2008 Annual Report to Congress

NATIONAL TAXPAYER ADVOCATE

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Volume One

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National Taxpayer Advocate
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TAXPAYER ADVOCATE SERVICE
INTERNAL REVENUE SERVICE
YOUR VOICE AT THE IRS

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Dedication

This report is dedicated
in memoriam to
Greg Lintner.

In his personal heroism,
and as a revenue officer and
Taxpayer Advocate Service employee,
he sought to do what was right and honorable, and serves as
an inspiration to friends, colleagues, and even strangers.

He is sorely missed.

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Honorable Members of Congress:

I respectfully submit for your consideration the National Taxpayer Advocate's 2008 Annual Report to Congress. Section 7803(c)(2)(B)(ii) of the Internal Revenue Code requires the National Taxpayer Advocate to submit this report each year and in it, among other things, to identify at least 20 of the most serious problems encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems. Thus, the statute requires that the report focus on problems and areas in need of improvement.

Indeed, with a tax system as complex as ours, there are inevitably many problems and areas in which improvements can be made, and I will address the major ones in detail. For context, however, I note that 2008 marks the ten-year anniversary of the enactment of the Internal Revenue Service Restructuring and Reform Act of 1998, and this therefore seems like an appropriate time to point out that the IRS has improved substantially over the past decade. It is more responsive to taxpayers than it was in 1998. It has also made strides in improving its technology. This year we watched as the IRS delivered a successful filing season despite numerous changes in law that were enacted late in 2007 and delivered economic stimulus checks to about 119 million taxpayers with just a few months to plan.[1] These two challenges required the IRS to make trade-offs, which included a reduction in the level of service on its toll-free lines from 82 percent in fiscal year 2007 to 53 percent in Fiscal Year (FY) 2008,[2] but in light of the hand the IRS was dealt, it performed extremely well. I think it is important to take stock of how much the IRS has improved before proceeding to discuss taxpayer problems.

The IRS and the Current Economic Environment

This report is published as a new Administration and a new Congress arrive to address the daunting challenges facing the U.S. economy. Tax administration and the Internal Revenue Service have an important role to play in furthering the nation's recovery – not just because the IRS collects about 96 percent of the federal government's revenue but also because burdensome tax policies, inadequate customer service, and inappropriate enforcement actions drive up compliance costs for all taxpayers, including small businesses, and thereby impede economic growth.

Thus, in this year's report – presented in two volumes – we focus on challenges to tax administration in the 21st century, especially during economic downturns. First and foremost among the most serious problems facing taxpayers is the complexity of the tax code, followed by the IRS's enforcement activity toward taxpayers who are experiencing economic hardships and by the tax treatment of cancellation of debt income. In the Legislative Recommendations section of this report, we pick up the discussion about complexity. We reprise our call for simplification in several major areas of tax law, including the Alternative Minimum Tax (AMT),

1 U.S. Department of the Treasury, *Treasury Distributes 1.546 Million Additional Stimulus Checks in November*, HP-1319 (Dec. 5, 2008) (data reflects number of payments made through November 2008).

2 *See Internal Revenue Service Fiscal Year 2008 Enforcement Results (Slide 7: Taxpayer Service)*, *at* http://www.irs.gov/pub/irs-news/2008_enforcement.pdf.

education and retirement savings incentives, and the family status provisions.[3] We also submit several new recommendations for your consideration, including proposals to reform the worker classification regime and to revamp the current penalty provisions in the Internal Revenue Code. Finally, Volume II of this report presents three research studies of importance to tax administration in economically challenging times: (1) a comprehensive review of the Code's penalty regime; (2) an automated method to identify taxpayers who are experiencing economic hardship so the IRS can systemically screen them from automated levies; and (3) a second installment in our series of research studies on the impact of tax preparers on taxpayer compliance.

A Call for Tax Reform and Simplification

In earlier Annual Reports to Congress, we have highlighted the "confounding complexity of the Internal Revenue Code" as one of the most serious problems facing taxpayers.[4] We do so again this year. While in past reports we have focused on the Alternative Minimum Tax as the primary example of this complexity,[5] this year the "poster child" for complexity is Cancellation of Debt Income (CODI).[6] This issue – which has received very little attention in the media – threatens to undermine any nascent recovery by homeowners facing loan restructuring or foreclosures, not to mention by taxpayers who find themselves unable to pay their automobile or credit card debts as a result of declining economic conditions. Although Congress provided partial relief to taxpayers with home mortgages in the Mortgage Forgiveness Debt Relief Act, CODI problems persist. The Act provided that taxpayers may exclude CODI resulting from taxable mortgage debt cancellation where the proceeds were used to acquire or improve their principal residence. But it appears that the majority of homeowners who took out subprime mortgages used a portion of the loan proceeds for other purposes, including paying off car loans, credit card balances, student loans, and medical bills. Thus, if these taxpayers either work out a debt reduction agreement with their lenders or abandon or lose their homes in foreclosure, they will have CODI unless some other exclusion – such as insolvency – applies.[7]

Moreover, lenders are required to report CODI to the IRS on Form 1099-C, *Cancellation of Debt*, and the IRS generally may assume any reported CODI is taxable unless the taxpayer files a form with his tax return to claim an exclusion. Very few taxpayers know to file this form, and as a result, taxpayers may be unnecessarily targeted for examination and tax assessment in tens of thousands of cases. It is probably safe to say that taxpayers facing eviction from their homes and the resulting disruption of their financial and personal lives will not be thinking about

3 The family status provisions include filing status (IRC § 1), personal and dependent exemptions (IRC § 151), the child tax credit (IRC § 24), the earned income tax credit (IRC § 32), the child and dependent care credit (IRC § 21), and the separated spouse rules (IRC § 7703(b)).

4 *See* National Taxpayer Advocate 2004 Annual Report to Congress 2-7.

5 *See* National Taxpayer Advocate 2001 Annual Report to Congress 166-77; National Taxpayer Advocate 2003 Annual Report to Congress 5-19; National Taxpayer Advocate 2004 Annual Report to Congress 383-85; and National Taxpayer Advocate 2006 Annual Report to Congress 3-5.

6 When a borrower is unable to pay a debt and the creditor cancels some or all of it, the amount of loan cancellation is generally treated as taxable income to the debtor. IRC § 61(a)(12).

7 The Mortgage Forgiveness Debt Relief Act expressly provided that CODI is excludable under this provision only to the extent that the amount of debt cancellation exceeds the amount used for these "non-qualified" purposes.

CODI. These taxpayers and those who are able to arrange debt reduction will find, a few years down the road when they are about to achieve some measure of financial stability, that they owe the IRS a sizable sum. In our report, we make several administrative recommendations and one legislative recommendation that should mitigate this problem and prevent millions of taxpayers from getting ensnared in this incredibly complex, burdensome, and devastating regime.

Of course, we haven't let up on our advocacy for repeal or reform of the Alternative Minimum Tax, either. Over the last eight years we have championed the need for AMT reform, and while there is now widespread agreement that reform is needed, the sheer scope of the revenue impact paralyzes all efforts other than one-year fixes. Today, we have reached a point where even one-year fixes are extremely expensive[8] – and the perniciousness and invasiveness of the AMT is demonstrated by the fact that *it will cost more in 2009 to repeal the AMT than it would cost to repeal the regular income tax rules and leave the AMT in place.* Absent continual one-year patches, almost a quarter of all individual taxpayers will have to navigate the AMT. That is a sad statement about the complexity of our tax system, and that fact alone should compel the new administration and Congress to undertake the fundamental tax reform necessary to repeal the AMT.[9] It is simply inexcusable for a tax system to impose this kind of burden on millions of taxpayers.

As if CODI and AMT were not enough to demonstrate the current complexity of the Internal Revenue Code, consider this: the number of civil tax penalties has increased from about 14 in 1954 to more than 130 today.[10] Many of these penalties are rarely applied, and some contribute little to the generally accepted premise that civil tax penalties should primarily serve to promote voluntary compliance. In our legislative proposal for penalty reform and the accompanying study in Volume II, we lay out some basic principles for penalty provisions, including horizontal equity, proportionality, and procedural fairness. We highlight one penalty, IRC § 6707A, in a separate legislative recommendation. As currently designed, IRC § 6707A violates the basic proposition that a penalty should be proportional to the harm that occurs. The purpose of the penalty is to combat tax shelters by requiring taxpayers who enter into transactions deemed by the IRS as aggressive to make special disclosures. As written, however, Section 6707A requires the IRS to impose a penalty of $200,000 per entity per year and $100,000 per individual per year even if the taxpayer had no knowledge that the IRS deemed the transaction aggressive and even if the taxpayer derived no tax savings from the transaction. In the case of a "listed transaction," the IRS must impose the full amount of the penalty and may not waive or rescind it under any circumstances.

8 The cost of the AMT patch for 2008 is estimated at $78.9 billion. Some revenue will be recouped in subsequent years, resulting in an estimated ten-year cost of $64.1 billion. Joint Committee on Taxation, *Estimated Budget Effects of the Tax Provisions Contained in an Amendment in the Nature of a Substitute to H.R. 1424, Scheduled for Consideration on the Senate Floor on October 1, 2008* (Oct. 1, 2008).

9 Absent any changes in law, it is now projected that in 2010, 33 million individual taxpayers will be subject to the AMT. Tax Policy Center, *Aggregate AMT Projections, 2008-2018*, Table T08-0248 (Nov. 4, 2008), *available at* http://www.taxpolicycenter.org/numbers/Content/PDF/T08-0248.pdf. Most observers believe that Congress, at a minimum, will pass another "patch" that limits the growth in the AMT by increasing the AMT exemption amounts.

10 For a list of about 130 current law penalties, see Vol. II, *A Framework for Reforming the Penalty Regime*, Appendix A, *infra.*

A final illustration of how complex our tax system has become. Although few people enjoy paying taxes, most understand that "taxes are what we pay for a civilized society."[11] But it adds insult to injury that more than 80 percent of taxpayers today find tax filing so complicated that they feel compelled to pay transaction fees simply to pay their taxes. About 60 percent of taxpayers pay preparers to do the job, and another 22 percent purchase tax software to help them perform the calculations themselves. In the long run, we recommend that Congress simplify the tax code so that taxpayers can compute and pay their taxes far more simply.

In addition, we advocate an immediate step to assist taxpayers who seek return preparation assistance. Since 2002, we have recommended that Congress protect taxpayers who use preparers by requiring unenrolled preparers to pass a minimum competency test, register with the IRS, and satisfy continuing professional education requirements. Oregon has had success with a similar system, and recent "shopping visits" to unenrolled preparers conducted by the Government Accountability Office, the Treasury Inspector General for Tax Administration, and most recently and dramatically, the New York State Department of Taxation and Revenue,[12] have shown significant deficiencies in the competence and professional standards of unenrolled preparers. The Senate has previously approved legislation to regulate preparers, and the House Ways and Means Subcommittee on Oversight has held a hearing focused in part on the subject. In this report, we reiterate our recommendation that Congress act to professionalize the return preparation industry.

Taxpayer Service and Enforcement in Challenging Economic Times

During economic downturns, the IRS is placed in a difficult position. On the one hand, more taxpayers are experiencing economic setbacks – loss of jobs, loss of homes, losses on investments – and thus are more likely to be unable to pay all their taxes. On the other hand, as the budget deficit grows, the IRS comes under subtle pressure to collect more federal revenue and close the tax gap. In addition, as the administration and Congress look for ways to reduce federal spending, the IRS's annual appropriation becomes an attractive target for budgetary savings.

All of the most serious problems of taxpayers that we identify in this year's report address the delicate balance the IRS must achieve between these competing pressures. We note that the IRS must change some of its practices to avoid exacerbating the financial distress of taxpayers who are already experiencing economic difficulties. We note that the IRS's own studies show that more enforcement actions – liens and levies – do not translate into commensurate increases in revenue collection. For example, while the number of levies issued by the IRS increased by an astonishing 1,608 percent from FY 2000 to FY 2007 – from 220,000 levies to about 3.76 million – the increase in total collection yield during this period was slightly less

11 *See Compania General De Tabacos De Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

12 Tom Herman, *New York Sting Nabs Tax Preparers*, Wall Street Journal (Nov. 26, 2008).

than 45 percent.[13] We note that current IRS guidance provides little direction to help IRS employees identify taxpayers who are experiencing economic hardship and prevent undue economic burden on affected taxpayers. We also show that the IRS underutilizes collection alternatives, particularly offers in compromise and partial pay installment agreements, currently available to resolve taxpayer liabilities. For example, the number of accepted offers in compromise has decreased by over 72 percent from FY 2001 to FY 2008.[14] While it is commendable that the IRS is now talking about how it wants to help taxpayers who are experiencing economic difficulties,[15] the IRS has always possessed the tools to help these taxpayers, and training its employees to utilize these tools properly and flexibly would go a long way toward improving tax compliance, especially in challenging economic times.[16]

Effecting Culture Change in the IRS

This year, in an effort to better identify where there is agreement and clarify where there is disagreement between the National Taxpayer Advocate and the IRS, we identified our tentative recommendations in the initial section of each "Most Serious Problem" discussion so that the IRS could address our tentative recommendations in its responses. As a result of this procedure, we have been able to narrow issues, and our final recommendations are more discrete, actionable, and fewer than in earlier reports. In many instances, the IRS either identified or committed to initiatives in its responses that, if properly administered, will address our concerns. The National Taxpayer Advocate's final recommendations, however, often reflect a fundamental philosophical disagreement between TAS and the IRS – particularly in the area of looking at IRS actions from the taxpayer's perspective. The good news is that there is lots the IRS is currently doing to improve its operations. The not-so-good-news is that there is lots more work to do – particularly in the area of internal culture change – before the IRS achieves its potential as a disciplined but compassionate tax administration.

What appears to be driving this disconnect is the sense, in the IRS responses to the Most Serious Problems included in this report, that the IRS is so hampered by the requirements of its work that it simply doesn't have the time, resources, or energy to look at itself critically and ask fundamental questions about how it is doing its job. In responses to discussions of taxpayer service, collection, examination, and local compliance initiatives herein, the IRS resists questioning whether it is measuring the right actions to improve voluntary compliance, resists exploring new methods of providing face-to-face service to taxpayers, resists measuring

13 IRS, Small Business/Self-Employed Division (SB/SE) Research, *Liens, Levies, Seizures, and Total Yield: 10 Year Filing Trend*, (Aug. 19, 2005), supplemented with data from various SB/SE Collection Activity Reports and Statistics of Income (SOI) Data Book information for FY 1999 to FY 2007.

14 SB/SE Collection Activity Report, *No-5000-108* (FY 2001-FY 2008). In FY 2001, the IRS accepted 38,643 offers compared to 10,677 in FY 2008.

15 IRS News Release, *IRS Speeds Lien Relief for Homeowners Trying to Refinance, Sell*, IR-2008-141 (Dec. 16, 2008).

16 In this report, we also note that it is important for the IRS to maintain balance in its approach to collecting unpaid employment tax liabilities. The IRS has come under pressure to ramp up its collection of unpaid employment tax liabilities. This pressure stems, in part, from a recent GAO report which found that unpaid employment tax liabilities increased from $49 billion in 1998 to $58 billion in 2008. While that may be a true statement, it is critical that observers interpret the data correctly. Inflation increased by 30 percent over that period, so the employment tax gap has seemingly shrunk in real (inflation-adjusted) terms. Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Dec. 29, 2008). As well, the $58 billion figure represents a multi-year, cumulative total, and the majority of that total consists of interest and penalties rather than tax itself. For a detailed discussion of the IRS response to unpaid employment taxes, *see* Most Serious Problem, *Employment Taxes, infra.*

the impact of its centralization initiatives on voluntary compliance, resists making real changes to its examination strategy to address the difficulties taxpayers face in responding to correspondence exams, and resists establishing a world-class, 21st century think tank to explore what actions and initiatives help taxpayers achieve and maintain tax compliance.[17]

If the IRS is not able to make the case for itself that with the proper funding it will deliver world class tax administration, who will? If the IRS is unwilling to challenge the status quo with respect to its way of doing business in these challenging times, who will support its current funding? Well, to some extent this report makes that case. As the National Taxpayer Advocate, I believe (and describe in the report that follows) that – right here, right now – the IRS has the tools it needs to help taxpayers be compliant. And I believe the IRS has the talent available to it – right here, right now – to challenge its entrenched assumptions about service and enforcement and become a truly world class tax administrator. And I believe it is *essential* to the economic well-being of the United States that the new Administration and the new Congress invest in the IRS so that it can better serve the taxpayers who provide the lifeblood of government, in good times and in bad times alike.

As the agency that collects about 96 percent of all federal revenue and the agency that more Americans interact with each year than any other, the IRS has an important and demanding job to do. I hope Members of Congress and their staffs find this report helpful as you consider how to best assist the IRS in collecting revenue while simultaneously protecting taxpayer rights and minimizing taxpayer burden.

Respectfully submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2008

[17] See Most Serious Problems, *Customer Service Within Compliance; Taxpayer Service: Bringing Service to the Taxpayer; The Impact of IRS Centralization on Tax Administration; Customer Service Issues in the IRS's Automated Collection System (ACS); The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties; The IRS Correspondence Examination Program Promotes Premature Notices, Case Closures, and Assessments; Suitability of the Examination Process*; and *Local Compliance Initiatives Have Great Potential But Face Significant Challenges, infra.*

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Introduction: The Most Serious Problems Encountered by Taxpayers

Internal Revenue Code (IRC) § 7803(c)(2)(b)(ii)(III) requires the National Taxpayer Advocate to prepare an Annual Report to Congress which contains a summary of at least 20 of the most serious problems encountered by taxpayers each year. For 2008, the National Taxpayer Advocate has identified, analyzed, and offered recommendations to assist the IRS in resolving 20 such problems. This year's report also includes a status update on the IRS's Private Debt Collection (PDC) initiative, which reiterates the National Taxpayer Advocate's prior recommendation that the initiative be discontinued.[1]

As in previous years, this report discusses at least 20 *of the most serious problems* encountered by taxpayers – but not necessarily the top 20 most serious problems. That is by design. Since there is no objective way to select the 20 most serious problems, we consider a variety of factors when making this determination. Moreover, while we carefully rank each year's problems under the same methodology (described immediately below), the list remains inherently subjective in many respects.

To simply report on the top 20 problems would pose many difficulties. First, in doing so, it would require us to repeat much of the same data and propose many of the same solutions year to year. Our tax system and the Code have grown to a point where the IRS employs more than 100,000 workers and collects in excess of $2 trillion each year from individuals, small and large businesses, and tax-exempt entities. This state of affairs inevitably creates problems that may not be transparent but nonetheless merit the attention of the National Taxpayer Advocate and the IRS. Thus, the statute allows the National Taxpayer Advocate to be flexible in selecting both the subject matter and the number of topics to be discussed, and to use the report to put forth actionable and specific solutions instead of mere criticism and complaints.

Methodology for Determining the Most Serious Problems

The National Taxpayer Advocate considers a number of factors in identifying, evaluating, and ranking the most serious problems encountered by taxpayers. The 20 issues and the status update in this section of the Annual Report were ranked according to the following criteria:

- Impact on taxpayer rights;
- Number of taxpayers affected;
- Interest, sensitivity, and visibility to the National Taxpayer Advocate, Congress, and other external stakeholders;

[1] See National Taxpayer Advocate 2007 Annual Report to Congress 411-31; National Taxpayer Advocate 2006 Annual Report to Congress 34-61.

- Barriers these problems present to tax law compliance, including cost, time, and burden;
- The revenue impact of noncompliance; and
- Taxpayer Advocate Management Information System (TAMIS) and Systemic Advocacy Management System (SAMS) data.

Finally, the National Taxpayer Advocate and the Office of Systemic Advocacy examine the results of this ranking and adjust it where editorial or numeric considerations warrant a particular placement or grouping. This year, we placed the majority of the 20 problems in four basic categories: taxpayer service issues, compliance issues, examination issues, and tax administration issues.

Taxpayer Advocate Management Information System List

The identification of the most serious problems reflects not only the mandates of Congress and the IRC, but TAS's integrated approach to advocacy – using individual cases as a means for detecting trends and identifying systemic problems in IRS policy and procedures or the Code. TAS tracks individual taxpayer cases on the TAMIS. The top 25 case issues, which are listed in Appendix 1, reflect TAMIS receipts based on taxpayer contacts in fiscal year (FY) 2008, a period spanning October 1, 2007 through September 30, 2008.

IRS Responses

TAS provides the IRS's respective 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.

Use of Examples

The examples presented in this report illustrate issues raised in cases handled by the TAS. To comply with IRC § 6103, which generally requires the IRS to keep taxpayers' returns and return information confidential, the details of the fact patterns have been changed.

MSP #1

The Complexity of the Tax Code

Definition of Problem

The most serious problem facing taxpayers is the complexity of the Internal Revenue Code.

Analysis of Problem

The largest source of compliance burdens for taxpayers – and the IRS – is the overwhelming complexity of the tax code.[1] The only meaningful way to reduce these burdens is to simplify the tax code enormously.

Consider the following:

- According to a TAS analysis of IRS data, U.S. taxpayers and businesses spend about 7.6 billion hours a year complying with the filing requirements of the Internal Revenue Code.[2] And that figure does not even include the millions of additional hours that taxpayers must spend when they are required to respond to an IRS notice or an audit. (For a breakdown of hours by tax form and information reporting document, see Table 1.1.1 at the end of this section.)
- If tax compliance were an industry, it would be one of the largest in the United States. To consume 7.6 billion hours, the "tax industry" requires the equivalent of 3.8 million full-time workers.[3]
- Compliance costs are huge both in absolute terms and relative to the amount of tax revenue collected. Based on Bureau of Labor Statistics (BLS) data on the hourly cost of an employee, TAS estimates that the costs of complying with the individual and

1 This report focuses on the impact of tax complexity on taxpayers. It should be noted that tax complexity also places a significant burden on the IRS as the tax administrator.

2 The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed in tax year 2006 by the average amount of time the IRS estimated it took to complete the form. While the IRS data is the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. TAS cannot determine the margin of error of existing estimates. Apart from the inherent imprecision of measuring time burdens for the "average" taxpayer, this TAS estimate may be low because it does not take into account all forms and it does not include the amount of time taxpayers spend responding to post-filing notices, examinations, or collection actions. Conversely, the TAS estimate may be high because IRS time estimates have not necessarily kept pace fully with technology improvements that allow a wider range of processing activities to be completed via automation. The TAS estimate includes both the time individual and business taxpayers spend filling out their tax returns and the time businesses spend generating information reporting documents like Forms W-2 and Forms 1099. Other published estimates generally have not included the time spent generating information reporting documents.

3 This calculation assumes each employee works 2,000 hours per year (*i.e.*, 50 weeks, with two weeks off for vacation, at 40 hours per week).

corporate income tax requirements in 2006 amounted to $193 billion – or a staggering 14 percent of aggregate income tax receipts.[4]

- Since the beginning of 2001, there have been more than 3,250 changes to the tax code, an average of more than one a day, including more than 500 changes in 2008 alone.[5]
- The Code has grown so long that it has become challenging even to figure out how long it is. A search of the Code conducted in the course of preparing this report turned up 3.7 million words.[6] A 2001 study published by the Joint Committee on Taxation put the number of words in the Code at that time at 1,395,000.[7] A 2005 report by a tax research organization put the number of words at 2.1 million, and notably, found that the number of words in the Code has *more than tripled* since 1975.[8]
- Tax regulations, which are issued by the Treasury Department to provide guidance on the meaning of the Internal Revenue Code, now stand about a foot tall.[9] The CCH Standard Federal Tax Reporter, a leading publication for tax professionals that summarizes administrative guidance and judicial decisions issued under each section of the Code, now comprises 25 volumes and takes up nine feet of shelf space.[10] Two companies publish newsletters *daily* that report on new developments in the field of

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4 The IRS and several outside analysts have attempted to quantify the costs of compliance. For an overview of previous studies, see Government Accountability Office (GAO), GAO-05-878, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System* (Aug. 2005). There is no clearly correct methodology, and the results of these studies vary. All monetize the amount of time that taxpayers and their preparers spend complying with the Code. The TAS estimate of the cost of complying with individual and corporate income tax requirements (and thus excluding the time spent complying with employment, estate and gift, and excise tax requirements) was made by multiplying the total number of such hours (7.0 billion) by the average hourly cost of a civilian employee ($27.54), as reported by the BLS. *See* BLS, U.S. Department of Labor, *Employer Costs for Employee Compensation – December 2006*, USDL: 07-0453 (Mar. 29, 2007) (including wages and benefits), *at* http://www.bls.gov/news.release/archives/ecec_03292007.pdf. The TAS estimate of compliance costs as a percentage of total income tax receipts for 2006 was made by dividing the income tax compliance cost as computed above ($193 billion) by total 2006 income tax receipts ($1.4 trillion). See Office of Management and Budget, Budget of the United States Government - Fiscal Year 2009, Historical Tables, Table 2-1. TAS's estimate that compliance costs amount to about 14 percent of aggregate income tax receipts falls within the range of previous estimates. For example, Professor Joel Slemrod has computed that compliance costs constitute about 13 percent of income tax receipts, while the Tax Foundation has computed that compliance costs constitute about 22 percent of income tax receipts. *See* Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Joel Slemrod, Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, University of Michigan Stephen M. Ross School of Business), *at* http://www.taxreformpanel.gov/meetings/meeting-03032005.shtml; J. Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), *at* http://www.taxfoundation.org/research/show/1281.html.

5 Unpublished CCH data provided to TAS.

6 To determine the number of words in the Internal Revenue Code, a librarian in the IRS Office of Chief Counsel downloaded a zipped file of Title 26 of the U.S. Code (*i.e.*, the Internal Revenue Code) from the website of the U.S. House of Representatives at http://uscode.house.gov/download/title_26.shtml. She unzipped the file, copied it into Microsoft Word, and used the "word count" feature to compute the number of words. The version of Title 26 she used was dated Jan. 3, 2007, so the count does not reflect legislation passed during the 110th Congress. The Code contains certain information, such as a description of amendments that have been adopted, effective dates, cross references, and captions, that do not have the effect of law. It is possible that other attempts to determine the length of the Code have attempted to exclude some or all of these components, but there is no clearly correct methodology to use, and there is no easy way to selectively delete information from a document of this length.

7 *See* Staff of the Joint Committee on Taxation, 107th Cong., 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), at 4 (Comm. Print 2001).

8 J. Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), *at* http://www.taxfoundation.org/research/show/1281.html.

9 *See* CCH Income Tax Regulations (which runs 11,700 pages in six volumes) or RIA Federal Tax Regulations (which runs five volumes).

10 CCH Standard Federal Tax Reporter (2008).

taxation; the print editions often run 50-100 pages and the electronic databases contain substantially more detailed information.[11]

- The complexity of the Code leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them either to overpay their tax or to become subject to IRS enforcement action for mistaken underpayments of tax. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities.
- Individual taxpayers find the return preparation process so overwhelming that more than 80 percent pay transaction fees to help them file their returns. About 60 percent[12] pay preparers to do the job,[13] and another 22 percent purchase tax software to help them perform the calculations themselves.[14]
- The Code contains no comprehensive Taxpayer Bill of Rights that explicitly and transparently sets out taxpayer rights and obligations.[15] Taxpayers do have rights, but they are scattered throughout the Code and the Internal Revenue Manual and are neither easily accessible nor written in plain language that most taxpayers can understand.[16]

The Office of the Taxpayer Advocate sees dozens of examples of the impact of tax law complexity each year. Here are some key illustrations:

- ***Excessive Number of Education and Retirement Savings Incentives.*** The Code currently contains at least 11 incentives to encourage taxpayers to save for and spend on education; the eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to

11 These publications are *Highlights & Documents* (published by Tax Analysts) and the *Daily Tax Report* (published by BNA). According to the Federal Editor in Chief of Tax Analysts, *Tax Notes Today* (the electronic publication that serves as the main source for stories in *Highlights & Documents*) contains an average of 50-70 items a day.

12 Among unincorporated business taxpayers, about 74 percent use preparers. IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

13 In Tax Year 2007, about 62 percent of returns were prepared by preparers. IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2007). To compute the percentage prepared for a fee, we subtracted the number of returns prepared by Volunteer Income Tax Assistance (VITA) sites.

14 The number of individual taxpayers who purchase tax software was computed by starting with the number of On-Line File and Self V-Code returns (33.2 million), subtracting the number of Free File returns (3.9 million), and dividing the result (29.3 million) by the total number of returns (134.4 million). IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008); 2007 Free File Weekly Snapshot Report Week 40. This data relates to Tax Year 2006.

15 Congress has enacted several pieces of legislation that bear the title, "Taxpayer Bill of Rights," but those pieces of legislation contain discrete provisions rather than an overarching list of core rights. *See* Technical and Miscellaneous Revenue Act, Pub. L. No. 100-647 (1988) (containing the Omnibus Taxpayer Bill of Rights, also known as "TBOR 1"); Taxpayer Bill of Rights 2, Pub. L. No. 104-168 (1996) (also known as "TBOR 2"); and Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206 (1998) (containing the Taxpayer Bill of Rights 3, also known as "TBOR 3").

16 The National Taxpayer Advocate has previously recommended that Congress enact a Taxpayer Bill of Rights that sets out taxpayer rights and obligations. *See* National Taxpayer Advocate 2007 Annual Report to Congress 478–89 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis "Apology" Payments*).

provision.[17] The Code also contains at least 16 incentives to encourage taxpayers to save for retirement; these incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability.[18] Taxpayers wishing to choose the optimal vehicle to save for college must know the difference between a Section 529 plan, a Coverdell Education Savings Account, and the Hope and Lifetime Learning Credits, among other alternatives. Taxpayers wishing to choose the optimal plan in which to save for retirement must know the difference between a traditional IRA, a Roth IRA, a Section 401(k) plan, a Section 403(b) plan, and a SARSEP, among others.

The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. But taxpayers can only respond to incentives if they know they exist and understand them. Choice is good, but too much choice is overwhelming. It is not reasonable to expect the average taxpayer to learn the details of at least 27 education and retirement incentives to determine which ones provide the best fit.[19]

- ***The Alternative Minimum Tax (AMT).*** The AMT concept, originally enacted in response to a report that 155 high-income taxpayers had paid no tax for the 1966 tax year,[20] now effectively requires taxpayers to compute their taxes twice – once under the regular rules and again under the AMT regime – and then to pay the higher of the two amounts.[21] The AMT was originally conceived to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions. However, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed, and it is now estimated that about 77 percent of the additional income subject to tax under the AMT is attributable simply to family

17 Tax benefits for past educational expenses include the deduction for interest on education loans in IRC § 221 and an income exclusion for the cancellation of student loan debt in IRC § 108(f). Tax incentives for current expenses include the Hope and Lifetime Learning Credits in IRC § 25A, the above-the-line deduction for qualified tuition and related deductions in IRC § 222, the income exclusion for qualified scholarships in IRC § 117, and the income exclusion for employer education assistance programs in IRC § 127. Tax incentives for future education expenses include the exclusion of interest income from U.S. Savings Bonds used to pay education tuition and fees in IRC § 135, the income exclusion for early distributions to pay qualified higher education expenses from Roth IRAs in IRC § 408A, Qualified Tuition Programs in IRC § 529, and Coverdell Education Savings Accounts in IRC § 530.

18 Types of retirement plans available under the Internal Revenue Code include traditional IRAs, nondeductible IRAs, nonworking spousal IRAs, Roth IRAs, rollover IRAs, Savings Incentive Match Plan for Employees (SIMPLE) IRAs, IRC § 401(k) plans, profit-sharing plans, money purchase plans, employer-funded defined benefit plans for private employers, Simplified Employee Pensions (SEPs), Salary Reduction Simplified Employee Pension Plans (SARSEPs), SIMPLE 401(k) plans used by small employers, IRC § 403(b) tax-sheltered annuity plans for IRC § 501(c)(3) organizations and public schools, IRC § 414(d) governmental plans, and IRC § 457(b) deferred compensation plans for state and local governments.

19 This report contains legislative recommendations to streamline the multitude of education and retirement incentives. *See* Legislative Recommendation, *Simplify and Streamline Education Tax Incentives*, and Legislative Recommendation, *Simplify and Streamline Retirement Savings Tax Incentives*, *infra.* For more detailed recommendations proposed in a prior report, see National Taxpayer Advocate 2004 Annual Report to Congress 403-22 (Key Legislative Recommendation, *Simplification of Provisions to Encourage Education*) and National Taxpayer Advocate 2004 Annual Report to Congress 423-32 (Key Legislative Recommendation, *Simplification of Provisions to Encourage Retirement Savings*).

20 Congress acted after learning 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 forerunner of the AMT was an "add-on" minimum tax enacted in 1969.

21 The AMT rules are contained in IRC §§ 55-59.

size or residing in a high-tax state.[22] Few people think of having children or living in a high-tax state as a tax avoidance maneuver, but under the unique logic of the AMT, that is how those actions are treated. Yet government has become so dependent on AMT revenue that Congress to date has been unwilling to make permanent changes in law to curtail the AMT, and it is not likely that such changes will be made outside the context of major tax reform.[23]

- ***Tax Consequences of Mortgage Foreclosures and Canceled Debts.*** Most financially distressed individuals who lose their homes to foreclosure or cannot pay off their car loans, credit card balances, student loans, or medical bills probably do not realize that their delinquency may increase their tax liabilities, but it often does. If a creditor writes off a debt, the tax code generally treats the amount of the canceled debt as taxable income to the debtor.[24] Congress has carved out a number of exclusions, including a recently enacted exclusion to help homeowners whose mortgage debts are canceled when their houses are foreclosed upon and sold.[25] However, taxpayers do not receive the benefit of these exclusions automatically. A taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to claim an exclusion. Form 982 is extremely complex, and very few taxpayers or preparers are familiar with it. The IRS estimates that it takes business taxpayers ten hours and 43 minutes to complete the form,[26] and the form is not included in many tax software packages available to taxpayers.

  IRS data shows that approximately two million Forms 1099-C, *Cancellation of Debt*, are issued to taxpayers each year reporting canceled debts.[27] The National Taxpayer Advocate estimates that tens of thousands and possibly hundreds of thousands of taxpayers who qualify to exclude canceled debts from gross income

22 *See* Tax Policy Center, *Tax Facts: AMT Preference Items 2002, 2004-2006* (citing unpublished tabulations from the Office of Tax Analysis, Department of the Treasury), *at* http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt_preference.pdf. With respect to personal exemptions, the AMT disallows the personal exemptions that are allowed under the regular tax rules to reflect the additional costs of maintaining a household and raising a family. With respect to state and local taxes, 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.

23 This report contains a legislative recommendation to repeal the AMT. *See* Legislative Recommendation, *Repeal the Alternative Minimum Tax for Individuals, infra.* The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony. *See* National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem, *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-85 (Key Legislative Recommendation, *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem, *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-77 (Key Legislative Recommendation, *Alternative Minimum Tax for Individuals*); *see also Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (Mar. 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *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* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

24 IRC § 61(a)(12).

25 IRC § 108(a)(1).

26 The IRS does not provide a separate estimate of the amount of time individual taxpayers spend completing Form 982.

27 IRS Document 6961, Table 2 (showing that the IRS expects to receive about 1.9 million Forms 1099-C in 2008 and about 2.1 million Forms 1099-C in 2009).

do not file Form 982 to claim allowable exclusions.[28] Instead, some of these taxpayers unnecessarily include the amount of the canceled debt in gross income, and other taxpayers who fail to include it unnecessarily face IRS examinations and tax assessments.[29]

- ***Earned Income Tax Credit (EITC) Complexity.*** About 22 million low income taxpayers claim the EITC each year.[30] The eligibility requirements and computations are complex, yet EITC recipients are relatively less able to understand complex rules and less likely to speak English as their primary language, creating a recipe for confusion.[31] EITC complexity leads to improper claims by taxpayers – some intentional but many inadvertent – and to improper denials by the IRS. A 2004 TAS study surveyed cases in which the IRS denied an EITC claim on audit but the taxpayer asked the IRS to reconsider its findings. Despite the initial IRS denials, the study found that taxpayers ultimately obtained some or all of the EITC amount they had claimed on their returns in 43 percent of the cases (and they received, on average, 94 percent of the amount they had originally claimed).[32]

  Another window into EITC complexity: One might expect that low income taxpayers would be less likely to need return preparers because their sources of income are often limited to wages and perhaps interest income, yet 72.5 percent of taxpayers who claim the EITC use tax preparers.[33]

- ***Proliferating Tax Sunsets.*** The tax code contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Although most such benefits are periodically renewed, some are not. For example, the AMT patch and the deductions for state and local taxes and for tuition and fees paid to a post-secondary institution are generally renewed for one or two years at a time, but the extensions are not guaranteed and the amount of the AMT patch is generally changed with each renewal. If taxpayers do not know whether

28 This report identifies the tax treatment of canceled debts as one of the most serious problems facing taxpayers and contains a legislative recommendation designed to ensure that more taxpayers who are entitled to exclusions are able to obtain them. *See* Most Serious Problem, *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income*, and Legislative Recommendation, *Simplify the Tax Treatment of Cancellation of Debt Income, infra.* The National Taxpayer Advocate also identified the tax treatment of canceled debts as a serious problem in her 2007 report. *See* National Taxpayer Advocate 2007 Annual Report to Congress 13-34 (Most Serious Problem, *Tax Consequences of Cancellation of Debt Income*).

29 The IRS receives Forms 1099-C, *Cancellation of Debt*, from lenders reporting the amount of each canceled debt. The IRS document-matching program compares each Form 1099-C it receives against the tax return of the taxpayer with the same taxpayer identification number. If a canceled debt is reported to the IRS on Form 1099-C and the amount is not reported on the taxpayer's return, the discrepancy will be flagged and the taxpayer may face IRS examination and tax assessment.

30 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

31 This report contains a recommendation to restructure and simplify the family status provisions in the Code, including the EITC. *See* Legislative Recommendation, *Simplify the Family Status Provisions, infra*. For a previous recommendation to simplify the family status provisions in the Internal Revenue Code, see National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Key Legislative Recommendation, *Tax Reform for Families: A Common Sense Approach*).

32 National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2 (Research Report, *Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

33 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

a tax benefit will remain in the Code, the incentive is less likely to influence their decision-making, thereby undermining its purpose. The uncertainty associated with an expiring tax benefit also makes it difficult for taxpayers to estimate their tax liabilities and pay the correct amount of estimated tax, potentially subjecting them to penalties and causing disillusionment with the tax system.[34]

- ***Phase-out Complexity.*** More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits. A common phase-out relates to the deduction allowed for personal exemptions. For example, a married couple with two minor children is generally allowed to claim four personal exemptions if they file a joint return, with each deduction worth $3,500 ($14,000 in the aggregate) in tax year 2008.[35] If the family's adjusted gross income (AGI) exceeds a certain threshold, however, the exemption amount is phased out at a rate of two percentage points for each additional $2,500 (or fraction thereof) of income. Thus, under permanent law, the benefits of the personal exemptions would fully phase out over a $125,000 income range. But under a temporary provision that will sunset after 2009, the phase-out is capped at one-third of the exemption amount. Thus, the phase-out may not reduce the exemption amount below $2,333 per family member ($9,332 in the aggregate).[36] This computation is not obvious to the average taxpayer, and as noted, there are about 100 phase-outs that operate in this manner. Like tax sunsets, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. However, phase-outs add substantial complexity and create marginal "rate bubbles" – income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer. This inequity is largely hidden by the complexity of the phase-out calculations.[37]
- ***Unclaimed Telephone Excise Tax Refunds.*** In 2006, taxpayers were permitted to claim a one-time tax credit for telephone excise taxes that the government concluded it had improperly collected in the past.[38] The amount of the credit ranged from $30 to $60, depending on the number of personal exemptions the taxpayer was entitled to claim on the return.[39] No substantiation was required unless a taxpayer claimed a larger amount, so this credit was essentially free money. Yet IRS data show that 28 percent of eligible taxpayers (37 million out of 133.2 million) did not claim the credit.[40] The only

34 This report contains a legislative recommendation to reduce the procedural incentives for Congress to enact tax sunsets. *See* Legislative Recommendation, *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets, infra.*

35 IRC § 151(d).

36 *See* IRS Form 1040 Instructions at 36 (2008).

37 This report contains a legislative recommendation to reduce the number of phase-outs in the Internal Revenue Code. *See* Legislative Recommendation, *Eliminate (or Simplify) Phase-Outs, infra.* To the extent that phase-outs are intended to increase the tax burden on higher income taxpayers, the same result can be achieved by adjusting the marginal tax rates, a more straightforward approach that is simpler and avoids the problem of marginal rate bubbles.

38 *See* IRS Notice 2006-50, 2006-1 C.B. 1141. Unlike the other examples cited in this section, the telephone excise tax refunds were authorized by the Department of the Treasury and did not involve congressional action.

