC	Doubt As To Collectibility
DATL	Doubt As To Liability
DDP	Daily Delinquency Penalty
DI	Desktop Integration or Debt Indicator
DIF	Discriminant Inventory Function
DOJ	Department of Justice
DPT	Dynamic Project Team
DRC	Disaster Relief Council
DRG	Desk Reference Guide
DTAPG	Disaster Tax Administration Policy Group
EAR	Electronic Account Resolution
EBT	Electronic Benefits Transfer
ECRU	External Civil Rights Unit
EDS	Exempt Determinations System
EGTRRA	Economic Growth and Tax Relief Reconciliation Act

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APPENDIX

ACRONYM GLOSSARY – ANNUAL REPORT TO CONGRESS 2006 (CONT.)

Acronym	Definition
EFIN	Electronic Filing Identification Number
EFDS	Electronic Fraud Detection System
E-FOIA	Electronic Freedom Of Information Act
EFTPS	Electronic Federal Tax Payment System
EIN	Employer Identification Number
EITC	Earned Income Tax Credit
ELS	Electronic Lodgment Service
EO	Exempt Organization
EP	Employee Plans
EPR	Emergency Preparedness and Response
EPRS	Emergency Preparedness and Response Directorate
EQRS	Embedded Quality Review System
ERCS	Examination Return Control System
ERIS	Enforcement Revenue Information System
ERO	Electronic Return Originator
ERSA	Employee Retirement Savings Account
ES	Estimated Tax Payments
ESA	Educational Savings Account
ESL	English as a Second Language
ETA	Electronic Tax Administration or Effective Tax Administration
ETACC	Electronic Tax Administration Advisory Committee
ETLA	Electronic Tax Law Assistance
FA	Field Assistance
FCMS	Federal Mediation and Conciliation Service
FDC	Fraud Detection Center
FDCPA	Fair Debt Collection Practices Act
FEMA	Federal Emergency Management System
FICA	Federal Insurance Contribution Act
FMS	Financial Management Service
FOIA	Freedom Of Information Act
FPDC	Federal Procurement Data Center
FPDS	Federal Procurement Data System
FMV	Fair Market Value
FOIA	Freedom Of Information Act
FPLP	Federal Payment Levy Program
FTC	Federal Trade Commission
FTD	Federal Tax Deposit or Failure To Deposit
FTE	Full Time Equivalent
FTF	Failure To File
FTI	Federal Tax Information
FTP	Failure To Pay
FTS	Fast Track Settlement

ACRONYM GLOSSARY – ANNUAL REPORT TO CONGRESS 2006 (CONT.)

Acronym	Definition
FY	Fiscal Year
GCM	General Counsel Memorandum
GLD	Governmental Liaison and Disclosure
GAO	Government Accountability Office or General Accounting Office
GO	Government Entities
IA	Installment Agreement
ICM	Intelligent Call Management
ICP	Integrated Case Processing
ICS	Integrated Collection System
IDAP	IDRS Decision Assisting Program
IDFA	Integration Development for Enterprise Automation
IDFP	IRS Directory for Practitioners
IDRS	Integrated Data Retrieval System
IDS	Inventory Delivery System
IMF	Individual Master File
IRC	Internal Revenue Code
IRI	Incomplete Return Item
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
IRSAC	Internal Revenue Service Advisory Council
ISATF	IRS-TAS Innocent Spouse Allocation Task Force
ISP	Industry Specialization Program
ISRP	Integrated Submission and Remittance Processing
ISTS	Innocent Spouse Tracking System
ITIN	Individual Taxpayer Identification Number
JOC	Joint Operations Center
LEP	Limited English Proficient
LITC	Low Income Taxpayer Clinic
LLC	Lifetime Learning Credit
LMSB	Large & Mid-Sized Business Operating Division
LOS	Level of Service
LRF	Last Return Filed
LSA	Lifetime Savings Account
LTA	Local Taxpayer Advocate
MAGI	Modified Adjusted Gross Income
MFT	Master File Transaction Code
MITS	Modernization and Information Technology Services
MLI	Multilingual Initiative or Most Litigated Issue
NCOA	National Change of Address
NFTL	Notice of Federal Tax Lien
NMF	Non-Master File
NQRS	National Quality Review Staff

ACRONYM GLOSSARY – ANNUAL REPORT TO CONGRESS 2006 (CONT.)