39 IRS News Release, *IRS Announces Standard Amounts for Telephone Tax Refunds*, IR-2006-137 (Aug. 31, 2006).

40 IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008).

plausible explanation is that taxpayers missed the credit because of the complexity of the law and the tax forms.[41]

- ***Burgeoning Penalties.*** The number of civil penalties in the Code has grown from about 14 in 1954 to approximately 130 today.[42] Penalties should be designed to enhance voluntary tax compliance, but they also should be reasonable and can only influence future taxpayer behavior if taxpayers are aware that the penalties exist. As a consequence of "penalty creep," some penalties are obscure or unduly harsh. For example, Section 6707A of the Code, which was enacted in 2004 to combat tax shelters, imposes a minimum penalty of $100,000 per individual per year and $200,000 per entity per year for a failure to disclose a "listed transaction."[43] The penalty reflects strict liability – the IRS must impose the penalty even if the taxpayer derived little or no tax benefit, even if the taxpayer had no reason to know the transaction was questionable, and even if the transaction was not "listed" until years after the taxpayer's return was filed and the transaction was complete. Taxpayers cannot challenge this penalty in court. As a result, an individual who does business as an S corporation and who entered into a transaction that he did not know was listed and that provided little or no tax savings would face an automatic $300,000 penalty per year. In addition, the usual three-year statute of limitations on tax assessments does not apply in the case of listed transactions,[44] so if the taxpayer entered into a listed transaction that was reflected on his return for ten years, he would face an automatic $3 million penalty overall. TAS has about 40 cases in its inventory involving non-rescindable Section 6707A penalties,[45] and we understand the IRS is considering this penalty in hundreds of additional cases. If Congress does not change the law quickly, this penalty may bankrupt middle-class families that had no intention of entering into a tax shelter.[46]
- ***Small Business Burdens.*** Small business taxpayers face a particularly bewildering array of laws, including a patchwork set of rules that governs the depreciation of equipment, numerous and overlapping filing requirements for employment taxes, and a vague set of factors that govern the classification of workers as either employees or independent contractors and that can keep businesses and the IRS battling each other for years with no obvious "correct" answer.[47]

41 One might assume that tax preparers would know about the credit. Yet IRS data show that 16 percent of practitioner-prepared returns failed to claim the credit as well. IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008).

42 This estimate excludes criminal penalties and certain excise tax penalties. For a list of penalties and additional information about how the list was compiled, see *A Framework for Reforming the Penalty Regime*, in volume 2 of this report.

43 IRC § 6707A.

44 IRC § 6501(c)(10).

45 TAS, Taxpayer Advocate Management Information System (keyword and history search performed in December 2008).

46 This report contains a legislative recommendation to modify IRC § 6707A to mitigate the harsh results the penalty can produce. *See* Legislative Recommendation, *Modify Internal Revenue Code § 6707A to Ameliorate Unconscionable Impact, infra.* This report also contains a comprehensive set of recommendations to simplify the penalty provisions of the Code overall. *See* Legislative Recommendation, *Reforming the Penalty Regime, infra*, and an accompanying study, *A Framework for Reforming the Penalty Regime*, in volume 2 of this report.

47 This report contains a legislative recommendation to simplify worker classification determinations. *See* Legislative Recommendation, *Worker Classification, infra.* In addition, the National Taxpayer Advocate previously proposed a package of legislative recommendations designed reduce the tax burdens on small business. *See* National Taxpayer Advocate 2004 Annual Report to Congress 386-402 (Key Legislative Recommendation, *Small Business Burdens*).

Recommendation

The National Taxpayer Advocate recommends that Congress substantially simplify the Internal Revenue Code.

America's taxpayers deserve a simpler and less burdensome tax system that enables them to comply with their tax obligations expeditiously – not one that requires them to spend 7.6 billion hours filing their returns every year, thereby consuming the equivalent of 3.8 million full-time workers. Taxpayers deserve a tax system that enables them to prepare their returns cheaply – not one that requires them to pay practitioners for help, as nearly 61 percent of individual taxpayers and 74 percent of unincorporated business taxpayers do today. Taxpayers deserve more clarity about their rights and obligations under the tax code in the form of a Taxpayer Bill of Rights. Taxpayers deserve a tax system that enables them to make wise choices about education and retirement savings – without having to wade through the details of at least 27 tax-favored alternatives. Taxpayers deserve a tax system that enables them to compute their tax liabilities fairly and transparently – not one that effectively requires them to compute their tax liability under two sets of rules (the regular rules and the AMT rules) and often to pay more tax under the AMT regime simply because they engaged in the "tax-avoidance behavior" of having children or living in a high-tax state.

Taxpayers deserve better than a tax system so complex that honest taxpayers often overpay while sophisticated taxpayers often find loopholes, and so complex that 37 million taxpayers could fail to claim a tax credit because they did not know it was available. Taxpayers deserve better than a tax system that gives financially distressed taxpayers a tax break when they default on their mortgage or other consumer debts and the debts are cancelled – but then makes claiming the tax break so burdensome that many and probably most eligible taxpayers do not claim it. Low income taxpayers deserve a simpler set of rules by which determine EITC eligibility.

Taxpayers deserve certainty about which provisions will remain in the tax code so they can plan accordingly – without having to regularly grapple with uncertainty because more than 100 provisions sunset regularly and may or may not be renewed or modified. Taxpayers deserve to understand exactly how their tax liabilities are computed – not provisions like phase-outs, which make the computations seem impenetrable and subject lower income taxpayers to higher marginal tax rates than upper income taxpayers. Taxpayers deserve simplicity and proportionality in the penalty rules; it is not reasonable that a taxpayer who claims minimal or even no tax savings may face a mandatory, non-waivable $300,000 penalty per year for failing to file a disclosure form that he may not even know he is required to file.

These are a few aspects of a system that requires pervasive reform. The good news is that there is widespread agreement on the need for tax simplification. The National Taxpayer Advocate has previously identified the complexity of the tax code as the most serious

problem facing taxpayers,[48] members of Congress regularly complain about the complexity of the Code, and in 2005, an advisory panel created by President Bush to study the federal tax system delivered a detailed report with substantive recommendations.[49] The bad news is that despite widespread agreement on the need for tax simplification, there has not yet been sustained action to make it happen.

To assist the Congress in pursuing tax simplification, we offer a number of proposals in the Legislative Recommendations section of this report, including recommendations to streamline the education and retirement savings incentives, repeal the AMT, allow taxpayers to exclude modest amounts of canceled debts from income without filing Form 982, simplify the family status provisions of the Code, reduce tax sunset and phase-out provisions, and revise the penalty structure.

The National Taxpayer Advocate continues to view tax simplification as essential and urges the new administration and the new Congress to make it a priority. In doing so, she recommends that emphasis be given to six core principles:

1. The tax system should not "entrap" taxpayers.
2. The tax laws should be simple enough so that most taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistors can fully and accurately answer taxpayers' questions.
3. The tax laws should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.
4. The tax laws should provide some choices, but not too many choices.
5. Where the tax laws provide for refundable credits, they should be designed in a way that is administrable; and
6. The tax system should incorporate a periodic review of the tax code – in short, a sanity check.[50]

48 *See* National Taxpayer Advocate 2004 Annual Report to Congress 2-7 (Most Serious Problem, *The Confounding Complexity of the Tax Code*).

49 Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005), *at* www.taxreformpanel.gov.

50 The National Taxpayer Advocate previously articulated these principles in a presentation to the President's Advisory Panel on Federal Tax Reform. *See* Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate), *at* http://www.taxreformpanel.gov/meetings/meeting-03032005.shtml. For more detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-80 (Key Legislative Recommendation, *A Taxpayer-Centric Approach to Tax Reform*).

TABLE 1.1.1, Hours Required to Prepare Tax Returns and Information Reporting Documents

Type of Return	Number (in millions)	Average Total Hours/Minutes	Total Hours (in millions)
Tax Returns			
Individual Income Tax (1040)	134.6	26.40	3,553.44
Estate and Trust Income Tax (1041)	3.6	116.27	418.56
Estate and Trust Est'd Tax (1041-ES)	0.7	3.28	2.30
Partnerships (1065)	3.0	126.75	380.25
Electing Large Partnerships (1065-B)	0.0001	113.95	0.01
S Corporations (1120S)	3.9	145.97	569.27
Corporations (1120)	1.8	193.77	348.78
1066	0.03	54.25	1.63
1120-A	0.2	115.08	23.02
1120-C	0.001	107.60	0.11
1120-F	0.02	222.45	4.45
1120-FSC	0.006	152.90	0.92
1120-H	0.2	32.62	6.52
1120-L	0.001	178.20	0.18
1120-PC	0.006	212.33	1.27
1120-POL	0.005	36.62	0.18
1120-REIT	0.01	130.37	1.30
1120-RIC	0.009	118.15	1.06
Estate Tax (706)	0.5	7.75	3.88
Gift Tax (709)	0.2	5.77	1.15
Employment Tax (940 series)	6.0	37.32	223.92
Employment Tax (941 series)	24.0	15.40	369.60
Tax-Exempt Organizations (990)	0.4	152.33	60.93
Excise Tax (720) (data from 10/2008)	0.1	28.67	2.87
Form 1040X (data from 11/07/2006)	3.7	3.50	12.95
Tax Returns Subtotal			**5,988.56**

Information Reporting	Number (in millions)	Average Total Hours/Minutes	Total Hours (in millions)
W-2	243.3	0.50	121.65
K-1 (1041)	3.5	12.47	43.63
K-1 (1065)	17.8	45.87	816.49
K-1 (1120S)	6.7	42.03	281.62
1096	5.6	0.22	1.21
1098	105.2	0.12	12.27
1098-C	0.2	0.25	0.05
1098-E	18.2	0.12	2.12
1098-T	24.2	0.22	5.24
1099-A	0.5	0.15	0.08
1099-B	538.1	0.33	179.37
1099-C	1.7	0.17	0.28
1099-CAP	0.002	0.18	0.00
1099-DIV	103	0.30	30.90
1099-G	72.7	0.18	13.33
1099-H	0.02	0.30	0.01
1099-INT	231.7	0.22	50.20
1099-LTC	0.2	0.22	0.04
1099-MISC	83.5	0.27	22.27
1099-OID	4.1	0.20	0.82
1099-PATR	1.6	0.25	0.40
1099-Q	1.0	0.18	0.18
1099-R	76.3	0.30	22.89
1099-S	4.2	0.13	0.56
1099-SA	1.0	0.13	0.13
5498	108.5	0.20	21.70
5498-ESA	0.8	0.12	0.09
5498-SA	1.4	0.17	0.23
W2-G	9.7	0.30	2.91
Information Returns Subtotal			**1,630.69**
Grand Total			**7,619.25**

Except as noted, all data is for Tax Year 2006. Sources: IRS Form Instructions for Tax Year 2006; IRS Fiscal Year 2007 Data Book; Document 6961 (Calendar Year 2007 Projections); Document 6149 (Calendar Year 2007 Projections); and Document 6186 (Calendar Year 2007 Projections).

MSP #2

The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties

Responsible Officials

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

Definition of Problem

For the last eight years, the National Taxpayer Advocate has criticized the IRS for its continuing failure to fully and properly utilize alternatives to collection enforcement actions.[1] In light of the recent downturn in the United States economy, it is imperative for the IRS to consider the circumstances of taxpayers facing economic hardship before initiating enforcement actions. In today's economic environment, taxpayers who previously were able to pay their taxes find themselves unemployed, behind on housing payments, and unable to meet their basic living expenses. Thus, the ranks of taxpayers who are unable to meet their tax obligations will swell.

The IRS is entrusted with a wide variety of powerful enforcement tools (*e.g.*, federal tax liens, levies, property seizures, suits to foreclose the federal tax lien, and summonses) to collect delinquent tax revenue. The National Taxpayer Advocate recognizes the need for appropriate enforcement action against uncooperative or evasive taxpayers. However, when the IRS too quickly initiates "hard line" enforcement, regardless of the taxpayer's level of cooperation and compliance, and without careful consideration of the facts and circumstances and the full impact of these actions, the end result will likely be undue economic hardship on the taxpayer. This might ultimately lessen the ability of the taxpayer to resolve the debt and remain in compliance with future tax obligations.

The National Taxpayer Advocate has identified the following concerns with the IRS's current collection strategy, which, if left unchecked, will create far more problems than it resolves – worsening the financial woes of many American taxpayers, while recovering

1 *See* National Taxpayer Advocate 2007 Annual Report to Congress 374-87 (Most Serious Problem, *Offers in Compromise*), 388-94 (Most Serious Problem, *Inadequate Training and Communication Regarding Effective Tax Administration Offers*), 432-47 (Status Update, *IRS Collection Strategy*); National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem, *Early Intervention in IRS Collection Cases*), 83-109 (Most Serious Problem, *IRS Collection Payment Alternatives*), 507-19 (Key Legislative Recommendation, *Improve Offer in Compromise Program Accessibility*); National Taxpayer Advocate 2005 Annual Report to Congress 270-91 (Most Serious Problem, *Allowable Living Standards for Collection Decisions*); National Taxpayer Advocate 2004 Annual Report to Congress 226-45 (Most Serious Problem, *IRS Collection Strategy*), 311-41 (Most Serious Problem, *Offers in Compromise*), 433-50 (Key Legislative Recommendation, *Offers in Compromise: Effective Tax Administration*); National Taxpayer Advocate 2003 Annual Report to Congress 99-112 (Most Serious Problem, *Offers in Compromise*); National Taxpayer Advocate 2002 Annual Report to Congress 15-24 (Most Serious Problem, *Processing of Offer in Compromise Cases*); National Taxpayer Advocate 2001 Annual Report to Congress 202-15 (Most Serious Problem, *IRS Collection Procedures*).

much less revenue than the IRS could potentially realize through more cooperative payment arrangements:

- Current IRS enforcement initiatives do not reflect a proper balance between service and enforcement;
- Increased enforcement actions such as liens and levies do not necessarily translate into increased collection revenue;[2]
- Current IRS guidance provides little direction to prevent undue economic hardship for affected taxpayers; and
- The IRS has multiple collection alternatives at its disposal, such as installment agreements (IA) and offers in compromise (OIC), but fails to properly utilize them. For example, the number of *accepted* offers has decreased by over 72 percent from fiscal year (FY) 2001 to FY 2008.[3]

Under current economic conditions, it is reasonable to expect taxpayers to experience other financial stresses, such as foreclosure on a home, unemployment, or even bankruptcy. Recent reports indicate bankruptcy filings have now increased by 29 percent from FY 2007 to FY 2008,[4] foreclosures have risen by 71 percent in the third quarter of 2008 compared to the same period in 2007,[5] and the nation's unemployment rate now stands at six percent.[6] Thus, if there was ever a time for the IRS to reevaluate its collection tactics, this would be it. An approach that balances the need for enforcement with an equal concern for customer service and taxpayer rights is more essential now than ever.

Analysis of Problem

Background

Congress Has a Long History of Emphasizing the Need for Restraint in the Use of IRS Collection Tools.

Section 6331(a) of the Internal Revenue Code (IRC) authorizes the IRS to collect taxes "by levy upon all property and rights to property" belonging to a person who "neglects or refuses to pay" any tax, and IRC § 6331(b) defines "levy" as including "the power of distraint and seizure by any means." However, over the past 30 years, Congress has enacted several

2 The number of levies issued by the IRS increased by 1,608 percent (from 220,000 to roughly 3.76 million) from FY 2000 to FY 2007. However, the increase in total collection yield during this period was only slightly less than 45 percent. Moreover, from 1998 to 2000, IRS levies *decreased* from over 2.5 million to 220,000, yet collection yield during this period actually *increased*. From FY 2001 to FY 2002, the use of IRS levies almost doubled (increased by 91 percent), yet collection yield increased by only two percent. Our analysis is based on an IRS study: IRS, Small Business/Self-Employed Division (SB/SE) Research, *"Liens, Levies, Seizures, and Total Yield: 10 Year Filing Trend,"* (Aug. 19, 2005) and then supplemented with data from various SB/SE Collection Activity Reports and Statistics of Income (SOI) Data Book information for FY 1999 to FY 2007.

3 SB/SE Collection Activity Report, *NO-5000-108* (FY 2001 - FY 2008). In FY 2001, the IRS accepted 38,643 OICs compared to 10,677 in FY 2008.

4 *See* United States Bankruptcy Court, *at* http://www.uscourts.gov/Press_Releases/2008/bankrupt_newstat_ftable_mar2008.xls (last visited Nov. 14, 2008).

5 Alan Zibel, *US Foreclosure filings up 71 percent in 3Q*, Associated Press, Nov. 6, 2008.

6 *See* United States Bureau of Labor Statistics, *at* http://www.bls.gov (last visited Nov. 14, 2008).

key pieces of legislation to properly restrain the IRS's awesome collection powers. Most recently, the IRS Restructuring and Reform Act of 1998 (RRA 98) had a profound impact on the IRS's approach to enforcement actions.[7] This important legislation placed a renewed emphasis on customer service and taxpayer rights. For example, RRA 98 significantly changed the management and oversight structure of the IRS. It also strengthened and enhanced the rights and protections applicable to taxpayers, such as:

- Establishing collection due process (CDP) hearing rights;[8]
- Requiring that the IRS receive the written approval of a U.S. District Court judge or magistrate prior to seizure of a principal residence;[9]
- Requiring an administrative review and appeal of any rejected OIC or IA;[10] and
- Realigning the IRS's method of measuring its employees' performance to encourage and achieve an even-handed approach to tax administration, particularly as it relates to enforcement activities.[11]

Over the years, the IRS has attempted to emphasize the need for an approach to administering the tax laws with proper balance between enforcement and service. IRS policies involving the collection of delinquent taxes include:

- Policy Statement P-5-1, which states, "The Service is committed to educating and assisting taxpayers who make a good faith effort to comply... In determining the appropriate enforcement action to take, factors such as the taxpayer's delinquency history should be considered. Promotion of long-term voluntary compliance is a basic goal of the Service, and in reaching this goal, the Service will be cognizant not only of taxpayers' obligations under our system of taxation but also of their rights."[12]
- Policy Statement P-5-34, which states, "The facts of a case and alternative collection methods must be thoroughly considered before determining seizure of personal or business assets is appropriate. Taxpayer rights must be respected. The taxpayer's plan to resolve past due taxes while staying current with all future taxes will be considered. Opposing considerations must be carefully weighed, and the official responsible for making the decision to seize must be satisfied that other efforts have been made to collect the delinquent taxes without seizing. Alternatives to seizure and sale may include

7 The Internal Revenue Service Reform and Restructuring Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685 (1998).

8 RRA 98 § 3401(a) adding IRC § 6320 which allows a taxpayer the right to a CDP hearing within five days after filing of the first notice of federal tax lien with respect to a tax liability; RRA 98 § 3401(b) adding IRC § 6330 which allows a taxpayer the right to a CDP hearing prior to the first levy (except in special or jeopardy situations).

9 RRA 98 § 3445(a) (amending IRC § 6334(a)(13)); RRA 98 § 3445(b) (amending IRC § 6334(e)).

10 RRA 98 § 3462(c)(1) and (c)(2) (adding IRC §§ 7122(d) and 6159(e), respectively).

11 For a more detailed discussion of IRS measures, see Most Serious Problem, *Customer Service Within Compliance, infra*.

12 Internal Revenue Manual (IRM) 1.2.14.1.1 (Aug. 18, 1994).

an installment agreement, offer in compromise, notice of levy, or lien foreclosure. Seizure action is usually the last option in the collection process."[13]

- Policy Statement P-5-2, which states, "Case resolution, including actions such as lien, levy seizure of assets, installment agreement, offer in compromise, substitute for return, summons, and IRC 6020(b), are important elements of an effective compliance program. When it is appropriate to take such actions, it should be done promptly, yet judiciously, and based on the facts of each case."[14]

Moreover, the IRS revamped its procedural guidance to require collection employees (*i.e.*, revenue officers) to determine whether a taxpayer presents a "will pay," "can't pay," or "won't pay" situation when a seizure is contemplated. The guidance further stated, "Generally, seizures should be limited to those taxpayers who represent true 'won't pay' situations."[15]

IRS Enforcement Initiatives Do Not Reflect a Proper Balance Between Service and Enforcement.

In recent years, the tone of communications from the IRS Commissioner's office began to drift from the guidance drafted after RRA 98, by focusing more on enforcement than service. As former Commissioner Mark Everson noted in a 2004 speech to the Internal Revenue Service Advisory Council (IRSAC), "The word 'enforce' is one that people didn't even like to use when I turned up here. That's not the case anymore."[16] Not surprisingly, the IRS's use of enforcement tools has significantly increased each year since the lows in the years following the implementation of RRA 98. For example,

- Levies have increased by 1,608 percent (220,000 issued in FY 2000 compared to 3,757,190 in FY 2007);[17]
- Notice of federal tax lien (NFTL) filings have increased by 308 percent (167,867 filed in FY 1999 compared to 683,659 in FY 2007);[18] and
- Seizures have increased by 320 percent (161 conducted in FY 1999 compared to 676 in FY 2007).[19]

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13 IRM 1.2.14.1.8 (2) (May 28, 1999).

14 IRM 1.2.14.1.2 (Feb. 17, 2000).

15 IRM 5.10.1.4 (Oct. 1, 2004) provides a detailed description of these three categories.

16 Heidi Glenn and Warren Rojas, *Everson Delays EITC Certification Effort, Backs Other IRSAC Ideas*, 105 Tax Notes 905 (2004).

17 SB/SE Collection Activity Reports and SOI Data Book information for FY 2000 to FY 2007. *See* National Taxpayer Advocate 2006 Annual Report to Congress 110-29. Note: For the purpose of our analysis, 2008 data was not used due to the impact of the 2008 economic stimulus payment (ESP) on IRS collection activities. The IRS was forced to shift many of its Automated Collection System (ACS) resources away from normal collection work for several months to focus on answering ESP questions.

18 Various SB/SE Collection Activity Reports and SOI Data Book information for FY 1999 to FY 2007. Note that the FY 2007 figures were 79 percent higher than the FY 1998 figures (382,755).

19 SB/SE Collection Activity Report, *Seizure Disposition Reports, NO-5000-33*, and SOI Data Book information for FY 1999 to FY 2007. While the current number of seizures represents only a small fraction of the FY 1998 total (2,259), the significant increase in recent years bears watching.

These increases reflect areas of emphasis within the IRS Collection program in recent years. For example, the Small Business/Self-Employed (SB/SE) Division's FY 2008 Collection Program Letter directed priority attention to "increase the timely pursuit and appropriate application of complex enforcement tools such as seizures, nominee liens, transferee assessments, and suits to protect the government's interest in liabilities owed."[20] Accordingly, the IRS developed and delivered specialized training to its collection employees on these subjects in FY 2007 and early FY 2008. Training sessions for employees working bankruptcy cases placed a great deal of emphasis on subjects such as pursuing collection actions against exempt, excluded, or abandoned assets at the conclusion of a Chapter 7 bankruptcy proceeding,[21] and initiating suits to enforce the federal tax lien in lieu of conducting an administrative seizure.[22]

The National Taxpayer Advocate has maintained a vigilant watch on these trends and devoted a large portion of her 2006 and 2007 Annual Reports to Congress to the IRS's collection strategy and programs.[23] In response to the issues raised and recommendations proposed in these reports, the IRS agreed to collaborate with TAS on several collection task forces. TAS and the IRS established five such working groups in February 2008 to address the IRS's application of allowable living expense (ALE) standards, collection payment alternatives (OIC and IA), the levy program, and early intervention techniques.[24] More recently, the IRS Chief of Collection agreed to collaborate with the National Taxpayer Advocate to develop training for collection employees on taxpayer rights and the proper use of collection alternatives.

While these joint task forces are a step in the right direction, the National Taxpayer Advocate has still noted an emerging trend in TAS cases involving collection issues. TAS is now seeing an IRS inclination to use enforcement very early in the case, rather than as a last resort. Local TAS offices and practitioners confirm the Collection function is more frequently requiring taxpayers to liquidate equity in assets, including personal residences and retirement accounts, to pay delinquent tax bills or the IRS will use its powerful collection

20 SB/SE, *SB/SE Collection Program Letter FY 2008*, 6.

21 U.S. Bankruptcy Code § 541(a)(1) provides that when a person files a bankruptcy petition, a bankruptcy estate is created consisting of "all legal and equitable interests of the debtor in property as of the commencement of the case," except for the interests identified in subsections (b) and (c)(2). Section 541(b) excludes from the bankruptcy estate certain types of property, including interests in Individual Retirement Accounts and Qualified Tuition Programs, more commonly known as 529 plans. Section 541(c)(2) excludes from the bankruptcy estate, property which is subject to an anti-alienation provision enforceable under applicable non-bankruptcy law. The Supreme Court in *Patterson v. Shumate*, 504 U.S. 753, 759-760 (1992) held that ERISA qualified pension plans are excluded from the bankruptcy estate under this section. Additionally, the debtor is allowed to exempt certain property from the bankruptcy estate under § 522. Further, property that is considered burdensome or of inconsequential value to the estate can be abandoned as property of the estate by the trustee. As a general rule, exempt or abandoned property cannot be used to satisfy any pre-petition debts during and after the bankruptcy case, unless the liens encumbering such property survive bankruptcy which would occur only if a prepetition notice of tax lien had been filed. U.S. Bankruptcy Code § 522(c)(2)(B). Unlike exempt or abandoned property, which was initially property of the estate, excluded property never becomes part of the bankruptcy estate. As such, excluded property can be used to satisfy prepetition debts *in rem* without regard to whether a prepetition notice of federal tax lien was filed because unlike with property of the estate, liens against excluded property cannot be avoided.

22 The government uses a suit to foreclose a tax lien where there is a specific, presently available source of collection. In a foreclosure action, the Department of Justice often requests a judgment against the taxpayer.

23 *See* National Taxpayer Advocate 2007 Annual Report to Congress 324-95, 432-47; National Taxpayer Advocate 2006 Annual Report to Congress 31-171.

24 For a detailed discussion of the five task forces, see National Taxpayer Advocate Fiscal Year 2009 Objectives Report to Congress 39-40.

tools to do so. IRS consideration of the current economy and the hardship consequences of these actions are not evident in many of these cases. We believe the dilemma facing these taxpayers is often a "false choice" - liquidate your assets or the IRS will do it for you. As a result, we have seen an increase in the need for TAS involvement and the use of Taxpayer Assistance Orders to provide relief in these situations.[25]

Increased Enforcement Actions Such as Liens or Levies Do Not Necessarily Translate Into Increased Collection Revenue.

As the nation faces a period of economic decline, with a corresponding decrease in tax revenues and an increase in the federal budget deficit, it is natural for the IRS to ramp up efforts to ensure all taxpayers pay their fair share of taxes. Intuitively, it seems to follow that a significant increase in the use of the IRS's more powerful collection tools would lead to a corresponding increase in collected revenue. Surprisingly, an analysis of data representing IRS enforcement actions and results does not support this assumption. In the years immediately following RRA 98, the use of traditional IRS collection enforcement actions fell substantially, primarily because of the need to implement the changes brought about by the new law. This decline eventually led to a perception that the IRS tax enforcement programs were underutilized and "out of balance." *Interestingly, IRS studies have shown the total Collection yield was actually higher from FY 2000 to FY 2002 (the years when, according to many sources, IRS Collection went "out of business") than in FY 1995 and FY 1996, the peak years for levies and seizures.*[26]

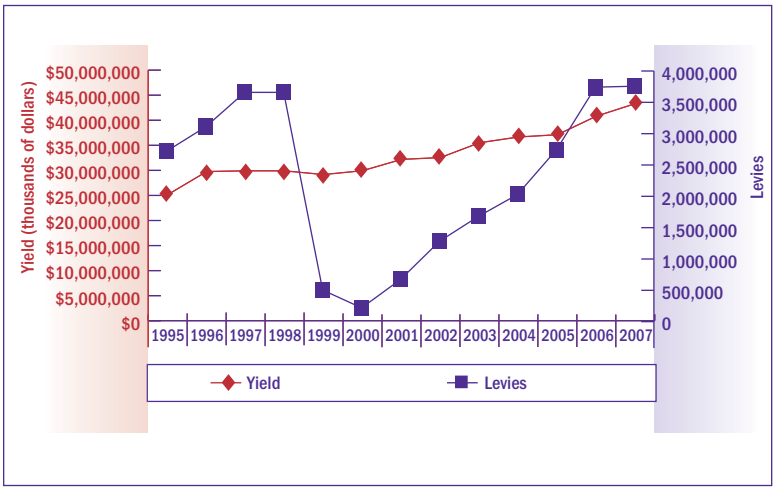
For example, the number of levies issued by the IRS increased by 1,608 percent (from 220,000 to roughly 3.76 million) from FY 2000 to FY 2007. The increase in total collection yield during this period was only about 45 percent. An analysis of this relationship on a year-to-year basis shows no direct correlation between the volume of levies issued and the corresponding collection yield. As the following chart reveals, from FY 1998 to FY 2000, IRS levies *decreased* from over 2.5 million to 220,000. Yet, collection yield during this period actually *increased!* From FY 2001 to FY 2002, the use of IRS levies almost doubled (increased by 91 percent), yet collection yield increased by only two percent. An IRS research study has concluded that although traditional enforcement actions declined substantially post-RRA 98, "total collection yield was not dramatically impacted by RRA 98," and actually increased in every year but one after RRA 98![27]

25 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 if relief is not granted. *See also* IRM 13.1.20.2 (Dec. 15, 2007). In certain circumstances, the National Taxpayer Advocate or her delegate may issue a TAO to direct the IRS to take a specific action, cease a specific action, or refrain from taking a specific action, or to direct the IRS to review at a higher level, expedite consideration of, or reconsider a taxpayer's case. IRM 13.1.20.3 (Dec. 15, 2007). In FY 2008, TAS issued 28 TAOs on collection-related matters. This accounts for slightly more than 41 percent of all TAOs issued.

26 SB/SE Research, *Liens, Levies, Seizures, and Total Yield: 10 Year Filing Trend* (Aug. 19, 2005).

27 *Id.*

CHART 1.2.1, Total Collection Yield and Levies Issued FY 1995 – FY 2007



One possible explanation for this result is that if the public perceives a more open and flexible IRS, taxpayers with collection problems might be more willing to come forward and "get right" with their government.[28] Another possible explanation is that the IRS filed liens and issued levies inappropriately – *i.e.*, in unproductive cases. It is clear that the IRS Collection operation did not actually go "out of business" during the post-RRA 98 years, but rather replaced its more traditional tools with new alternatives, including earlier intervention on employment tax cases and expanded use of streamlined IAs. While levy and seizure authority are important collection tools that allow the IRS to address serious incidents of non-compliance (*i.e.*, taxpayers who clearly "won't pay"), the data indicates that expanded use – as opposed to judicious use – of these tools does not necessarily translate into tax dollars collected. Moreover, the data indicates that reasonable collection alternatives and methods may be more effective at collecting delinquent liabilities for taxpayers having trouble in paying their tax debts.

IRS Guidance Provides Little Direction to Prevent Undue Economic Hardship on Affected Taxpayers.

TAS has reviewed the IRS procedural guidance to Collection employees that governs the nature of enforcement actions, in order to identify the degree to which an overly aggressive approach to enforcement may be facilitated, or even encouraged, by system design or emphasis. In general, we have found that the Collection portions of the Internal Revenue Manual (IRM) pertaining to enforcement actions provide little or no direction to IRS employees regarding proper pre-decisional consideration of economic hardship issues. Economic hardship is derived from IRC § 6343; however, the IRM procedures provide very

28 *See* National Taxpayer Advocate 2007 Annual Report to Congress 156-61 (Most Serious Problem, *Taxpayer Service and Behavioral Research*); National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 158-67 (*Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*).

little actual guidance about applying this concept to actual case decisions, particularly in the areas governing enforced collection. IRM 5.19.4.4.10(j) does include an adequate explanation of economic hardship, but this guidance is for consideration *after* the IRS issues a levy, not before.

Policy Statement P-5-71 states that, "A hardship exists if the levy action prevents the taxpayer from meeting necessary living expenses. In each case a determination must be made as to whether the levy would result in actual hardship, as distinguished from mere inconvenience to the taxpayer."[29] Yet, the most commonly used enforcement action — a levy of a taxpayer's salary, wages, or bank account — is predominantly issued via automation. Thus, the IRS requires little to no human intervention to make a distinction of hardship or "mere inconvenience."[30] Similarly, the IRS's Automated Collection System's (ACS) current process of systemically filing an NFTL on cases that are "shelved" or placed into the queue (regardless of whether the IRS made or initiated contact with the taxpayer), has the potential for further economic harm in today's economic times.[31] At a time when so many homes are in foreclosure, the IRS should use caution when issuing federal tax liens, which are often more damaging than bankruptcy to taxpayers' attempts to secure credit.

Bankruptcy Does Not Always Provide a "Fresh Start" for Taxpayers with IRS-Related Debts – Even When the Tax Debts Are Discharged.

It seems that obvious economic hardship is most likely in situations where IRS enforcement actions will cause the loss of a taxpayer's home or retirement assets. The loss of a home invariably will affect the ability of a typical taxpayer to meet today's necessary living expenses, and in many cases, the loss of retirement assets will have a significantly negative impact on the taxpayer's ability to meet future living expenses. Yet, consider current IRS procedures involving taxpayers who have filed for bankruptcy protection utilizing Chapter 7 of the United States Bankruptcy Code (11 USC), commonly known as a "liquidating bankruptcy." In Chapter 7 proceedings, a debtor may claim certain property as "exempt." The trustee cannot liquidate such property, nor can it be used to satisfy a debt, except in the case of alimony, security interests, non-dischargeable tax debts, and dischargeable taxes secured by an NFTL.[32] A common asset claimed as "exempt" is the debtor's home. Other types of property are considered "excluded" from the bankruptcy estate. Generally, "excluded" property involves retirement assets (*e.g.*, Employment Retirement Income Security Act (ERISA) qualified pension plans and Individual Retirement Accounts).[33] In these

29 IRM 1.2.14.1.14 (Nov. 19, 1980).

30 For a more detailed discussion of IRS levies, *see* National Taxpayer Advocate 2006 Annual Report to Congress 110-29.

31 IRM 5.19.4.5.2 (Apr. 26, 2006).

32 IRM 5.9.17.4(1) (May 16, 2008).

33 IRM 5.9.17.4(3) (May 16, 2008). *See also*, Most Serious Problem, *Customer Service Issues in the IRS's Automated Collection System (ACS), infra.*

situations, the ability of debtors to retain their homes and retirement assets are a critical component of the "fresh start" concept that is a key element of the bankruptcy process.[34]

The IRC, on the other hand, allows the IRS to pursue assets claimed as "exempt" or "excluded" in the bankruptcies, provided the prepetition tax lien encumbering those assets survived the bankruptcy even where the taxes have been discharged. Unlike exempt property where an NFTL must have been filed prepetition for a lien to survive bankruptcy, an NFTL need not be filed prepetition in order for the IRS to take collection action against excluded property, as the statutory lien under IRC § 6321 survives bankruptcy and is sufficient to allow the IRS to collect the discharged taxes from excluded property.[35]

In recent years, the IRS has placed greater emphasis in pursuing collection on cases where a prepetition federal tax lien had been filed involving tax periods that were discharged in a Chapter 7 bankruptcy, and the taxpayer claimed a home or retirement accounts as exempt or excluded assets. Once identified, the IRS mails a letter to this taxpayer requiring him or her to either pay in full the outstanding lien interest in the property, or pay an amount equal to the available equity in the asset.[36] Otherwise, the IRS may initiate enforcement action – typically a suit to foreclose on real property or a notice of levy on retirement accounts. In some situations, the IRS may forego immediate collection from exempt property and allow the NFTL to remain on file in the prospect of collecting dischargeable taxes at some future date.[37]

In reviewing IRS procedural guidance in this area, we found very little recognition that the IRS demands on these taxpayers could create an economic hardship. Yet, these taxpayers have already been found insolvent by a bankruptcy court, which certainly would indicate they might have difficulty paying their liabilities. Particularly in light of the current U.S. economy, and the substantial tightening of the credit markets, a requirement for taxpayers to turn over to the IRS an amount equal to the equity in their homes is essentially requiring them to sell their homes in a deflated, stalled market.

We have found no evidence that SB/SE has established management controls to monitor the number of these demand letters or the volume and nature of enforcement actions initiated in these types of insolvency cases. Nor could we obtain reliable data on the number of suit to foreclose recommendations that Collection employees have made in these situations.[38] We have seen firsthand in TAS casework the serious economic harm these actions can create for taxpayers because of these suit recommendations. Consequently, we

34 11 USC § 522. Federal bankruptcy law embraces the entire field of debtor-creditor relationships to provide a uniform and equitable method to distribute the debtor's assets to the debtor's creditors. At the same time, it gives the debtor an opportunity to start over with a clean (or at least improved) financial slate.

35 IRC § 6321. A federal tax lien is created by statute and attaches to a taxpayer's property and rights to property for the amount of the liability. This is known as the "statutory" or "secret" federal tax lien.

36 IRM 5.9.17.4.1(9) (May 16, 2008).

37 IRM 5.9.17.4.2(3) (May 16, 2008).

38 SB/SE response to TAS research request (Oct. 27, 2008).

are very concerned that the increase of enforcement activity in this area, without adequate safeguards and controls or guidance to employees to fully consider the economic harm to taxpayers, may very well create negative consequences for many taxpayers who were seeking a "fresh start" through the insolvency process.

IRS Guidance Lacks Distinction as to What Constitutes a "Won't Pay" Taxpayer.

Another area in which IRS guidance fails to recognize the effects of the current economic environment is its consideration of whether a taxpayer is a "won't pay" or a "can't pay." Presently, only one IRM section contains any reference to the differing characteristics of such taxpayers.[39] Examples of "won't pay" taxpayers include:

- Taxpayers who have the ability to remain current and resolve their delinquent taxes through an alternative collection method but will not do so;
- Taxpayers who do not have the ability to remain current and resolve their liabilities, but have assets in excess of exempt amounts that will yield net proceeds to apply to the liabilities and are unwilling or unable to borrow on or liquidate these assets; and
- Taxpayers who will not cooperate with the IRS (*e.g.*, those that evade contact or withhold financial information).

Unwillingness and evasiveness are legitimate reasons to designate a taxpayer as a "won't pay." However, his or her inability to borrow is not a proper indicator, especially in today's tough lending market. Yet, under current IRS procedures, even if a taxpayer is cooperative, in compliance with current filing and payment requirements, and is making a good faith effort to resolve his or her tax liability but simply cannot quite meet all of the IRS's demands, he or she will be labeled as a "won't pay." By our account, the taxpayer "wants" to comply but "can't." Clearly, there is a significant difference between the two. It is imperative for the IRS to adapt its policies to properly reflect that enforced collection actions should only be taken where unwillingness and a lack of cooperation are present.

Moreover, in many situations where taxpayers have met our three criteria (cooperation, current compliance, and good faith efforts), the IRS uses the noncompliance that led to the taxpayer's deficiencies, and other past behavior, to justify seizure or enforcement action. In general, a taxpayer's current level of cooperation and willingness to find a way to resolve the liabilities should be judged as the standard and in such instances, the IRS should explore a viable collection alternative. This is particularly true in situations where the IRS has devoted little or no effort to contacting the delinquent taxpayers in a timely manner, and has allowed the tax problems to fester – sometimes for many years.[40]

39 IRM 5.10.1.4 (Oct. 1, 2004).

40 For more detail, *see* National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem, *Early Intervention in IRS Collection Cases*).

The IRS Has Multiple Collection Alternatives at its Disposal But Fails to Use Them Properly.

Although they are not widely considered as such, IAs and OICs are in fact collection tools and not resolutions of last resort. As IRS Policy Statement P-5-2 makes clear, IAs and OICs are as useful as a lien, levy, or seizure of assets when trying to collect tax.[41] Further, Policy Statement P-5-34 provides that, "Collection enforced through seizure and sale of the assets occurs only after thorough consideration of all factors and of alternative collection methods."[42] Moreover, the statement reminds employees "the official responsible for making the decision to seize must be satisfied that other efforts have been made to collect the delinquent taxes without seizing... Seizure is usually the last option in the seizure process."[43] However, TAS cases suggest the IRS is taking the position that the taxpayer must sell all assets with equity (including personal residences) or secure financing before the IRS will consider any other collection option, which seems to be contrary to IRS policy.

For example, if a taxpayer has significant equity in assets as well as the ability to make monthly payments but cannot fully pay his or her liabilities prior to expiration of the Collection Statute Expiration Date (CSED), the IRS has several potential collection alternatives at its disposal.[44] The American Jobs Creation Act of 2004 amended IRC § 6159 to clarify that the IRS is authorized to enter into IAs that do not provide for full payment of the taxpayer's liability over the life of the agreement.[45] These agreements are known as Partial Payment Installment Agreements (PPIA). IRS guidance states that, "Before a PPIA may be granted, equity in assets must be addressed, and if appropriate, be used to make payment. In most cases taxpayers will be required to use equity in assets to pay liabilities."[46] However, the same guidance also provides that, "A PPIA may be granted if a taxpayer does not sell or cannot borrow against assets with equity because ... it would impose an economic hardship on the taxpayer to sell property, borrow on equity in property, or use a liquid asset to pay the taxes."[47] Given today's economic conditions (*e.g.*, a slumping real estate market, strict lending requirements, poor credit histories, and a lack of funds to service equity loans), a taxpayer's ability to "cash in" on the equity in his or her assets may be limited. In such cases, it makes good business sense for the IRS to enter into IAs or PPIAs to collect at least those funds that are immediately available, while addressing taxpayers' economic hardship. Yet, the IRS continues to underuse PPIAs. In the past two Annual Reports to Congress, the National Taxpayer Advocate has urged the IRS to increase awareness and

41 IRM 1.2.14.1.2 (Feb. 17, 2000).

42 IRM 1.2.14.1.8(2) (May 28, 1999).

43 *Id.*

44 IRC § 6502(a).

45 *See* H.R. Rep. No. 108-755, at 1697 (2004) (Conf. Rep.).