Acronym	Definition
NRP	National Research Program
NSG	Notice Support Group
NTA	National Taxpayer Advocate
OAR	Operations Assistance Request
OIC	Offer in Compromise
OMB	Office of Management and Budget
OPERA	Office of Program Evaluation, Research, & Analysis
OPI	Office of Penalty and Interest Administration or Over the Phone Interpreter
OPR	Office of Professional Responsibilitly
PAC	Program Action Case
PCA	Private Collection Agency
PCI	Potentially Collectible Inventory
PDC	Private Debt Collection
PDF	Portable Document Format
POA	Power Of Attorney
PPIA	Partial Payment Installment Agreement
PTIN	Preparer Tax Identification Number
QRP	Questionable Refund Program
RAC	Refund Anticipation Check
RACS	Revenue Accounting Control System
RAL	Refund Anticipation Loan
RCA	Reasonable Cause Assistant
RCP	Reasonable Collection Potential
RFQ	Request For Quotations
RGS	Report Generating Software
ROFT	Record of Federal Tax Liability
RRA 98	(Internal Revenue Service) Reform and Restructuring Act of 1998
RPC	Return Preparer Coordinator
RPS	Revenue Protection Strategy
RPP	Return Preparer Program
RSED	Refund Statute Expiration Date
SAMS	Systemic Advocacy Management System
SAR	Strategic Assessment Report
SB/SE	Small Business/Self Employed Operating Division
SBJPA	Small Business Job Protection Act
SCOD	Standing Committee on Disasters
SERP	Servicewide Electronic Research Program
SFR	Substitute for Return
SL	Stakeholder Liaison
SNOD	Statutory Notice of Deficiency
SPDER	Office of Servicewide Policy, Directives, and Electronic Research
SPEC	Stakeholder Partnerships, Education & Communication

ACRONYM GLOSSARY – ANNUAL REPORT TO CONGRESS 2006 (CONT.)

Acronym	Definition
SPOC	Single Point of Contact
SSA	Social Security Administration
SSI	Supplemental Security Income
SSN	Social Security Number
STARS	Scheme Tracking and Referral System
SWFT	Standard Workflow Tools
TAB	Taxpayer Assistance Blueprint
TAC	Taxpayer Assistance Center
TAMIS	Taxpayer Advocate Management Information System
TANF	Temporary Assistance to Needy Families
TAP	Taxpayer Advocacy Panel
TAS	Taxpayer Advocate Service
TCE	Tax Counseling for the Elderly
TCMP	Tax Compliance Measurement Program
TCS	Tax Computation Specialist
TDA	Taxpayer Delinquent Account
TDRA	Tip Rate Determination Agreement
TDI	Taxpayer Delinquent Investigation
TDQAS	Training Development Quality Assurance System
TDS	Transcript Delivery System
TE	Tax Examiner or Tax Exempt
TEC	Taxpayer Education and Communication
TE/GE	Tax Exempt & Government Entities Operating Division
TEI	Tax Executives Institute
TFRP	Trust Fund Recovery Penalty
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TIPRA	Tax Increase Prevention and Reconciliation Act
TOP	Treasury Offset Program
TPDS	Third Party Data Store
TPNC	Taxpayer Notice Codes
TPI	Total Positive Income
TRA 97	Taxpayer Relief Act of 1997
URF	Unidentified Remittances File
VITA	Volunteer Income Tax Assistance
VTO	Virtual Translation Office
W & I	Wage and Investment Operating Division
WFTRA	Working Families Tax Relief Act
WIC	Women, Infants and Children
XSF	Excess Collections File
XSFTG	Excess Collections File Task Group

TAXPAYER ADVOCATE SERVICE

DIRECTORY

HEADQUARTERS

NATIONAL TAXPAYER ADVOCATE
1111 Constitution Avenue NW
Room 3031, TA
Washington, DC 20224
Phone: 202-622-6100
FAX: 202-622-6113

DEPUTY NATIONAL TAXPAYER ADVOCATE
1111 Constitution Avenue NW
Room 3031, TA
Washington, DC 20224
Phone: 202-622-4300
FAX: 202-622-6113

EXECUTIVE DIRECTOR, SYSTEMIC ADVOCACY
1111 Constitution Avenue NW
Room 3219, TA:SA
Washington, DC 20224
Phone: 202-622-7175
FAX: 202-622-3125

EXECUTIVE DIRECTOR, CASE ADVOCACY
1111 Constitution Avenue NW
Room 3215, TA:CA
Washington, DC 20224
Phone: 202-622-3942
FAX: 202-622-4646

CONGRESSIONAL AFFAIRS LIAISONS
1111 Constitution Avenue NW
Room 3031, TA
Washington, DC 20224
Phone: 202-622-4321 or 202-622-4315
FAX: 202-622-6113

SYSTEMIC ADVOCACY DIRECTORS

DIRECTOR, ADVOCACY PROJECTS
1111 Constitution Avenue NW
Room 3219, TA:SA:AP
Washington, DC 20224
Phone: 202-622-7175
FAX: 202-622-3125

DIRECTOR, IMMEDIATE INTERVENTIONS
1111 Constitution Avenue NW
Room 3219, TA:SA:II
Washington, DC 20224
Phone: 202-622-7175
FAX: 202-622-3125

AREA OFFICES

NEW YORK/NEW ENGLAND
290 Broadway, 14th Floor
New York, NY 10007
Phone: 212-298-2015
FAX: 212-298-2016

RICHMOND
400 N. 8th Street, Room 328
Richmond, VA 23240
Phone: 804-916-3510
FAX: 804-916-3641

ATLANTA
401 W. Peachtree Street
Stop 101-R Room 1970
Atlanta, GA 30308
Phone: 404-338-8710
FAX: 404 338-8709

CINCINNATI
312 Elm Street, Suite 2250
Cincinnati, OH 45202
Phone: 859-669-5556
FAX: 869-669-5808

DALLAS
4050 Alpha Road
Mail Stop 1005 MSRO, Room 1224A
Dallas, TX 75244-4203
Phone: 972-308-7019
FAX: 972-308-7166

SEATTLE
915 2nd Avenue, Stop W-404
Seattle, WA 98174
Phone: 206-220-4356
FAX: 206-220-4930

OAKLAND
1301 Clay Street, Suite 1030-N
Oakland, CA 94612
Phone: 510-637-2070
FAX: 510-637-3189

CAMPUS OFFICES

ANDOVER
310 Lowell Street, Stop 120
Andover, MA 01812
Phone: 978-474-5549
FAX: 978-247-9034

ATLANTA
4800 Buford Highway, Stop 29-A
Chamblee, GA 30341
Phone: 770-936-4500
FAX: 770-234-4445

AUSTIN
3651 S. Interregional Highway
Stop 1005 AUSC
Austin, TX 78741
Phone: 512-460-8300
FAX: 512-460-8267

BROOKHAVEN
1040 Waverly Avenue, Stop 02
Holtsville, NY 11742
Phone: 631-654-6686
FAX: 31-447-4879

CINCINNATI
201 Rivercenter Boulevard, Stop 11-G
Covington, KY 41011
Phone: 859-669-5316
FAX: 859-669-5405

FRESNO
1171 Fulton Mall
Fresno, CA 93721-1913
Phone: 559-442-6400
FAX: 559-442-6507

KANSAS CITY
333 W. Pershing
Stop 1005
Kansas City, MO 64108
Phone: 816-291-9000
FAX: 816-292-6003

MEMPHIS
5333 Getwell Road, Stop 13-M
Memphis, TN 38118
Phone: 901-395-1900
FAX: 901-395-1925

OGDEN
1973 N. Rulon White Boulevard, Stop 1005
Ogden, UT 84404
Phone: 801-620-7168
FAX: 801-620-3096

PHILADELPHIA
11601 Roosevelt Boulevard, Stop SW 820
Philadelphia, PA 19154
Phone: 215-516-2499
FAX: 215-516-2677