46 IRM 5.14.2.2(2) (July 12, 2005).

47 IRM 5.14.2.2.2(2)(E) (July 12, 2005). TAS applauds the IRS for including language referencing an economic hardship in this IRM section and encourages the IRS to place similar guidance within all sections related to enforced collection actions.

usage of PPIAs.[48] In FY 2008, the IRS granted 22,555 PPIAs, which accounts for less than one percent of all IAs granted.[49]

An even more useful and successful collection payment alternative is the streamlined IA. The IRS may approve a streamlined IA 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.[50] These agreements do not require detailed financial analysis or approval by IRS managers, and may be granted even when a taxpayer could pay the full balance sooner.[51] Yet, the IRS has recently restricted the use of streamlined IAs by requiring loan denial letters from taxpayers who would otherwise qualify if financial information reveals potential equity in assets.[52]

Although RRA 98 promoted the use of IAs as a viable collection tool, the number of agreements granted by the IRS also declined in the years after the law took effect. From 1998 to 2001, IAs decreased by over 680,000. From 1999 to 2002, the IRS experienced a corresponding decrease in revenue dollars collected through IAs – approximately $485.8 million.[53] The IRS Office of Chief Counsel's position, which questioned the authority of the IRS to enter into IAs that would not fully pay the outstanding tax liabilities, may have contributed significantly to these reductions.[54] Not until the American Jobs Creation Act of 2004 was the IRS able to resume granting IAs that would only partially pay the outstanding tax liabilities, known as PPIAs. However, as noted above, the number of PPIAs granted since the legislative change represents only a fraction of the decrease in IA activity and revenue dollars collected. We continue to question whether the IRS's overly cautious use of the PPIA represents lost opportunities to collect a significant amount of additional revenue, and afford many more taxpayers reasonable payment solutions for their tax debts.

In RRA 98, Congress encouraged the IRS to be flexible in its use of OICs.[55] Yet since the 2001 centralization of offer processing, both the number of offers submitted and the number of offers accepted have declined. Over this period, the IRS introduced many strict procedural requirements aimed at greater "efficiencies" in processing, and narrowly

48 National Taxpayer Advocate 2007 Annual Report to Congress 432-47; National Taxpayer Advocate 2006 Annual Report to Congress 86-87.

49 SB/SE Collection Activity Report, *NO- 5000-6, Installment Agreement Cumulative Report* (Sept. 29, 2008). A total of 2,624,487 IAs were granted in FY 2008.

50 IRM 5.14.5.2 (Sept. 26, 2008).

51 *Id.*

52 IRM 5.19.1.5.4.2(3) (Apr. 28, 2008).

53 SB/SE Collection Activity Report, *NO-5000-6, Installment Agreement Cumulative Report*, FY 1999 to 2002. For our analysis of dollars collected via installment agreements, we used FY 1999 to FY 2002 data to account for the fact that the revenue for installment agreements is not likely to be fully received within the same year the IA is granted.

54 *See* National Taxpayer Advocate 2001 Annual Report to Congress 210-14.

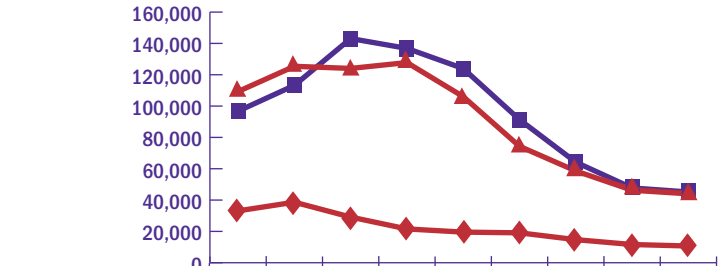
55 The conference report for RRA 98 states,

> 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.

H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 289 (1998).

interpreted requirements imposed by Congress.[56] Not surprisingly, this approach has substantially chilled the submission of "good" OICs, with accepted offers declining by over 72 percent from FY 2001 to FY 2008.[57] As a result, and as the following chart vividly illustrates, taxpayers and practitioners no longer view the IRS offer program as a viable collection alternative.

CHART 1.2.2, IRS OIC Program, FY 2000 - FY 2008[58]



	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Receipts	109,296	125,390	124,033	127,769	106,025	74,311	58,586	46,270	43,989
Dispositions	96,763	113,209	143,102	136,822	123,970	91,343	64,169	47,719	45,163
Accepted	33,114	38,643	29,140	21,570	19,546	19,080	14,734	11,618	10,677
% Accepted	34%	34%	20%	16%	16%	21%	23%	24%	24%

Similarly, under another provision of RRA 98, Congress granted the IRS authority to accept an OIC based on Effective Tax Administration (ETA), which the IRS interprets as allowing it to compromise based on "economic hardship" or "equity and/or public policy."[59] For an individual to qualify for an ETA offer based on economic hardship, he or she must have net equity of his or her assets plus future income (reasonable collection potential) which must be greater than the amount owed and exceptional circumstances, such as when the collection of the tax in full would create an economic hardship.[60] However, guidance addressing ETA offers based on hardship is conspicuously absent from published policies and procedures governing the Collection program.[61] As discussed in the 2007 Annual Report to Congress, this guidance should include, among other things, a requirement to consider

56 *See* T.D. 9086, 68 Fed. Reg. 48,785 (Aug. 15, 2003); Treas. Reg. § 300.3 (explaining the IRS's ability to charge a user fee for offer processing and investigation); Pub. L. No. 109-222 § 509, 120 Stat. 362 (2006), effective July 16, 2006, and codified at IRC § 7122(c)(1) (explaining The Tax Increase Prevention & Reconciliation Act of 2005 (TIPRA) and allowing the IRS to require a nonrefundable partial payment of 20 percent at the time of offer submission or monthly installment payments depending on the offer type and terms). For more information regarding IRS's processing of offers, see IRM 5.8.3.4 (Sept. 23, 2008).

57 SB/SE Collection Activity Report, *NO-5000-108* (FY 2001 - FY 2008). In FY 2001, the IRS accepted 38,643 OICs compared to 10,677 in FY 2008.

58 SB/SE Collection Activity Report, *NO-5000-108* (FY 2000 - FY 2008).

59 RRA 98; H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 289 (1998); Treas. Reg. § 301.7122-1(b)(3). "Economic hardship" occurs when an individual taxpayer is unable to pay reasonable basic living expenses. *See* Treas. Reg. § 301.6343-1.

60 IRM 5.8.11.2.1 (Sept. 1, 2005).

61 For a more detailed discussion of ETA OICs, *see* National Taxpayer Advocate 2007 Annual Report to Congress 388-94.

whether an ETA offer might be an appropriate collection alternative before determining to seize or recommending foreclosure on a personal residence.[62] This reminder remains a necessity as TAS continues to encounter situations where the IRS has pursued collection on the equity in taxpayers' homes, with no consideration of whether the ETA offer is a viable option.

Conclusion

The IRS has many powerful enforcement tools at its disposal to help administer the nation's tax laws. However, effective tax administration calls for the IRS to reserve the more intrusive of these tools for situations involving uncooperative taxpayers who refuse to voluntarily comply with their filing and payment requirements and who will not work with the IRS to establish reasonable payment plans. The line between "won't pay" and "can't pay" is a fine one, especially in today's tough economic times when taxpayers feel desperate. As more and more taxpayers suddenly find themselves struggling to make ends meet, it is incumbent upon the IRS to take into account the economic realities of the day. In fact, there is nothing new about this duty – it is already incorporated into many of the IRS's longstanding policy statements. When the IRS moves too quickly to collect revenue and fails to consider each taxpayer's specific circumstances, an imbalance between customer service, taxpayer rights, and enforcement is the unnecessary byproduct.

To more effectively deal with taxpayers in these difficult economic times, the IRS should consider taking the following actions: clarify or develop a new uniform policy statement that defines the concept of economic hardship; provide specific guidance requiring predecisional consideration of the concept of economic hardship in all IRM sections related to IRS Collection enforcement activities; review polices and procedures related to insolvency and the pursuit of exempt and excluded assets and establish adequate managerial safeguards and controls for situations when enforcement is appropriate; remove any procedural guidance related to the need to secure loan denial letters when a streamlined IA is an acceptable alternative; review and revise all existing policies and procedures related to collection payment alternatives such as OICs and PPIAs to allow for more flexibility and better usage in situations where economic hardship is present; continue to review and revise current case assignment practices to provide earlier intervention and resolution before a taxpayer's financial uncertainty worsens; and proceed in partnership with the National Taxpayer Advocate to develop training for collection employees on taxpayer rights and collection alternatives.

IRS Comments

The IRS understands the sensitive nature of the current economy and the potential effects it is having or will have on taxpayers. The IRS anticipates that taxpayers who previously

62 National Taxpayer Advocate 2007 Annual Report to Congress 388-94.

were able to pay their taxes may be unable to do so as a result of the economic downturn. As reflected in our current case dispositions, we already have procedures in place for taxpayers who are experiencing financial hardships and are unable to pay their tax liability. Collection alternatives such as an installment agreement, an offer in compromise, and currently not collectible status are all used to resolve taxpayer cases. We are closely monitoring our receipt patterns and installment agreement and offer in compromise defaults to be able to effectively manage an increase in taxpayer cases, a subset of which would be those with economic hardship. Additionally, we plan to expand our outreach efforts to ensure taxpayers understand the availability of payment alternatives and where to go for assistance in resolving their tax liability if they are experiencing financial hardship.

We believe our collection policies and procedures maintain the proper balance between service and enforcement. The Fiscal Year 2008 Collection Program Letter outlined collection priorities and our focus on quality and timeliness. As the National Taxpayer Advocate states, a collection priority in FY 2008 was to increase the timely pursuit and appropriate application of enforcement tools. The focus, however, was not to take more enforcement action, but to take timely and appropriate case actions. The Collection Program Letter also included priorities to:

- Ensure that employees consider all available options in resolving taxpayer accounts.
- Improve Field Collection casework quality by ensuring that employees communicate clearly with taxpayers as to what is expected and the possible consequences if expectations are not met, and that there are clear actions dates with timely follow-up.
- Improve service to taxpayers to facilitate their understanding and fulfillment of their tax responsibility.
- Identify and take action to address problems being experienced by taxpayers in the Collection program

The use of enforcement action is authorized by the Internal Revenue Code and Treasury Regulations. IRS policies and procedures provide further guidance and limit the use of enforcement action. There are checks and balances in place to ensure employees follow procedures and adhere to IRS policies. The Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO) conduct independent reviews of IRS enforcement programs. TIGTA stated in its FY 2008 report, *Review of Compliance with Legal Guidelines When Conducting Seizures of Taxpayers' Property*, that there were no instances in the cases reviewed where taxpayers were adversely affected by the seizure action.[63] In addition, the IRS continuously conducts program reviews to evaluate adherence to policies and procedures. When necessary, changes are made or guidance clarified to improve program effectiveness.

63 TIGTA, Ref. No. 2008-30-126, *FY 2008 Review of Compliance with Legal Guidelines When Conducting Seizures of Taxpayers' Property.*

The National Taxpayer Advocate notes increases in the number of liens, levies, and seizures from 1999 to 2007 and correlates the increase directly to an increased emphasis on enforcement action. However, the message to collection employees was, and continues to be, "take the right action at the right time" to move the case toward resolution. By taking timely and appropriate case actions, we have increased our case dispositions and are able to work more cases. As a result, there is the potential for an increase in the number of levies, liens, and seizures.

The IRS disagrees with the National Taxpayer Advocate's notion that due to the economic decline and possible decrease in tax revenues that it is natural for the IRS to ramp up efforts to ensure all taxpayers pay their fair share of taxes. We will continue resolving cases with timely and appropriate case actions. Each case resolution is determined based on the individual facts and circumstances of the case, including economic hardship. We believe a balanced measure of an effective Collection program includes overall case quality and appropriate case resolutions, and not the number of enforcement actions taken.

Current guidance provides direction to collection employees on addressing situations and resolving cases when taxpayers experience an economic hardship.[64] Levies are released and cases reported currently not collectible based on the taxpayer's inability to pay the tax liability while paying necessary living expenses. Enforcement decisions are made based on the individual facts and circumstances of the case available at the time the action is taken. IRS procedures limit situations in which enforcement actions, such as seizure of a taxpayer's principal residence or levy of certain retirement plans, may be taken.[65] Seizure of a principal residence requires judicial consideration and approval affording the taxpayer the opportunity for a review by an independent third party. Prior to levying on a retirement plan, procedures, which were developed in coordination with the National Taxpayer Advocate, require consideration of the availability of other assets to pay the outstanding liability. Additionally, even if no other assets are available, a determination must be made that the taxpayer's conduct has been flagrant. IRM 5.11.6.2 provides guidance for this type of levy, including examples of flagrant conduct.[66]

The IRS agrees the "fresh start" afforded individual debtors is an important element of bankruptcy policy. The fresh start is just one of the competing policies Congress sought to balance when it created the Bankruptcy Code's comprehensive scheme for treatment of debts. The most recognized example of this balance is found in the numerous exceptions to discharge found in section 523 of the Bankruptcy Code. In balancing the fresh start sought by debtors, creditors' interest in collecting, and the general public's interest in having an orderly process to support the flow of commerce, Congress determined that

64 IRM 5.11.2.2.1 (Jan. 1, 2006); IRM 5.16.1.2.9 (Dec. 1, 2006).

65 IRM 5.10.2 (Nov. 3, 2006); IRM 5.11.6.2 (Mar. 15, 2005).

66 IRM 5.11.6.2 (Mar. 15, 2005).

certain debts would not be discharged, even by a debtor who successfully completed the bankruptcy process.[67]

Similarly, bankruptcy law has long recognized that a bankruptcy discharge does not generally affect lien interests,[68] and the Supreme Court has affirmed that this rule survives under the current Code.[69] Collection from such assets is consistent with the policy decisions made by Congress in establishing and defining the scope and limits of the relief afforded to debtors under the Bankruptcy Code. Any collection actions taken to enforce the federal tax lien against assets that were exempt, abandoned, or excluded from the bankruptcy estate must be in accordance with the provisions of the Internal Revenue Code, Treasury Regulations, and IRS policies and procedures. The same IRS requirements applicable to seizures of principal residences or levying on retirement plans,[70] such as level of approval required, consideration of economic hardship, and use of other collection alternatives, continue to apply when such assets were part of a bankruptcy estate.

The IRS agrees it is important to recognize the effects of the current economic environment and the taxpayer's ability to resolve their tax delinquency. We also believe our current policies and procedures provide sufficient guidance for the "won't pay" determination prior to consideration of seizure action. IRM 5.10.1.4 provides detailed guidance to assist Revenue Officers with this determination.[71] The National Taxpayer Advocate states that enforced collection action should only be taken where unwillingness and a lack of cooperation are present. The actual enforcement decision is often much more complicated. A taxpayer may be willing to make some form of payment and yet still not reach agreement with the IRS on ability to pay or the appropriate resolution of the case. Whether the use of enforced collection action is appropriate must be determined based on all of the facts and circumstances of each individual case.

The IRS agrees installment agreements and offers in compromise are viable collection tools to be used when appropriate to resolve taxpayer liabilities. The IRS uses IAs to collect delinquent taxes and foster compliance. In FY 2007, over 97 percent of the installment agreements granted by the IRS were streamlined agreements which require little or no financial documentation. With respect to documentation requirements, it should be noted that the procedures for streamlined installment agreements have been revised to clarify that loan denial letters are not required as part of the necessary documentation for such agreements

The National Taxpayer Advocate makes the assumption that the reduction in dollars collected via installment agreements is directly related to the number, or reduction in

67 *See Grogan v. Garner*, 498 U.S. 279, 287 (1991). "Congress evidently concluded that the creditors' interest in recovering full payment debts in these categories outweighed the debtors' interest in a complete fresh start.")

68 *See Long v. Bullard*, 117 U.S. 617 (1886).

69 *See Johnson v. Home State Bank*, 501 U.S. 78 (1991); *Dewsnup v. Timm*, 502 U.S. 410 (1992).

70 IRM 5.10.2 (Nov. 3, 2006); IRM 5.11.6.2 (Mar. 15, 2005).

71 IRM 5.10.1.4 (Oct. 1, 2004).

the number, of installment agreements established over a period of time, that being 1999 through 2002, post RRA 98. However, making that assumption may not necessarily be accurate, as the length of the term of a streamlined installment agreement changed from thirty six (36) months to sixty (60) months in April 1999.[72] Reduction in the tax dollars collected could as well be directly attributable to the change in the length of terms in the installment agreements subsequently granted during the same period of time. The change in length from thirty-six (36) months to sixty (60) would correspond with payment amounts being reduced by almost half.

The Partial Payment Installment Agreement (PPIA) 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. Legislation allowing the use of the PPIA was enacted in 2004; hence, this is a fairly new collection tool for the IRS. In 2006, the first year PPIAs were available, the IRS granted 13,328 agreements. We continue to emphasize the use of PPIAs, when appropriate, to collection employees. We have seen corresponding increases in the number of PPIAs granted in FY 2007 (18,921) and in FY 2008 (22,555).[73] Additionally, a recent change in policy requires that a PPIA must be considered in cases where an offer in compromise is being rejected.

The Offer in Compromise program is an important alternative for taxpayers that are unable to pay in full, particularly those taxpayers that are experiencing economic difficulties. Our goal is to evaluate each offer and make a decision based on the facts presented by the taxpayer. As such, the policies and procedures we have established are meant to ensure that taxpayers who qualify have access to the program at any point during the collection process.[74]

While the total number of offer receipts has declined since 2003, the rate of decline has slowed and, over the past three months, total offer receipts as compared to the same time period last year has increased.[75] There are several factors that have contributed to the decrease in offer receipts, including but not limited to, implementation of the $150 application fee and implementation of the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 which mandated a payment equal to 20 percent of the OIC amount with all OIC submissions. In an effort to ensure the accessibility of the OIC program the IRS increased its outreach efforts to identify who qualifies for an OIC and provided clearer instructions and worksheets in the Form 656, *Offer in Compromise.*

The IRS continues to be proactive with internal and external stakeholders by providing outreach and clear guidance on economic hardship, as well as public policy Effective Tax Administration (ETA) offers. Our outreach efforts have been geared toward providing a

72 IRM 21.9.1 (Apr. 1999).

73 IDRS Extracts, SB/SE Collection Activity Report, *NO-5000-6, Installment Agreement Cumulative Report* (Sept. 28, 2008).

74 IRM 5.8 (Sept. 23, 2008).

75 SB/SE Collection Activity Report, *NO-5000-108 (FY 2003-FY 2008), Monthly Report of Offer in Compromise Activity* (FY 2008 and FY 2009).

clear understanding of the regulations governing ETA offers. Publication 594, *The IRS Collection Process*, also discusses ETA offers as an acceptable resolution. In addition, the Form 656, *Offer in Compromise*, definition of an ETA offer was revised to help clarify when an ETA offer is appropriate and outline the documentation a taxpayer should include with an ETA offer. Internal guidance, including several sections of the IRM,[76] specifically discusses ETA offers and alternative resolutions. Effective Tax Administration training was also provided to all field revenue officers during FY 2008.

The National Taxpayer Advocate makes seven specific suggestions to more effectively deal with taxpayers in these difficult economic times. We are taking or have taken the following actions with respect to these issues:

As noted earlier, we believe that current guidance provides sufficient direction to collection employees on addressing situations and resolving cases when taxpayers experience an economic hardship.[77] However, the IRS is looking to expand outreach efforts to ensure taxpayers understand the availability of payment alternatives and where to go for assistance in resolving their tax liability if they are experiencing financial hardship.

Pre-decisional consideration of economic hardship is present as part of the analysis and determination to pursue certain enforcement actions. In order to ensure our employees have the most up to date guidance, IRM sections, including those related to enforcement actions and economic hardship, are continually reviewed and revised to ensure they are in conformance as policies and procedures are updated. Additionally, we are developing a course for FY 2009 Revenue Officer Continuing Professional Education on responding to economic conditions. The course will focus on current economic conditions and the potential impact to taxpayers in general and collection cases specifically.

Managerial safeguards and controls including managerial approval of enforcement action taken against assets that were exempt, abandoned, or excluded from the bankruptcy estate are incorporated into current IRS policies and procedures. Any collection actions taken to enforce the federal tax lien against these assets must be in accordance with the provisions of the Code, Treasury Regulations, and IRS policies and procedures. The same IRS requirements applicable to seizures of principal residences or levying on retirement plans,[78] such as level of approval required, and consideration of economic hardship and use of other collection alternatives, continue to apply even when such assets were part of a bankruptcy estate.

The requirements for streamlined installment agreements have been revised to clarify that loan denial letters are not required as part of the necessary documentation for such

76 IRM 5.8.11 (Sept. 23, 2008); IRM 5.8.7.8 (Sept. 23, 2008); IRM 5.10.1.3.2 (Dec. 13, 2005); IRM 5.15.1.35 (May 9, 2008).

77 IRM 5.16.1.2.9 (Dec. 2006).

78 IRM 5.10.2 (Nov. 3, 2006); IRM 5.11.6.2 (Mar. 15, 2005).

agreements.[79] In FY 2007, over 97 percent of the installment agreements granted by the IRS were streamlined installment agreements.

Current policies and procedures allow for flexibility and use of PPIA and OIC in cases where economic hardship is present. A recent revision to the IRM requires that alternative resolutions, including a PPIA, must be discussed with a taxpayer prior to rejecting an OIC.[80] Additionally, we continue to emphasize the appropriate use of PPIAs to all collection employees.

We agree that reviewing case assignment practices should be an ongoing course of action. The current Consolidated Decision Analytics Project is developing more sophisticated decision analytics to route cases earlier, faster, and more accurately to the correct treatment streams.

The IRS will continue to work with representatives from the National Taxpayer Advocate on established collection improvement teams. These teams are focused on taxpayer rights and issues related to IAs, OICs, notices of federal tax lien, and the Trust Fund Recovery Penalty.

Taxpayer Advocate Service Comments

Troubled economic times require preemptive rather than reactive solutions. Thus, the National Taxpayer Advocate is encouraged that the IRS recognizes that current economic conditions create an environment where many more taxpayers will find it difficult to meet their federal tax obligations in a timely manner, as they struggle financially. We are pleased to note that many of the IRS's comments reflect a proactive approach to dealing with taxpayers who are unable to pay, particularly those affected by the economic uncertainty of the day.

For example, we commend the IRS for its plans to expand outreach efforts so that taxpayers understand the availability of payment alternatives and how to obtain help in resolving their tax liabilities when experiencing financial hardship. Another positive development is the IRS plan to develop a course for revenue officers to provide additional guidance on considering the impact of current economic conditions on taxpayers with IRS tax debts. We expect the IRS will work with TAS in developing this course, particularly since taxpayers with significant hardships frequently end up as TAS cases, and TAS can provide the IRS with valuable information on how the IRS can avoid exacerbating the taxpayers' economic situations. We are very pleased to see that the IRS has clarified its position that loan denial letters are not mandatory prerequisites for streamlined IAs. Moreover, we acknowledge

79 IRM 5.19.1.5.4.2 (Nov. 19, 2008).

80 IRM 5.8.7.8 (Sept. 23, 2008).

recent communications from the IRS to alert taxpayers to the availability of lien subordinations in situations where such actions will facilitate the ability of some taxpayers to refinance their mortgages, rather than lose their homes to foreclosure actions.[81]

The National Taxpayer Advocate also agrees that the IRS actually needs to look no further than its existing collection toolkit to effectively resolve taxpayer cases where economic hardship exists, as it already possesses numerous viable collection alternatives, such as IAs, OICs, and CNC. However, the National Taxpayer Advocate remains concerned that IRS's response to the current economic downturn in regards to collection does not adequately consider the taxpayer's perception of IRS collection practices. Failing to take the appropriate steps to address this economic crisis could result in the perception of the IRS using "harsh" collection tactics in troubled times, thereby, discouraging taxpayers from trying to work things out with the IRS. Conversely, the perception of a more reasonable and flexible IRS is likely to encourage more taxpayers to try.

An Imbalance Between Service and Enforcement Remains.

The National Taxpayer Advocate has repeatedly stated, and the IRS has reiterated "that enforcement and service are not mutually exclusive." The IRS asserts that its collection policies and procedures maintain the proper balance between service and enforcement, but this is not always the case. We acknowledge that the IRS's intent of the FY 2008 Collection Program Letter may have been to focus not on taking *more* enforcement actions, but rather taking *timely* and *appropriate* case actions. In reality, the IRS may have sent mixed signals to its employees by placing a heightened emphasis on maximizing the use of enforcement tools, such as seizure and sale, suits to foreclose on the federal tax lien or reduce the tax liability to judgment, and the pursuit of exempt, abandoned, and excluded assets following a successful Chapter 7 bankruptcy. Considering the training material's lack of direction for employees to consider the potential economic hardship such actions could have on a taxpayer, along with the corresponding lack of procedural guidance in this area, we do not believe that the delivered message adequately reflected a balance of service *and* enforcement.

Moreover, in FY 2008, the IRS continued to issue the majority of its levies via automation (*e.g.*, ACS and the Federal Payment Levy Program), generally initiating such enforcement action prior to attempting a personal contact with the taxpayer. The IRS's stated goal for collection is "taking the right action at the right time." The National Taxpayer Advocate believes the right time and right action are predicated on two simple factors – early intervention and personal contact. By personally interacting with a taxpayer when the problem first arises, it is easier to ascertain the appropriate facts and circumstances *prior* to taking enforcement action and avoid having to deal with negative downstream consequences such as economic hardship and taxpayer burden. The heavy reliance on automated levy and lien

81 *See* IRS News Release IR-2008-141, *IRS Speeds Lien Relief for Homeowners Trying to Refinance, Sell* (Dec. 16, 2008).

filing – without taxpayer contact – undermines the IRS's mission of increasing voluntary compliance.

IRS Guidance for Consideration of Economic Hardship Is Lacking.

The National Taxpayer Advocate respectfully disagrees with the IRS's assertions that its current guidance provides sufficient direction to collection employees on how to address economic hardship. As noted in this report, our review of IRS Collection procedures in Part V of the IRM reveals very little specific guidance on what to include in pre-decisional consideration of economic hardship issues prior to initiating enforcement actions. Moreover, the IRM contains very few meaningful examples to illustrate to IRS Collection employees situations where these factors should lead to the use of collection alternatives, such as PPIAs and OICs. In fact, during the past year the National Taxpayer Advocate has seen a number of IRS Collection cases where these considerations were disregarded.

The IRS also states its guidance for levying on a retirement plan properly accounts for and considers whether the action will impose an economic hardship on a taxpayer. However, the National Taxpayer Advocate recently identified serious concerns with the guidance specifically referenced by the IRS and took exception with the IRS's definition of what constitutes "flagrant conduct." IRM 5.11.6.2 cites several examples of flagrant behavior but many of them focus on past actions of the taxpayer rather than his or her current level of compliance. For example, we agree that a taxpayer who is currently raising frivolous arguments or willfully evading the IRS should be classified as flagrant. However, under existing guidelines, a taxpayer who continues to contribute to a retirement plan while taxes are accruing, or who was assessed a Trust Fund Recovery Penalty ten years ago, would also be considered as having exhibited flagrant behavior.[82] The IRS's rationale is flawed since it fails to consider whether the taxpayer's continued contributions were voluntary or if the IRS ever notified him or her that making future contributions could be construed as flagrant behavior, nor does it account for the current level of compliance by the taxpayer with an old TFRP assessment. The National Taxpayer Advocate has asked the IRS to reconsider this position and to clarify that in general a determination of flagrant behavior should be based on *current* actions rather than historical.

A Fresh Start in the Eyes of Whom?

The National Taxpayer Advocate appreciates the IRS's acknowledgment of the concept of a "fresh start" for taxpayers whose taxes are discharged through a Chapter 7 bankruptcy. We do not disagree that the IRS retains specific authority to enforce the federal tax lien against assets that were exempt, abandoned, or excluded from the bankruptcy estate. However, we are concerned that current IRS guidance provides far too little direction for local offices to determine which assets they wish to pursue. Moreover, the IRS's lack of any mechanism to track enforcement actions taken against these assets makes the matter even more troubling.

82 IRM 5.11.6.2(5) (Mar. 15, 2005).

Since many taxpayers survive bankruptcy proceedings with very little to their names other than their exempt or excluded property, the National Taxpayer Advocate respectfully requests the IRS reconsider its pursuit of these assets and develop specific guidance that incorporates consideration of economic hardship into each and every determination. Although the National Taxpayer Advocate agrees there are specific enforcement authorities for the IRS to pursue assets that were exempt, abandoned, or excluded from the bankruptcy estate, it is important to keep in mind the fundamental concept of bankruptcy – providing taxpayers with a "fresh start."

Limited Use of Available Collection Alternatives

Interestingly, the National Taxpayer Advocate has been engaged in this same dialogue about collection alternatives with IRS Collection management for several years. While we believe that IRS Collection policies and procedures unduly restrict reasonable payment alternatives to many taxpayers who require such flexibility in order to rebuild their lives, the IRS has routinely responded as it has again this year – "we already have procedures in place for taxpayers who are experiencing financial hardships and are unable to pay their tax liability." However, the IRS fails to fully utilize these collection tools now, and continuing this flawed approach is especially shortsighted in these economic times. For example, in FY 2008, the IRS Collection Field operation collected approximately $6.6 billion dollars on delinquent taxpayer accounts (excluding formal installment agreements).[83] Yet, over $11 billion dollars were abated on these accounts, and $12.9 billion were reported as uncollectible.[84] As a percentage of overall case dispositions, the number of taxpayers granted PPIAs and OICs last fiscal year was negligible.[85] The IRS only collected a little more than $200 million with OICs in FY 2008, the lowest amount in many years, and approximately 45 percent of those dollars were accepted by Appeals. Tax practitioners increasingly tell us that the OIC has become irrelevant in their considerations of collection solutions for their clients. At the conclusion of FY 2008, the IRS reported over 9.2 million taxpayer delinquent accounts (TDAs) in active inventory.[86] Of these, approximately 3.3 million – over a third – of these accounts were inactive and assigned to the Collection "queue."[87] Approximately 6.2 million of these accounts involved delinquencies for tax periods from 2004 or older.[88] The IRS response to this report indicates that the emphasis in the Collection program in FY 2008 was "take the right action at the right time," and "we will continue resolving cases with timely and appropriate actions." Unfortunately, the FY 2008 program data does not reflect the IRS position on this matter.

83 SB/SE Collection Activity Report, *Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Sept. 29, 2008)

84 *Id.*; SB/SE Collection Activity Report, *Recap of Accounts Currently not Collectible Report, NO-5000-149* (Sept. 27, 2008); SB/SE Collection Activity Report, *NO- 5000-6, Installment Agreement Cumulative Report* (Sept. 29, 2008).

85 SB/SE Collection Activity Report, *Report of Offer in Compromise Activity, NO-5000-108* (Sept. 29, 2008).

86 SB/SE Collection Activity Report, *Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Sept. 29, 2008).

87 *Id.*

88 *Id.*

The National Taxpayer Advocate continues to urge the IRS to reevaluate its Collection strategy, and develop procedures that deliver a true balance of service and enforcement with taxpayers who owe delinquent tax dollars. The conditions discussed in this report are not new. We have identified these concerns for several years. However, the current downturn in the economy has created a situation where many more taxpayers will be suffering through financial difficulties that may lead to tax debts. A continuation of the IRS's current inflexible Collection strategy will likely result in numerous lost opportunities to collect the delinquent revenue while providing service to taxpayers in a manner that fosters voluntary compliance.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Clarify or develop a new uniform policy statement that defines the concept of economic hardship.
2. Provide specific guidance requiring pre-decisional consideration of the concept of economic hardship in all Internal Revenue Manual sections related to IRS Collection enforcement activities.
3. Review all polices and procedures related to insolvency and the pursuit of exempt and excluded assets and establish adequate managerial safeguards and controls for situations when enforcement is appropriate, including the tracking of collection actions against exempt and excluded assets.
4. Continue to review and revise current case assignment practices to provide earlier intervention and resolution before a taxpayer's financial uncertainty worsens.

MSP #3

Understanding and Reporting the Tax Consequences of Cancellation of Debt Income

Responsible Officials

Richard J. Byrd, Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

Definition of Problem

The National Taxpayer Advocate, in her 2007 Annual Report to Congress, identified the tax consequences of cancellation of debt income as one of the most serious problems encountered by taxpayers.[1] The rules that determine whether cancellation of debt income is includible in gross income are complex. There are several exceptions to the general rule of includibility, such as the exception for debt canceled when a homeowner becomes unable to make payments on a loan secured by his or her principal residence under the Mortgage Forgiveness Debt Relief Act (MFDRA).[2] The requirements for reporting excluded amounts are also complex, and taxpayers often do not receive reliable information about their tax reporting and payment obligations concerning cancellation of debt income.

For example, the New York Times described the operation of MFDRA as follows: "Suppose a buyer defaults on a $220,000 mortgage. The bank forecloses and sells the house in today's battered market for $180,000. The $40,000 of remaining debt is discharged. Under previous law, the $40,000 was considered income and was subject to taxation. Under this law, the tax obligation is forgiven."[3] According to the Fort Worth Star-Telegram: "In tax law, the amount of forgiven debt is typically treated as income and is taxed. But to help people who are affected by the mortgage crisis, Congress excluded homeowners whose mortgage debt was forgiven in years 2007, 2008 and 2009. Keep good records, and keep track of the amount that the bank wrote off."[4]

These newspaper accounts are not inaccurate, but they fail to mention two important points. First, even though "qualified principal residence indebtedness" under MFDRA includes most home loans whether they resulted from a refinancing transaction, a second mortgage, or a home equity line of credit, the fact that the canceled debt is a home loan does not mean the MFDRA exception applies. *The exception does not cover loan proceeds used for any purpose other than to acquire or improve a principal residence.*[5] As described

1 National Taxpayer Advocate 2007 Annual Report to Congress 13-34. This problem ranked second among the 26 most serious problems addressed.

2 Pub. L. No. 110-142 (2007).

3 Jan M. Rosen, *New Rules Ease the Sting of Mortgages*, The New York Times, Feb. 10, 2008.

4 Vicki Lee Parker, McClatchy Newspapers, *Tax Tips for Dealing with Turbulent Markets*, Fort Worth Star-Telegram, Sept. 28, 2008.

5 Pub. L. No. 110-142 § 2(b)(2007).

below, many homeowners used a portion of their home loans to pay off medical bills, student loans, or other expenses. These canceled debts are not excludible from income under MFDRA (although they may be excludible under a different exception). Second, neither homeowners nor any other debtors who exclude cancellation of debt from income *automatically* receive the benefit of the exclusion. To claim the exclusion, taxpayers are required to file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)* with their tax returns.[6] If they fail to file Form 982, the IRS will assume the cancellation of indebtedness income is taxable.[7]

In recognition of the seriousness of the problems taxpayers face in reporting cancellation of debt, the National Taxpayer Advocate makes a Legislative Recommendation in this year's Annual Report to Congress suggesting three options that would make it easier for financially distressed taxpayers to exclude cancellation of debt from gross income.[8]

Analysis of Problem

Background

According to RealtyTrac, "one in every 475 U.S. housing units received a foreclosure filing in September [of 2008]. Foreclosure filings were reported on 765,558 U.S. properties during the third quarter, up more than three percent from the second quarter and up 71 percent from the third quarter of 2007."[9] In response to this foreclosure crisis, Congress extended MFDRA, which was originally set to terminate on December 31, 2010, through 2012.[10] The rise in foreclosures has taken place against a backdrop of increasingly risky loan practices.

In recent decades, an increasing number of housing loans were made by lenders specializing in subprime lending.[11] Subprime loan originations reached $160 billion in 1999, representing 12.5 percent of total originations.[12] According to a Department of Housing and Urban Development and Department of Treasury Task Force on Predatory Lending report, "The primary purpose of over 50 percent of first lien subprime mortgages and up to 75 percent of second lien subprime mortgages is debt consolidation and/or general consumer credit, not home purchase, home improvement or refinancing the rates and terms

6 IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*, 4-7 (2007).

7 *Id.* at 3 (2007). The IRS is notified that a debt has been canceled by means of Form 1099-C, *Cancellation of Debt*, issued by creditors who forgive a debt of $600 or more.

8 *See* Legislative Recommendation, *Simplifying the Tax Treatment of Cancellation of Debt Income, infra.*

9 Press Release, RealtyTrac, *Foreclosure Activity Decreases 12 Percent in September, at* http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5299&accnt=64847 (Oct. 23, 2008).

10 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 303.

11 Department of Housing and Urban Development and Department of the Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending* 28 [hereinafter Treasury-HUD Report], *at* http://www.hud.gov/library/bookshelf12/pressrel/treasrpt.pdf (2000).

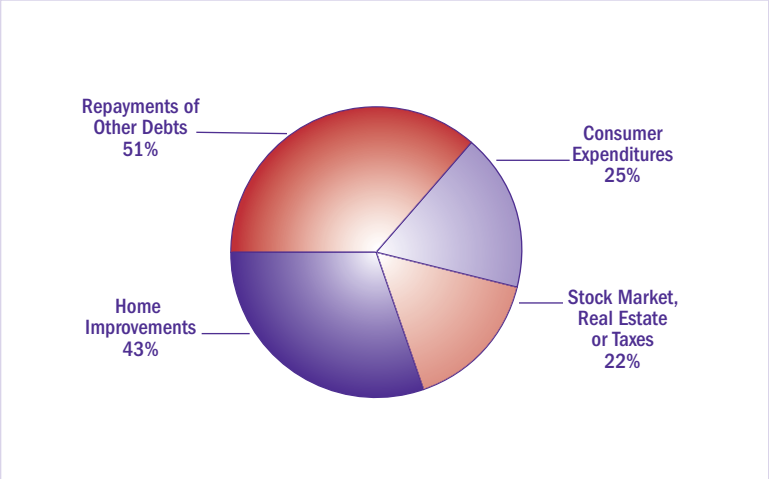
12 *Id.* at 29.

of a mortgage."[13] Borrowers 65 years of age or older were three times more likely to hold subprime mortgage loans than borrowers under 35.[14]

Of the subprime loans that were second lien mortgages, 45 percent of the loans were used for debt consolidation, 30 percent for medical, education and other expenses, and 25 percent for home improvement.[15]

In the majority of loans, a portion of the proceeds was still being used to cover living expenses and pay other non-mortgage debt such as credit cards in 2001 and early 2002, as shown below:[16]

CHART 1.3.1, Use of Funds from Refinancings, 2001 and 2002



Percentages add up to more than 100 because each refinancing loan could have been used for multiple purposes.
Source: Federal Reserve System, Flow of Funds Accounts of the United States.

From 1992 to 2001, the level of credit card debt among seniors between 65 and 69 years old increased by 217 percent.[17] "With virtually all medical expenses now payable by credit card, there is evidence to suggest that deductibles, co-pays, dental and vision care, prescription drugs and other uncovered costs played a significant role in the increased credit card balances of many older Americans."[18]

13 *Id.* at 26.

14 Neil Walters and Sharon Hermanson, *Subprime Mortgage Lending and Older Borrowers*, AARP, *at* http://www.aarp.org/research/credit-debt/mortgages/aresearch-import-182-DD57.html (March 2001).

15 Treasury-HUD Report at 31.

16 Javier Silva, *A House of Cards: Refinancing the American Dream*, *at* http://archive.demos.org/pubs/house_cards.pdf (2005). Percentages are based on number of loans issued and not on loan amounts.

17 Heather C. McGhee & Tamara Draut, *Retiring in the Red: The Growth of Debt Among Older Americans* 3, *at* http://archive.demos.org/pubs/Retiring_2ed.pdf (2004) (percentage based on 2001 dollars).

18 *Id.* at 6.

According to the New York Times, after years of "flooding Americans with credit card offers and sky-high credit lines, lenders wrote off an estimated $21 billion in bad credit card loans in the first half of 2008."[19] If unemployment continues to increase, debt cancellation could exceed historic norms.[20]

Cancellation of this debt does not qualify for exclusion from income under MFDRA, and using home loan proceeds to pay this debt disqualifies canceled loans for exclusion under MFDRA. Taxpayers need to be able to determine whether their canceled debt is excludible from income under a different exception (such as the insolvency exception) and must file Form 982 to claim the benefit of that exception.

Developments Since the 2007 Annual Report to Congress

The 2007 Annual Report recommended changes to various aspects of the reporting process to make it easier for taxpayers to understand their obligations in reporting cancellation of indebtedness income. The report recommended that the IRS:

- Develop a comprehensive publication that would assist taxpayers in preparing returns;
- Provide in-person assistance to taxpayers who seek information or return preparation assistance;
- Improve the form used by lenders to report cancellation of indebtedness income and the form used by taxpayers to report reductions in tax attributes; and
- Improve its communications with taxpayers who it believes misreported cancellation of indebtedness income.

We commend the IRS for taking the steps described below that improved the availability of reliable information and assistance to taxpayers, and for working with the office of the National Taxpayer Advocate to address our concerns.

New Publication 4681 Provides Better Information to Taxpayers

The National Taxpayer Advocate strongly recommended "that the IRS develop a publication on the tax treatment and reporting of cancellation of indebtedness income that consolidates all relevant information in one place."[21] The IRS developed Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*, in collaboration with the Taxpayer Advocate Service and released it in May 2008. The publication fills a critical

19 Eric Dash, *Consumers Feel the Next Crisis: It's Credit Cards*, The New York Times, Oct. 29, 2008.

20 *Id.*

21 National Taxpayer Advocate 2007 Annual Report to Congress 31.

information gap, because it provides an exhaustive explanation of cancellation of indebtedness issues.[22]

The Taxpayer Advocate Service (TAS) Raised Awareness about Cancellation of Debt

As part of the 2008 IRS Nationwide Tax Forums, held in six major cities (Atlanta, Chicago, Orlando, Las Vegas, New York, and San Diego), TAS developed and presented a training session entitled *Cancellation of Debt – What You Need to Know*. The session was designed to raise awareness of the issue among practitioners and to provide guidance for them. It opened with a video podcast showing the National Taxpayer Advocate describing cancellation of debt income and how this issue affects taxpayers. The session proceeded in a panel format with a TAS executive serving as moderator, a TAS attorney or systemic advocacy analyst sharing the TAS perspective, a representative from the Wage and Investment (W&I) division Automated Underreporter (AUR) unit describing how the IRS handles Forms 1099-C, and a local Low Income Taxpayer Clinic (LITC) staff member discussing the impact of cancellation of debt income on taxpayers and practitioners.

This session proved extremely popular, attracting standing room only crowds at all of the first three Tax Forums. The Atlanta and Chicago presentations drew more than a thousand attendees. In each of the final three locations, the session was presented twice to accommodate everyone who wished to attend, and attendees were given the new Publication 4681 as a reference document.

The IRS Revised Form 982

The National Taxpayer Advocate noted in the 2007 Annual Report that "The IRS could substantially simplify the task of completing the form [Form 982] for non-business taxpayers by clarifying the instructions."[23] In 2008, the IRS, in collaboration with TAS, revised Form 982 and the instructions to incorporate the MFDRA provisions (and other statutory provisions pertaining to Hurricane Katrina) and to provide clarification. The revised instructions include a detailed chart that guides taxpayers to the appropriate lines on the form. The taxpayer sees a column captioned "*IF the discharged debt you are excluding is...*" with a menu of different types of debt (qualified principal residence indebtedness, nonbusiness debt, or any other debt). Each category of debt on the menu corresponds to a column captioned "*THEN follow these steps...*" The steps explain exactly which lines on the form to complete.

22 In July 2008, the National Taxpayer Advocate awarded the National Taxpayer Advocate award to TAS and other IRS and Chief Counsel employees who worked on the new Publication. The National Taxpayer Advocate Award is conferred on IRS employees who make extraordinary contributions in support of the following TAS strategic objectives: advocate changes in tax law or procedures that protect taxpayer rights, reduce taxpayer burden, and improve IRS effectiveness; improve TAS's ability to identify and respond to taxpayer concerns; identify significant sources of TAS casework and work with operating divisions on strategies to reduce inappropriate TAS workload; and ensure the human resources component of TAS is adequate to meet its workload demands.

23 National Taxpayer Advocate 2007 Annual Report to Congress 23.

The revised Form 982 is a substantial improvement over the previous version, although it does not reference Publication 4681 because the publication was issued later. As described below, further changes in Form 982 are desirable.

The IRS Revised Form 1099-C

Form 1099-C, *Cancellation of Debt*, is used by lenders to report cancellation of indebtedness.[24] Lenders issued Forms 1099-C to over 1.4 million taxpayers in 2006 and to more than 1.6 million taxpayers in 2005.[25] In 2006, over 15 percent of the taxpayers issued a 1099-C received more than one, but on only two percent of the Forms 1099-C did the issuer check the box to indicate the debt was discharged in bankruptcy.[26]

The 2007 Annual Report to Congress noted that although taxable cancellation of indebtedness income does not arise if the underlying debt is nonrecourse, "there is no difference in the way canceled recourse debts and canceled nonrecourse debts are reported on Form 1099-C."[27] Form 1099-C also did not instruct the issuer to provide its telephone number, which made it more difficult for a debtor who disagrees with the amount recorded by the issuer as the fair market value of the property (or with any other aspect of the form) to communicate with the issuer to resolve the problem. The IRS revised Form 1099-C in 2008 to include the field "Was borrower personally liable for repayment of the debt?" and to instruct the issuer to provide its telephone number. The reverse side of the 1099-C, which contains "Instructions for Debtor," was changed to incorporate references to Publication 4681. The National Taxpayer Advocate applauds the IRS for making these improvements and looks forward to continued collaboration with the IRS in further refining and developing Form 1099-C and instructions.

The IRS Expanded Assistance to Taxpayers

In her 2007 report, the National Taxpayer Advocate noted that the IRS designated the tax treatment of canceled debt a subject that is "out of scope" for tax return preparation assistance at Volunteer Income Tax Assistance (VITA) sites, Tax Counseling for the Elderly (TCE) sites, and at the IRS's own Taxpayer Assistance Centers (TACs).[28] She recommended that the IRS designate the tax treatment of canceled debts as "in scope" for purposes of preparing returns and answering general questions at the TACs. She further recommended that the IRS provide specialized training on cancellation of indebtedness issues to a unit of telephone assistors and then route taxpayer calls on these issues to those assistors.[29]

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24 Treas. Reg. § 1.6050P-1(a)(1).

25 Lenders issued Forms 1099-C to 1,452,393 taxpayers in 2006 and to 1,635,820 taxpayers in 2005. IRS Compliance Data Warehouse, *Individual Returns Master File* (Tax Years 2005, 2006).

26 IRS Compliance Data Warehouse, *Individual Returns Master File* (Tax Year 2006).

27 National Taxpayer Advocate 2007 Annual Report to Congress 18.

28 *Id.* at 24.

29 *Id.* at 33.

The IRS removed the "out of scope" designation at VITA and TCE sites with respect to the MFDRA exception for cancellation of debt income. Volunteers who staff these sites may now assist taxpayers in determining whether the MFDRA exception applies to them. However, training at VITA and TCE sites appears to incorporate Publication 4702, *Mortgage Forgiveness Debt Relief Act of 2007*, which is inadequate and out of date. We recommend that the IRS develop better training materials for VITA and TCE sites, confirm that VITA and TCE volunteers who staff these sites can spot potential application of other exceptions to cancellation of debt income, and refer taxpayers who visit VITA and TCE sites to TACs or LITCs, as appropriate.

The IRS also removed the "out of scope" designation at the TACs, and is providing more extensive training on cancellation of debt income for some TAC employees. Senior staff began training in November 2008 to be qualified to assist taxpayers with this issue by January 2, 2009, when the new filing season begins. As of December 15, 2008, 277 employees certified that they received such training. The printed training materials cover the insolvency and bankruptcy exceptions for cancellation of debt income, but not the exceptions for qualified farm indebtedness or qualified real property business indebtedness (these exceptions continue – we believe, appropriately – to be designated "out of scope").[30] The materials explain the meaning of insolvency and state "Note: Advise the taxpayer to attach a statement to their return explaining how they arrived at their insolvency amount. This could be done by listing all their assets in one column and liabilities in another."[31] The materials include several examples from the new Publication 4681, as well as a glossary of terms and training on how to complete Form 982.[32]

The printed training materials will be used in conjunction with an interactive electronic assistance program that was also recently developed and is scheduled to be launched in January 2009. The software, referred to as ITLA (Interactive Tax Law Assistant), is organized as an interview in which the taxpayer (through the IRS employee) answers a series of questions that lead to a conclusion and a recommended course of action.

Although one of the ITLA questions is "Were you insolvent at the time the debt was canceled?" the assistor is cautioned, "Note to Assistor: do not assist taxpayer with the insolvency calculation." Further, ITLA does not appear to distinguish between qualified principal residence indebtedness and home loan proceeds used to pay other types of debt. The relevant question, "Did you incur the debt in acquiring, constructing, or substantially improving your principal residence?" does not permit the taxpayer to respond that only

30 *Cancellation of Debt for Field Assistance & SPEC Employees* (Oct. 2008). Taxpayers who ask questions that are out of scope are referred to the IRS toll-free numbers, the Internet, or a trained phone assistor. If a qualified assistor is not available, the IRS arranges a callback with a response time of up to 15 days. *See* I.R.M. 21.3.4.3.7.5 (Oct. 1, 2008).

31 *Cancellation of Debt for Field Assistance & SPEC Employees* at 5-20 (Oct. 2008).

32 The glossary contains, among other entries, "Insolvency/Solvency" which states, in part: "You were insolvent immediately before the cancellation to the extent that the total of all your liabilities exceeded the FMV of all of your assets immediately before the cancellation. For purposes of determining insolvency, assets include the value of everything you own (including assets that serve as collateral for debt and exempt assets which are beyond the reach of your creditors under the law, such as your interest in a pension plan and the value of your retirement account)."

a portion of the debt was so used. Therefore, the assistor may incorrectly conclude that all (or none) of the taxpayer's canceled debt is excludible from income.[33] For this reason, only IRS employees who receive separate training on cancellation of debt income should use ITLA. Taxpayers who call the IRS toll-free number (1-800-829-1040) to inquire about cancellation of indebtedness issues will speak with a Customer Service Representative who has received training and will use the same interactive ITLA software described above. Moreover, the IRS should add a follow-up question to ITLA inquiring whether the taxpayer used the proceeds for another purpose such as debt consolidation.

Continuing Challenges

Since the National Taxpayer Advocate's 2007 Annual Report to Congress, the IRS has dealt with several aspects of cancellation of indebtedness that pose difficulties for taxpayers. Particularly with respect to raising awareness of the issue and providing taxpayers with useful information, the IRS has been proactive. However, the difficulty of accurately describing this area of the law in terms that make sense to many taxpayers makes misreporting more likely. Misreporting will not, in many cases, result in an underpayment of tax, yet it may trigger an enforcement action by the IRS. The IRS needs to communicate with taxpayers who do not perfectly account for their cancellation of debt income before resorting to enforcement measures. As Commissioner Shulman has said, the IRS must show sensitivity in dealing with taxpayers buffeted by difficult economic times.[34]

Taxpayer Challenges in Reporting Canceled Debts on Form 982 Persist.

Taxpayers who exclude cancellation of indebtedness from income are required to report a corresponding reduction in tax attributes by filing Form 982. As described below, the IRS matches this form (and the taxpayer's tax return) with Forms 1099-C issued to the taxpayer to determine whether the taxpayer properly reported cancellation of indebtedness income. Taxpayers who exclude cancellation of debt from income entirely under MFDRA need only reduce their basis in their residence by the amount of the canceled debt.[35]

As described above, however, many taxpayers cannot use the MFDRA exception to exclude all of the canceled debt because they used some of the debt proceeds for purposes other than the acquisition, construction, or improvement of their principal residences. These taxpayers may avail themselves of the insolvency exception. Form 982, which is used to claim insolvency, contains a definition of insolvency and an example that illustrates the concept, but the form does not include a worksheet for calculating insolvency, nor does it direct

33 The IRS has indicated that a revised version of the ITLA software will be available on Dec. 5, 2008, which will address these shortcomings in the current application. IRS response to TAS Nov. 21, 2008.

34 Martin Vaughan, *IRS Head: Tough Economic Times Call for Sensitive Approach*, Dow Jones Newswires, Oct. 27, 2008. *See also* Most Serious Problem, *Customer Service within Compliance, infra*; Most Serious Problem, *The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experience Economic Difficulties, infra.*

35 Pub. L. No. 110-142 § 2(b); IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* 7 (2007).

the taxpayer to submit any substantiation of insolvency with the completed Form 982. As described below, this lack of guidance may result in later enforcement action by the IRS.

Further, taxpayers who qualify for another exception (such as the insolvency exception) will have to contend with the ordering rules set out in Form 982, which direct them to reduce tax attributes (such as basis, net operating losses, general business credit carryovers, minimum tax credits, and capital losses) in relation to the amount of the canceled debt. Taxpayers who are not farmers or businesses will very likely not have tax attributes other than personal property. Therefore, they will face the requirement of reporting adjustments to personal property such as furniture, jewelry, and clothing.

The reduction in basis in personal property will increase the gain on any subsequent disposition of these items or reduce the (nondeductible) loss. Implicit in the logic of this statutory scheme is the supposition: (1) that the taxpayer can establish that he or she has basis in personal property in an amount greater than zero; (2) that the taxpayer who reduces his or her basis in personal property may later sell such personal property; and (3) in the event of such sale the taxpayer will accurately report the gain or (nondeductible) loss, having kept track of the basis in the sold property in the interim. Also implicit in this framework is the supposition that the IRS likewise keeps track of basis in taxpayers' personal property as reported on Form 982. In a statutory environment such as this, to say nothing of the economic difficulty the taxpayer is likely facing, the importance of engaging in sensitive, proactive, and helpful communications with taxpayers, especially those whom the IRS identifies as having misreported collection of indebtedness income, is evident.

The IRS Is Too Quick to Take Enforcement Measures When Taxpayers Misreport Cancellation of Debt.

Taxpayers may first become aware they may need to report cancellation of indebtedness income when they receive a letter, Notice CP 2000, *Notice Proposing Adjustments to Income, Payments, or Credits*. The IRS issued 126,906 such notices in 2005.[36] The Notice CP 2000 is the first step toward assessment of the tax and in this sense is an enforcement measure.

The IRS may issue Notice CP 2000 after an AUR analyst evaluates a discrepancy between amounts shown on a Form 1099-C and on the taxpayer's return. It may be issued *even if the taxpayer files a Form 982 claiming that he or she was insolvent*, if the taxpayer does not also include a statement showing the amount of the insolvency. As described above, Form 982 does not direct the taxpayer to include such a statement. The Notice CP 2000 states that a discrepancy exists and instructs the taxpayer: "If you claimed insolvency, please provide us with a breakdown of your total assets and liabilities immediately before the cancellation of debt."

36 IRS response to TAS research request (Oct. 31, 2007); UR TY 2005 Process Code Results – Data Extracted 10/27/07, AUR National Rollup for Category 29 (cancellation of debt).

Therefore, taxpayers who successfully navigate Form 982 and attest to their insolvency may nevertheless find themselves facing an IRS enforcement action when they receive a Notice CP 2000 instructing them to provide a breakdown of their assets and liabilities, without any guidance as to what form the report is to take. The IRS should develop tools and schedules, including an insolvency worksheet, to help taxpayers accurately and completely meet their reporting obligations for cancellation of debt income when they file their tax returns.

The IRS Should Create a Single Unit Dedicated to Handling Cancellation of Debt Issues.

The complexity of this area of the law, coupled with the frequency of the issue and the expectation, in view of continued economic difficulties, that the number of taxpayers affected by cancellation of debt will grow, warrants the creation of a specialized IRS unit to handle related questions. This approach is not unusual: the IRS set up a specialized unit in 1998 to handle claims for relief from joint liability under newly enacted IRC § 6015,[37] and created procedures for accessing the "U.S. competent authority" in the early 1970s to help taxpayers deal with certain provisions of international tax treaties.[38] Providing more in-depth training to fewer employees would lead to better quality control and consequent improvement in service on a more timely basis (or in real time), consistency in service, and greater ease in spotting and accommodating emerging trends. The centralized unit should be given authority to initiate communications with taxpayers who may have misreported their cancellation of debt income by writing to them at their last known addresses and attempting to ascertain their current addresses. The unit should be responsible for initiating communications that focus on helping taxpayers meet their reporting obligations, rather than establishing that they have not.

Conclusion

The rules pertaining to cancellation of indebtedness income are complex and, for most taxpayers, counterintuitive. In 2008, the IRS responded to several concerns raised by the National Taxpayer Advocate in her 2007 Annual Report to Congress, but needs to do more to inform taxpayers of the rules and simplify the reporting procedures. The IRS should update the materials it uses to train volunteers who staff the VITA and TCE sites and revise the new ITLA software to verify that it accurately reflects the statutory framework and complements the written training materials. To the extent the IRS requires taxpayers to furnish a breakdown of assets and liabilities in order to claim the insolvency exception, it should provide appropriate forms and instructions, and revise Form 982 to direct taxpayers to provide this information with their returns. The IRS should create a specialized unit to handle cancellation of debt issues. IRS communications to taxpayers who misreport their cancellation of debt should take into account the economic difficulty that these taxpayers are likely facing. By extending the term of MFDRA through 2012, Congress recognized that

37 *See* IRS Form 8857, *Request for Innocent Spouse Relief* (1998).

38 *See* Rev. Proc. 70-18, 1970-2 C.B. 493.

the economic distress that leads to debt cancellation is not likely to abate in the next few years. The tax treatment of debt cancellation will therefore require continued attention.

IRS Comments

As a result of the downturn in the economy and the increasing numbers of taxpayers affected by taxable debt forgiveness income, the IRS has taken, and will continue to take actions to help taxpayers better understand and comply with these very complex provisions of the Internal Revenue Code. Many of these actions were taken in close collaboration with the National Taxpayer Advocate, who timely identified this as an emerging issue and provided the IRS with a number of excellent suggestions. As outlined in more detail below, the IRS developed a new Publication 4681, clarified other related forms, instructions, and publications, and expanded the scope of the services offered at TACs and IRS-sponsored volunteer sites to address this issue. In addition, IRS compliance notices are being revised to reference the Mortgage Forgiveness Debt Relief Act of 2007 and to include the new Publication 4681. Finally, as an integral part of the planning for the 2009 filing season, the IRS is developing enhanced communications products, updating and expanding IRS.gov, and increasing outreach to taxpayers, partners, and tax practitioners on this important subject.

The IRS developed Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*, in collaboration with TAS, to consolidate all relevant information in one document. The publication, which was released in May 2008, provides a thorough explanation of cancellation of debt (COD) issues. The National Taxpayer Advocate recognized this accomplishment by awarding the National Taxpayer Advocate award to IRS employees who worked on the new publication.

The IRS, in collaboration with TAS, also revised Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, and the instructions to incorporate MFDRA provisions and simplify the task of completing the form for non-business taxpayers. A new table was also added to the instructions on *How to Complete the Form*, to clearly explain which lines on Form 982 must be completed in situations involving qualified principal residence debt, other non-business debt (such as car loan or credit card debt), and other debts.

Although the National Taxpayer Advocate states the revised Form 982 is a substantial improvement over the previous version, she also states taxpayers continue to face challenges in reporting canceled debts on Form 982. Specifically, the National Taxpayer Advocate mentions that Form 982, which is used to claim insolvency, does not include a worksheet for calculating insolvency, nor does it direct taxpayers to submit substantiation of insolvency. The IRS notes that, because of the vast numbers and types of assets and liabilities that can exist for taxpayers, it is impossible to develop a worksheet that would work for all taxpayers. The IRS believes it would be more beneficial to illustrate the calculation through the use of examples, such as those in Publication 4681. To this end, the IRS plans to add

a reference in Form 982 that directs taxpayers to the insolvency examples in Publication 4681. Further, the IRS is updating Publication 525, *Taxable and Nontaxable Income*, to include more specific guidelines on the types of assets and liabilities that must be included in the computation for taxpayers seeking to exclude income based on the insolvency exclusion.

With regard to the National Taxpayer Advocate's recommendation that the IRS direct taxpayers to submit substantiation of insolvency with the completed Form 982, the IRS believes this would pose unnecessary burden on those taxpayers since most will not receive a CP 2000 notice from the IRS. The IRS further notes this information is not required during the processing of Form 982, but is normally requested only in connection with resolution of an information return document matching discrepancy, or when a return is selected for examination.

With respect to the VITA and TCE programs, the IRS expanded the scope at VITA/TCE sites to include COD issues relating to the MFDRA. Volunteers with advanced certification will be trained to assist taxpayers with tax return preparation for income excluded due to "discharge of qualified principal residence indebtedness." A Screening Sheet will be available for volunteers to identify those taxpayers who can be assisted at the volunteer sites and those that need to be referred to TACs or Low Income Taxpayer Clinics. In addition, a training supplement to the 2008 Publication 4491, *Volunteer Student Guide*, is currently under development. The supplement, Publication 4491-X, will include information about the MFDRA, plus updates on other legislation that have become available since Publication 4491 was published. Two outreach products – Publication 4702, *Mortgage Forgiveness Debt Relief Act of 2007 Overview*, and Publication 4705, *Tax Relief for Struggling Homeowners and FAQs* – are also being updated to provide partners, volunteers, and employees with current information about the MFDRA.

With respect to TACs, the IRS has also expanded the scope of return preparation assistance to include COD issues related to MFDRA. Further, for tax law assistance, the IRS removed the "out of scope" designation and is providing extensive training on COD income for TAC employees who have received Intermediate Tax Law Training. The Interactive Tax Law Assistant (ITLA), an interactive electronic assistance program, will address insolvency, allowing trained assistors to help with a comparison of assets vs. liabilities.[39] Additional probes were added to determine the portion of principal residence indebtedness that was used for a purpose other than acquiring, constructing, or substantially improving the taxpayer's principal residence. The ITLA will also include a resulting response that will address the equity portion of the debt.

The IRS agrees that only IRS employees who receive separate training on COD income should use ITLA. Providing high quality service depends on employees knowing when and

39 http://serp.enterprise.irs.gov/databases/irm-sup.dr/current/itla/itla-home.htm.

where to refer issues that are outside their training, certification and expertise. As such, referral procedures are in place to assist taxpayers when an employee encounters a question beyond their training or expertise. Taxpayer issues beyond these levels will be handled through a clearly defined referral process.[40]

The National Taxpayer Advocate asserts the IRS is too quick to take enforcement action when taxpayers misreport COD. For example, the National Taxpayer Advocate states taxpayers may first become aware that they may need to report COD income when they receive a letter, Notice CP 2000, *Notice Proposing Adjustments to Income, Payments, or Credits*. The IRS believes taxpayer's first indication that they need to report COD income more often arises when they receive Form 1099-C, *Cancellation of Debt*, from the lender. Form 1099-C is required to be filed with the IRS and the taxpayer for cancellation of any debts of $600 or more. However, if the taxpayer fails to include this income on their return or to claim one of the applicable exceptions or exclusions on Form 982, they may receive a CP 2000 notice from the IRS. This notice includes a special paragraph that instructs the taxpayer that under certain conditions, cancelled or forgiven debt should be included on returns as income. This paragraph also informs taxpayers that if they claim insolvency, they should provide a breakdown of total assets and liability immediately before the cancellation of debt. Further, TY 2007 and future CP 2000 notices that involve COD income will include reference to the MFDRA and a copy of Publication 4681.

For COD cases selected for review by the Automated Underreporter (document matching) Program, if the taxpayer files Form 982 to claim the insolvency exception, a CP 2000 request for substantiation of insolvency is much like any other issue where the IRS is verifying the taxpayer's claim. The practice of requesting additional information from the taxpayer, even though inclusion of that information is not required at the time of filing, is not unique to situations involving COD insolvency status.

Finally, the National Taxpayer Advocate recommends the IRS create a single unit dedicated to handling COD issues, similar to the current Innocent Spouse program or the U.S. competent authority procedures created in the early 1970s. It is important to understand that unlike Innocent Spouse or the recently centralized Identity Theft unit, where specialized handling is provided to address unique claims or uncommon issues, the requirement to report and pay tax on COD income is an integral part of IRS' information, education, assistance, and compliance operations. In light of current economic conditions, the IRS believes the additional focus and attention to the COD income issue, as outlined above, is fully warranted. However, there are myriad complex provisions in the Code. At this time, the IRS does not believe the COD income issue is so unique as to justify creation of redundant, centralized operations dedicated solely to this particular tax provision.

40 IRM 21.3.4.3.7, *Referral Procedures*.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate applauds the IRS for recognizing the seriousness of this problem and taking appropriate action such as working with TAS to develop Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*; revising Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*; and expanding assistance to taxpayers at TACs and IRS-sponsored volunteer sites. The National Taxpayer Advocate welcomes the IRS's commitment to continue to enhance its training materials and communications products.

While the IRS and the National Taxpayer Advocate have worked together very effectively in addressing issues surrounding the problem of understanding and reporting the tax consequences of cancellation of debt income, some challenges remain where the IRS appears not to appreciate the uniqueness and long-term nature of the problem. For example, the IRS believes that a taxpayer first realizes he or she may have cancellation of indebtedness income upon receipt of the Form 1099-C. This assertion simply does not correspond to the realities taxpayers face when their homes are foreclosed, they are evicted, and their former residences sold. Taxpayers in this situation seek alternative living arrangements, such as with friends or family or in shelters, and they may move several times. It should come as no surprise that many taxpayers in this situation do not notify the lender that foreclosed on their home of their current whereabouts in order to ensure that they will receive a form they have never heard of which will permit them to meet a tax reporting obligation that they do not even suspect exists. This is a unique problem, and the IRS should find unique approaches to helping taxpayers understand and report the tax consequences of their debt cancellation. An AUR notice, as the likely first indication taxpayers receive that they may have a tax liability, should be explanatory and helpful, keeping in mind that many taxpayers will not in fact owe additional taxes. The outreach and communications products that the IRS is creating, described in its response, could be included with the initial letter AUR sends.

We are unconvinced that the IRS cannot produce an insolvency worksheet for taxpayers to submit with their tax returns when they claim the insolvency exception. The IRS is developing specific guidelines pertaining to insolvency for inclusion in Publication 525, *Taxable and Nontaxable Income*, which demonstrates that the capability exists. Designing a form with that information (including a line for "other" assets or liabilities if necessary), providing a general explanation for the form, and referencing Publication 525, would be helpful and appropriate.

As another example of the IRS's underestimate of the significance of this issue, the IRS explains that it solicits substantiation from taxpayers claiming the insolvency exception "much like any other issue where the IRS is verifying the taxpayer's claim." It is true that the rules pertaining to cancellation of debt income have been in place for many years. As our statistics show, however, entire segments of the population, such as the elderly with

credit card debt used to pay for medical care, are now affected by these rules for the first time. Middle-class taxpayers whose jobs will be impacted by the economic downturn and the subprime lending spree of recent years will join the ranks of those with debt cancellation reporting obligations. These conditions will transform the problem of cancellation of debt reporting into a taxpayer crisis for the next five years at least. The IRS is short-sighted to resist immediate and fundamental accommodation of this reality.

Recommendations

In summary, the National Taxpayer Advocate recommends that the IRS:

1. Develop an insolvency worksheet for taxpayers claiming the insolvency exception;
2. Revise Form 982 to instruct taxpayers claiming the insolvency exception to attach an insolvency worksheet to their returns; and
3. Create a centralized unit dedicated to handling cancellation of debt issues.

MSP #4

Employment Taxes

Responsible Official

Chris Wagner, Commissioner, Small Business/Self-Employed Division

Definition of Problem

With an estimated $58 billion in unpaid employment taxes, it is clear that the IRS faces a significant noncompliance problem.[1] At the same time, approximately 88 percent of all employment tax returns are filed with no balance due.[2] Thus, recognizing that the majority of taxpayers are compliant, the IRS needs to take a balanced approach to collecting these taxes. While the need to collect unpaid payroll taxes is clear, the IRS should apply different treatments to taxpayers depending on their level of and reasons for noncompliance. The National Taxpayer Advocate has the following concerns about the IRS's current procedures and initiatives to address noncompliance:

- IRS policies may overreach and undermine some of the important protections enacted in the Taxpayer Bill of Rights 2 (TBOR 2) and the IRS Restructuring and Reform Act of 1998 (RRA 98), especially with respect to Trust Fund Recovery Penalties (TFRPs);[3]
- While it is essential to address the existing significant level of noncompliance, the IRS must also focus on encouraging voluntary compliance by assisting those taxpayers attempting to comply with complex rules and procedures;
- The IRS has not concentrated sufficient resources on early intervention techniques to prevent the accumulation of substantial employment tax liabilities; and
- To avoid costly downstream enforcement actions, the IRS needs to focus on building up a local compliance presence for enforcement purposes and to perform outreach and education initiatives.

1 IRS Compliance Data Warehouse, Accounts Receivable Dollar Inventory, Cycle 200738 (the closest cycle to Sept. 30, 2007) for employment tax (Form 941) delinquencies outstanding. The Government Accountability Office (GAO) recently conducted an audit to address the problem of unpaid payroll taxes at the request of the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security and Governmental Affairs. The results of the study were the focus of a hearing on July 29, 2008, titled "Payroll Tax Abuse: Businesses Owe Billions and What Needs to Be Done About it." GAO, GAO-08-617, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* 23 (July 2008). This discussion will detail this audit and recommendations, *infra*.

2 Compliance Data Warehouse, Business Return Transaction File and Accounts Receivable Dollar Inventory for Tax Periods 200609, 200612, 200703, and 200706 (the data does not account for unfiled return investigations remaining after third quarter 2008).

3 TBOR 2, Pub. L. No. 104-168 § 903, 110 Stat. 1452, 1466 (1996); RRA 98, Pub. L. No. 105-206 § 3307, 112 Stat. 685, 744 (July 22, 1998).

Analysis of Problem

High Rate of Employment Tax Compliance

Employment taxes constitute a significant source of revenue for the federal government. In fiscal year (FY) 2007, of the total $2.7 trillion the IRS collected, payroll taxes represented approximately $850 billion.[4] Despite the burdensome and complex requirements associated with employment taxes, the rate of compliance among employment taxpayers is quite high. For example, IRS data shows that in FY 2007, over 88 percent of all employment tax returns were filed with no balance due.[5] Thus, IRS data indicates that the overwhelming majority of employers are presumably compliant.

GAO Report on Significant Employment Tax Noncompliance

While employment tax compliance is relatively high, noncompliance is still a significant problem. The Government Accountability Office (GAO) recently conducted an audit to address the problem of unpaid payroll taxes at the request of the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security and Governmental Affairs. The results of the study were the focus of a hearing on July 29, 2008, titled "Payroll Tax Abuse: Businesses Owe Billions and What Needs to be Done About it." The audit found that as of September 30, 2007, over 1.6 million businesses owed over $58 billion in unpaid federal payroll taxes (including penalties and interest) that have accumulated over the last 10 years. The IRS has classified over half of the debt as currently uncollectible.[6]

The National Taxpayer Advocate's research similarly indicates that as of September 2007, 1.6 million taxpayers owed approximately $58 billion in employment taxes. Less than half of this amount – $26.2 billion – represented actual taxes, as interest ($17.5 billion) and penalties ($14.2 billion) made up the rest.[7] Approximately 30 percent of the $58 billion consists of interest, demonstrating that the timing of IRS intervention is extremely vital, because the accumulation of interest and penalties significantly exacerbates delinquency issues.

In its report, GAO concluded employment tax noncompliance is increasing. In a 1998 study, GAO found unpaid payroll taxes totaled $49 billion. The recent GAO report found that in the ten years since, the number of businesses with unpaid payroll taxes has

4 IRS, *FY 2007 Data Book* Table 1.

5 Compliance Data Warehouse, Business Return Transaction File and Accounts Receivable Dollar Inventory for Tax Periods 200609, 200612, 200703, and 200706 (the data does not account for unfiled return investigations).

6 GAO, GAO-08-617, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* 23 (July 2008). It is unclear why the IRS classified the unpaid taxes as currently uncollectible. GAO noted that the IRS assigned to revenue officers about $7 billion, and about $9 billion remained in the queue awaiting assignment. In addition, GAO's analysis found that the number of businesses with more than 20 quarters of tax debt (five years of unpaid payroll tax debt) more than doubled between 1998 and 2007.

7 IRS Compliance Data Warehouse, *Accounts Receivable Dollar Inventory, Cycle 200738* (the closest cycle to September 30, 2007) for employment tax (Form 941) delinquencies outstanding.

decreased from 1.8 million to 1.6 million, but the size of the tax debt increased by approximately 20 percent.[8]

The National Taxpayer Advocate questions whether employment tax noncompliance has in fact increased over the past decade. The 1998 figures cited by GAO were not adjusted for inflation; such adjustment is necessary to reflect the change over ten years. In fact, the amount of the inflation-adjusted employment tax gap appears to have shrunk, because $49 billion in 1998, adjusted for the consumer price index, is equivalent to over $62 billion in 2007. In addition, the GAO data does not indicate whether the number of employers in the United States has increased in the last ten years, or whether the ratio of unpaid payroll taxes to total payroll taxes has increased during this time. Merely providing aggregate data without making these adjustments and comparisons can distort the picture and prevent the IRS from designing appropriate solutions.

Complex Employment Tax Requirements

Employers that pay wages for services of an employee are required to deduct and withhold Social Security, Medicare, and income taxes from the wages.[9] Employers are also responsible for unemployment tax (FUTA) and their share of the Social Security and Medicare tax for their employees.[10] Employers may receive a credit, subject to limitations, on their unemployment tax up to the amount of state unemployment taxes they pay.[11] The determination of whether an employer has employees subject to withholding is based on the facts and relationship surrounding the employment.[12]

Generally, employers are responsible for filing tax returns and making periodic payments, known as deposits, to the IRS for employment taxes. While the rates for Social Security and Medicare taxes are fixed by law, employers may calculate income tax withholding under the percentage method or the wage bracket method.[13] An employer determines withholding based on the wage bracket method by finding the proper withholding on the tables provided in Publication 15, (Circular E), *Employer's Tax Guide*, and referencing the bracket for the withholding from the employee's pay period wages, pay period, marital status, and number of allowances for withholding. If the wages exceed the amount for the period and marital status provided, the employer may use the percentage method to determine

8 GAO, GAO-08-617, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* 23 (July 2008).

9 *See* IRC §§ 3102(a) and 3402(a). The employee's rate of tax is 6.2 percent of wages for Social Security up to the contribution and benefit base and 1.45 percent of wages for Medicare. *See* IRC § 3121(a). The contribution and benefit base as determined under § 230 of the Social Security Act is $102,000 for 2008 and $106,800 for 2009. *See* http://www.ssa.gov/pressoffice/factsheets/colafacts2009.htm (last visited Dec. 22, 2008).

10 *See* IRC §§ 3301, 3111(a) and (b). The employer's tax for Social Security and Medicare is identical to the employee's tax. The employer's unemployment tax under IRC § 3301 is equal to 6.2 percent of each employee's wages up to $7,000. *See* IRC § 3306(b).

11 IRC § 3302(a). The credit may not exceed 5.4 percent of the wages subject to Federal Unemployment Taxes (FUTA). *See* IRS Pub. 15, (Circular E), *Employer's Tax Guide*, 30 (2008).

12 *See* Legislative Recommendation, *Worker Classification*, *infra*; IRC §§ 3121(b) and 3306(c); IRS Pub. 15-A, *Employer's Supplemental Tax Guide*, 4-5 (2008).

13 IRC § 3402(b) and (c).

withholding.[14] The percentage method involves multiplying the employee's pay period wages, reduced by the amount of each withholding allowance for a certain period and marital status, by the percentage for the income level on the table in Publication 15.

An employer determines the amount of allowances for or exemption from withholding from the employee's Form W-4, *Employee's Withholding Allowance Exemption Certificate*, which is to be completed and submitted at the time the employee begins employment.[15] If the employee fails to provide Form W-4, the employer must withhold taxes as if the employee were single and had no withholding allowances.[16] The IRS requires employers to retain current Forms W-4 for all of their employees and may require the employer to submit copies upon written notice or as directed in published guidance.[17]

Employers with total FUTA exceeding $500 in any quarter must deposit the tax with the IRS.[18] Employers are required to deposit Social Security, Medicare, and income tax withholding for employees either annually, semiweekly, or monthly. Those with total Social Security, Medicare, and income tax withholding less than $50,000 during the lookback period (the annual period ending on June 30) generally deposit these taxes by the 15th of the month following the month the taxes were collected.[19] Employers with aggregate employment taxes exceeding $50,000 during the lookback period must deposit the taxes on a semiweekly basis.[20] Semiweekly depositors must make their employment tax deposits on or before the following Wednesday if their payroll is paid on Wednesday, Thursday or Friday, or on or before the following Friday if their payroll is paid between Saturday and Tuesday.[21]

Employers may deposit employment taxes through the Electronic Federal Tax Payment System (EFTPS) or by depositing or mailing the funds to an authorized financial institution or IRS lockbox. Employers with deposits exceeding $200,000 in a year are required to use the EFTPS the following year.[22] The IRS provides instructions to taxpayers with Form 8109, *Federal Tax Deposit Coupon*.[23] The IRS may assert a penalty under IRC § 6656 for failure to timely make any required employment tax deposit.[24] There are two exceptions to

14 IRS Pub. 15, (Circular E), *Employer's Tax Guide*, 36 (2008).

15 IRC § 3402(f)(2)(A).

16 IRS Pub. 15, (Circular E), *Employer's Tax Guide*, 15 (2008).

17 Treas. Reg. § 31.3402(f)(2)-(1)(g)(1)(i); IRS Publication 15, (Circular E), *Employer's Tax Guide*, 16 (2008).

18 IRS Pub. 15, (Circular E), *Employer's Tax Guide*, 15 (2008).

19 Treas. Reg. § 31.6302-1(b)(2).

20 Treas. Reg. § 31.6302-1(b)(3).

21 Treas. Reg. § 31.6302-1(c)(2)(i).

22 Internal Revenue Manual (IRM) 5.7.1.7 (July 18, 2008).

23 IRS Pub. 15, (Circular E), *Employer's Tax Guide*, 22-23 (2008).

24 For failing to make a timely or proper deposit, the penalties are: two percent for deposits made one to five days late; five percent for deposits made six to 15 days late; ten percent for deposits made more than 15 days late; ten percent for deposits made within ten days from notice and demand for payment; ten percent for deposits made at an unauthorized financial institution, directly to the IRS, or with a payroll tax return (unless excepted); ten percent for amounts subject to electronic deposit requirements but not deposited with EFTPS; 15 percent for deposits not made within the earlier of ten days from notice and demand or on the day that demand for immediate payment is made by the IRS. *See* IRC § 6656(a).

monthly or semiweekly deposits: (1) if in any deposit period an employer has accumulated $100,000 or more of employment taxes, the employer must make a deposit the next banking day;[25] and (2) in some cases, a payment with the payroll tax return may be made in lieu of a monthly or semiweekly deposit without penalty.[26]

Most employment tax returns are due at times other than when the deposits are due. The taxpayer must file Form 941, *Employer's Quarterly Federal Tax Return,* no later than the last day of the month following the close of the calendar quarter. Some employers may receive written notification from the IRS that they are entitled to file annually on Form 944, *Employer's Annual Federal Tax Return,* instead of Form 941.[27] Employers file Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return,* to report federal unemployment tax,[28] and must file Forms 940 and 941 by the last day of the month following the close of the tax year.[29] Employers are required to report to each employee the amounts of wages paid and withholding by January 31 of each year on Form W-2, *Wage and Tax Statement.*[30] Employers must file Form W-3, *Transmittal of Wage and Tax Statements,* with copy A of all Forms W-2 with the Social Security Administration by the last day of February each year.[31]

IRS Employment Tax Enforcement Procedures

Most IRS collection efforts for employment taxes focus on early intervention and the detection of pyramiding taxpayers.[32] In addition to using the specific tools for employment taxes identified below, the IRS collects these taxes through balance due notices, lien and levy determinations, and filing notices of federal tax lien or levy and seizure of the employer's property. The IRS is particularly concerned with collecting employment tax deposits and imposes a trust for these taxes on employers under IRC § 7512(b) by providing notice.[33] The IRS also imposes a special trust under IRC § 7501 on any person required to collect

25 Treas. Reg. § 31.6302-1(c)(3).

26 For example, an employer may be able to submit a monthly deposit with its Form 941, which is due one month after the close of the calendar quarter, if the liability reported on the form is $2,500 or less, or there is a deposit shortfall not greater than the lesser of two percent of the total tax liability or $100 and the payment is made with the return when its due date is the shortfall makeup date. Similarly, an employer who files Form 944 may be able to make its deposit for the fourth quarter with its return if its tax liability does not exceed $2,500 and it has made its deposits for the first, second and third quarters. *See* IRS Publication 15, (Circular E), *Employer's Tax Guide*, 19, 22 (2008).

27 *See* IRS Pub. 15, (Circular E), *Employer's Tax Guide*, 25 (2008).

28 *See id.* at 30.

29 *See id*. at 25, 30.

30 *See* IRC § 6041(d).

31 *See* IRS Pub. 15, (Circular E), *Employer's Tax Guide*, 2 (2008).

32 *See* IRM 5.7.8.3 (Oct. 6, 2006). A pyramiding taxpayer is an in-business taxpayer, not current with federal tax deposits (FTDs), that has two or more tax modules assigned to the IRS's Collection Field function (CFf). "A taxpayer that is pyramiding taxes is not demonstrating a good faith effort to comply." IRM 5.7.8.3(2) (Oct. 6, 2006).