LOCAL TAXPAYER ADVOCATES

ALABAMA
801 Tom Martin Drive
Room 151-PR
Birmingham, AL 35211
Phone: 205-912-5631
FAX: 205-912-5633

ALASKA
949 E 36th Avenue, Stop A-405
Anchorage, AK 99508
Phone: 907-271-6877
FAX: 907-271-6157

ARIZONA
210 E. Earll Drive, Stop 1005 PHX
Phoenix, AZ 85012-2623
Phone: 602-207-8240
FAX: 602-207-8250

ARKANSAS
700 West Capitol Street, Stop 1005 LIT
Little Rock, AR 72201
Phone: 501-396-5978
FAX: 501-396-5768

CALIFORNIA (LAGUNA NIGUEL)
24000 Avila Road, Stop 2000
Laguna Niguel, CA 92677
Phone: 949-389-4804
FAX: 949-389-5038

CALIFORNIA (LOS ANGELES)
300 N. Los Angeles Street, Stop 6710LA
Los Angeles, CA 90012
Phone: 213-576-3140
FAX: 213-576-3141

CALIFORNIA (OAKLAND)
1301 Clay Street, Suite 1540-S
Oakland, CA 94612
Phone: 510-637-2703
FAX: 510-637-2715

CALIFORNIA (SACRAMENTO)*
4330 Watt Avenue, Stop SA5043
Sacramento, CA 95821
Phone: 916-974-5007
FAX: 916-974-5902

CALIFORNIA (SAN JOSE) *
55 S. Market Street, Stop 0004
San Jose, CA 95113
Phone: 408-817-6850
FAX: 408-817-6851

COLORADO
600 17th Street, Stop 1005 DEN
Denver, CO 80202-2490
Phone: 303-446-1012
FAX: 303-446-1011

CONNECTICUT
135 High Street, Stop 219
Hartford, CT 06103
Phone: 860-756-4555
FAX: 860-756-4559

DELAWARE
1352 Marrows Road, Suite 203
Newark, DE 19711-5445
Phone: 302-286-1654
FAX: 302-286-1643

DISTRICT OF COLUMBIA
500 North Capitol Street, NW
Suite 1301-A
Washington, D.C. 20221
Phone: 202-622-4300
FAX: 202-874-8753

FLORIDA (FT. LAUDERDALE)
7850 SW 6th Court, Room 265
Plantation, FL 33324
Phone: 954-423-7677
FAX: 954-423-7685

FLORIDA (JACKSONVILLE)
841 Prudential Drive, Suite 100
Jacksonville, FL 32207
Phone: 904-665-1000
FAX: 904-665-1817

* LTA located in Oakland, California.

GEORGIA
401 W. Peachtree Street, NW
Summit Bldg., Room 510,
Stop 202-D
Atlanta, GA 30308
Phone: 404-338-8099
FAX: 404-338-8096

HAWAII
300 Ala Moana Boulevard, #50089
Stop H-405 / Room 1-214
Honolulu, HI 96850
Phone: 808-539–2870
FAX: 808-539-2859

IDAHO
550 W. Fort Street, Box 041
Boise, ID 83724
Phone: 208-387-2827
FAX: 208-387-2824

ILLINOIS (CHICAGO)
230 S. Dearborn Street
Room 2860, Stop-1005 CHI
Chicago, IL 60604
Phone: 312-566-3800
FAX: 312-566-3803

ILLINOIS (SPRINGFIELD)
3101 Constitution Drive
Stop 1005 SPD
Springfield, IL 62704
Phone: 217-862-6382
FAX: 217-862-6373

INDIANA
575 N. Pennsylvania Street
Room 581 - Stop TA770
Indianapolis, IN 46204
Phone: 317-685-7840
FAX: 317-685-7790

IOWA
210 Walnut Street
Stop 1005 DSM, Room 483
Des Moines, IA 50309
Phone: 515-564-6888
FAX: 515-564-6882

KANSAS
271 West 3rd Street North
Stop 1005-WIC, Suite 2000
Wichita, KS 67202
Phone: 316-352-7506
FAX: 316-352-7212