33 *See* IRC § 7512(a). The trust is imposed if the person fails to collect, truthfully account for, or pay over such tax, or fails to make deposits, payments, or returns for such tax. The notice required must be delivered in hand to such person for any such failure. For purposes of a corporation, partnership or trust, a notice delivered in hand to an officer, partner or trustee shall be deemed to be delivered in hand to such corporation, partnership or trust and all officers, partners, trustees and employees thereof.

and withhold an employee's taxes, which forms the basis for the TFRP under IRC § 6672.[34] In practice, the IRS ensures employment tax compliance by monitoring federal tax deposits (FTDs) and taking action when the employer is delinquent or late on making the deposits.[35] However, the IRS appears to focus most of its monitoring efforts on employers making semiweekly deposits.[36]

Once the IRS is alerted to an employer's noncompliance, it will assign an FTD Alert to a revenue officer.[37] During the initial contact with the taxpayer, the revenue officer will explain the noncompliance; provide Publication 1, *Your Rights as a Taxpayer*, and Notice 931, *Deposit Requirements for Employment Taxes*; discuss the true cost of failing to deposit taxes, including the FTD penalty, with the employer; ensure that the employer understands the consequences of continued noncompliance; and encourage the employer to remain current with deposits first, while working to resolve past due deposits. After the initial contact, the revenue officer will monitor compliance until the account is resolved.[38]

A revenue officer who is unsuccessful at collecting employment taxes from the employer or the responsible person after proceeding with any levies and filing any liens will then decide whether a criminal referral is necessary. The revenue officer will determine if the employer's case is egregious; that is, collection procedures have been unproductive or futile in stopping or reducing trust fund pyramiding. The revenue officer will hand-deliver to the employer or, if the employer is unavailable, leave at the place of business a letter explaining the employer has flagrantly failed to pay and collect employment taxes and prosecution under IRC § 7215 may be appropriate.[39] The revenue officer may then require monthly filing of Form 941-M and monthly or semimonthly tax deposits.[40] If the employer fails to comply with the requirements, the revenue officer may seek prompt assessment of unpaid monthly liabilities, prepare substitutes for returns under IRC § 6020(b), or take enforcement action by the end of the quarter. The revenue officer may request a civil injunction to stop further pyramiding or make a criminal referral for failure to adhere to special bank account rules.[41]

Assessment and Collection of Trust Fund Recovery Penalties

The IRS has the statutory authority to assess the TFRP against any person responsible for collecting and paying the delinquent employment taxes.[42] Upon initial contact with the delinquent employer and within 120 days of assignment of the balance due account,

34 IRC § 7501(a) and (b).

35 *See* IRM 5.7.1 (July 18, 2008).

36 IRM 5.7.1.2 (July 18, 2008).

37 IRM 5.7.1.4 (July 18, 2008).

38 IRM 5.7.1.6 and 5.7.1.7 (July 18, 2008).

39 IRM 5.7.2.1 (June 4, 2002).

40 IRM 5.7.2.2 (June 4, 2002).

41 IRM 5.7.2.2(5) (June 4, 2002).

42 IRC § 6672.

the revenue officer will determine whether the IRS will assert the TFRP.[43] The period for a TFRP determination may be shortened if necessary to meet the statutory period for assessment.[44] The amount of the penalty equals 100 percent of the income and FICA taxes withheld from the employees.[45]

The IRS imposes the TFRP on responsible persons that willfully fail to collect or pay over trust fund taxes to the IRS.[46] The IRS assigns responsibility for this failure as a matter of position, authority, and status that is heavily dependent on the facts and circumstances of each case.[47] A responsible person may include another business entity or an officer, employee, owner or surety of the employer.[48] A person is responsible to pay or collect the trust fund taxes if he or she has a duty to perform, a power to direct collection of and payment of the employer's taxes, accountability and authority to pay, and power to control which creditors are paid. The revenue officer will pursue the TFRP against the responsible person(s) unless the employer pays or liquidates specific assets to pay the trust fund taxes within 90 days of the initial contact, the responsible person agrees to pay or liquidate specific assets to pay within 90 days of the initial contact, or the employer enters an In-Business Trust Fund Express installment agreement.[49]

The assessment of TFRPs came under intense congressional scrutiny in the time leading up to and during the RRA 98 hearings. TBOR 2 and RRA 98 included several provisions protecting taxpayer rights during assessment and collection of the TFRP. For example, TBOR 2 required the IRS to provide advance notice of the penalty at least 60 days before assessing it, as well as providing a right to contribution where more than one person is liable for the penalty.[50] RRA 98 permitted personal service of the preliminary notice informing the "responsible person" of the proposed penalty. The conference report specifically stated that such measure could "afford taxpayers the opportunity to resolve cases involving the 100-percent penalty at an earlier stage."[51] In addition, RRA 98 prevents the IRS from collecting the full amount of any assessed penalty while litigation is pending.[52]

43 IRM 5.7.4.1 (Sept. 23, 2008).

44 IRC § 6501(a) and (b)(2); IRM 5.7.4.1 (Sept. 23, 2008). In addition, the IRS is statutorily authorized to initiate jeopardy assessments for TFRPs. IRC § 6672(c)(5); IRM 5.1.4.2 (Apr. 1, 2005).

45 IRC §§ 6671(b), 6672(a); IRM 5.7.3.3.1 (Apr. 13, 2006); IRM 5.7.3.3.2 (Apr. 13, 2006).

46 IRC § 6672; IRM 5.7.3.3 (Apr. 13, 2006). Willful means intentional, deliberate, voluntary, reckless, or knowing, as opposed to accidental. No evil intent or bad motive is required. IRM 5.7.3.3.2 (Apr. 13, 2006).

47 IRM 5.7.3.3.1(1) (Apr. 13, 2006).

48 *Id.*

49 IRM 5.7.4.1(3) (Sept. 23, 2008).

50 TBOR 2, Pub. L. No. 104-168 §§ 901-903, 110 Stat. 1452, 1466 (1996).

51 RRA 98, S. Rep. No. 105-174, 105th Cong. § 3307 (Apr. 22, 1998); Pub. L. No. 105-206 § 3307, 112 Stat. 685, 744 (July 22, 1998).

52 RRA 98, S. Rep. No. 105-174, 105th Cong. § 3307 (Apr. 22, 1998); Pub. L. No. 105-206 § 3307, 112 Stat. 685, 744 (July 22, 1998).

General Concerns Regarding Development of IRS Employment Tax Strategy

Acknowledgement of IRS Progress

The National Taxpayer Advocate agrees that the IRS should make the collection of unpaid payroll taxes an utmost priority. Employers have already withheld the taxes from their employees' salaries and the IRS pays refunds on these amounts to these employees regardless of whether it collects the withheld funds. In addition, payroll taxes fund the Social Security program, which is projected to experience an excess of program expenses over payroll tax revenue within the next ten years.[53] However, considering the high tax dollars at stake and the intense congressional scrutiny, the National Taxpayer Advocate is concerned that the IRS may take a reactive approach to this problem that will not serve the long-term best interests of taxpayers or tax administration.

The IRS has undertaken some efforts to address employment tax noncompliance. For example:

- From FY 2005 to FY 2007, the number of employment tax audits increased by 66.8 percent, while the audit coverage rate rose from 0.11 percent to 0.20 percent.[54]
- The IRS states that it has committed to help employers avoid problems by educating them on their employment tax responsibilities. It says that virtually every IRS function and division participates in employment tax outreach and education.[55]
- The IRS sends fewer notices in employment tax cases so personal contact can occur sooner. The highest priority cases even bypass the telephone operation in favor of making first contact in the field.[56]
- The IRS attempts to identify potential problems as early as possible in the process. For example, the FTD Alert process helps identify at an early stage those semi-weekly depositors that have not made federal tax deposits in the current quarter or have deposited substantially smaller amounts than in prior quarters.[57]

These IRS initiatives, however, are either underutilized, inadequately staffed, or lacking strategic focus. For example, the Treasury Inspector General for Tax Administration (TIGTA) reviewed the FTD Alert program and found positive results, such as increased deposits and a higher percentage of fully paid subsequent tax liabilities. However, TIGTA

53 The Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *2006 Annual Report* 2 (May 1, 2006).

54 *Payroll Tax Abuse: Businesses Owe Billions and What Needs to Be Done About It: Hearings Before the Perm. Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs*, 110th Cong. (July 29, 2008) (testimony of Linda Stiff, IRS Deputy Commissioner, Services and Enforcement).

55 *Id.*

56 *Id.* However, even these high priority cases could wait in a queue before being assigned. As discussed *infra*, at the end of FY 2007, 30.2 percent of the modules in the collection queue awaiting assignment were employment tax liabilities (Forms 941 and 944). Over 50 percent of the modules were in the collection queue for 16 months or more. IRS, *5000-2 Collection Activity Report* (Sept. 2008); IRM 5.1.20.2.3.2 (May 27, 2008).

57 *Payroll Tax Abuse: Businesses Owe Billions and What Needs to Be Done About It: Hearings Before the Perm. Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs*, 110th Cong. (July 29, 2008) (testimony of Linda Stiff, IRS Deputy Commissioner, Services and Enforcement).

noted that the IRS did not regularly analyze the program to determine its impact on compliance; nor did revenue officers follow such procedures as contacting the taxpayers within the required times, monitoring current FTDs, or informing taxpayers about potential penalties or enforcement consequences.[58] The National Taxpayer Advocate has identified the inadequacy of the IRS's outreach and education to small business taxpayers as a most serious problem in several Annual Reports to Congress.[59]

Assessment and Collection of Trust Fund Recovery Penalties

The National Taxpayer Advocate is particularly concerned about the assessment and collection of TFRP under IRC § 6672. It is important that the IRS tread carefully when engaging in enforcement activities or developing new policies regarding this penalty. IRS employment tax examination and collection actions were subject to intense scrutiny during the hearings that led to RRA 98. As the Senate Finance Committee pointed out in a conference report for RRA 98, "[t]he imposition of the 100-percent penalty is a serious matter." In fact, during the hearings, one practicing attorney stated the following:

> Trust Fund Recovery Tax: This is really not a penalty. It is a tax .... Currently, the IRS uses a "shotgun approach" to assessing this penalty within an organization. It's something like the old Army joke: "I need volunteers – you, you, and you." Field cases are not properly and thoroughly developed. Many targeted taxpayers are innocent. Taxpayers wishing to contest this assessment have to plead their case before the IRS. The IRS is the sole judge, jury, and executioner. The IRS knows that most targeted taxpayers cannot afford to go to court, so the IRS sticks them with the assessment, guilty or not. The bottom line is an economic life sentence.[60]

During the same set of hearings, the National Taxpayer Advocate, who at the time was the Executive Director of The Community Tax Law Project, a low income taxpayer clinic, also voiced concerns about the IRS assessment of TFRPs. In her testimony, she discussed how revenue officers frequently did not explain to the taxpayer the concept of "responsible person" or the underlying purpose of the inquiry into responsibility for payment and the possible results of a finding of responsibility. She represented several taxpayers who were coerced to agree to the assessment of the penalty and were not advised of their right to disagree with the revenue officer and obtain further review of the proposed assessment.[61] Accordingly, she requested that the IRS require revenue officers to provide the taxpayer with a separate statement outlining the requirements for making an IRC § 6672

58 TIGTA, Ref. No. 2007-30-180, *The Federal Tax Deposit Alert Program Helps Taxpayers Comply with Paying Taxes, but Alerts Can Be Worked More Effectively* (Sept. 17, 2007). In response to the audit, the IRS committed to improve the shortcomings in the program.

59 *See, e.g.*, National Taxpayer Advocate 2006 Annual Report to Congress 172-96.

60 *IRS Restructuring: Hearing Before the S. Comm. on Finance*, 105th Cong. (Feb. 5, 1998) (statement of Robert Schriebman, practicing tax attorney).

61 *IRS Restructuring: Hearing Before the S. Comm. on Finance,* 105th Cong. (Feb. 5, 1998) (statement of Nina E. Olson).

assessment, the taxpayer's rights pertaining to the responsible person penalty assessment, and an explanation of the effect of consenting to an assessment.

In addition to the protections afforded taxpayers in TBOR 2,[62] RRA 98 included several provisions protecting taxpayer rights during assessment and collection of the TFRP. For example, RRA 98 permitted personal service of the preliminary notice informing the "responsible person" of the proposed penalty. Personal service would increase the likelihood that taxpayers would pay attention to and resolve disputes earlier in the process.[63] In addition, RRA 98 prevented the IRS from collecting the full amount of any assessed penalty while litigation is pending.[64] Considering that Congress enacted these protections in response to the hearings, it is important that the IRS strictly monitor compliance with the provisions to verify that taxpayer rights are safeguarded.

In the 2007 Annual Report to Congress, the National Taxpayer Advocate identified the following aspects of the TFRP process as in need of improvement:

- Incomplete TFRP investigations;
- Delays by Collection personnel in sending taxpayer protests to the Appeals function;
- Failure to apply payments and credits accurately and in a timely manner;
- The lack of collectability determinations prior to assessment of the TFRP; and
- Collection policies that compromise the rights of taxpayers before the IRS actually determines a responsible person's liability.[65]

In its response to the 2007 report, the IRS pointed out several remedial actions then in place or underway. We appreciate the IRS's commitment to improving TFRP assessment and collection. However, we are concerned that the latest GAO report and related congressional hearing may have the effect of undermining the IRS's efforts to protect taxpayers' rights in the complex TFRP process; therefore, we will actively monitor the IRS's actions in this area.

Encouraging Voluntary Compliance

While the GAO study raised concerns about the IRS's focus on voluntary compliance, the National Taxpayer Advocate believes this focus on balance is beneficial. First, the IRS needs to look at the hard facts. In FY 2007, over 88 percent of all employment tax returns were filed with no balance due.[66] This data indicates the IRS needs to assist the

62 TBOR 2 required advance notice of the penalty at least 60 days before assessment and provided a right to contribution where more than one person is assessed the penalty. TBOR 2, Pub. L. No. 104-168 §§ 903, 110 Stat. 1452, 1466 (1996).

63 RRA 98, S. Rep. No. 105-174, § 3307 (Apr. 22, 1998); Pub. L. No. 105-206, § 3307, 112 Stat. 685, 744 (July 22, 1998).

64 *Id.*

65 For a detailed discussion, *see* National Taxpayer Advocate 2007 Annual Report to Congress 395-410.

66 Compliance Data Warehouse, Business Return Transaction File and Accounts Receivable Dollar Inventory for Tax Periods 200609, 200612, 200703, and 200706 (the data does not account for unfiled return investigations).

overwhelming majority of employers in *maintaining compliance*. To do this, the IRS must first understand the causes, barriers, and challenges employers face in complying with employment taxes. Noncompliance may stem from a variety of factors, including but not limited to (1) confusion over complex filing and payment responsibilities, (2) cash flow issues, and (3) intentional tax evasion.[67] For an effective enforcement strategy, the IRS needs to treat each type of taxpayer according to the particular cause of their noncompliance. The success of this approach would depend upon the IRS's ability to distinguish among taxpayers based on their level of compliance and reason for noncompliance, if applicable. The first step in this approach is for the IRS to continue its field tests of education initiatives.[68] The IRS should next supplement these tests with combined education and enforcement pilots, which will enable it to determine which techniques encourage compliance for each type of employer and at various stages of the business lifecycle. For example, fully compliant taxpayers might benefit from receiving certain types of outreach and education to ensure future compliance. Businesses struggling to survive but falling behind on payroll tax responsibilities could receive education coupled with early intervention techniques. In addition, where taxpayers might benefit from better business practices, the IRS could work with the Small Business Administration and organizations such as SCORE to pair the taxpayer up with a mentor.[69] Finally, the IRS should reserve more severe collection techniques for repeat offenders that intentionally fail to comply.[70] The IRS should also research and analyze the best time to intervene based on the type of taxpayer.

Early Intervention

The recent GAO report noted that early intervention benefits both the government and taxpayers, and encouraged the IRS to concentrate more resources on this process. The National Taxpayer Advocate strongly agrees with GAO in this regard, and has written at length about the benefits of early intervention.[71] Early intervention includes education, outreach, and enforcement initiatives aimed at "touching" the taxpayer as soon as possible after the IRS detects a delinquency. The FTD Alert program is one example of an early intervention technique. While the IRS has an interest in collecting taxes, businesses also benefit if they are prevented from accumulating substantial unpaid payroll taxes, along

67 The Small Business/Self-Employed division (SB/SE) conducted focus groups during the 2007 IRS Nationwide Tax Forums on the topic of employment tax compliance. In general, the focus group participants gave the following four main reasons why small business owners do not timely or fully pay their trust fund taxes: (1) cash flow problems, (2) "snowballing" missed payments, (3) lack of enforcement, and (4) poor planning. SB/SE Research, 2007 Nationwide Tax Forums: Employment Tax Compliance – Are Your Clients at Risk? NCH0088 (May 2008).

68 *See* SB/SE Research Report, Project No. 06.08.004.03, *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes* 29 (Jul. 2004); 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). Both studies found that general outreach seemed to improve employment tax compliance in the construction industry.

69 SCORE is a nonprofit association that works with the Small Business Administration to educate and promote the success of small businesses nationwide. For more information on SCORE, see http://www.score.org (last visited on Nov. 9, 2008).

70 *See* IRS Office of Program Evaluation and Risk Analysis (OPERA), *Study of TEC, SPEC, and NPL's Prefiling/Outreach Services, Organizational Model Options for Greater Efficiency* (Dec. 30, 2004); Memorandum from Mark Gillen, Director of Office of Program Evaluation and Risk Analysis to Deputy Commission for Services and Enforcement, OPERA TEC/SPEC/NPL Study – Organization Model Options (Dec. 30, 2004).

71 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 395-410, 432-47; National Taxpayer Advocate 2006 Annual Report to Congress 62-82.

with the associated penalties and interest. Over time, unpaid balances may compound beyond the business's ability to pay and ultimately cause financial jeopardy.[72] For example, IRS data shows that for FY 1998, the average amount owed on employment tax returns with a balance due was $8,271 in 1999. However, the average amount of FY 1998 tax module liabilities increased to $19,250 in 2003 and $28,343 in 2008.[73]

The National Taxpayer Advocate strongly believes early intervention is important to prevent pyramiding of employment tax liabilities. Once a taxpayer demonstrates noncompliance, the IRS should act as quickly as possible to prevent further accumulation of liabilities. While its resources are limited, any additional resources allocated to early intervention will certainly save resources downstream for the IRS. The IRS could use lower grade employees to make personal contacts early in the process, help the taxpayer enter into an installment agreement to satisfy existing liabilities, as well as requiring the taxpayer to pay more frequently in the future.[74] If the taxpayer continues to fail to make payments, the IRS can initiate enforcement procedures to bring the taxpayer into compliance before the debt grows too large to resolve and the taxpayer acquires a habit of noncompliance. Toward this end, the IRS needs to make many more outbound calls to taxpayers than it does now. Simply sending letters and placing taxpayers into collection queues awaiting assignment is not an effective compliance strategy.

At the end of FY 2008, 30.2 percent of the modules in the collection queue waiting assignment were employment tax liabilities (Forms 941 and 944). Table 1.4.1 illustrates the age of the cases.[75]

TABLE 1.4.1, Age of Employment Tax Modules

Less than 6 months	278,255	28.1%
6 to 9 months	86,218	8.7%
10 to 15 months	110,779	11.2%
16 months and over	516,402	52.1%
Total	991,654	100.0%

72 GAO, GAO-08-617, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* (July 2008).

73 IRS Compliance Data Warehouse, IRS Accounts Receivable Inventory File (the data reflects FY 1998 liabilities as of 199934, 200334, and 200834). The data only includes FY 1998 liabilities assessed as of the 199934 cycle and does not reflect the addition of other late filed returns or returns from other tax periods. Our 2006 Annual Report to Congress noted that 71.1 percent of business (BMF) employment tax cases involved delinquencies of less than $3,000. However, due to the small dollar figures, the IRS did not assign high priority to these cases despite the fact that fact that employment tax deficiencies tend to pyramid very quickly. In FY 2005, the IRS briefly worked employment tax deficiencies on a "last due, first worked" basis and saw almost immediate positive results. However, the IRS decided to discontinue this initiative and assign small dollar delinquencies to the Automated Collection System rather than the CFf, because they are not priority assignments. As a result, BMF revenue declined. *See* National Taxpayer Advocate 2006 Annual Report to Congress 62-82.

74 *See* National Taxpayer Advocate 2006 Annual Report to Congress 68-69. As noted in the 2006 report, IRS data provides ample evidence to suggest the IRS may not be working its optimal inventory, and collecting newer, lower dollar inventory is more effective than working older, higher dollar inventory. *See* IRS CACI Hybrid Test Update (Aug. 13, 2008). Recently, at the urging of the National Taxpayer Advocate, the IRS designed plans for a test that would measure the success of low grade IRS employees in attempting to collect on cases with small dollar amounts, which the IRS is not currently working.

75 IRS, *5000-2 Collection Activity Report* (Sept. 2008).

The Need for Local Compliance Presence

Participants in a Small Business/Self-Employed division (SB/SE) focus group at the IRS's 2007 Nationwide Tax Forums suggested the most important way to educate small business owners about trust fund tax responsibilities is for IRS personnel to conduct field visits. These tax professionals indicated phone calls and letters do not work because many clients just bring unopened IRS letters to their practitioners and ignore the calls. In addition, participants suggested that any marketing materials include stories about the worst penalties.[76] These focus group findings support the National Taxpayer Advocate's position that a local compliance presence is absolutely critical for an effective collection strategy. The IRS needs to make person-to-person contact with taxpayers as early as possible in the collection process. However, we see no evidence that the IRS plans to increase local compliance initiatives. In fact, the IRS has raised limited resources as an obstacle to pursuing this avenue further.[77] We agree that local presence would require additional resources. However, making personal contact earlier in the process, especially with respect to employment tax liabilities, could help bring taxpayers into compliance before their liabilities spiral out of control and avoid more costly enforcement actions downstream.

The Need for More Local Outreach and Education Initiatives

The IRS increasingly relies on industry partners to provide outreach and education to taxpayers. While strategic partnerships are vital, the IRS should devote more resources to grassroots initiatives.[78] A local presence is essential to understand the local economy and culture, and identify issues that may affect compliance.[79] In fact, as discussed above, focus group participants recommended the IRS educate taxpayers about payroll tax responsibilities through field visits. While any contact is better than no contact, the participants indicated the IRS needs to educate taxpayers through other means besides phone calls and letters.[80] Thus, the IRS should consider conducting more outreach and education through local initiatives, including field compliance visits.[81] The IRS should also consider developing pilot outreach programs to test the impact of local outreach initiatives on employment tax compliance, and should consider using a cognitive learning lab to design the pilot programs.[82]

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76 SB/SE Research, 2007 Nationwide Tax Forums: Employment Tax Compliance – Are Your Clients at Risk? NCH0088 (May 2008).

77 For more information, *see* National Taxpayer Advocate 2004 Annual Report to Congress 226-45.

78 Memorandum from Mark Gillen, Director of Office of Program Evaluation and Risk Analysis to Deputy Commission for Services and Enforcement, Opera TEC/SPEC/NPL Study – Organization Model Options (Dec. 30, 2004).

79 For a more detailed discussion of the benefits of local compliance, *see* Most Serious Problem, *Local Compliance Initiatives Have Great Potential but Face Serious Challenges, infra.*

80 SB/SE Research, 2007 Nationwide Tax Forums: Employment Tax Compliance – Are Your Clients at Risk? NCH0088 (May 2008).

81 In 2005, the IRS eliminated the Taxpayer Education and Communications (TEC) organization within SB/SE. The elimination of TEC resulted in the virtual elimination of the local footprint for outreach and education services provided by the IRS to small businesses. *See* National Taxpayer Advocate 2006 Annual Report to Congress 172-96. In addition, *see* SB/SE Research Report, Project No. 06.08.004.03, *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes* 29 (July 2004); 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). The studies both found that general outreach seemed to improve employment tax compliance in the construction industry.

82 For more information about cognitive learning labs, *see* National Taxpayer Advocate 2007 Annual Report to Congress 156-61.

Public Service Campaigns

The IRS should test the impact of a public information campaign that shows the social cost of unpaid employment taxes and warns employers of the risks of noncompliance, with messages such as:

> Don't get behind on your payroll taxes – Don't even think about it! By failing to comply with your payroll tax responsibilities, you are cheating your employees, and you are unfairly competing in the marketplace. If you fail to pay your payroll taxes, the IRS can pierce the corporate veil and assess you personally. These taxes are nondischargeable in bankruptcy.[83]

This type of message will convey the importance of meeting employment tax obligations. It also makes clear the detrimental impact noncompliance can have on the employer's ability to stay in business and on the personal finances of individual employees and officers.

GAO Report and Congressional Hearings

Based on its review of the IRS's collection actions for egregious payroll tax offenders, GAO made the following recommendations:[84]

- Develop a process to monitor collection actions against egregious payroll tax offenders.
- Determine the feasibility of treating businesses with egregious payroll tax debt and the responsible owners/officers with TFRP assessment as a single, unified, coordinated collection effort assigned to a single revenue officer.
- Develop and implement procedures to expeditiously file a notice of federal tax lien as soon as possible once a payroll tax debt is identified – including cases in the queue awaiting assignment. GAO recommended the IRS file liens on both the businesses with unpaid payroll taxes and the owners or officers assessed a TFRP.[85]
- Develop and implement procedures to monitor compliance with the new TFRP assessment time frames.[86] In addition, develop performance goals and measures to evaluate the accumulation of unpaid payroll taxes by businesses, the extent and timeliness of TFRP assessments, and the effectiveness of collection actions.

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83 See also our recommendation to the IRS to develop educational materials explaining third party payers and the responsibilities and liabilities each party assumes in such arrangements. Third party arrangements could assist employers in meeting their employment tax obligations. They could also help ensure that the business owners do not spend the funds inappropriately before remitting them to the IRS. National Taxpayer Advocate 2007 Annual Report to Congress 337-54.

84 This list is a summary of the GAO report recommendations and is not verbatim. GAO also recommended that the IRS develop performance goals and measures to specifically evaluate the accumulation of unpaid payroll taxes, the extent and timeliness of TFRP assessments, and the effectiveness of actions taken to collect unpaid payroll taxes and TFRP assessments.

85 In his opening statement for the hearing, Senator Carl Levin recommended that Congress enact S. 1124, the Levin-Coleman "Tax Lien Simplification Act," which would require Treasury to establish an electronic tax lien registry at the federal level. *Payroll Tax Abuse: Businesses Owe Billions and What Needs to Be Done About It: Hearings Before the Perm. Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs*, 110th Cong. (July 29, 2008) (testimony of Sen. Carl Levin, Chairman, Subcomm. on Investigations).

86 Revenue officers are required to determine whether to pursue a TFRP within 120 days of the case being assigned and to complete the assessment within 120 days of the determination. IRM 5.7.4.1 (Sept. 23, 2008).

- Work with states that have developed procedures for matching financial accounts to tax debts. The IRS should evaluate the potential to develop and implement similar procedures or collaborate with the states to leverage their efforts.[87]

The National Taxpayer Advocate agrees with several of GAO's recommendations, including the monitoring of egregious accounts, a unified corporate/responsible persons case strategy, and performance measures aimed at increasing voluntary compliance and the effectiveness of collection actions. As discussed below, however, the National Taxpayer Advocate is concerned about several of the other recommendations presented in the GAO report and in testimony presented at the associated congressional hearing.

Streamlining the Procedures to Assess Trust Fund Recovery Penalties

The GAO study found the IRS took an average of 40 weeks to determine whether to assess a TFRP and an additional 40 weeks to actually assess the penalty. In addition, GAO cited an IRS study that found 43 percent of taxpayers assessed the TFRP never made a payment on the penalty.[88] Based on the findings of the study, both GAO and testimonies submitted for the associated congressional hearing recommended the IRS streamline the assessment of TFRPs. In fact, one proposal provided that the IRS should automatically impose the penalty after a business misses a specified number of quarterly payroll payments, unless a revenue officer provides a written justification why the action should not be taken.[89]

The National Taxpayer Advocate believes the GAO TFRP data does not present the entire picture because it does not reflect the statutory assessment and abatement process. Taxpayers have a right to challenge a proposed TFRP assessment.[90] It is unclear from GAO's data how much of the 43 percent nonpayment figure is attributable to abatement as a result of an appeal. Further, the TFRP may be assessed on multiple responsible persons for one entity. If the IRS collects fully against the entity or one of the responsible persons, it cannot collect against the others. It is unclear whether the 43 percent figure reflects adjustments for responsible persons who do not pay the liability because one of the parties fully pays that liability.[91]

The National Taxpayer Advocate is particularly concerned with the recommendation to automate the assessment of the TFRP, as it appears inconsistent with current law and is likely to result in erroneous assessments that will negatively impact taxpayers. Before the IRS can assess the penalty against an individual, it is statutorily required to conclude the individual was responsible for withholding and paying over the payroll taxes and *willfully*

87 GAO, GAO-08-617, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* (July 2008).

88 GAO, GAO-08-617, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* (July 2008).

89 *Payroll Tax Abuse: Businesses Owe Billions and What Needs to Be Done About It: Hearings Before the Perm. Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs*, 110th Cong. (July 29, 2008) (testimony of Sen. Carl Levin, Chairman, Subcomm. on Investigations).

90 For more information on the appeal procedures for proposed TFRP assessments, see National Taxpayer Advocate 2007 Annual Report to Congress 395-410.

91 IRC § 6672(d). TBOR 2, Pub. L. No. 104-168, § 903, 110 Stat. 1452, 1466 (1996), provided a federal statutory right of contribution in favor of responsible persons who actually pay more than their share of trust fund penalties.

failed to do so.[92] Courts have settled on a variety of factors to consider in determining liability for the TFRP. IRM 5.7.3.3 incorporates the judicially determined factors by providing relevant indicators to determine personal responsibility and willfulness.[93]

Automating these processes would be a step in the wrong direction. Human involvement is absolutely necessary to determine whether the indicia for responsibility and willfulness are present before the IRS assesses this severe penalty on any individual. In addition, assessing the penalty on an individual involves piercing the corporate veil, which raises due process concerns.[94] Revenue officers need to interview potentially responsible persons, gather and review relevant documents, and look to the role and responsibility the person played in the day-to-day financial affairs of the business entity.[95] As discussed in the 2007 Annual Report to Congress, the assessment of the TFRP can have disastrous economic results on those deemed responsible. Thus, the IRS needs to confirm that necessary indicia are present, which requires a complete TFRP investigation. Moreover, given that a taxpayer can meet the statutory criteria for a responsible person for one quarter and not for another quarter, an automated or truncated process will not be able to make such determinations and would cause unnecessary downstream work for other IRS functions – Appeals, TAS, and the Office of Chief Counsel – and the courts.[96]

In the 2007 Annual Report to Congress, the National Taxpayer Advocate raised concerns about incomplete TFRP investigations and the high abatement rate for the penalty. The failure to follow established procedures for TFRP may lead the IRS to erroneous liability determinations and may even violate taxpayer rights. Table 1.4.2 below sets forth the assessment and abatement data for the TFRP for fiscal years 2000 to 2007:[97]

92 IRC § 6672(a).

93 *See* National Taxpayer Advocate 2007 Annual Report to Congress 396-97 (for a detailed discussion of the judicially determined factors).

94 Unlike corporations, sole proprietors and partners are already personally liable for business debts, so this discussion is solely directed at corporations.

95 IRM 5.7.4 (Apr. 13, 2006). Revenue Officers use Form 4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes*, to interview potentially responsible persons. IRM 5.7.4.2.1 (Apr. 13, 2006).

96 The IRS is statutorily authorized to initiate jeopardy assessments for TFRPs. IRC § 6672(c)(5); IRM 5.1.4.2 (Apr. 1, 2005). When the National Taxpayer Advocate was in private practice, she represented many taxpayers against whom the penalty was applied as a result of a "blanket assessment." That is, the IRS merely looked at state corporation records to identify the corporate officers, and without further inquiry assessed the TFRP against anyone listed, regardless of their involvement in or control of the corporation's affairs. In several instances, these "officers" were merely family members who had no involvement with the corporation. In response to concerns such as these, TBOR 2 imposed a requirement of a proposed notice of assessment, providing the taxpayer with the ability to challenge the penalty before it is assessed. TBOR 2, Pub. L. No. 104-168, §§ 901-903, 110 Stat. 1452, 1465 (1996); IRC § 6672.

97 IRS Enforcement Revenue Information System (ERIS), *Data on IRS Compliance Data Warehouse* (as of Mar. 31, 2008).

TABLE 1.4.2, Trust Fund Recovery Penalties Assessed and Abated[98]

Assessment FY	Penalty Assessment Count	Penalty Assessment Amount	Penalty Abatement Count	Penalty Abatement Amount	Percent Abated Count	Percent Abated Amount
2000	52,233	$ 834,576,985	27,777	$ 345,772,561	53.2%	41.4%
2001	69,128	$ 1,234,252,130	37,388	$ 440,977,235	54.1%	35.7%
2002	179,046	$ 1,616,752,742	85,722	$ 590,860,337	47.9%	36.5%
2003	212,302	$ 1,881,521,456	106,127	$ 668,216,827	50.0%	35.5%
2004	207,395	$ 2,271,334,173	102,667	$ 987,341,530	49.5%	43.5%
2005	208,662	$ 1,897,399,091	105,102	$ 587,221,865	50.4%	30.9%
2006	179,000	$ 1,719,460,445	84,244	$ 423,273,153	47.1%	24.6%
2007	167,811	$ 1,829,332,461	60,184	$ 359,848,189	35.9%	19.7%

The data indicates that over the eight-year period from FY 2000 through FY 2007, the IRS abated an average of 47.8 percent of the number of assessed TFRPs and 33.1 percent of the amount of assessed TFRPs. While many factors affect the abatement rate, including insufficient computer coding to indicate related party payments as adjustments, the high abatement rate is one indicator that the TFRP assessment process is ineffective, or at the very least that the IRS cannot provide data to accurately measure the performance of the TFRP process. Accordingly, the National Taxpayer Advocate is concerned that automation will weaken the process even further.

In response to the GAO audit and associated congressional hearings, the IRS committed to conduct an end-to-end review of the TFRP process to identify factors that adversely affect the ability of the IRS to enforce employment tax compliance as well as pursue timely and effective collection. As part of this project, the IRS will review its guidance and employee adherence to the guidance and determine whether to modify existing procedures.[99] We applaud the IRS for reviewing this topic and encourage the IRS to take a balanced approach with an emphasis on taxpayer rights. We ask that the IRS invite TAS to participate in any such reviews.

Streamlining the Lien Filing Process

GAO recommended that the IRS expedite its procedures to file notices of federal tax lien (NFTL). Specifically, GAO recommended that the IRS file liens as soon as possible once it identifies a payroll tax debt, including in cases awaiting assignment in the queue. It also recommended that the IRS file liens on both the businesses with unpaid payroll taxes and

98 It is important to note that that the FY 2007 assessment data reflects newly assessed penalties. The decrease in the abatement rate is not reflective of the IRS's performance. Rather, it merely indicates that these penalties were recently assessed and abatements may not have occurred yet.

99 IRS Enterprise Wide Employment Tax Program, *Talking Points/Status Update for BOD Commissioners Meeting on June 2, 2008* (May 29, 2008).

the owners or officers assessed a TFRP.[100] However, based on the abatement data for TFRPs and the intensive, fact-specific nature of TFRP determinations, it appears that such expedited procedures may be inaccurate and impose undue burdens on taxpayers. For example, the IRS abated 47.1 percent of the TFRPs assessed in FY 2006.[101] Considering the high dollar amounts of these penalties and the fact that the IRS is piercing the corporate veil by assessing the penalty on individuals, the IRS should proceed cautiously if it plans to implement the recommendation with respect to TFRPs.

The IRS has formed a Lien Policy Analyst Team to review the lien filing process and determine the feasibility of filing the liens as soon as payroll tax liabilities are identified. The National Taxpayer Advocate encourages the IRS to take a balanced approach that increases efficiency with minimal taxpayer burden.[102] The review should also consider whether liens are a productive collection tool for payroll tax liabilities. The IRS should not merely focus of the number of liens filed, because increasing the number of liens may not necessarily bring in more tax dollars. The review should track the dollars collected solely from liens (adjusting for the amount of dollars brought in by refund offsets where individuals are concerned). In addition, the review should include gathering data to determine whether the act of filing the lien impedes the business's ability to continue in business and pay taxes. Further, the IRS needs to review whether employment tax cases were not addressed early before penalties and interest accrue to the business's detriment.

Impact on Worker Misclassification

Before the IRS streamlines the lien process for employment taxes, it needs to consider the impact of such action on the growing worker misclassification problem. There are many reasons for worker misclassification, including situations when, due to the burden and risk associated with having employees, employers inappropriately classify their workers as independent contractors rather than employees. Whether a worker is classified as an employee or independent contractor affects the application of labor laws as well as tax treatment for both the worker and the service recipient. Whether inadvertent or deliberate, the misclassification of employees as independent contractors can have serious consequences for workers and the recipients of the services they provide. In addition, misclassification has a significant revenue impact due to the difference in, and in many cases the absence of, information reporting and tax withholding requirements for independent contractors.[103] Automatic liens and enforcement initiatives just for the sake of enforcement without the necessary supporting research will only exacerbate the growing trend of worker misclassification.

100 GAO, GAO-08-617, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* (July 2008). In his opening statement Senator Carl Levin recommended that Congress enact S. 1124, the Levin-Coleman "Tax Lien Simplification Act," which would require Treasury to establish an electronic tax lien registry at the federal level. *Payroll Tax Abuse: Businesses Owe Billions and What Needs to Be Done About It: Hearings Before the Perm. Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs,* 110th Cong. (July 29, 2008) (testimony of. Sen. Carl Levin, Subcomm. on Investigations).

101 IRS ERIS, as of the end of March 2008.

102 IRS Lien Policy Analyst Team, *Conference Call Agenda* (Aug. 20, 2008) (on file with the Office of the Taxpayer Advocate).

103 For a detailed discussion of this topic, *see* Legislative Recommendation, *Worker Misclassification, infra.*

Conclusion

The National Taxpayer Advocate is concerned that the IRS is taking a reactive rather than proactive approach to employment taxes, which will not serve the best interests of taxpayers and tax administration. Instead of merely focusing on egregious noncompliance, it is essential to acknowledge that the majority of taxpayers are attempting to comply with their employment tax obligations. As such, the IRS needs to research the causes of employment tax noncompliance and treat each type of taxpayer accordingly. For those struggling to understand and meet their complex employment tax obligations, the IRS needs to offer assistance as well as early intervention techniques to bring those taxpayers into compliance. The IRS should reserve its more severe enforcement initiatives for taxpayers who intentionally fail to meet their obligations. Finally, considering that employment taxes, and trust fund recovery penalties in particular, came under intense scrutiny during the landmark 1998 hearings on restructuring the IRS, the IRS needs employment tax procedures that are not only effective but protect taxpayers' due process rights.

The IRS should consider taking the following actions to improve the employment tax program: perform research to determine the reasons for employment tax noncompliance, the types of service or enforcement-related treatments necessary to bring each type of taxpayer into compliance, and the best time for the IRS to intervene with such treatments; partner with the Small Business Administration and organizations such as SCORE to pair up taxpayers with mentors once they have indicated they are confused about tax filing and payment obligations; develop pilot outreach programs through cognitive learning labs to test the impact local outreach initiatives have on employment tax compliance; explore and test a public information campaign to convey to employers the importance of meeting employment tax obligations, and the detrimental impact noncompliance can have on the finances of both the business entity and individuals deemed responsible; as part of the Lien Policy Analyst Team, track the dollars generated by liens to determine whether they are an effective collection tool for payroll tax liabilities; and include the Taxpayer Advocate Service in all studies, reviews, and workgroups associated with the employment tax program.

IRS Comments

Collection of employment taxes is a core mission of the IRS. Historically, we succeed in collecting 99.8 percent of all employment taxes owed.[104] Over the past ten years, the IRS has collected more than $11 trillion in payroll taxes.[105]

To achieve this level of success, the IRS uses a balanced approach of service and enforcement to assist businesses in understanding the requirements related to employment taxes and to encourage compliance. The IRS also acknowledges that it can be difficult to start

[104] IRS Masterfile.

[105] GAO Blue Book and IRS Financial Statements.

and maintain a business over a number of years given the myriad of laws and regulations with which businesses must comply and the competitive pressures that exist in the market.

To that end, virtually all of the IRS functional and operating divisions participate in employment tax outreach and education. The IRS provides substantial information about employment taxes on IRS.gov, on other websites through partnerships and work with other organizations, including groups that represent small businesses, and through electronic and print media. In FY 2008, IRS partnered with almost 700 tax professional and industry Web sites to include such information.

Quarterly, the IRS sends out approximately seven million Social Security Administration (SSA) IRS Reporter newsletters with Form 941. The newsletter is received by all businesses that receive Form 941 and contains information on subjects such as Social Security Administration laws, the Electronic Federal Tax Payment System, and changes in SSA or IRS electronic filing systems.

The IRS continues to strengthen the Enterprise Wide Employment Tax Program (EWETP). We are developing a EWETP Strategic Plan that outlines objectives to provide affected key stakeholders and the public with the right information pertaining to employment taxes. The identified key stakeholders include practitioner groups, industry and professional organizations, applicable federal, state, and local agencies. The IRS continues to encourage voluntary compliance through outreach and education geared to the small business owner, by providing a host of products and services that assist this customer base with their tax responsibilities, including their employment tax responsibilities, and offers these products and services through a variety of vehicles that meet the needs of the small business audience. For example, the Small Business Tax Workshops (SBTWs) are available in a classroom setting, while the *Virtual* SBTW is available on a compact disc or on irs.gov. Another example is the "e-News for Small Businesses" which has accumulated over 118,000 subscribers during FY 2008 and includes small business owners as well as other external tax professional and industry stakeholders. We 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 website;
- Reminders and tips to assist small businesses with tax compliance; and
- IRS news releases and special announcements.

We used research data to determine locations with the highest concentration of small business and self-employed taxpayers and that data drove the decision on employee placement.

We leverage outreach events with external stakeholders such as Small Business Development Centers, SCORE, CPAs, enrolled agents, and chambers of commerce. We

provide support to these stakeholders by providing products and approved presentations for key message delivery on various topics concerning the small business owner, including employment taxes. Employment taxes are either a topic of a general small business tax workshop or the only topic presented.

The decision to conduct a workshop is driven by identified demand and determining a leveraged stakeholder to deliver the workshop. During FY 2008 there were Small Business Workshops held in 47 states. We expect to expand these workshops to locations in all 50 states, to include industry specific sessions, and to increase the number offered.

SB/SE did not design its outreach and education function 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 strategically leverage stakeholder relationships in such a way to form networks through which we would provide the latest tax law and policy information. With focused research aimed at stakeholder groups, we are able to enhance our network to include channels of communication directly to individual members of these groups.

The vast majority of small business customers rely on practitioners to prepare their tax returns. Our relationship with national practitioner groups and their local affiliates such as the AICPA, National Enrolled Agents, National Public Accountants, American Bar Association, and NATP continues to afford us outreach and educational opportunities while providing a systematic method of capturing issues concerning tax administration. We continue to expand our network each year in order to reach more of the small business community. We believe that this type of educational approach through capable leveraged partners is a successful one.

In addition, the IRS supports the Large and Midsize Business (LMSB) customer base by working with major accounting and law firms to resolve employment tax issues expeditiously. Our LMSB Employment Tax Program and engineers also play an integral role in the valuing of stock options. Our valuations will be utilized as part of a nationwide analysis on the valuation of stock options and will be disseminated at various professional groups of accountants, valuation/ appraisal groups and bar associations through out the year.

In situations where our extensive outreach and education efforts do not achieve voluntary compliance to the tax laws, the IRS utilizes the FTD Alert process, which helps to identify, at an early stage, taxpayers classified as semi-weekly depositors who have not made federal tax deposits during the current quarter, or have made deposits in substantially lower amounts from prior quarters.

This program has very positive results, such as increased deposits and a higher percentage of fully paid subsequent tax liabilities. The IRS recognizes that although the program is effective, it must be periodically reviewed and modified to ensure it remains an effective early intervention tool. During FY 2009, the IRS will conduct an end-to-end review of the

program to include a thorough analysis of available data, current procedures and guidance as well as the program's impact on compliance. An overall assessment of the program will enable the IRS to better leverage this program to assist taxpayers, at a very early stage, if they have fallen behind on FTDs.

The IRS's policies and procedures for assessing and collecting the TFRP follow the requirements of the Taxpayer Bill of Rights[106] and the IRS Restructuring and Reform Act of 1998.[107] We continually monitor and safeguard taxpayer rights throughout the TFRP process through program reviews and case/quality reviews. The IRS is committed to continually safeguard taxpayer rights and approach cases strategically as we consider GAO's recommendations. The proposal to automatically impose the TFRP in certain circumstances was made by Senator Levin during his opening remarks at the Permanent Subcommittee on Investigations (PSI) hearing on Tuesday, July 29, 2008. The IRS is giving thorough consideration to all recommendations resulting from GAO's review of payroll taxes and the subsequent PSI hearing, but has not made final decisions on them at this time.

The IRS has already taken steps to address the National Taxpayer Advocate's concern regarding the timeliness and thoroughness of taxpayers being informed that they are potentially a "responsible person." To ensure potentially responsible individuals are better informed up front of the potential for personal liability and their rights in the TFRP process, we developed guidance that will require revenue officers, during the initial contact, to discuss specifics of the TFRP and its potential impact on the individuals.

The IRS is also developing face-to-face training material entitled "Strategic Approach to Employment Taxes" to reinforce the many tools available to revenue officers to assist taxpayers in achieving and maintaining compliance and actions that can and should be taken when a taxpayer does not cooperate or become current in paying employment tax liabilities. This training will be delivered in 2009 to all revenue officers.

We disagree with the National Taxpayer Advocate's conclusion that the 'high abatement rate is one indicator that the TFRP assessment process is ineffective.' Transaction Code (TC) 241, labeled "abate miscellaneous penalty," is used to adjust the TFRP of responsible individuals when credits are received on either the underlying corporate assessment or on related TFRP accounts. Use of the TC 241 ensures that we collect the unpaid payroll taxes only once; it does not indicate that the original TFRP assessment was erroneous or that the assessment process is ineffective. Financial Management Information System data for FY2006 showed that 82 percent of TFRP transactions coded as "abatements" were actually adjustments to accounts because of payments on related responsible persons' TFRP assessments or on the underlying corporate trust fund liability. Actual abatements may also result from a debtor's successful completion of a Chapter 13 payment plan.

106 TBOR 2, Pub. L. No. 104-168, § 903, 110 Stat. 1452, 1466 (1996); RRA 98, Pub. L. No. 105-206 § 3307, 112 Stat. 685, 744 (July 22, 1998).

107 RRA 98, S. Rep. No. 105-174, § 3433 (Apr. 22, 1998); Pub. L. No. 105-206, § 3433, 112 Stat. 685, 759 (July 22, 1998).

In her report, the National Taxpayer Advocate makes six specific suggestions to improve the employment tax program. We are taking or have taken the following actions with respect to these issues:

We have launched two research projects to gather information that will enable us to more accurately define "egregious," a term often used to describe taxpayers that repeatedly pyramid employment tax liabilities. These projects will not only identify traits and characteristics of taxpayers that pyramid employment tax liabilities but also help us detect ways to improve procedures, guidance and treatment streams that could assist all employers in staying current with payroll tax liabilities.

The IRS routinely leverages partnerships with the Small Business Administration as well as other external stakeholders such as Small Business Development Centers, SCORE, CPAs, enrolled agents, and chambers of commerce to address taxpayer's confusion regarding employment tax reporting and payment compliance. We continually strive to identify issues and concerns that may be impacting taxpayers and work to expand and tailor workshops and outreach efforts to alleviate taxpayer confusion.

The IRS continues to examine products and services that would accurately gauge the impact local outreach initiatives have on employment tax compliance. Currently, we rely on an effective survey and feedback process administered by both the IRS and our external partners as a part of each outreach effort.

The IRS has an effective public information and outreach program that leverages electronic and printed media, as well as personal involvement through directed contact with external stakeholder partners. In addition, IRS policy and requirements ensure taxpayers are provided information throughout the filing and payment process that explains their rights, responsibilities and potential consequences of non-compliance.

The IRS is also engaged in an end-to-end review of the Federal Tax Lien program, in which the overall effectiveness of the program, existing guidance, current policy and the overall cost/benefits of filing liens are being analyzed.

TAS is participating in the current review of the Federal Tax Lien program, and on other teams the IRS has established to analyze various employment tax programs.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate believes the collection of employment taxes warrants top priority and commends the IRS for its continued efforts to develop a balanced strategic plan for the Enterprise Wide Employment Tax Program (EWETP). We agree with the IRS that success of the EWETP hinges upon an approach that encourages compliance through both service and enforcement.

Given the high level of employment tax compliance, the EWETP needs to focus heavily on helping taxpayers maintain compliance. The first step in this process is to assist businesses in understanding their employment tax obligations. We are pleased that the IRS engages in extensive outreach and education by leveraging its partnerships with external stakeholder groups. We understand the vital role such partnerships play in the program. However, we continue to believe that local IRS presence is essential for the IRS to understand the local economy and culture, and identify issues that may affect compliance. Thus, the IRS should conduct more outreach and education through local initiatives, including field compliance visits. The IRS should also develop pilot programs to test the impact of local outreach initiatives on employment tax compliance, and should consider using a cognitive learning lab to design the pilot programs.

The IRS needs to focus on early intervention techniques for businesses trying but struggling to meet their employment tax obligations. Both the IRS and taxpayers benefit from early intervention, which prevents taxpayers from accumulating substantial unpaid payroll taxes along with the associated penalties and interest. The FTD Alert process is an important early intervention "touch" and we commend the IRS for planning to assess the program.

We encourage the IRS to safeguard taxpayers' rights as it responds to the recommendations made by GAO and others during the July 2008 hearings by the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security and Governmental Affairs. Protecting taxpayers' due process rights is especially important during the assessment and collection of the Trust Fund Recovery Penalty (TFRP), the imposition of which can have a devastating impact on a taxpayer.

As noted in our discussion above and by the IRS in its response, there are several reasons why the IRS may abate TFRPs. Unlike some other penalties, the high abatement rate does not necessarily indicate a high rate of erroneous assessments. While the IRS may abate a TFRP for several reasons, IRS computer systems do not track the particular reasons for the abatement. Thus, the IRS cannot provide data to accurately reflect the performance of the TFRP process.

We are pleased with the IRS's plans to conduct research on issues related to employment tax. The research on common characteristics of taxpayers who pyramid employment tax

liabilities is essential to determine how to prevent such behavior. In addition, the IRS's planned research to determine appropriate treatments to encourage compliance is a very important step in a balanced approach. The National Taxpayer Advocate also encourages the IRS to research the effectiveness of local outreach initiatives and looks forward to assisting in this research.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following actions to improve the employment tax program:

1. Perform research to determine the reasons for employment tax noncompliance, the types of service or enforcement-related treatments necessary to bring each type of taxpayer into compliance, and the best time for the IRS to intervene with such treatments;
2. Partner with the Small Business Administration and organizations such as SCORE to pair up taxpayers with mentors once they have indicated they are confused about tax filing and payment obligations;
3. Develop pilot outreach programs through cognitive learning labs to test the impact local outreach initiatives have on employment tax compliance;
4. Explore and test a public information campaign to convey to employers the importance of meeting employment tax obligations, and the detrimental impact noncompliance can have on the finances of both the business entity and individuals deemed responsible;
5. As part of the Lien Policy Analyst Team, track the dollars generated by liens to determine whether they are an effective collection tool for payroll tax liabilities; and
6. Collaborate with the Taxpayer Advocate Service in all studies, reviews, and workgroups associated with the employment tax program.

MSP #5

IRS Process Improvements to Assist Victims of Identity Theft

Responsible Officials

Jim Falcone, Acting Deputy Commissioner for Operations Support
Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Deborah G. Wolf, Director, Office of Privacy, Information Protection and Data Security
Julie Rushin, Director, Strategy and Finance, Wage and Investment Division

Definition of Problem

Over the past several years, the National Taxpayer Advocate has cited identity theft as a most serious problem encountered by taxpayers.[1] In her 2007 Annual Report to Congress, the National Taxpayer Advocate included a comprehensive review of IRS identity theft procedures and identified several major concerns.[2]

Congress also recognizes identity theft as a growing problem. The House Committee on Ways and Means and the Senate Committee on Finance each held hearings about the IRS response to identity theft in early 2008. The National Taxpayer Advocate testified at both hearings.[3] In the April 10, 2008 hearing before the Senate Finance Committee, IRS Commissioner Douglas Shulman acknowledged the need for the IRS to improve its procedures for assisting victims of identity theft and promised that the IRS would develop a comprehensive plan to help these taxpayers.[4]

We applaud the IRS for recognizing identity theft as a serious problem and devoting significant resources to resolve many of the issues we have previously identified. Over the past year, the IRS has made a number of improvements to its procedures to assist victims of identity theft. For example, the IRS now tracks victims of identity theft by placing

1 *See* National Taxpayer Advocate 2007 Annual Report to Congress 96-115 (comprehensively addressing the problems with IRS identity theft procedures); National Taxpayer Advocate 2005 Annual Report to Congress 180-91 (addressing the excessive delays in resolving taxpayer problems and deficiencies in IRS procedures); National Taxpayer Advocate 2004 Annual Report to Congress 133-36 (addressing the inconsistent treatment of identity theft cases across the IRS); National Taxpayer Advocate Fiscal Year 2009 Objectives Report to Congress viii-xx; National Taxpayer Advocate Fiscal Year 2008 Objectives Report to Congress 15-16, 36-40; National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress 24.

2 *See* National Taxpayer Advocate 2007 Annual Report to Congress 96-115.

3 *Identity Theft in Tax Administration: Hearing Before the Senate Committee on Finance*, 110th Cong. (Apr. 10, 2008) (statement of Nina E. Olson, National Taxpayer Advocate); *The Tax Return Filing Season, Internal Revenue Service Operations, Fiscal Year 2009 Budget Proposals, and the IRS National Taxpayer Advocate's Annual Report: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 110th Cong. (Mar. 13, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

4 *See Identity Theft in Tax Administration: Hearing Before the United States Senate Committee on Finance*, 110th Cong. (Apr. 10, 2008) (statement of Douglas Shulman, IRS Commissioner); *see also* Tax Notes Today, IRS Officials Pledge Improved Communications with Taxpayers, 2008 TNT 91-5 (May 9, 2008); Tax Notes Today, *Shulman Promises Improvement in IRS Response to Identity Theft*, 2008 TNT 71-2 (Apr. 11, 2008).

a marker on the victim's account.[5] The IRS has also established an Identity Protection Specialized Unit and a toll-free hotline for identity theft victims.[6]

However, the National Taxpayer Advocate has concerns with the approach the IRS has taken in implementing the new procedures to assist identity theft victims. First, we are concerned that identity theft victims with tax problems will not receive comprehensive assistance from the Identity Protection Specialized Unit. Second, we have identified gaps in the way the IRS tracks identity theft victims. Third, we would like the IRS to improve its communication with identity theft victims. Fourth, we would like the IRS to allow its employees to exercise greater discretion to deviate from established guidelines when determining the rightful owner of a disputed Social Security number (SSN).

Analysis of Problem

Background

Identity theft occurs when someone unlawfully uses another's personal data to commit fraud or other crimes. Identity theft is most commonly encountered in tax administration when an individual intentionally uses the SSN of another person to file a falsified tax refund claim or fraudulently obtain employment. Identity theft affects almost every aspect of tax administration – tax return filing, auditing, collection, protection of taxpayer information, etc. – and harms innocent taxpayers.

According to the Federal Trade Commission (FTC), the lead federal agency charged with combating identity theft, there were 258,427 reported incidents of identity theft in 2007, up from 246,124 in 2006.[7] As shown in Table 1.5.1 below, TAS stolen identity cases have increased over sixfold from fiscal year (FY) 2005 to FY 2008.[8]

TABLE 1.5.1, TAS Stolen Identity Cases, FY 2005 TO FY 2008

	FY 2005	FY 2006	FY 2007	FY 2008
Primary Issue Code 425, Stolen Identity	922	2,486	3,327	7,147
Secondary Issue Code 425, Stolen Identity	739	1,381	2,603	3,690
Combined Stolen Identity	1,661	3,867	5,930	10,837

5 *See* Memorandum for Division Commissioners, Chiefs, National Taxpayer Advocate, Directors, from Director, Privacy, Information Protection and Data Security, *Identity Theft Tracking Implementation* (Jan. 4, 2008).

6 Servicewide Electronic Research Program (SERP) Alert, *Identity Theft Hotline* (Sept. 24, 2008).

7 Federal Trade Commission, *Consumer Fraud and Identity Theft Complaint Data, January – December 2007* 5, *at* http://www.ftc.gov/opa/2008/02/fraud.pdf (last visited Dec. 16, 2008).

8 Taxpayer Advocate Management Information System, FY 2005, FY 2006, FY 2007, and FY 2008.

In general, there are two motives for identity theft in the context of tax administration. In refund-related identity theft, the perpetrator files a falsified tax return to obtain a fraudulent refund. This type of identity theft harms taxpayers by blocking their efforts to file legitimate returns and receive refunds. Identity theft victims may also be denied certain deductions and credits while the IRS addresses the fraudulent return on its systems.

The second motive is employment-related identity theft, where the perpetrator utilizes the personal information of another to obtain employment. The employer prepares a Form W-2 with the victim's SSN. This can cause problems for the identity theft victim, who may receive bills from the IRS for tax owed on income he or she never earned.

Regardless of the motive, identity theft creates serious consequences for the innocent taxpayer. For a detailed explanation of these problems, please refer to prior Annual Reports to Congress issued by the National Taxpayer Advocate.[9]

Concerns Regarding the IRS's Identity Theft Victim Assistance Strategy

The Identity Protection Specialized Unit Should Monitor All Identity Theft Cases.

Identity theft victims should have a single point of contact within the IRS to assist in resolving all federal identity theft-related tax issues, and should not need to contact the IRS multiple times to resolve their issues. Until recently, the IRS did not have an enterprise-wide strategy to deal with identity theft cases. For example, the Automated Underreporter (AUR), Automated Collection System, Accounts Management (AM), Examination functions, and the Criminal Investigation division all assisted victims of identity theft, but no single function had the overall responsibility to resolve all of the victim's tax account issues, which resulted in taxpayers coming to TAS for assistance. Without a coordinated effort, each function worked identity theft cases independently according to its own procedures, requiring some taxpayers to provide the same information to the IRS several times. More importantly, there was a real danger that the IRS was not addressing all related issues or all tax periods of accounts impacted by identity theft.

The National Taxpayer Advocate recommended in her 2007 Annual Report to Congress that the IRS establish a dedicated, centralized unit to handle all identity theft cases.[10] The IRS concurred with this recommendation and created an Identity Protection Specialized Unit to assist victims of identity theft. Effective October 1, 2008, taxpayers can call a toll-free hotline (800-908-4490) to report their identity theft issues, obtain information, and take steps to protect their accounts.[11]

9 *See* National Taxpayer Advocate 2007 Annual Report to Congress 96-115 (comprehensively addressing the problems with IRS identity theft procedures); National Taxpayer Advocate 2005 Annual Report to Congress 180-91 (addressing the excessive delays in resolving taxpayer problems and deficiencies in IRS procedures); National Taxpayer Advocate 2004 Annual Report to Congress 133-36 (addressing the inconsistent treatment of identity theft cases across the IRS); National Taxpayer Advocate Fiscal Year 2009 Objectives Report to Congress viii-xx; National Taxpayer Advocate Fiscal Year 2008 Objectives Report to Congress 15-16, 36-40; National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress 24.

10 *See* National Taxpayer Advocate 2007 Annual Report to Congress 115.

11 *See* SERP Alert, Identity Theft Hotline, *at* http://www.irs.gov/individuals/article/0,,id=136324,00.html (Sept. 24, 2008).

The Identity Protection Specialized Unit provides two essential services to identity theft victims. First, it conducts a global account review to identify all issues related to the identity theft. Second, the unit provides regular account monitoring to ensure full case resolution. These are two very valuable services the IRS provides to identity theft victims. However, current IRS procedures provide these benefits only to identity theft victims who call the specialized unit with a tax-related problem. The IRS does not provide these benefits to taxpayers who directly call other IRS functions to resolve tax issue(s).

For identity theft victims who have not received any notices from the IRS regarding tax issues, the IRS encourages these individuals to call the toll-free hotline to report their identity theft incident.[12] For individuals who have received notices from the IRS about their identity theft-related tax issues, the IRS directs them to contact the Identity Protection Specialized Unit only "if you have previously been in contact with the IRS and have not achieved a resolution."[13] A recent Servicewide Electronic Research Program (SERP) Alert advises that "employees in AM, AUR, Collections, Exam, etc., with existing tax-related identity theft cases, or receiving new tax-related identity theft cases, should follow their established procedures to work these cases.... Do NOT route these cases to the [Identity Protection Specialized Unit]."[14]

To reiterate, the IRS refers identity theft victims *without* tax account problems to the Identity Protection Specialized Unit, yet directs identity theft victims *with* tax account problems not to call this unit.[15] It seems counterintuitive for the IRS to devote significant resources to establishing a centralized unit to assist victims of identity theft, only to limit access to this unit to taxpayers who have had their wallets stolen or experienced some other non-tax identity theft issue.

The National Taxpayer Advocate recognizes that there is a benefit in asking taxpayers to respond to the IRS function originating the correspondence – otherwise, the function may proceed to the taxpayers' detriment. However, if the IRS simply relies on existing procedures, we cannot be confident that the IRS will address all related issues.

The IRS needs to take a much more taxpayer-centric approach to resolving the myriad of account problems created by identity theft. The National Taxpayer Advocate recommends that the IRS operating division or function, as it addresses the tax account issue at hand, refer the case of the identity theft victim back to the centralized unit for a global account review. This account review is necessary to ensure that all of a victim's identity theft-related account issues are addressed. If the account review uncovers additional issues, then the Identity Protection Specialized Unit should refer the case to the appropriate function(s)

12 *See* http://www.irs.gov/individuals/article/0,,id=136324,00.html (last visited Oct. 3, 2008).

13 *See id.*

14 *See* SERP Alert 080389, *Functions Are Referring Their Tax-Related Identity Theft Cases to the AM Identity Theft Units in Error* (Oct. 6, 2008).

15 *See* http://www.irs.gov/individuals/article/0,,id=136324,00.html (last visited Oct. 3, 2008).

and monitor the case until full resolution. If there are no other open issues, the centralized unit would close the case.

The IRS Is Unable to Accurately Quantify Incidents of Identity Theft.

Identity theft is a recurring issue for many taxpayers, who often find themselves battling to resolve account problems with the IRS over multiple years. The IRS recently developed a method to systemically identify taxpayers whose identities were stolen. On January 1, 2008, the IRS implemented a tracking system that places an indicator on an identity theft victim's account once he or she has provided verification of identity theft.[16] This indicator will alert the IRS in subsequent filing years that this taxpayer may need special attention.

The operating divisions will develop "business rules" – that is, a set of rules intended to filter out fraudulent returns – that will apply to accounts flagged with the identity theft indicator.[17] Beginning in January 2009, returns that do not meet the business rules will be removed from the posting process.[18] If the return falls outside the established parameters, the IRS will review the return manually before processing any refund claims.

We are pleased with this positive development, as the National Taxpayer Advocate has long advocated such a tracking system.[19] With the ability to track identity theft cases, the IRS will be better able to allocate appropriate resources and identify areas where procedures need to be improved. However, the National Taxpayer Advocate has identified several shortcomings with the way the IRS currently tracks identity theft cases.

The IRS does not place the marker in many situations where the IRS itself identifies identity theft cases. For example, the IRS will not use its identity theft marker in employment-related fraud cases involving a "name-SSN mismatch" (*i.e.*, where the taxpayer's name, according to IRS data files, does not match the associated SSN for that name). If an identity thief uses another taxpayer's SSN but the name does not correspond, the AUR function will not attribute the income reported on information returns (*e.g.*, Forms W-2 or Forms 1099) bearing the SSN to the identity theft victim.[20] While this result spares the victim significant headaches, it also means that no identity theft marker will be applied, even though it is clear that the SSN has been misused and may be misused for years to come.

In addition, the IRS still does not track cases where taxpayers do not respond to IRS correspondence or where they provide insufficient documentation of identity theft. If a taxpayer does not reply to a request for information or responds after the prescribed time,

16 *See* Memorandum for Division Commissioners, Chiefs, National Taxpayer Advocate, Directors, from Director, Privacy, Information Protection and Data Security, *Identity Theft Tracking Implementation* (Jan. 4, 2008). *See also* IRM 4.19.13.25 (Jan. 4, 2008) (implementing identity theft tracking procedures in the Automated Underreporter units).

17 *See* PIPDS, *Substantiated Identity Theft Tracking and Implementation* (Jan. 4, 2008).

18 *See id.*

19 *See* National Taxpayer Advocate 2005 Annual Report to Congress 191.

20 *See* Internal Revenue Manual (IRM) 4.19.3.4.1 (Nov. 8, 2005).

the IRS simply moves the taxpayer into scrambled SSN procedures and does not count the case as an identity theft case.[21]

For these reasons, it is apparent that even with the identity theft marker, the IRS will not be able to accurately quantify the number of tax-related identity theft cases. Without an accurate estimate, it will be difficult for the IRS to allocate appropriate resources to assist victims of identity theft. More significantly, accounts that are not tracked will not receive the benefit of account monitoring or global account review provided by the Identity Protection Specialized Unit.

The concern over the IRS's ability to accurately estimate the number of tax-related identity theft incidents underscores the need for a centralized unit that monitors *all* instances of tax-related identity theft. The IRS should apply an indicator on all identity theft cases, whether identified by the IRS or reported by the taxpayer.

Need for Improved Communication with Identity Theft Victims

Current IRS communications with identity theft victims lack clarity. When the IRS receives multiple filings using the same SSN and cannot determine which person rightfully owns the number, it issues a Letter 239C, *Scrambled SSN Clarification to Taxpayer*, to both taxpayers (the first of two Letters 239C that may be sent). The first letter instructs the taxpayer to provide documents that are not part of the standard identity theft documentation, *e.g.,* a copy of a current utility bill or bank statement. At this point, the only thing the taxpayer knows for sure is that he or she has a tax problem. The requirement to obtain such documents places an unnecessary burden on taxpayers and may delay case resolution.

The Letter 239C does not notify the taxpayer that identity theft is a possible or likely cause of the problem; it merely says that "there may be a problem with the Social Security number you used on your income tax return."[22] At no point does the IRS clearly explain that the taxpayer may be a victim of identity theft. More importantly, the letter fails to adequately describe the consequences of an insufficient or untimely response. If taxpayers do not timely respond to this vague notice, the IRS initiates scrambled SSN procedures, which may result in the identity theft victim being unable to claim certain credits and deductions (such as the earned income tax credit (EITC) or the personal exemption) for several years.[23]

Even when the IRS has verified the existence of fraud, it still does not notify taxpayers that they may be victims of identity theft. Before June 2008, the IRS was not clear as to whether the disclosure restrictions in Internal Revenue Code (IRC) § 6103 would prevent the IRS from sharing any information about the identity theft with the owner of the compromised SSN. However, in June 2008, the IRS received written guidance from the Office of Chief

21 See IRM 21.6.2.4.3.9.1 (June 4, 2008).

22 IRM 21.6.2.4.4 (Oct. 1, 2007).

23 See National Taxpayer Advocate 2007 Annual Report to Congress 545-46.

Counsel stating that the IRS may disclose to the SSN owner that the number has been used on another return and that he or she is an apparent victim of identity theft, without violating IRC § 6103.

The IRS should not only alert taxpayers of potential identity theft when another tax return is filed using their SSN, but also when their number shows up on a document associated with another tax return. For example, the AUR unit does not notify taxpayers about the misuse of their SSNs if the name on the tax return does not match the SSN shown on the associated Form W-2.[24]

We recommend that the IRS stop using the Letter 239C for identity theft cases and develop a new letter for these cases. This letter should explain why the IRS thinks the taxpayer may be a victim of identity theft, instruct the taxpayer on the next steps to take, provide a form the taxpayer can submit to the IRS, and provide a phone number for the identity theft hotline.

Not only does the IRS use unclear language when communicating with identity theft victims, it also delays processing their tax returns. Some identity theft cases are initially treated as a "duplicate filing," which means that the IRS receives multiple filings of the same tax form using the same name and the same SSN.[25] For example, a duplicate filing can occur when an identity thief files a tax return under the name and SSN of the victim.

It is the job of the AM function to sort out whether the duplicate filing is a situation where the taxpayer was attempting to file an amended return or where he or she was the victim of identity theft.[26] Given the difficulties in working identity theft cases, this determination ought to be a priority for the IRS. Rather than prioritizing these cases, however, the IRS actually delays the processing of duplicate filings by two to three weeks.[27]

IRS Employees Should Be Allowed to Exercise More Discretion in Identity Theft Cases.

In 2007, the IRS established standardized documentation requirements for taxpayers to substantiate their claim of identity theft. Identity theft victims are directed to provide either a copy of a police report or an affidavit of identity theft obtained from the FTC.[28] There is nothing magical about the FTC affidavit of identity theft. It is a self-reported document that actually contains a statement emblazoned in red ink and capital letters:

24 *See* IRM 4.19.3.4.1 (Nov. 8, 2005).

25 *See* IRM 21.6.7.4.4 (Oct. 1, 2008).

26 *See id.*

27 *See* Most Serious Problem, *Incorrect Examination Referrals and Prioritization Decisions Cause Substantial Delays in Amended Return Refunds for Individuals, infra.*

28 *See* Memorandum for Commissioner, Small Business/Self-Employed Division, Commissioner, Wage and Investment Division, and Chief, Appeals, from Deputy Commissioner for Services and Enforcement and Deputy Commissioner for Operations Support, *Standard Identity Theft Documentation* (June 11, 2007).

"DO NOT SEND AFFIDAVIT TO THE FTC OR ANY OTHER GOVERNMENT AGENCY."[29] Faced with contradictory instructions from the IRS and FTC, identity theft victims are understandably confused about the purpose and use of the affidavit.

When the IRS developed its standardized list of acceptable documents, it did so with the intention of easing taxpayer burden. With this in mind, the IRS should recognize that some identity theft victims are faced with extremely unusual circumstances and may not be able to comply with the requirement to produce one of the two acceptable documents. In order to deal with extraordinary situations, the IRS should allow its managers the discretion to deviate from established guidelines.

For example, a taxpayer came to TAS in 2008 with an unusual situation. He had recently been released from prison after serving several years, and was surprised to receive a letter from the IRS stating that he had failed to report income from a job in another state during one of the years he was incarcerated. The taxpayer provided prison records verifying his whereabouts and a letter from the SSA stating that it had determined that he had no earnings in the year in question. The IRS did not dispute that the earnings were not the taxpayer's, but refused to adjust his account until it received one of the two types of documentation listed in the IRM.

Here, the taxpayer provided two documents that proved he was a victim of identity theft, yet the IRS refused to adjust his account, even when TAS elevated the issue by issuing a Taxpayer Assistance Order (TAO). The issue was finally resolved in the taxpayer's favor after the National Taxpayer Advocate issued a TAO to the Deputy Commissioner of the Wage and Investment division.

Another area where IRS employees should be able to exercise discretion is when deciding whether to implement "scrambled SSN" procedures. When the IRS cannot determine the true owner of an SSN in question, it initiates scrambled SSN procedures and assigns a temporary IRS number (IRSN) to all users of the SSN, including the victim of identity theft.[30] All parties are told to use the IRSN on their future tax returns instead of the SSN. This action means these filers will not be eligible for tax benefits that require a valid SSN, such as the EITC and the personal exemption.[31]

For years, the National Taxpayer Advocate has expressed concern that the IRS has been moving identity theft cases into the scrambled SSN process prematurely, rather than

29 The Identity Theft Affidavit may be obtained from the FTC website *at* http://www.ftc.gov/bcp/edu/resources/forms/affidavit.pdf (last visited Dec. 16, 2008).

30 The IRS follows scrambled SSN procedures when two or more taxpayers file returns using the same SSN and there is no clear indication as to which taxpayer owns the SSN. *See* IRM 21.6.2.4.2(4) (Jan. 22, 2008).

31 *See* IRM 21.6.2.4.4 (Oct. 1, 2007).

using information already available to the IRS to avoid these procedures.[32] Not only are scrambled SSN procedures burdensome for innocent taxpayers, but they affect too many taxpayers unnecessarily.

The IRS should give its employees more latitude in determining the rightful owner of the SSN and avoid the scrambled SSN process altogether. For example, if the IRS receives two returns using the same SSN, the IRS employee should be instructed to look at the filing history and utilize all available research tools.[33] If the research shows that taxpayer A has filed returns reporting wages using the associated SSN for ten years, but the SSN belongs to a 16-year-old child (taxpayer B, who has filed a return for the first time this year), the IRS employee should be able to determine who owns the number. In this instance, the IRS should not initiate scrambled SSN procedures, but should place an identity theft indicator on taxpayer B's account and alert taxpayer B that his or her SSN has been compromised so that he or she can take measures to protect his or her identity.

The IRS should allow its employees and managers the latitude to exercise discretion where appropriate. We note that current IRS guidance does instruct AM employees to "make every effort to locate the correct TIN [taxpayer identification number] for each taxpayer before contacting the taxpayer(s)."[34] However, our experience is that AM employees have been reluctant to exercise any discretion in making a determination as to which filer is the true owner of the SSN in question. This reluctance may be a result of a slight change in the IRM in 2005. Prior to 2005, the IRM instructed AM employees that "[e]very effort should be made to locate a correct TIN for both taxpayers BEFORE using scramble procedures" (emphasis in original).[35] Note that TAS experienced a significant increase in stolen identity cases post-2005.

The IRS can provide adequate guidance to its employees about how to exercise judgment in making these determinations, and can update this guidance with examples derived from actual cases. If warranted, the Identity Protection Specialized Unit should track these "unusual circumstances" and meet with TAS to develop any administrative or legislative changes needed to address these situations systemically.

32 *Identity Theft in Tax Administration: Hearing Before the United States Senate Committee on Finance*, 110th Cong. (Apr. 10, 2008) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2007 Annual Report to Congress 101-03; National Taxpayer Advocate 2005 Annual Report to Congress 184; National Taxpayer Advocate 2004 Annual Report to Congress 134-36.

33 While current IRS guidance does instruct AM staff to "make every effort to locate the correct TIN [taxpayer identification number] for each taxpayer before contacting the taxpayer(s)," TAS's experience is that these employees are reluctant to exercise any discretion in determining the true owner of the SSN. *See* IRM 21.6.2.4.2.3 (May 23, 2008).

34 IRM 21.6.2.4.2.3 (May 23, 2008).

35 IRM 21.6.2.4.2.2 (Oct. 27, 2004). The IRM further instructs employees to research CC IMFOL, RTVUE, INOLE, NAMES, DUPOL, FFINQ, and REINF, request MFTRA, obtain NUMIDENT, and request all returns for the years involved.

Conclusion

Commissioner Shulman has expressed a desire to focus on the taxpayer's experience in dealing with the IRS, stating "we must not only meet legal requirements, we must walk a mile in the taxpayers' shoes and help them navigate the system."[36] The National Taxpayer Advocate applauds this approach and feels that this should be the IRS's focus in developing procedures for assisting identity theft victims.

We are pleased that the IRS has made positive strides in addressing the concerns we identified in prior years. However, we have identified a number of concerns with the IRS approach. The IRS should consider taking the following actions to improve its assistance to victims of identity theft: provide global account review and account monitoring (if necessary) for all identity theft victims; allow its employees the discretion to deviate from established guidelines in accepting evidence of identity theft; and allow its employees more latitude in determining the rightful owner of a disputed Social Security number.

We urge the IRS to continue working with TAS to improve assistance to victims of identity theft. We will closely monitor the impact of these new procedures and will work collaboratively with the Office of Privacy, Information Protection, and Data Security to address new issues as they arise.

IRS Comments

The IRS appreciates that the National Taxpayer Advocate recognizes the significant progress the IRS is making to address identity theft. We continue to work closely with the National Taxpayer Advocate to identify areas for improvement in meeting the challenges of resolving tax problems related to identity theft. The IRS is committing significant resources to address the challenges posed in protecting taxpayers' identities and identity information. An enterprise-level Identity Protection Strategy serves as the foundation for all of our efforts to provide services to victims of identity theft and to reduce the effects of identity theft on both taxpayers and tax administration. This strategy, which was initiated in 2004 and updated this year, focuses on three priority areas that are fundamental to protecting taxpayers' identities and addressing the impact of identity theft.

Victim Assistance: It is a strategic goal of the IRS to better assist taxpayers by expediting and improving resolution of identity theft-related tax issues. On October 1, 2008, the IRS opened the Identity Protection Specialized Unit (IPSU), a unit dedicated to resolving tax issues incurred by identity theft victims. This unit enables victims to have their questions answered and issues resolved quickly and effectively. In its first two months, the IPSU responded to approximately 7,500 inquiries. We expect this number to rise as awareness of this service increases.

[36] IRS Commissioner Douglas Shulman made these remarks during a discussion of the ten-Year Anniversary of the IRS Restructuring and Reform Act of 1998 at a conference organized by Tax Analysts. *See* IR-2008-90 (July 18, 2008).

The IRS has also begun sending a series of new letters to taxpayers regarding identity protection. This year, we began by sending letters to individuals identified through our work processes as actual or probable victims of identity theft. Through the pilot program for these notifications, the IRS sent over 2,000 letters. These letters inform taxpayers that their personal information was used by another individual to file a fraudulent refund return or that their information may have been compromised through phishing scams. They provide contact information for the IRS, as well as valuable information on steps victims can take to resolve any tax-related issues and to prevent potential future harm. During the coming year, we will expand our efforts and begin notifying all IRS-discovered victims of refund crimes. Additionally, based on information received by the IRS during return filing, we will begin a new pilot project to notify taxpayers whose information has been improperly used by another person to gain employment.

The IRS is committed to an ongoing review of our communications with identity theft victims to ensure they are clear, meaningful, and necessary. We will continue our practice of vetting communications extensively and requesting feedback from taxpayers to inform these reviews. We look forward to our continued collaboration with the National Taxpayer Advocate on this important area of victim assistance.

Outreach: The IRS is committed to increasing awareness of identity protection through multiple communication channels and education efforts. The IRS has focused heavily this year on raising awareness of identity protection issues through direct contact with the tax practitioner and taxpayer communities. Led by our newly formed Office of Privacy, Information Protection, & Data Security, the IRS has addressed groups at over 40 events throughout the country, including six Nationwide Tax Forums. During the Nationwide Tax Forums, we addressed over 5,700 practitioners on this topic. Additionally, the newly established IRS Online Fraud Detection and Prevention (OFDP) office is a co-sponsor of the Onguardonline.gov website, along with the Federal Trade Commission (FTC), Department of Homeland Security, Naval Criminal Investigative Service, and other federal government agencies. This website is an excellent resource for consumers and contains information from the federal government and technology industry on strategies for protecting personal information. The response to IRS outreach in these settings has been overwhelmingly positive and we have received valuable feedback from taxpayers and the practitioner community.

This year, the IRS engaged key executives and experts in the fields of privacy and identity theft, in the domestic and international arenas, to share and acquire information on best practices for protecting and assisting the public. On July 21-22, 2008, the IRS hosted these individuals in the first IRS Identity Protection Forum. The goal of the forum was to share common experiences and successes in the protection of identity information and gain insights into trends and future developments in this area of growing interest. This forum has proven successful in bringing together its participants to combat identity theft. For example, the IRS has held discussions with one of the forum presenters to discuss vulnerabilities

for identity theft in check cashing establishments and is collaborating internally to identify possible opportunities for pursuing proactive identity theft solutions. In addition, the FTC forum participants engaged the IRS to collaborate on developing an identity theft guide for pro bono attorneys. Representatives at the forum from Her Majesty's Revenue & Customs have held several follow-up meetings with the IRS and the Department of Justice (DOJ), resulting in increased collaboration in combating identity theft, generally, and particularly the global problem of phishing.

Prevention: The IRS is building a strong prevention program to reduce incidents of identity theft. This program is based upon three priorities: (1) reducing opportunities for thieves to obtain identity information, (2) reducing the opportunities for thieves to use the data they have stolen, and (3) increasing deterrence efforts to discourage identity theft. The IRS has established the OFDP office to address the increasing and evolving threat of online fraud and reduce opportunities for identity thieves to obtain information. The IRS Criminal Investigation (CI) Division and the OFDP office are working closely with the Treasury Inspector General for Tax Administration (TIGTA), the DOJ, the FBI, and the FTC to pursue criminal investigations and prosecutions of phishing perpetrators, as appropriate.

The IRS has significantly improved the ability to quantify and track incidents of identity theft. In January 2008, the IRS began placing an identity theft marker on the accounts of taxpayers who identify themselves to the IRS as victims of identity theft who have experienced an impact on their tax accounts. This marker is an excellent tool for assisting taxpayers because it indicates to any employee handling the taxpayer's account that they are dealing with a substantiated case of identity theft. We project that more than 24,000 accounts will carry this particular marker by the end of this calendar year.

On October 1, 2008, we rolled out several new markers. One marker is being placed on the accounts of taxpayers who self-identify as potential or actual victims with no apparent impact on tax administration. Another is being used where, through our business processes, we have identified individuals as being impacted by refund fraud or phishing schemes. We project that more than 23,000 accounts will carry this marker by the end of this calendar year.

We also use an account marker to annotate identity theft cases identified through our duplicate returns determination process. When two returns are filed using the same SSN and the IRS is unable to determine the true owner of the SSN through its normal business processes, we have historically used our scrambled SSN procedures to resolve the case. This involves submitting limited information from the returns to the Social Security Administration for verification of the true owner of the SSN. We have been working to improve our procedures to more efficiently resolve duplicate returns cases without using the scrambled SSN process. As we work through the current inventory of scrambled SSN cases and make a determination as to the true owner of the SSN, we are marking the account of the legitimate SSN owner and notifying that individual with a modified, more targeted

Letter 239C. This letter contains specific information concerning the impact of identity theft on the taxpayer's account. Within the next few months, we will be working through the existing inventory of cases and notifying the impacted taxpayers.

In 2009, we will test the use of another new account marker with taxpayer notification to annotate the accounts of taxpayers whose SSNs have been inappropriately used by others to gain employment. The IRS receives tax returns each year that are filed using an Individual Tax Identification Number (ITIN) with a Form W-2 attached containing an SSN, and the new marker will specifically address this population of victims.

We are also employing our identity theft markers to reduce the ability of identity thieves to use stolen information. Beginning in January 2009, any tax return filing activity on the accounts of taxpayers who have been flagged in our system as victims of identity theft will be filtered based on a thorough analysis of common indicators of fraud. The use of these filters will enable an automatic, systemic review of a taxpayer's account to determine whether new return filings are legitimate. Suspicious filings will be systemically removed from return processing for manual review. Most legitimate taxpayers will not experience an additional delay in the amount of time it takes to receive a refund in this situation. We will communicate with those taxpayers from whom we may need additional information in order to resolve their cases.