KENTUCKY
600 Dr. Martin Luther King Jr.
Place
Room 325
Louisville, KY 40202
Phone: 502-582-6030
FAX: 502-582-6463

LOUISIANA
1555 Poydras Street, Suite 220,
Stop 2
New Orleans, LA 70112-3747
Phone: 504-558-3001
FAX: 504-558-3348

MAINE
68 Sewall Street, Room 313
Augusta, ME 04330
Phone: 207-622-8528
FAX: 207-622-8458

MARYLAND
31 Hopkins Plaza, Room 900
Baltimore, MD 21201
Phone: 410-962-2082
FAX: 410-962-9340

MASSACHUSETTS
JFK Building
15 New Sudbury Street, Room 725
Boston, MA 02203
Phone: 617-316-2690
FAX: 617-316-2700

MICHIGAN
McNamara Federal Building
477 Michigan Avenue
Room 1745 - Stop 7
Detroit, MI 48226
Phone: 313-628-3670
FAX: 313-628-3669

MINNESOTA
Wells Fargo Place
30 E. 7th Street, Suite 817
Stop 1005 STP,
St. Paul, MN 55101
Phone: 651-312-7999
FAX: 651-312-7872

MISSISSIPPI
100 West Capitol Street,
Stop 31
Jackson, MS 39269
Phone: 601-292-4800
FAX: 601-292-4821

MISSOURI
1222 Spruce Street
Stop 1005 STL, Room 10.314
St. Louis, MO 63103
Phone: 314-612-4610
FAX: 314-612-4628

MONTANA
10 West 15th Street, Suite 2319
Helena, MT 59626
Phone: 406-441-1022
FAX: 406-441-1045

NEBRASKA
1313 Farnam Street
Stop 1005 OMA, Room 208
Omaha, NE 68102
Phone: 402-221-4181
FAX: 402-221-3051

NEVADA
110 City Parkway, Stop 1005 LVG
Las Vegas, NV 89106
Phone: 702-868-5179
FAX: 702-868-5445

NEW HAMPSHIRE
Thomas J. McIntyre Federal
Building
80 Daniel Street, Room 403
Portsmouth, NH 03801
Phone: 603-433-0571
FAX: 603-430-7809

NEW JERSEY
955 South Springfield Avenue
1st Floor
Springfield, NJ 07081
Phone: 973-921-4043
FAX: 973-921-4355

NEW MEXICO
5338 Montgomery Boulevard NE
Stop 1005 ALB
Albuquerque, NM 87109
Phone: 505-837-5505
FAX: 505-837-5519

NEW YORK (ALBANY)
Leo O'Brien Federal Building
1 Clinton Square, Room 354
Albany, NY 12207
Phone: 518-427-5413
FAX: 518-427-5494

NEW YORK (BROOKLYN)
10 Metro Tech Center
625 Fulton Street
Brooklyn, NY 11201
Phone: 718-488-2080
FAX: 718-488-3100

NEW YORK (BUFFALO)
201 Como Park Blvd.
Buffalo, NY 14227-1416
Phone: 716-686-4850
FAX: 716-686-4851

NEW YORK (MANHATTAN)
290 Broadway - 5th Floor
New York, NY 10007
Phone: 212-436-1011
FAX: 212-436-1900

NORTH CAROLINA
320 Federal Place, Room 125
Greensboro, NC 27401
Phone: 336-378-2180
FAX: 336-378-2495

NORTH DAKOTA
657 Second Avenue North
Stop 1005 FAR, Room 244
Fargo, ND 58102-4727
Phone: 701-239-5141
FAX: 701-239-5323

OHIO (CINCINNATI)
550 Main Street, Room 3530
Cincinnati, OH 45202
Phone: 513-263-3260
FAX: 513-263-3257

OHIO (CLEVELAND)
1240 E. 9th Street, Room 423
Cleveland, OH 44199
Phone: 216-522-7134
FAX: 216-522-2947

OKLAHOMA
55 North Robinson
Stop 1005 OKC, Room 138
Oklahoma City, OK 73102
Phone: 405-297-4055
FAX: 405-297-4056