The National Taxpayer Advocate recommends that the Identity Protection Specialized Unit monitor all identity theft cases.

Often, the first IRS point of contact for a taxpayer is the function that initiated a notice to the taxpayer. Our analysis indicates that centralization of all identity theft cases in one unit would increase case resolution time and, thus, taxpayer burden. The function that is the business owner of that taxpayer's specific issue has the case background and specialized knowledge necessary to most effectively and efficiently resolve the problem. To ensure fair and consistent treatment of victims across all functions, the IRS is developing a central reference point in the Internal Revenue Manual that links all identity theft-related procedures outlined in the IRM and cites examples of common issues and proper case resolution. We issued interim guidance in a series of memoranda in September 2008, and intend to release the finalized *Servicewide Identity Theft Guidance* in early 2009.

The IRS recognizes that tax-related identity theft cases can be very complex and may require specialized support, particularly where a victim has multiple tax-related issues. The IPSU is specifically chartered to assist taxpayers who have experienced tax problems as a result of identity theft and either have been unable to have their issues effectively resolved by the function or have multiple issues that require coordination among various functions. One mission of the IPSU is to reduce the burden of victims by serving as their central contact point within the IRS. IPSU assistors are responsible for working with the various functions to ensure that all known identity theft-related issues are resolved. Taxpayers may

contact the IPSU of their own accord or may be referred to the IPSU by the originating function.

We are in the process of establishing mandatory procedures for global account review by all functions that have contact with victims. Our analysis indicates that review by the taxpayer's first point of contact is a more effective and efficient means of reducing taxpayer burden than mandatory referral of the taxpayer to the IPSU for global account review. Where a review uncovers other identity theft-related issues, those specific cases will be routed to the IPSU; which will ensure complete and timely resolution.

The IRS is pleased with the initial success of the IPSU and will continue to raise awareness of this valuable service, both internally and externally. Further, we will review our policies on an ongoing basis to ensure they are consistent with our commitment to provide effective and efficient service in a manner that reduces taxpayer burden.

The National Taxpayer Advocate recommends that employees be allowed the discretion to deviate from established guidelines in accepting evidence of identity theft.

Where taxpayers self-identify as victims of identity theft, in an effort to prevent further fraud, we require proof of identity and substantiation of identity theft with either a police report or the FTC's Affidavit of Identity Theft. We do this to prevent identity thieves from committing further fraud by identifying themselves as the legitimate taxpayer. Because of this risk, we currently limit employee discretion on variations to our standard documentation requirements. The IRS is developing its own identity theft affidavit that will collect from victims the information most pertinent to tax administration, and will require a sworn signature. We expect this form to be available for use in 2009. This new form, which will be both simpler and more specific to IRS use, will make it easier for taxpayers to complete the substantiation process.

For cases with exceptional circumstances, where this documentation cannot be provided, we have established a working group, with representatives from TAS, to address unusual conditions. This working group is also charged with reviewing our business processes in light of such cases and making recommendations for meaningful change where appropriate.

The National Taxpayer Advocate recommends that employees be allowed more latitude in determining the rightful owner of a disputed Social Security number.

The IRS has recently implemented process changes for empowering employees with greater discretion in determining the rightful owner of an SSN in our duplicate returns cases. This year, the IRS chartered a Lean Six Sigma team consisting of process review experts with a mandate to improve the duplicate returns determination process. After a thorough review, the team made specific recommendations for streamlining the resolution process and preventing future duplicate returns cases from being submitted to the SSA

through our scrambled SSN process. The team developed a criteria-based checklist that enabled employees to use their knowledge and judgment to make a determination as to the rightful owner of the SSN in approximately 63 percent of the cases that would have been referred for scrambled procedures. This means that 63 percent of legitimate taxpayers whose returns would otherwise have been held up in the scrambled SSN process had their account issues resolved efficiently and received their refunds quickly.

As of October 1, 2008, a group of employees with specialized training are applying the new process modifications, as detailed in interim procedural guidance, to the entire existing open inventory of scrambled SSN cases. Based on feedback from their experience in working through the cases, we will further modify the redesigned processes as appropriate. We are confident that, with additional experience, training, and, if necessary, process modifications, our employees will be able to use their knowledge and judgment to prevent a greater percentage of duplicate returns cases from being placed in the scrambled SSN process.

Conclusion

The IRS has made significant progress in the area of identity protection this year. We are committed to the ongoing implementation and improvement of our Identity Protection Strategy. We will continue to engage taxpayers, the practitioner community, and industry experts in educational and collaborative outreach initiatives such as the Identity Protection Forum. We look forward to continuing our collaboration with the National Taxpayer Advocate in identifying, developing, and implementing additional improvements in this important area of tax administration.

Taxpayer Advocate Service Comments

We are pleased that the IRS recognizes identity theft as a serious problem and has made it a priority to address many of the concerns identified in this report. In the past year, the IRS has improved a number of processes relative to identity theft-related tax issues.

We advocated for a global account review for all identity theft victims who come to the IRS. The IRS notes in its response that it is establishing mandatory procedures for global account review. The IRS prefers that this review be conducted by the function having the first contact with the victim. From a taxpayer perspective, it does not matter which function performs this global account review, as long as it is conducted timely and thoroughly. The National Taxpayer Advocate does not have any concerns with the IRS's proposed approach, and looks forward to seeing these procedures implemented.

We also recommended that the IRS allow its employees the discretion to deviate from established guidelines when accepting documentation as evidence of the identity theft. The IRS feels that the burden of providing documentation will be lessened with the develop-

ment of a new IRS identity theft affidavit. The IRS notes that a working group will review cases with exceptional circumstances. The National Taxpayer Advocate remains concerned that there will always be taxpayers with circumstances that the IRM does not contemplate. We feel that a better approach is to provide managers the authority to exercise discretion in these unique circumstances.

The National Taxpayer Advocate also recommended that the IRS empower its employees with greater discretion in determining the rightful owner of an SSN in duplicate returns cases. We are pleased to learn that the Lean Six Sigma team has reached a similar conclusion. We hope that the IRS will adopt this proposal to streamline the resolution process and prevent future duplicate returns cases from being submitted to the SSA through the Scrambled SSN process, and we applaud the IRS for applying these procedures to the current backlog of Scrambled SSN cases.

The IRS has made significant improvements to its procedures for assisting identity theft victims. The National Taxpayer Advocate looks forward to continued collaboration with the IRS in this area. She expects, as a result of these improvements, that TAS identity theft cases will be few and far between in the years to come.

Recommendations

In light of the IRS's agreement with our suggestions, the National Taxpayer Advocate has no specific recommendations at this time. However, she will continue to monitor that the IRS implements the following actions it has agreed to take to improve its assistance to victims of identity theft:

1. Provide global account review and account monitoring (if necessary) for all identity theft victims;
2. Allow its employees the discretion to deviate from established guidelines in accepting evidence of identity theft; and
3. Allow its employees more latitude in determining the rightful owner of a disputed Social Security number.

MSP #6

Taxpayer Service: Bringing Service to the Taxpayer

Responsible Officials

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division
Stephen T. Miller, Commissioner, Tax Exempt & Government Entities Division

Definition of Problem

The IRS has the responsibility to help taxpayers understand and meet their tax obligations. Taxpayer service is not a "one size fits all" endeavor, but one that requires continuous innovation and testing of new solutions. Fundamental to this concept is a proactive service strategy by which the IRS reaches out to the taxpayer with education and help in solving problems.

Although the IRS is improving its face-to-face service and outreach, it should explore additional taxpayer-centric services. As part of this effort, the IRS should return to its original "one-stop shopping" concept on which Taxpayer Assistance Centers (TACs) were founded (*i.e.*, a centralized location where taxpayers can resolve all issues related to their accounts, have questions answered, and receive tax preparation services) and extend this concept to other environments such as phone and Internet service.[1] The IRS should also offer taxpayers service through the channels they need and prefer; provide face-to-face assistance with tax law questions based on the needs of different geographic areas; offer taxpayers a more efficient method of submitting cash payments; explore new alternatives and best practices for future taxpayer service; and consolidate its outreach, marketing, and education initiatives.

Analysis of Problem

The Evolution of Taxpayer Assistance Centers

In response to concerns raised by the IRS Restructuring Commission,[2] Congress held hearings in 1997 and 1998 focusing on taxpayer problems and restructuring the IRS.[3] The

1 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-40-110, *The Effectiveness of the Taxpayer Assistance Center Program Cannot Be Measured* 7 (July 2005).

2 Bob Kerrey, Co-Chair and Rob Portman, Co-Chair, *Report of the National Commission on Restructuring the Internal Revenue Service, A Vision for a New IRS* (June 25, 1997).

3 *See Practices and Procedures of the Internal Revenue Service: Hearing of the S. Comm. on Finance*, 105th Cong. (Sept. 23-25, 1997); *Recommendations of the National Commission on Restructuring the IRS on Taxpayer Protections and Rights: Hearing of the Comm. on Ways and Means Subcomm. on Oversight*, 105th Cong. (Sept. 26, 1997).

hearings revealed, among other things, that the IRS failed to provide quality service to taxpayers.[4] Shortly thereafter, the IRS established Problem Solving Days,[5] which proved to be a great success and led the IRS to reevaluate services offered in its walk-in offices. The IRS modified services to make every day a problem-solving day.[6]

The hearings led to the IRS Restructuring and Reform Act of 1998 (RRA 98).[7] As part of RRA 98, Congress allocated funds to enable the IRS to extend more pre-filing and other assistance to taxpayers.[8] In 2001, the IRS created a business unit named Field Assistance (FA) to plan for 676 TAC sites[9] tasked with providing a wide variety of services.[10] Presently, however, the IRS has only 401 TACs, and those sites are within 30 minutes drive time of just 60 percent of the United States population.[11] As discussed in the 2007 Annual Report, the National Taxpayer Advocate considers this level of coverage insufficient.[12] The National Taxpayer Advocate hopes the IRS uses the lessons from its Geographic Coverage Initiative, an evaluation of TAC locations and services, to expand TAC services to a larger percentage of taxpayers.[13]

Improved Aspects of Face-to-Face Service

Commissioner Douglas Shulman stated the IRS should focus on transparency, seamlessness, and building an environment of trust in the agency.[14] He has also declared that the IRS must approach taxpayer service from a taxpayer's viewpoint to develop trust, providing the taxpayer with a seamless experience that produces the correct answer during the first

4 *Practices and Procedures of the Internal Revenue Service: Hearing of the S. Comm. on Finance*, 105th Cong. (Sept. 23-25, 1997). United States Senate, Committee on Finance, 105th Congress 2nd Sess. on H.R.2676 (Jan. 28-29; Feb.5, 11, 25, 1998).

5 *Many Unhappy Returns*, Charles O. Rossotti, 136-137, Harvard Business School Publishing (2005).

6 *The 2002 Tax Return Filing Season and the IRS Budget for Fiscal Year 2003: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 107th Cong. (Apr. 9, 2002) (testimony of Charles O. Rossotti, Commissioner of Internal Revenue).

7 RRA 98, Pub. L. No. 105-206 § 1002.

8 *Id.*

9 Charles O. Rossotti, Commissioner, Internal Revenue Service, Approval of the Wage and Investment (W&I) Organization 21 (Oct. 1, 2001); TIGTA, Ref. No. 2005-40-110, *The Effectiveness of the Taxpayer Assistance Center Program Cannot Be Measured* 1 (July 2005).

10 Services included: accepting cash and checks for taxes due; setting up installment agreements and payment plans; answering taxpayer questions and assisting in resolving issues detailed in various IRS letters and notices; active involvement in the IRS's enforcement efforts by focusing on face-to-face compliance activities and working delinquent taxpayer cases; and making appointments, including multilingual assistance. TIGTA, Ref. No. 2005-40-110, *The Effectiveness of the Taxpayer Assistance Center Program Cannot Be Measured* 7(July 2005).

11 IRS, *Taxpayer Assistance Blueprint: Phase 2*, 116 & 194 (Apr. 17, 2007).

12 National Taxpayer Advocate 2007 Annual Report to Congress 162-82 (Most Serious Problem, *Service at Taxpayer Assistance Centers*).

13 Although TAS provided three team members to assist on the Geographic Coverage Initiative, the team did not share its findings with the National Taxpayer Advocate. It is the understanding of the National Taxpayer Advocate that the IRS Commissioner was briefed on the Geographic Coverage Initiative. In May 2005, the IRS announced plans to close 68 of the 401 established TAC offices. In response to the IRS proposal, Congress directed that the IRS not close any TACs, and mandated that the IRS address taxpayer needs, and IRS service delivery. This directive prohibited reducing any level of taxpayer service until the completion of a TIGTA study detailing the results of any proposals. Congress also mandated that the IRS consult with the National Taxpayer Advocate and the IRS Oversight Board. TIGTA determined that inaccuracies in the TAC model's workload and the absence of customer information diminished the effectiveness of the closure model, but neither the IRS nor TIGTA were able to ascertain the effect TAC closures might have on compliance. TIGTA, Ref. No. 2005-40-061, *The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data* 3 (Mar. 2006).

14 IRS, *Remarks of Douglas Shulman Before the Federation of Tax Administrators on June 9, 2008, at* http://www.irs.gov/irs/article/0,,id=183721,00.html (last visited July 14, 2008).

contact.[15] The National Taxpayer Advocate commends the IRS on its most recent taxpayer service initiatives, which help increase trust and taxpayer understanding of the IRS through face-to-face contacts.[16]

Taxpayer Assistance Blueprint

Congress mandated that the IRS, in consultation with the National Taxpayer Advocate and the IRS Oversight Board, develop a five-year plan for taxpayer service by April 2006.[17] The IRS subsequently developed the Taxpayer Assistance Blueprint (TAB).[18] However, studies conducted for the TAB, the 2006 Oversight Board study, and the National Taxpayer Advocate's 2006 Annual Report to Congress demonstrate that taxpayers need different services provided through different channels.[19] The TAB addressed taxpayer service only for individual taxpayers. The National Taxpayer Advocate believes that the Small Business/Self-Employed division (SB/SE) would benefit from a similar initiative to understand the characteristics and needs of small business taxpayers.[20]

Geographic Coverage Initiative

In 2008, the IRS established the Geographic Coverage Initiative to evaluate TAC locations and determine the best locations and services based on IRS and taxpayer needs.[21] In the 2007 Annual Report to Congress, the National Taxpayer Advocate found the level of TAC coverage insufficient, in that 40 percent of the population is more than 30 minutes drive time from a TAC location.[22] The National Taxpayer Advocate recommends the IRS use the lessons from the Geographic Coverage Initiative to expand face-to-face service through the TACs to a larger percentage of taxpayers and urges the IRS to share the final report from this initiative with TAS.[23]

15 "First, in every interaction, every transaction we conduct with a taxpayer, we should think about it from the outside-in – from the taxpayer's point of view, even though we may not ultimately agree with the taxpayer. Taxpayers will be judging their interactions with the IRS and the government based on their most recent experiences with other world-class service organizations. This should be our standard. Second, if a taxpayer deals with more than one business group within the IRS, we should coordinate with each other so the hand-off is quick and trouble-free." IRS Commissioner Douglas Shulman, e-mail to all IRS employees (July 9, 2008).

16 IRS, *Report to Congress: Progress on the Implementation of the Taxpayer Assistance Blueprint, April 2007 to February 2008* (Apr. 2007).

17 *Processing Assistance, and Management (Including Rescission of Funds), Joint Explanatory Statement of the Committee of Conference*, Conference Report 109-307, 2-6, *at* http://www.rules.house.gov/109/text/hr3058cr/109hr3058jes.pdf (last visited Dec. 10, 2008).

18 IRS, *Taxpayer Assistance Blueprint: Phase* 2 (Apr. 17, 2007).

19 *See* IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey Special Report* (Nov. 2006); National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15, *Study of Taxpayers Needs, Preferences, and Willingness to Use IRS Services.*

20 National Taxpayer Advocate 2006 Annual Report to Congress 183.

21 In May 2005, the IRS announced plans to close 68 of the 401 established TAC offices. In response to the IRS proposal, Congress directed that the IRS not close any TACs, and mandated that the IRS address taxpayer needs, and IRS service delivery. This directive prohibited reducing any level of taxpayer service until the completion of a TIGTA study detailing the results of any proposals. Congress also mandated the IRS consult with the National Taxpayer Advocate and the Oversight Board. As a result, TIGTA determined that inaccuracies in the TAC model's workload and the absence of customer information diminished the effectiveness of the closure model, but neither the IRS nor TIGTA were able to determine the effect TAC closures might have on compliance. TIGTA, Ref. No. 2005-40-061, *The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data* 3 (Mar. 2006).

22 IRS, *Taxpayer Assistance Blueprint: Phase* 2, 116 & 194 (Apr. 17, 2007).

23 Although TAS contributed three members to the team, the IRS did not share the final report with them or the National Taxpayer Advocate before briefing the IRS Commissioner. The IRS also denied repeated requests from the National Taxpayer Advocate for a copy of the report to be used in developing this Most Serious Problem.

Facilitated Self-Assistance Research Project

The Facilitated Self-Assistance Research Project (FSRP) is located at 15 TACs where the IRS provides help with self-assistance (on computer workstations) or telephone self-assistance via the IRS toll-free system.[24] FSRP provides the IRS the opportunity to educate taxpayers on different services channels, freeing the TAC employees to help taxpayers with issues that are more complex. While the potential exists for the FSRP to be successful, current operating procedures hinder that success. To accomplish the goals of the FSRP, the IRS needs to use screeners effectively to determine which taxpayers can use self-assistance stations. TIGTA is concerned that screeners are not available or used effectively and efficiently at all FSRP sites.[25] The program needs the full support of the IRS in both staffing and effective evaluation to succeed.[26]

Account Transcripts

TACs provided account transcripts until October 1, 2003,[27] when the IRS changed its policy and made transcripts available only by methods not conducive to the time-sensitive needs of taxpayers. In response, TAS cases increased. The IRS finally recognized that taxpayers need to receive transcripts face-to-face and changed its policy again in 2007, which the National Taxpayer Advocate recommended in several Annual Reports to Congress and in testimony before the Senate and House.[28] The original decision to cease providing transcripts at TACs flew in the face of taxpayer needs and preferences, and if the IRS had researched the decision effectively, it would have avoided imposing substantial taxpayer burden. The account transcript history should serve as a cautionary tale to the IRS regarding the hazards of making decisions without fully researching the consequences to taxpayers. The IRS now provides account transcripts to all taxpayers on an immediate basis at walk-in offices. This service reduces both taxpayer burden and the need for taxpayers to seek account transcript assistance from TAS.[29]

Bringing the IRS to the Taxpayer

Service Delivery

The IRS is making strides in improving taxpayer outreach through face-to-face services, but needs to do more to meet taxpayer needs. The expansion of the IRS's Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs increased VITA

24 IRS, *Report to Congress: Progress on the Implementation of the Taxpayer Assistance Blueprint, April 2007 to February 2008* 31 (Apr. 2007).

25 Information provided by TIGTA (Oct. 15, 2008).

26 *Id.*

27 IRS Field Assistance Newsletter, Congressional Update, *Get Copies of Tax Return Information in Two Easy Ways* (2002).

28 *See* National Taxpayer Advocate 2007 Annual Report to Congress 162-82; National Taxpayer Advocate 2005 Annual Report to Congress 254; National Taxpayer Advocate 2004 Annual Report to Congress 8-25; *United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies*, 109th Cong. (Apr. 7, 2005) (statement of Nina E. Olson, National Taxpayer Advocate); *Joint Review of the Strategic Plans and Budget of the Internal Revenue Service: Hearing Convened by the Chairman of the Joint Committee on Taxation*, 109th Cong. (May 19, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

29 IRM 21.3.4.14.4 (Dec. 19, 2007).

tax preparation to more than 3.5 million returns through June 2008, a gain of more than 33 percent compared to June 2007.[30] The National Taxpayer Advocate believes VITA and the TACs should complement and coordinate with each other. This approach should include the use of mobile vans to provide taxpayer service to remote locations during the filing season, offering tax preparation and including issues that are normally "out of scope", but needed in different geographic areas.[31] However, TACs and VITA sites should only be part of the IRS strategy to deliver service to the taxpayer. Previously, the IRS committed to providing alternate service methods.[32] The IRS should coordinate with other federal and state agencies, such as the Social Security Administration or state tax authorities, to provide one-stop shopping for taxpayers. The IRS could target specific groups of taxpayers by collaborating with agencies the groups use frequently; for example, by working with state motor vehicle departments, the IRS could offer excise fuel tax assistance to truck drivers.

Outreach Examples

On February 13, 2008, the President signed the Economic Stimulus Act (ESP) of 2008, providing stimulus payments to approximately 124 million households.[33] To help deal with the task of delivering these payments IRS employees contributed ideas for outreach, education, and services to taxpayers, with outstanding results.[34] The ESP effort was a one-time, unanticipated, consolidated outreach initiative, and the National Taxpayer Advocate commends the IRS for the efficiency of its work. The IRS opened 700 IRS and partner sites in 50 states on Saturday, March 29, 2008, and another 200 sites in April to reach out to taxpayers to file ESP returns. These efforts resulted in approximately 155,700 ESP returns prepared in the TACs through July 31, 2008,[35] and approximately 11 million ESP telephone services provided between October 1, 2007 and August 30, 2008.[36] The IRS also found that taxpayers demanded direct personal contact about the ESP program, despite receiving mailings and having information available online.[37]

Another example of outstanding service is the IRS's Office of Indian Tribal Governments outreach to Indian Nations. During 2008, the office conducted 85 events with a total attendance of more than 3,600 customers.[38] The office also offered large-scale workshops for 227 Alaskan tribal villages and 112 Navajo villages.[39] Services include educational

30 IRS, *Customer Assistance, Relationships and Education (CARE) Weekly Report* (Sept. 28, 2008). Tax returns prepared increased by 872,733, or 33.2 percent (this includes Economic Stimulus Package Returns).

31 "Out of scope" refers to issues in the areas of tax law questions, account questions and tax return preparation that TAC employees cannot address. IRM 21.3.4.3.7.5 (Dec. 31, 2007); IRM 21.3.4-1 (Apr. 7, 2008); IRM 21.3.4.3.7.5 (Dec. 31, 2007).

32 National Taxpayer Advocate 2003 Annual Report to Congress 149.

33 IRS, *Basic Information on the Stimulus Payments, at* http://www.irs.gov/newsroom/article/0,,id=179211,00.html (last visited on Sept.15, 2008).

34 IRS, Wage and Investment Division (W&I), *Economic Stimulus Payments, IRS Employees Reach Out, at*: http://win.web.irs.gov/Econ_Stim_Paymnts/ESP_employee_stories_home.htm (last visited Sept. 15, 2008).

35 W&I, Field Assistance response to TAS information request Sept. 15, 2008.

36 W&I, Customer Account Services response to TAS information request Nov. 13, 2008.

37 *Financial Services and General Government Appropriations Bill 2009 Report*, 110th Congress, 2d session 24 (June 2008).

38 Tax Exempt and Government Entities (TE/GE), Office of Indian Tribal Governments response to TAS information request (Aug. 7, 2008).

39 *Id.*

workshops on Title 31, employment tax forms, tip reporting, employment taxes, the Earned Income Tax Credit (EITC), information reporting, and gaming issues.[40] VITA also held sessions at seven events.[41] The IRS should follow the Office of Indian Tribal Governments' model in targeting and bringing programs to other taxpayer populations.

Face-to-Face Service: One Step Forward, Two Steps Back.

After RRA 98, the IRS embarked on a campaign to improve face-to-face taxpayer service. However, before achieving its initial goals, the IRS began paring back face-to-face service and offering more Internet services, without adequately studying the impact of such reductions on taxpayer needs or their ability to comply with their tax obligations.[42]

Reduced Services for Small Business and Self-Employed Taxpayers

The SB/SE division, created after RRA 98, included the Taxpayer Education and Communications (TEC) organization, whose purpose was to deliver face-to-face education and outreach programs to small business taxpayers to help them comply with their tax obligations.[43] The IRS planned to provide TEC with over 1,200 staff in 15 major field locations by FY 2002.[44] Instead, in October 2005, the IRS merged TEC with other outreach and communications organizations under the Communication, Liaison and Disclosure (CLD) function in SB/SE and reduced it from 536 to 183 employees.[45] CLD provides information electronically or through partners and stakeholders in the field, and has eliminated specialized face-to-face services for small businesses.[46] To adequately assist this taxpayer base in complying with tax obligations, the IRS should revive the original concept of TEC, and develop a five-year strategic plan based on the services and delivery channels that small business taxpayers need and prefer.

Reduced Services for Tax-Exempt Organizations

The TE/GE division conducted workshops through its Exempt Organizations (EO) unit on various topics, including Form 990, Return of Organization Exemption from Income Tax, between October 2007 and May 2008.[47] These workshops include face-to-face interactive forums on the Form 990, *Return of Organization Exemption from Income Tax*.[48] However, EO delivers most of its education and outreach through the Internet, and responds to

40 TE/GE, Office of Indian Tribal Governments response to TAS information request (Aug. 7, 2008).

41 *Id.*

42 "We will continue to launch new and enhanced filing and payment programs to create an environment where electronic interaction is the preferred option for our customers." IRS, *Strategic Plan 2005-2009* 13.

43 National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS* 8 (June 25, 1997).

44 General Accounting Office, GAO-03-711, *Workforce Planning Needs Further Development for IRS's Taxpayer Education and Communication Unit* 2 (May 7, 2003).

45 National Taxpayer Advocate 2006 Annual Report to Congress 177.

46 IRS, *My SB/SE, at* http://mysbse.web.irs.gov/CLD/SL/AboutSL/default.aspx (last visited Dec. 10, 2008).

47 TE/GE response to TAS information request (Sept. 24, 2008).

48 TE/GE response to TAS information request (June 30, 2008).

invitations received rather than initiating speaking opportunities.[49] Because TE/GE received fewer of these requests, the number of customers reached dropped 35 percent compared to the first quarter of FY 2006.[50] Specifically, two 2006 events not repeated in 2007 accounted for 2,300 fewer customers reached.[51] Electronic taxpayer service should not supplant face-to-face outreach unless EO has data that supports organizations preference for these services.[52]

The IRS Should Consider Reviving Telefile.

The National Taxpayer Advocate commends the IRS for studying the revitalization of aspects of TeleFile, after previously failing to consider the consequences of eliminating the program, which enabled taxpayers to file returns at no charge by using their telephone keypads.[53] Approximately 4.4 million taxpayers used the program annually.[54] However, the IRS discontinued TeleFile in August 2005, over the objections of the National Taxpayer Advocate, because of increasing costs and declining use. The IRS ended TeleFile to save an estimated $17 million to $23 million,[55] but a subsequent TIGTA report found the move increased burden for a significant number of taxpayers.[56] Approximately two million taxpayers who used TeleFile in 2005 would have been eligible to do so again in 2006. Instead, more than one quarter of these taxpayers paid a total of $23.6 million to file their 2006 returns, and nearly half of the former Telefile taxpayers reverted to filing paper returns.[57] In the end, the elimination of TeleFile cost taxpayers more than the program would have cost the IRS.[58]

The IRS Needs to Provide More Face-to-Face Service.

Taxpayer service from the perspective of a taxpayer needs to be more taxpayer-centric, transparent, and seamless. The IRS needs to examine which services it can deliver to various demographic groups, and the channel, or means of delivery, that each group needs and prefers.[59]

49 TE/GE, *Business Performance Review* 23, *at* http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE_BPR_Feb_07.doc (Feb. 23, 2007).

50 *Id.*

51 *Id.*

52 *Internal Revenue Service FY 2009 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government, S. Comm. on Appropriations*, 110th Cong. (Apr. 16, 2008) (testimony of Nina E. Olson, National Taxpayer Advocate).

53 Information provided by IRS Customer Assistance, Relationships and Education (CARE) representative (Sept. 15, 2008).

54 TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* 2 (July 2007).

55 *Id.*

56 *Id.*

57 *Id.*

58 *Id.* at 3.

59 *See, e.g.*, National Taxpayer Advocate 2005 Annual Report to Congress 7; National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, *Study of Taxpayers Needs, Preferences, and Willingness to Use IRS Services* 14.

TAC Services Remain Out of Reach for Many Taxpayers.

Many opportunities exist for the IRS to improve face-to-face services. Taxpayers in remote areas may have difficulty obtaining services from a TAC since most TACs are in more populous areas.[60] Further, only 55 percent of TACs are open 36 to 40 hours per week.[61] Even though the IRS has hired seasonal workers to provide a higher level of staffing, more resources are necessary to meet taxpayer needs.[62] For example, many people can only visit TACs during their lunch hours, when many TACs are closed.[63] Thus, the IRS should vary the service times at different locations to allow more taxpayers to use the TACs. TACs could rotate tax preparation to Saturdays and certain evenings during the week, marketing these services to taxpayers in advance. By using alternatives to brick-and-mortar TACs, such as mobile vans, the IRS could deliver specialized services to communities that need them. In collaboration with state tax agencies, and other service-oriented agencies, such as the Social Security Administration, the IRS should target specific taxpaying populations and services.[64]

TACs Should Be Able to Answer More Tax Law Questions.

TACs are required to answer tax law questions for taxpayers.[65] Because the IRS considers many such issues out of scope at the TACs, their employees cannot provide seamless taxpayer service.[66] Not all geographic areas require identical tax law issues to be in scope, however, and the IRS could perform a comprehensive study to determine the need for issues to be back in scope in various areas. At present, the preparation of Schedule F, *Profit or Loss from Farming*, is out of scope in all areas.[67] A study might find it makes no sense to offer Schedule F preparation at all TACs, such as those in New York City, but it could benefit taxpayers to bring it into scope in areas where farming is a major industry, such as Iowa. The IRS does a disservice to taxpayers by universally declaring face-to-face assistance on certain issues out of scope without determining the geographically based demand for those services.

Taxpayers Continue to Face Problems in Submitting Cash Payments to the IRS.

Taxpayers who do not have checking or savings accounts (*i.e.*, the unbanked) encounter difficulties when trying to make payments at TACs. The IRS is offering a courier service

60 *See* http://www.irs.gov/localcontacts/index.html (last visited Dec. 22, 2008).

61 National Taxpayer Advocate 2007 Annual Report to Congress 166.

62 *Internal Revenue Service FY 2009 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government, S. Comm. on Appropriations*, 110th Cong. (Apr. 16, 2008) (testimony of Nina E. Olson, National Taxpayer Advocate).

63 Internal Revenue Service, Contact My Local Office, *at* http://www.irs.gov/localcontacts/index.html (last visited Nov. 12, 2008).

64 *Internal Revenue Service FY 2009 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government, S. Comm. on Appropriations*, 110th Cong. (Apr. 16, 2008) (testimony of Nina E. Olson, National Taxpayer Advocate).

65 IRM 21.3.4.3.6.(5) (June 2, 2008).

66 IRM 21.3.4-1 (Apr. 7, 2008). Taxpayers needing assistance with certain types of return preparation or tax law questions involving rental property, cancellation of debt, rental income, depreciation, Schedule F, *Profit or Loss from Farming*, or most self-employment income need to hire a preparer or call the toll-free line because these tax law areas are out of scope (assistors cannot answer) in the TACs.

67 IRM 21.3.4-1 (Apr. 7, 2008).

that allows taxpayers to make cash payments directly into an IRS account so the taxpayer will receive immediate account credit.[68] While the National Taxpayer Advocate commends this initiative, the IRS is piloting the service in only ten TACs due to funding issues.[69] The IRS needs to study the possibility of offering cash payment centers at local banks, grocery, or retail stores, many of which already have bank branches. The IRS needs numerous payment locations that are not just conventional brick and mortar sites, and should never turn away any taxpayer who is ready to make a payment, regardless of how he or she wants to make the payment.[70]

A Vision of Taxpayer Service

The National Taxpayer Advocate previously addressed the need to determine taxpayer preferences and needs for service, including preferred channels such as face-to-face, telephone, and the Internet.[71] Tax agencies and other organizations recognize the need for such information and focus on the needs of the taxpayer as crucial to the success of taxation systems. For example, the Organisation for Economic Co-Operation and Development (OECD) Taxpayer Services Sub-group identified putting the customer in the center as one of its guiding principles, and supports marketing and information based on individual customers according to socio-demographic criteria.[72]

The Australian Tax Office (ATO) strives to be an open and transparent organization where interaction with taxpayers allows for service channel choice.[73] Australia designs its taxpayer systems from the "outside in," that is, building customer interaction points from the perspective of the customer, taking into account the needs and preferences of the taxpayer.[74] In 2003 the ATO developed a channel strategy with the aim of creating a tax program that is "easier, cheaper, and more personalized" to the taxpayer.[75] Using research, studies of taxpayer needs and preferences, tax administration concerns, and channel restrictions, the ATO created a channel preference system for various types of taxpayer interactions.[76] Australia provides transaction assistance through the Internet, the phone, by paper, and face-to-face; customer interactions may be held over the phone, on the Internet, through e-mail, over paper, and face-to-face; and customers can receive information through the

68 W&I response to TAS information request (Sept. 15, 2008).

69 *Id.* Also, TACs do not accept payments at 22 percent of the locations. National Taxpayer Advocate 2007 Annual Report to Congress 172.

70 National Taxpayer Advocate 2007 Annual Report to Congress 172.

71 National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 14, *Study of Taxpayers Needs, Preferences, and Willingness to Use IRS Services*.

72 OECD is a global organization that produces global sources of comparable statistics, and economic and social data. In addition to collecting data, OECD monitors trends, analyzes and forecasts economic developments, and researches social changes or evolving patterns in trade, environment, agriculture, technology, and taxation in democratic countries. *See* The Organisation for Economic Co-Operation and Development, *Improving Taxpayer Service Delivery: Channel Strategy Development*, prepared by the Forum on Tax Administration Taxpayer Services Sub-group 9, 38 (May 2007)

73 ATO, *Towards the New Millennium, A Benchmark for Tax Administration, at* http://www.ato.gov.au/corporate/content.asp?doc=/content/22866.htm (Sept. 11, 2000).

74 *Id.*

75 OECD, *Improving Taxpayer Service Delivery: Channel Strategy Development*, prepared by the Forum on Tax Administration Taxpayer Services Sub-group 42, 58 (May 2007).

76 *Id.* at 16.

Internet, via paper, on the phone, by e-mail, or in person.[77] Through research, the ATO seeks to define the best channels to provide service to the taxpayers, balancing taxpayer needs and preferences with the achievement of the ATO mission.[78]

New Zealand's Inland Revenue Service developed a new business plan, *Our Way Forward*, in 2006.[79] The plan encompasses four goals, of which the first is to "target and tailor our activities through understanding our customers."[80] New Zealand presents its tax collection and administration activities as a collaborative agreement between the taxpayer and the government, emphasizing the role that each must play for the tax system to function effectively.[81] The goal is to form a "customer-led" revenue system where taxpayer involvement will encourage voluntarily compliance with tax obligations.[82] Based on this goal, New Zealand developed a Families Customer Perspective, which uses child support issues in New Zealand and Working for Families Tax Credits as well as paid parental leave to identify opportunities to improve and tailor the way the New Zealand tax administration communicates with its family customers.[83] New Zealand intends to complete a series of longitudinal studies to evaluate the effectiveness of the Working for Families program, encompassing elements such as awareness of the program, household economic surveys, and demographic information.[84]

OCED members report they intend to use interactive digital television or telepresence.[85] Several tax authorities are testing this channel, which will integrate video, text, and data, and be interactive. In the United States, medical professionals have used videoconferencing for some time but are also using a variety of tools, including one called "telemedicine."[86] Physicians can provide services through a robot with an attached computer beaming to a patient's bedside from anywhere in the world as long as the physician has a high-speed Internet connection. Using a joystick and laptop, the physician can navigate the robot down hospital corridors, rotate it 360 degrees, zoom in on a patient's eyes, X-rays, or vital signs monitor, and can hear and speak as if he were in the room with the patient.[87] The IRS could use similar technology to reach taxpayers in remote geographic locations with

77 OECD, *Improving Taxpayer Service Delivery: Channel Strategy Development*, prepared by the Forum on Tax Administration Taxpayer Services Sub-group 42, 58 (May 2007). *Id.* at 17.

78 *Id.* at 58.

79 Inland Revenue, *Our Way Forward, David Butler*, Commissioner of Inland Review, *at* https://www.ird.govt.nz/resources/file/eb3c8201af5d6c8/way-forward-2006.pdf (last visited Aug. 22, 2008).

80 *Id.*

81 Meeting with representatives of New Zealand's Inland Revenue Customer Insight Group (June 3, 2008).

82 *Id.*

83 Inland Revenue, *Families Customer Perspective, Families Child Support, Working for Families Tax Credits, Paid Parental Leave* (Aug. 2007).

84 Presentation of Valmai Copeland, *You Earn How Much! An Investigation of Self-Reported Income Versus Administrative Income Data*, New Zealand Inland Revenue, at the 2008 IRS Research Conference (June 11, 2008)

85 Cindy Waxer, *Telepresence; Current and Future*, VOIP-News, Making VoIP Connections, *at* http://www.voip-news.com/feature/telepresence-current-future-apps-051507/ (May 15, 2007).

86 Linda Lou, *Dr. Robot is On Call, Interactive tool can make rounds*, The San Diego Union Tribune, *at* http://www.signonsandiego.com/news/northcounty/20080815-9999-1m15robodoc.html (Aug. 15, 2008).

87 *Id.*

pre-filing and post-filing services, thereby using its staffing more efficiently and effectively. Since telepresence is interactive, the TACs could provide all services, including return preparation, tax law, and account services through this communication mode.

Conclusion

July 22, 2008, marked the tenth anniversary of the IRS Restructuring and Reform Act of 1998. In this time, the IRS has substantially improved its customer service to taxpayers. The development of the Taxpayer Assistance Blueprint (TAB) helped the IRS learn more about taxpayers than it ever knew in the past. It also provided a strategic roadmap for future services and research. However, the IRS, the world's largest tax administrator, must do better. To bring world-class customer-centric service to the taxpayer, the IRS should continue the TAB with a comprehensive study of taxpayer service needs and preferences, expand the TAB to address other taxpayer segments, and implement the findings in a taxpayer service strategy tailored to the needs of the population it serves. The IRS should conduct a survey of tax law needs by geographic location and bring tax law areas into scope at the TACs based on taxpayer demand. To make taxes easier, the IRS needs to expand its cash payment acceptance program to all TACs and consider offering payment stations in alternative locations such as banks. The IRS must put the needs and preferences of the taxpayer first to provide timely and effective service that encourages voluntary compliance.

IRS Comments

The IRS agrees that it must help taxpayers understand and meet their tax obligations. We are committed to offering top quality service and, in doing so, continuously evaluate and improve our large and diverse portfolio of customer services. We remain aware of changing taxpayers' preferences in how they access the IRS and receive the information they need and believe that we must innovate and evolve to provide customer service successfully.

2008 Filing Season and Economic Stimulus Payments

The 2008 filing season was very successful, both in terms of serving taxpayers through multiple channels and in meeting challenges the IRS faced. Through November 7, 2008, the IRS processed over 155 million individual income tax returns and issued over 107 million refunds, totaling nearly $259 billion. The IRS also processed an additional 8.5 million returns filed solely for purposes of claiming an economic stimulus payment. Electronic filing grew again this year with 89.9 million, or 58 percent, of individual taxpayers filing electronically. This represents a 12.4 percent increase over the prior year.

The ESP legislation had a dramatic impact on our telephone program, resulting in over twice the number of toll-free calls in the January-June period of 2008 than in 2007 (118 million versus 57 million). Automated Calls and Web Services more than doubled from last year's volumes while Assistor Calls Answered increased by 26 percent. The IRS.gov

website also proved to be a valuable resource to taxpayers, with a 24 percent increase in "Where's my Refund" inquiries, while our new "Where's my Rebate" tool experienced 37 million completed inquiries. In addition, as of November 8, 2008, the website has been visited more than 332 million times, a 65.9 percent increase over 2007. These visits resulted in more than two billion page views, an almost 67.3 percent increase over 2007.

During the 2008 filing season, the IRS continued to provide services at all 401 TACs. Assistance with ESP contributed to an increase in the volume of contacts at the TACs from February 15, 2008, through May 31, 2008, compared to the same period in 2007. The IRS also continued to provide services to low income, the elderly, the disabled, and those with limited-English proficiency through the VITA and TCE programs. The VITA/TCE volunteers prepared over 3.5 million returns, an increase of 33.2 percent over last year. Due to our outreach efforts, this increase includes many taxpayers that filed for ESP that normally do not have a filing requirement.

Face-to-Face Services

The IRS has improved its delivery of face-to-face services and will continue to do so. The National Taxpayer Advocate commends the IRS on its most recent taxpayer services initiatives and suggests the IRS do more to meet taxpayer needs. We have plans in place in several areas that will help improve our services.

Taxpayer Assistance Blueprint

With regard to continuing the TAB, we developed a multi-year research strategic plan to ensure that we expand and refine our understanding of taxpayer and partner needs, preferences, and behavior. This plan addresses a wide array of service-related research that will build upon the benchmark survey undertaken during the TAB, including recurring surveys of needs and preferences of taxpayers who have contacted the IRS, as well as those who have not.

In addition, we established a multi-divisional research council to ensure that the research plan addresses a broad spectrum of taxpayer segments. By helping the IRS increase its understanding of taxpayer needs and behaviors, efforts of the council and analysis of research findings will help to refine and improve future service delivery strategies.