OREGON
1220 S.W. 3rd Avenue, Stop O-405
Portland, OR 97204
Phone: 503-326-2333
FAX: 503-326-5453

PENNSYLVANIA (PHILADELPHIA)
600 Arch Street, Room 7426
Philadelphia, PA 19106
Phone: 215-861-1304
FAX: 215-861-1613

PENNSYLVANIA (PITTSBURGH)
1000 Liberty Avenue, Room 1400
Pittsburgh, PA 15222
Phone: 412-395-5987
FAX: 412-395-4769

RHODE ISLAND
380 Westminster Street
Providence, RI 02903
Phone: 401-525-4200
FAX: 401-525-4247

SOUTH CAROLINA
1835 Assembly Street
Room 466, MDP-03
Columbia, SC 29201
Phone: 803-253-3029
FAX: 803-253-3910

SOUTH DAKOTA
115 4th Avenue SouthEast
Stop 1005 ABE, Room 114
Aberdeen, SD 57401
Phone: 605-377-1600
FAX: 605-377-1634

TENNESSEE
801 Broadway, Stop 22
Nashville, TN 37203
Phone: 615-250-5000
FAX: 615-250-5001

TEXAS (AUSTIN)
300 E. 8th Street
Stop 1005-AUS, Room 136
Austin, TX 78701
Phone: 512-499-5875
FAX: 512-499-5687

TEXAS (DALLAS)
1114 Commerce Street
MC 1005DAL, Room 1004
Dallas, TX 75242
Phone: 214-413-6500
FAX: 214-413-6594

TEXAS (HOUSTON)
1919 Smith Street
Stop 1005 HOU, Room 1650
Houston, TX 77002
Phone: 713-209-3660
FAX: 713-209-3708

UTAH
50 South 200 East
Stop 1005 SLC
Salt Lake City, UT 84111
Phone: 801-799-6958
FAX: 801-799-6957

VERMONT
Courthouse Plaza
199 Main Street
Burlington, VT 05401-8309
Phone: 802-859-1052
FAX: 802-860-2006

VIRGINIA
400 N. 8th Street, Room 916
Richmond, VA 23240
Phone: 804-916-3501
FAX: 804-916-3535

WASHINGTON
915 2nd Avenue, Stop W-405
Seattle, WA 98174
Phone: 206-220-6037
FAX: 206-220-6047

WEST VIRGINIA
425 Juliana Street, Room 3012
Parkersburg, WV 26101
Phone: 304-420-8695
FAX: 304-420-8660

WISCONSIN
211 W. Wisconsin Avenue
Room 507
Stop 1005 MIL
Milwaukee, WI 53203
Phone: 414-231-2390
FAX: 414-231-2383

WYOMING
5353 Yellowstone Road
Cheyenne, WY 82009
Phone: 307-633-0800
FAX: 307-633-0918

PUERTO RICO
San Particio Office Building
7 Tabonuco Street,
Room 200
Guaynabo, PR 00966
Phone: 787-622-8930 (Spanish)
787-622-8940 (English)
FAX: 787-622-8933

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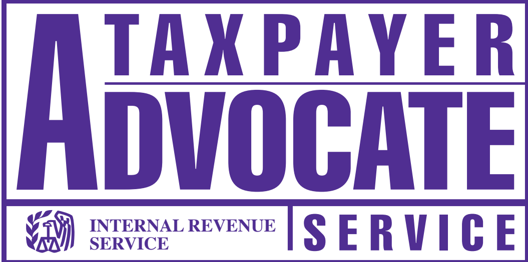
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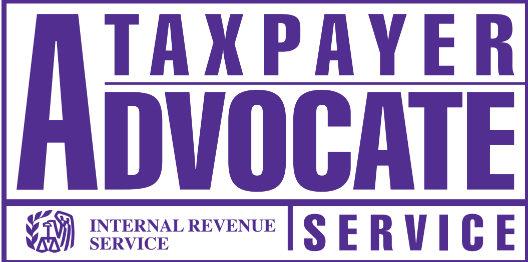
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