The IRS agrees the SB/SE division would benefit from a similar TAB initiative. The SB/SE division's Research office is already working with the W&I division on a TAB Research Plan to address similar issues with small business taxpayers and practitioners and has taken on several TAB projects and other related research on the characteristics and needs of small business taxpayers.

The SB/SE division CLD function is also partnering with SB/SE Research to obtain data to assist in determining and planning outreach activities. For example, SB/SE Research provided a comprehensive library of existing research targeted toward the non-filer

community. This research will be used to develop an outreach strategy aimed at small business taxpayers who are not complying with their filing requirements. SB/SE is also working on a project to determine whether significant portions of the tax gap can be isolated by industry and geography to best focus outreach. In the last two years, SB/SE Research has completed approximately 60 projects with many current projects underway.

Geographic Coverage Initiative

The IRS established the Geographic Coverage Initiative (GCI) in 2008 to evaluate TAC locations and services based on the IRS and taxpayer needs. Through the GCI, the IRS is exploring options for increasing the geographic coverage rate by using alternative locations and increasing partnership services. For example, the TAC program is partnering with the Volunteer program in FY 2009 to provide account resolution services in addition to the normal return preparation services offered at select VITA/TCE locations. After evaluating this pilot program, the IRS may offer these services at additional locations. In addition, the IRS is collaborating with Federal, State, and City agencies to establish alternative locations similar to disaster assistance sites where customers can receive one-stop assistance. There is already one multi-agency site in Salt Lake City, Utah, where IRS employees are co-located with the Utah State Tax Department. We expect to expand the number of locations offering multi-agency services during 2009.

Facilitated Self-Assistance Research Project

As the National Taxpayer Advocate mentions, the IRS implemented the FSRP to provide taxpayers options for self-assistance through computer workstations and access to the IRS toll-free system. The National Taxpayer Advocate believes that for the FSRP to be successful, the IRS needs to use screeners effectively to determine which taxpayers can use self-assistance stations. The IRS agrees and, based on analyses it performed on the current operating procedures, we are already implementing changes to improve the screening process. In this regard, we have allocated additional resources to ensure screeners are available and used effectively in each site and expanded training to ensure support for FSRP is readily available. For the 2009 filing season, FSRP has expanded to 35 additional TACs, bringing the total number of sites to 50.

Service Delivery to Taxpayers

The IRS is committed to providing service to taxpayers in the range of ways that they want. This includes face-to-face interaction at TACs, as well as by electronic means. How IRS provides services, both in terms of methods and through its organizational structure, needs to change and evolve with taxpayer preferences. The IRS continuously evaluates and studies its service delivery to maximize its assistance to taxpayers.

Face-to-Face Contact at Taxpayer Assistance Centers

The National Taxpayer Advocate mentions many taxpayers can only visit TACs during their lunch hours, when many TACs are closed and that the IRS should vary service times at different locations to allow more taxpayers to use the TACs. As noted in the IRS response to a similar point raised in the National Taxpayer Advocate's 2007 Annual Report for Congress, TAC standard operating hours are 8:30 a.m. to 4:30 p.m., which allows employees to have lunch as required by negotiated labor management agreements. However, to ensure we make face-to-face services available to those taxpayers unable to visit a TAC during normal operating hours, the IRS is adding a Super Saturday during the FY 2009 filing season to allow taxpayers to receive return preparation on Saturday. Further, with a goal of assisting over 530,000 EITC-eligible taxpayers with return preparation during the 2009 filing season, special EITC events will be held on January 31, February 7, and February 21, 2009, to help customers outside of normal business hours.

Scope of Questions Answered at TACs

The National Taxpayer Advocate also argues that TACs should be able to answer more tax law questions based on the needs of different geographic areas and asserts that, because the IRS considers many issues out of scope at the TACs, employees cannot provide "seamless" taxpayer service. As noted in the IRS response to the same point raised in the National Taxpayer Advocate's 2007 Annual Report for Congress, and again in its response to this year's Most Serious Problem on Centralization, just a few years ago the IRS was criticized for the relatively low level of tax law accuracy provided by its TACs. To address this concern, the IRS took aggressive action to increase employee training, implement enhanced quality measures and employee accountability, and control the scope of the issues addressed. The latter is intended to concentrate our employee training on the kind of issues most often encountered in the TAC environment, as well as to ensure consistency with TAC employees' grade levels and expertise.

The National Taxpayer Advocate is correct that TAC employees may not address Schedule F farm income issues currently. This complex area of tax law includes such issues as accrual accounting, leases and rents, inventory valuation, employee expenses, pensions and profit sharing, depreciation, cooperative distributions, agricultural program payments, crop insurance payments, and other sophisticated and specialized issues. However, the GCI is exploring the possibility of adding into scope geographic-based tax law topics, such as farming. The IRS expects to accomplish this by training selected subject matter experts and employing a referral system, while carefully evaluating the accuracy of these services. For FY 2009, two topics have already been added into scope at the TACs - Non-Resident Alien issues and Cancellation of Debt (Mortgage Forgiveness). Cancellation of Debt income has also been added into scope at the VITA/TCE sites.

Cash Payments at TACs

The IRS accepts all approved forms of payment at its TACs, including cash when nearby conversion options are unavailable. To address employee safety concerns and potential integrity issues involved in dealing with cash, the IRS is refining its payment processes and seeking other options for handling cash payments. In FY 2008, the IRS successfully implemented a pilot program that offered courier services at ten TAC locations. Using the courier service, taxpayers can make cash payments that are deposited directly into a Treasury account. These payments are secure and taxpayers receive immediate account credit. In FY 2009, the IRS will expand courier services to the 177 TACs that are not co-located with a financial institution or U.S. Post Office where taxpayers can otherwise readily convert cash into other forms of payment.

Taxpayer Education and Communication Division

The National Taxpayer Advocate offers the merging of TEC with other outreach and communications organizations under the CLD function in SB/SE as an example of reduced services for small businesses and self-employed taxpayers. The IRS disagrees with the National Taxpayer Advocate's assessment.

Since SB/SE's inception, it has been committed to balancing service and enforcement by educating its taxpayers on tax law and IRS policy using a leveraged outreach approach. Although SB/SE has adjusted its organizational structure since RRA 98, it has always contained an education and outreach function and staffing dedicated to pure outreach and education has not diminished.

The IRS used a strategic approach when it merged TEC with other outreach and communications organizations under the CLD function. Research data showed locations with the highest concentration of small business and self-employed taxpayers, which drove the decision on employee placement. External stakeholders in all 50 states and Washington, D.C., have a liaison contact in the Stakeholder Liaison function. With advancements in technology and strengthened stakeholder relationships, liaison activities are not diminished from changes to the numbers or physical locations of the IRS employees involved. Although the original TEC design included approximately 1,200 staff, the organization never reached that level. Further, the number of TEC staff that were to be fully dedicated to outreach activities is approximately the same as the number of staff in the redesigned Stakeholder Liaison function.

Service to the Tax-Exempt Community

The IRS agrees that service to the tax-exempt community is essential and is committed to educating this sector through the EOs division within the Tax TE/GE division. The EO division has expanded and diversified its efforts to communicate, update and share information for tax-exempt organizations by balancing "in-person" employee presentations for their

administrators with "round the clock" availability through the IRS.gov.[88] For example, the "Charities and Non-profits" section of IRS.gov has approximately 1,600 articles on 70 pages devoted specifically to tax-exempt organizations. Public reliance on the internet to receive timely and relevant information has grown exponentially. Use of the "Charities and Non-Profits" pages of IRS.gov has increased 81 percent since FY 2005.

This increased presence on the Internet was complemented by increased in-person presentations. Due in large part to the release of the redesigned Form 990 and the new Form 990-N (*e-Postcard*), requests for speakers during FY 2008 increased nearly 50 percent over the previous year.[89] To reach a broader audience, EO also offered 19 two-hour workshops on the new Form 990 at the six 2008 nationwide Tax Forums and introduced the form changes during its 17 Small and Mid-size Workshops in six cities across the country. In all, 41,752 people attended the speeches, Tax Forums, and Workshops, an increase over the FY 2006 figure of 32,368 and FY 2007 figure of 39,338.[90]

Reviving Telefile

With regard to reviving Telefile, the IRS launched a comprehensive study, the Advancing e-file Study, to review the characteristics of taxpayers who do not file electronically and analyze a number of options that could help drive up the rate of electronic filing, including Telefile. The IRS engaged an independent firm, the MITRE Corporation, to conduct the study and produce the report. The IRS will look at the experience of the States and other countries, consider costs, benefits and security issues, and discuss potential implementation issues. The Advancing e-file Study will be done in two phases. Phase I was completed and released to the public on November 6, 2008, and provides 13 options for expansion. Phase II will address initial costing, cost-benefit and return on investment analyses and predictions of growth and is expected to be delivered in August 2009.

Conclusion

In summary, the IRS currently offers a large and diverse portfolio of customer services targeted to meet the needs and preferences of specific taxpayer populations. The IRS strives continually to improve these services within appropriated funding levels in order to help taxpayers understand and meet their tax obligations.

88 TE/GE, *EO Annual Report and FY 2009 Work Plan* 7-8, *at* http://www.irs.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf.

89 TE/GE, *4th Quarter Business Performance Review* 13, *at* http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE_BPR_4th_Quarter_FY08_Executive_Summary.doc.

90 *Id.*

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is encouraged by the actions the IRS is taking and intends to take in regard to customer service. We understand the evolving nature of taxpayer needs and preferences and support the effort of the IRS to expand upon the TAB Benchmark Survey with continuing studies of taxpayer needs and preferences. The National Taxpayer Advocate commends the IRS efforts to study the SB/SE taxpayer population, to bring tax law issues back into scope at the TACs, and expand the FSRP and the courier cash payment acceptance program.

The Voice of the Taxpayer

The Taxpayer Advocate Service is the voice of the taxpayer within the IRS. When the IRS creates projects and working groups on issues affecting taxpayer service, it is essential that TAS be represented and able to voice concerns from the perspective of the taxpayer. TAS provided three team members for the IRS's Geographic Coverage Initiative, but after several months of work, the IRS stopped including our team members in the Initiative. The National Taxpayer Advocate is surprised to learn that these activities have continued while TAS has been excluded. It is also a matter of concern that TAS has not been included in plans for a TAB for small business and self-employed taxpayers, like the one already in place for individual taxpayers. While the National Taxpayer Advocate commends the IRS for beginning work on this strategy, it is necessary that TAS be a part of such projects if the IRS truly intends to think about service from the perspective of the taxpayer. The National Taxpayer Advocate has recommended in several Annual Reports that the IRS conduct a small business/self-employed TAB.[91] The Taxpayer Advocate Service was a significant author of the original TAB. It is in the interest of taxpayers and tax administration that the IRS reach out to the Office of the Taxpayer Advocate and invite participation on matters that have significant impact on taxpayers.

Scope of Tax Law Assistance

The National Taxpayer Advocate is encouraged by the effort to bring tax law issues into scope at TACs based on geographic need. However, we are concerned that the IRS reiterates the same response provided in last year's Report to Congress about not providing assistance on issues such as farming income because the issues are too complicated.[92] A tax law issue that is complex for IRS employees is just as complex for taxpayers, if not more so. Previous criticism of the IRS's accuracy rate in answering tax law questions does not justify the decision to simply declare those issues out of scope instead of training employees in complicated areas of the law where taxpayers need the most assistance. While we understand that the IRS may have needed to limit its scope of questions several years ago in order to get its quality under control, as the IRS itself notes, it is now doing well with the

91 *See, e.g.*, National Taxpayer Advocate 2006 Annual Report to Congress 172-96, National Taxpayer Advocate 2007 Annual Report to Congress 35-65.

92 National Taxpayer Advocate 2007 Annual Report to Congress 174.

limited scope of questions it is answering. The techniques that enabled it to achieve higher quality with easier tax law questions can and should be applied to more complex questions, where there is a demonstrated need. Complexity of the tax code is not an excuse for taxpayers' noncompliance; nor should it be an excuse for the IRS to fail to assist taxpayers in their need.

TAC Hours of Operation and Service Locations

While the National Taxpayer Advocate commends the IRS plan to hold a Super Saturday and three EITC Saturday events, this response does not address the concern that on a regular basis, taxpayers can only receive face-to-face assistance at TACs from 8:30 a.m. until 4:30 p.m. One Super Saturday is not enough, because it will only reach taxpayers available that one day. Holding more than one event would ease the burden on taxpayers who need IRS help. Varying the hours at TACs, staggering employees' lunch hours, and rotating tax preparation to evenings, combined with well-targeted outreach regarding the hours, would reach more taxpayers and permit flexibility in scheduling for taxpayers.[93]

Partnering with VITA and TCE sites is a good first step. However, the IRS needs more avenues for reaching taxpayers in remote areas where brick and mortar TACs do not exist. The IRS should consider using mobile vans, telepresence, and other creative solutions to meet the needs of these taxpayers. While co-locating a TAC with the Utah State Tax Department site in Salt Lake City, Utah, is a good example of working with other agencies, Salt Lake City is a relatively populated area that already has a TAC and at least five VITA sites.[94] Co-locating should be used especially as a tool where the IRS currently has little or no presence.

The Way Forward

The National Taxpayer Advocate is encouraged by the steps the IRS is taking and has committed to take to address customer service issues. We remind the IRS that including the perspective of the taxpayer is crucial when evaluating changes to taxpayer service and we encourage the IRS to include TAS in all taxpayer services initiatives. The National Taxpayer Advocate emphasizes the need for a comprehensive study of taxpayer needs and preferences. We are hopeful that as the IRS moves forward it will continue to study these evolving needs and preferences and look for innovative ways to provide service.

93 National Taxpayer Advocate 2007 Annual Report to Congress 179.

94 *See* http://www.irs.gov/localcontacts/article/0,,id=98338,00.html; http://utahtaxhelp.org/findSite.aspx (all sites last visited Dec. 18, 2008).

Recommendations

The National Taxpayer Advocate recognizes the efforts the IRS has made thus far to improve service and recommends the IRS make the following changes to bring more services to taxpayers:

1. Expand the Taxpayer Assistance Blueprint to other taxpayer segments, including TE/GE taxpayers, and implement the findings in a taxpayer service strategy tailored to the needs of the population the strategy serves.
2. Conduct a survey of tax law needs by geographic location and bring tax law areas into scope at the TACs based on taxpayer demand.
3. Co-locate with other federal and state agencies, use mobile vans, and explore the possibility of telepresence to reach taxpayers in locations where the IRS has limited or no face-to-face presence.
4. Collaborate with the Taxpayer Advocate Service in all ongoing and new studies pertaining to taxpayer service, including the Taxpayer Assistance Blueprint for small business and self-employed taxpayers currently underway.

MSP #7

Navigating the IRS

Responsible Officials

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division
Steven T. Miller, Commissioner, Tax-Exempt and Government Entities Division
Frank Y. Ng, Commissioner, Large and Mid-Size Business Division
Sarah Hall Ingram, Chief, Appeals
Eileen C. Mayer, Chief, Criminal Investigation
Art Gonzalez, Deputy Chief Information Officer for Modernization and Information Technology Services
Frank Keith, Chief, Communications and Liaison

Definition of Problem

The IRS Restructuring and Reform Act of 1998 (RRA 98) required the IRS to reorganize and improve customer service.[1] Congress directed the IRS to create separate units responsible for providing "end to end" service to groups of taxpayers with similar needs.[2] Ten years after RRA 98, employees, taxpayers, and practitioners still have difficulty locating the appropriate IRS office or employee to assist them in resolving tax problems.

In contrast, many state government agencies and tax agencies in other countries provide easy access and a wealth of information for their customers, suggesting the IRS can do much more to help taxpayers and practitioners navigate the IRS. Citizens compare the service they receive from the IRS with the service they receive from other organizations, where accessing account information, resolving problems, and sending and receiving information 24 hours a day with minimal inconvenience and cost, have become the norm. The IRS would do well to consider what it is like for taxpayers to accomplish these tasks when they encounter difficulties in simply determining where and to whom, in a 100,000-person agency, they should direct their inquiries.[3]

1 RRA 98, Pub. L. No. 105-206, 112 Stat. 690 (July 22, 1998).

2 Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998*, 1 (1998).

3 Commissioner Douglas Shulman recently stated, "In order to make voluntary compliance easier, we must walk a mile in the taxpayers' shoes and help them navigate the system. Taxpayers will be judging their interactions with the IRS and the government based on their most recent experiences with other world-class service organizations. This should be our standard." E-mail from Commissioner Shulman to all employees (July 9, 2008).

Analysis of Problem

Background

In years past, the IRS was the subject of a great deal of study and criticism. According to one IRS publication, studies identified a wide range of problems, including a lack of resources for employees and poor service for taxpayers.[4]

In the mid 1990s, Congress created the National Commission on Restructuring the IRS to review IRS practices and make recommendations for modernizing and improving efficiency and taxpayer services.[5] The House Committee on Ways and Means conducted hearings regarding the recommendations of the commission.[6] In 1997, the Senate Finance Committee held hearings to examine IRS practices and procedures,[7] restructuring,[8] and oversight.[9] The enactment of RRA 98 followed. First, RRA 98 required the IRS to reorganize its structure and restate its mission.[10] Specifically, RRA 98 called for the IRS to eliminate or modify its structure, at that time based on national, regional, and district subdivisions,[11] and to restate its mission to place greater emphasis on serving the public and serving taxpayers' needs.[12]

RRA 98 also required the IRS to be more accountable to taxpayers and practitioners. Section 3705 of the law requires IRS employees to provide taxpayers with their names and a unique identifying number, and to the extent practical and if advantageous to the taxpayer, assign one employee to handle a taxpayer's matter until it is resolved.[13]

4 *See* IRS Pub. 3349, *Modernizing America's Tax Agency* 1 (Jan. 2000).

5 Pub. L. No. 104-52, 109 Stat. 509 (1995), *amended by* Pub. L. No. 104-134, 110 Stat. 1321, § 2904 (1996) *and* Pub. L. 104-208, 110 Stat. 3009, § 643 (1996).

6 *Report of the National Commission on Restructuring the Internal Revenue Service: Hearing Before the House Ways and Means Committee*, 105th Cong. (June 25, 1997).

7 *Practices and Procedures of the Internal Revenue Service: Hearings Before the S. Comm. on Finance*, 105th Cong. (Sept. 23-25, 1997).

8 *IRS Restructuring: Hearings Before the S. Comm. on Finance*, 105th Cong. (Jan. 28, 1998).

9 *IRS Oversight: Hearings Before the S. Comm. on Finance*, 105th Cong. (April 28-30 and May 1, 1998).

10 Before enactment of RRA 98, the mission of the IRS read: "The purpose of the Internal Revenue Service is to collect the proper amount of tax at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness." IRS, Full Text: Revised IRS Policy Statement on Privacy, Tax Notes Today, Mar. 18, 1994, LEXIS 94 TNT 53-47. After enactment of RRA 98, the IRS changed the mission statement to read: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." IRM 1.1.1 .1 (1) (Mar. 1, 2006).

11 Pub. L. No. 105-206, § 1001, 112 Stat. 685, 689 (1998).

12 Pub. L. No. 105-206, § 1002, 112 Stat. 685, 690 (1988).

13 Pub. L. No. 105-206, § 3705, 112 Stat. 685, 777 (1988).

The IRS Faces Challenges in Helping Taxpayers Locate Assistance and Resolve Problems.

Taxpayer Characteristics Influence Communication with the IRS

Although the IRS encourages taxpayers to choose the Internet as their preferred method of communication,[14] Internet services "cannot be the only game in town."[15] Some taxpayers cannot use the Internet as their primary source of communication, due to technical problems,[16] language barriers,[17] literacy skills,[18] or problems associated with aging.[19] Even taxpayers who could use the Internet as their primary communication channel do not necessarily prefer it. As Table 1.7.1 (below) indicates, many would rather use the telephone when seeking help from the IRS.

The Type of Service Needed Influences Communication.

Table 1.7.1 shows the results of a study of taxpayer preferences for communicating with the IRS. The study illustrates that the method of communication taxpayers choose depends on the type of assistance they need.[20]

Table 1.7.1, Survey Respondents' First Choice of Method of Communication

Service Needed	Telephone	In Person	IRS Website	E-mail	Mail
Tax Law Questions	51%	14%	21%	9%	2%
Tax Dispute or Error	61%	22%	6%	5%	3%
Return Preparation	45%	4%	16%	6%	2%
Forms / Publications	27%	13%	30%	8%	8%

Note: Percentages do not total 100 because not all taxpayers stated their preferences.

The survey respondents consistently preferred personal contact, either by telephone or in person, to other types of assistance. Further, some taxpayers will use the method of

14 The IRS strategic plan states: "We will continue to launch new and enhanced filing and payment programs to create an environment where electronic interaction is the preferred option for our customers." *See IRS Strategic Plan 2005-2009* 13.

15 *Internal Revenue Service FY 2009 Budget Request: Hearing Before the Subcommittee on Financial Services and General Government, S. Comm. on Appropriations*, 110th Cong. 9 (Apr. 16, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

16 Nearly two-thirds of Americans (64 percent) have broadband access at home or at work, and the remaining 36 percent have dial-up access (13 percent) or no access at all (23 percent). Pew Internet and American Life Project, *How People Use the Internet, Libraries, and Government Agencies When They Need Help* 3 (Dec. 30, 2007).

17 Only one in ten recent immigrants is proficient in reading English. Among immigrants who have lived in the United States for 26 years or more, only 37 percent say they can read a book or newspaper in English very well. Pew Hispanic Center, *English Usage Among Hispanics in the United States*, Shirin Hakimzadeh and D'Vera Cohn 8 (Nov. 29, 2007).

18 The literacy skills of approximately 14 percent, or 30 million American adults, are below basic levels (no more than the most simple literacy skills). U.S. Department of Education, *National Assessment of Adult Literacy, at* http://nces.ed.gov/naal/kf_demographics.asp (last visited Sept. 9, 2008).

19 Physical and mental limitations attributable to age, including visual impairment, coordination problems, and ability to process information, contribute to decreased use of the internet. Only 22 percent of Americans age 65 and older use the internet. Pew Internet and American Life Project, *Older Americans and the Internet* 12-13 (Mar. 25, 2004).

20 IRS Oversight Board, *Taxpayer Customer Service and Channel Preference* (Nov. 2006).

communication they have always used. One survey of present and future Internet use concluded that taxpayers who prefer human contact would continue to prefer such assistance over digital channels.[21]

The Structure and Size of the IRS Contribute to Navigational Problems.

The IRS deals directly with more Americans than any other institution, public or private.[22] In fiscal year (FY) 2007, the IRS processed more than 138 million income tax returns.[23] The IRS employs more than 100,000 employees in 12 major business units with over 800 offices inside and outside the United States.[24] A taxpayer trying to find an employee with the knowledge and authority to help with a particular tax question or problem is facing a difficult task. The IRS does not have a topical directory or a personnel directory available to help the taxpayer determine the department or business function that he or she must contact. Instead, the IRS offers toll-free numbers that direct the taxpayer to one of almost 14,000 Customer Service Representatives (CSRs).[25] The CSR will research publications and Internal Revenue Manuals (IRM) to try to answer the taxpayer's question or help resolve a particular tax problem. If the question or problem is "out of scope," the CSR will use a list of over 1,000 topics, organized by issue, to determine the correct number to which to transfer the call.[26]

When the taxpayer ultimately reaches the "correct department," the results may be less than satisfying. Since the reorganization, and in spite of RRA 98's mandates, the IRS has moved away from providing end-to-end service to taxpayers. Because a taxpayer's problem may involve more than one program or function, he or she may need to make additional calls to separate functions — and as each function works independently, the problem may become worse before being resolved. For example, a taxpayer who needs to have an audit reconsidered, but in the meantime has received a notice of intent to levy, may have to work with the Examination, Collection, and Appeals units.

In addition to the list that CSRs research when transferring calls, the IRS maintains a topical list of publically marketed numbers.[27] However, neither list is available to the public.

21 Wage and Investment, Strategy and Finance, *Understanding Customer's Communications Channel Use* 6, 22 (Aug. 2003).

22 IRS, *IRS Organization Blueprint* (Apr. 2000).

23 The IRS processed 138,893,908 individual income tax returns in FY 2007. *See IRS 2007 Data Book*.

24 The actual number of employees as of Sept. 27, 2008, was 101,759. IRS, Human Resources Reporting Center, *IRS Staffing by Business Unit, at* http://152.217.41.30/ (last visited Oct. 15, 2008).

25 The actual number of CSRs as of Sept. 27, 2008 was 13,956. IRS, Human Resources Reporting Center, *IRS Staffing by Occupational Series and Grade, at* http://152.217.41.30/ (last visited Oct. 15, 2008).

26 Toll-free tax law assistance "Out of Scope" policy delineates the services the Customer Account Services: Accounts Management function (CAS: AM) will and will not provide in tax form/schedule preparation, tax planning, legal advice, and answering complex tax questions. "Out of scope topics" appear in the following categories: International, Partnership, Corporation, Exempt Organization, Trusts, Rentals, Sale of Business, Depreciation, Capital Gains and Losses, and more than a dozen miscellaneous topics. *See* Probe and Response Guide, *at* http://serp.enterprise.irs.gov/databases/irm-sup.dr/current/pr.dr/pr_home (last visited Dec. 15, 2008). Taxpayer calls are transferred to one of 40 English lines or one of 17 Spanish lines. *See* Telephone Transfer Guide, *at* http://serp.tcc.irs.gov/TTGuide/TTGuide.jsp (last visited Dec. 15, 2008).

27 A "publicly marketed" telephone number is available on IRS.gov or published in specific IRS forms, instructions or publications. This list is not available to the public in any one location. See "The Source," *at* http://gatekeeper.web.irs.gov/plList.asp (last visited Oct. 15, 2008).

How Successful is the IRS in Helping Taxpayers and Practitioners Navigate?

In accordance with § 3705 of RRA 98, the IRS assigns all employees unique identification numbers and requires them to give their names and identifying numbers during telephone, face-to-face and written contact with taxpayers.[28] However, IRM directives virtually ensure that the taxpayer's subsequent efforts to speak to the same employee will be futile. The manual instructs employees *not* to research internal phone directories in response to taxpayer requests to speak to a specific employee, even if the taxpayer knows the name and identifying number of that employee. Only if a taxpayer *insists* will the IRS try to locate a specific employee and ask that person to return the call.[29] It is unclear whether the IRS monitors the effectiveness of this procedure.

Apart from the obstacles the IRM provisions pose, knowing an IRS employee's identification number will not help the taxpayer find a specific employee because the IRS has no searchable database of these numbers. As a practical matter, it is virtually impossible for a CSR to identify the employee with whom the taxpayer previously spoke by name alone.[30] TAS has asked the IRS to create a searchable database of identification numbers as it converts to a new employee identification system.[31]

Even Internet-savvy taxpayers have difficulty in navigating the IRS. The Internet provides a wealth of information, including a topical tax index.[32] However, this directory does not have an associated telephone number the taxpayer can call for further help with a particular problem or question.

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28 IRM 3.21.259.1 (Jan. 1, 2008).

29 IRM 21.1.3.15 (Oct. 1, 2007), provides:

(1) A caller or visitor may ask to speak to a specific employee who previously handled their inquiry. The caller may provide the name and/or ID card number of the previous employee and indicate that he/she needs to discuss the account with that person.

Note: Do not research internal phone directories and give the taxpayer or their representative the name or phone number of any employee (*i.e.*, CSR, Manager, Analyst, etc.).

(2) Make every effort to resolve the taxpayer's issue yourself. Encourage the caller or visitor to allow you to research his/her account.

(3) If you cannot resolve the situation or if the taxpayer insists on speaking with the prior employee:

(a.) Advise the taxpayer that you will contact the other employee and have him/her return the call.

(b.) Prepare Form e-4442, 4442, 4442-DI, (Inquiry Referral), with the pertinent information, including the employee's name, ID number, the date the taxpayer spoke with the original employee and the specific issue.

(c.) Annotate "ACT SECTION 3705(a)" (RRA 98) at the top (or where text is first input) on Form e-4442, 4442, 4442-DI and immediately, within the hour, forward to your manager who will attempt to locate the other employee by contacting the ID Media Program Manager in Mission Assurance and Security Services.

30 Considering that the IRS has over 100,000 employees, many of whom have the same or similar names, the correct spelling of the first and last name, and even the first initial of the employee's middle name, is essential to locating that employee with the Discovery Directory, the only tool IRS has provided to its employees for this purpose. IRS employees are only required to give the taxpayer their last names (some employees have permission to use a pseudonym) rendering the task virtually impossible in some cases.

31 This initiative is in response to Homeland Security Presidential Directive 12 dated August 27, 2004. This initiative requires that all applicable IRS employees receive a new "Smart ID" badge with a personal identification number (PID) to meet the RRA 98 requirement for a unique identifier. The PID is a 10 digit number that will be static for the life of each employee's account. TAS has elevated the need for a researchable PID database in compliance with RRA 98 to the HSPD Project Management Office (PMO).

32 For more information, see IRS Tax Topics Index, *at* http://www.irs.gov/taxtopics/index.html (last visited Oct. 28, 2008).

International taxpayers face very special problems in navigating the IRS. Taxpayers located outside the United States cannot access the toll-free number to call the IRS for help with account problems, notices, and bills, or to request a publication.[33] In addition, the international taxpayer has very limited opportunities for face-to-face interaction as the IRS has offices in only four foreign cities.[34]

The problem of navigating the IRS is especially acute for practitioners who interact with the IRS frequently and need to give and receive information to resolve their clients' tax matters. Preparers who participated in TAS focus groups repeatedly stated that communicating with the IRS is a problem. The problems practitioners identified include the amount of time required to resolve issues; the inability to reach someone who can resolve the issue; the difficulty in finding a person familiar with the case; and the inability to talk with the same person more than once.[35]

Taxpayers Turn to the Taxpayer Advocate Service to Help Navigate the IRS.

The Systemic Advocacy Management System (SAMS) allows IRS employees, taxpayers, practitioners, and other interested parties to report systemic issues and problems directly to TAS. A systemic issue affects a segment of taxpayers locally, regionally, or nationally and involves systems, processes, policies, procedures, or legislation. Problems involving "Access to IRS" rated sixth among issues submitted on SAMS from October 1, 2007, to September 30, 2008.[36] Taxpayers who cannot resolve their cases with the IRS because they are continually referred to various divisions may turn to TAS. TAS handled approximately 274,000 cases in FY 2008, of which more than 180,000 related to systemic problems and failures.[37]

IRS Employees Have Trouble Navigating Their Own Agency.

The centralization of programs within the IRS has caused significant confusion about workload realignment and responsibility. If the IRS does not timely update the Campus Locater Guide used by TAS employees or inform TAS that a program has moved to a different campus, TAS employees have trouble determining where to send Operations Assistance

33 IRC § 7701(a)(9) defines the term "United States" to include the 50 states and the District of Columbia.

34 IRS offices are located in Frankfurt, Germany; London, United Kingdom; Paris, France; and Beijing, China. *See* IRM 4.30.3 (Sept. 12, 2006). For additional information on communication problems specific to international taxpayers, see Most Serious Problem, *Access to the IRS by Taxpayers Located Outside of the U.S.*, *infra*.

35 Preparers stated that employees in one location answering questions about letters sent from another IRS location contribute to the problem of finding someone knowledgeable about a case; the inability to contact the same person about an issue leads to several iterations of assistors asking the same questions and preparers restating the same issue before finding someone with the authority and knowledge to address the situation; relatively simple problems could be resolved quickly if they could just talk to one person; and when calling the telephone number given to them by CSRs, they were referred back to the CSRs. TAS, 2006 IRS Tax Forum Focus Group, *Most Serious Problems Facing Taxpayers* 6-7 (Feb. 2007).

36 SAMS database. In FY 2008, SAMS received 964 submissions covering 91 different issues. There were 37 submissions relating to problems involving Access to the IRS.

37 Taxpayer Advocate Management Information System (TAMIS) data obtained from Business Performance Review System (BPMS) (Sept. 30, 2008).

Requests (OARs).[38] OARs returned to TAS employees after being sent to an incorrect address create unnecessary delays in resolving taxpayers' issues. Other IRS employees experience similar problems and must diligently review daily updates to the Servicewide Electronic Research Program (SERP), multiple IRMs, and the Campus Locator Guide to determine the correct number to call or address to use when forwarding taxpayer correspondence. Informational tools, when updated in a timely manner, will remove obstacles for all IRS employees.

The IRS should pattern its internal navigation tools after those developed by TAS. The TAS intranet (internal) website includes a comprehensive directory of field and headquarters offices and staff.[39] It lists employees by position and location (state or TAS area, *i.e.,* region), which allows users to find specific TAS employees and determine the duties they perform.

How Does the IRS Compare to Other Agencies?

The IRS customer service line for individuals, 1-800-829-1040, requires taxpayers to navigate through a number of prompts before reaching a CSR, who will try to transfer the call to the correct department if he or she cannot help the taxpayer.[40] In contrast, many state tax agency websites display telephone directories with numbers for various departments.[41] For example, the Indiana Department of Revenue site has an option to "find a person" or "find an agency." This feature searches for personnel by name, phone number, or department. If the employee's name is unknown, the search will display all employees of the agency in alphabetical order when the user selects the Department of Revenue.[42]

The United Kingdom's revenue agency website also has a search feature that allows the user to select from contacts for individuals, employers, small businesses, and corporations.[43] Under each of these selections, the taxpayer will find tax information regarding the topic and contact information, including the phone number, e-mail address, and hours when the contact is available. The agency also has a textphone option for customers who are deaf, hearing impaired, or speech impaired.

Centralized customer call numbers help connect people to government and community services with greater accuracy and less wasted time. The Federal Communications

38 TAS uses OARs to request assistance from an IRS operating division or functional unit to complete an action on a TAS case when TAS does not have the authority to take the required action(s).

39 TAS, *TAS Directory, at* http://tasnew.web.irs.gov/TASdirectory/ (last visited Oct. 27, 2008).

40 The IRS offers other specialized help lines for businesses, exempt organizations, refund inquiry, TAS, hearing impaired, and IRS.gov website help.

41 Several state tax agencies have departmental phone numbers that taxpayers can use to direct dial the department that can help them with their particular tax problem. *See* California, *at* http://www.ftb.ca.gov/forms/misc/1240.pdf; Indiana, *at* http://www.in.gov/rde/xfw/in_core/phonebook.htm; Maine, *at* http://www.state.me.us/revenue/homepage_files/telephon.html; Minnesota, *at* http://www.taxes.state.mn.us/taxes/home_con/contact_page.shtml; New Hampshire, *at* http://www.nh.gov/revenue/contact/index.htm; New Mexico, *at* http://www.tax.state.nm.us/trd_fone.htm; Oklahoma, *at* http://www.tax.ok.gov/phone.html; Ohio, *at* http://tax.ohio.gov/channels/global/globalcall_us.stm; North Carolina, *at* http://www.dornc.com/aboutus/department.html; South Carolina, *at* http://www.sctax.org/shell/phone.pl?searchkey=B (all sites last visited Oct. 15, 2008).

42 *See* Indiana Government website, *at* http://www.in.gov/rde/xfw/in_core/phonebook.htm (last visited Oct. 15, 2008).

43 See Her Majesty's Revenue & Customs, *at* http://www.hmrc.gov.uk/index.htm (last visited Oct. 27, 2008).

Commission (FCC) approved a 311 telephone service for nationwide use in 1997.[44] More than 30 city governments use the three-digit dedicated phone number to allow residents and visitors to reach important government services from any location at any time.[45] When dialing 311, a customer service representative will answer the call, ask for detailed information about the request, and immediately transfer the call to the appropriate city department. New York City's three-digit number is the largest such system and perhaps the largest public call center in the country. The system is available 24 hours a day, in more than 150 languages.[46]

The 311 service is also accessible on nyc.gov. There, a customer can access a directory of community based organizations providing health and human services in New York City. The directory provides descriptions, addresses, and phone numbers of the various organizations and programs, and is searchable by category, location, zip code, or name. The 311 service also includes a look-up that allows customers to check the status of existing service requests created through the 311 call center.[47]

Conclusion

Taxpayers need to be able to navigate the IRS to determine correct tax liabilities, file returns, remit payments, and resolve any account problems. The IRS has the responsibility to provide the navigational tools that will enable taxpayers to accomplish these tasks.

The IRS should consider taking the following actions to enable navigation: for internal use, create a researchable directory of IRS personnel using a unique identifying number and a topical index organized by business function of IRS personnel; for Internet savvy taxpayers and practitioners, create a topical index on IRS.gov that outlines the related tax law and IRS procedures and gives a contact number for the department with the expertise to answer any questions that the site fails to resolve; and for taxpayers who need personal interaction, create a phone number (similar to the 311 system) staffed by operators who will obtain details about the taxpayer's question or problem, and direct the taxpayer to the department(s) that can help.

IRS Comments

We agree that navigating the IRS, both internally and externally, is essential to providing world class customer service and we are dedicated to providing the navigation tools necessary to serve taxpayers and IRS employees. The National Taxpayer Advocate's report implies that the IRS is not in conformance with requirement of the IRS Restructuring and Reform

44 Federal Communications Commission, Report CC97-7, *FCC Creates New 311 Code for Non-Emergency Police Calls and 711 Code for Access to Telecommunications Replay Services* (Feb. 1997).

45 *See* Cities with 311 Non-Emergency Telephone Service, *at* http://www.911 dispatch.com/info/311map.html (last visited Oct. 15, 2008).

46 *See* 311 Service Non-Emergency Government 311 Services, *at* http://www.311service.org/ (last visited Oct. 15, 2008).

47 *See* NYC 311, *at* http://www.nyc.gov/html/misc/html/311atnycgov.html (last visited Oct. 15, 2008).

Act of 1998 (RRA 98). The IRS disagrees and has taken every step necessary to implement both the requirements and spirit of this law. Although we were pleased to learn that for an agency as large as the IRS serving millions of taxpayers every year only four percent reported access to the IRS as a problem, we will continue to work to improve those results.[48]

Internally, IRS employees have access to extensive information regarding "who does what in the IRS" on internal websites and employee contact data on the Discovery Directory. The latter is an employee database researchable by name, Standard Employee Identification Number (or SEID), and job series. We believe current business unit directories available to IRS employees through the Intranet and the Discovery Directory meet the employee-locator needs of the vast majority of internal IRS customers without the addition of employee badge numbers.

Externally, the IRS provides taxpayers with multiple customer contact toll-free numbers, understanding that this is the preferred method to contact the IRS for the majority of customer service needs. These services are divided into three main categories:

- Taxpayer-initiated calls, such as Form 1040 individual tax law help, business and specialty tax help, and tax help for exempt organizations, retirement plan administrators, and government entities: These are publicly marketed numbers located in publications and forms instructions, media campaigns, on the IRS website, as well as telephone directory assistance.
- Calls in response to an IRS notice, letter or bill: These numbers are not published for general use. When the IRS initiates a contact with a taxpayer, (as opposed to taxpayer initiated contacts) a unique number is provided on the notice for the taxpayer to call. The telephone scripts and services reached through these numbers are targeted to notice recipients. For example, for Individual Master File (IMF) notices we provide a unique telephone number that provides only IMF options to the caller. The Customer Service Representatives that answer these calls are specifically trained to meet these taxpayers' needs. The comparable Business Master File (BMF) notice response number offers choices tailored to that customer segment. This reduces taxpayer burden by providing only a customized set of options and is more expeditious in getting the caller to the information they need or to an IRS employee trained and able to respond to their question.
- Calls from tax practitioners: Contact numbers are also provided to practitioners through the Practitioner Priority Service (PPS). The menu choices and associated employee skills are adapted to meet the unique needs of these customers. For example, PPS offers the support needed to resolve multiple cases with one call. By limiting the customer base to practitioners only, we can plan service delivery more accurately based on the number of calls received on this line, as well as ensure the line is adequately staffed with employees specifically trained to address practitioner issues.

[48] *See* footnote 36, *supra*.

Recognizing the complexity of tax law, and that taxpayers have different levels of understanding, if a taxpayer with a tax law related question is unable to navigate through our scripts or does not select a valid option, they are routed to a screener (operator) who determines the appropriate place to route their call. This is similar to the 311 service mentioned in the National Taxpayer Advocate's report. Via the Form 1040 menu, this service asks customers to choose from broad categories of subjects to get them to the correct IRS resource as quickly and efficiently as possible.

In addition, IRS stakeholder liaisons in every state maintain an IRS Telephone Directory for Practitioners to assist members of the local practitioner community as they attempt to resolve tax issues through normal channels. These directories provide the name and telephone contact information of each IRS employee having supervisory responsibility for IRS programs in the practitioner's state. In addition to the practitioner directory, the IRS.gov website lists stakeholder liaison contact information, by state, for use by practitioners and industry partners to discuss IRS policies and practices.[49]

The IRS continues to make improvements to IRS.gov, including website navigation. Currently, taxpayers can research specific topics by using the "Search" function. We also encourage taxpayers to use IRS.gov as a resource for the most updated tax and filing season information, answers to Frequently Asked Questions, and quick and easy access to IRS forms and publications. For FY 2009, we will be including an enhanced Frequently Asked Questions offering on IRS.gov, featuring "natural language" searchability that allows customers to enter a search question or topic in the same manner as everyday conversation. The system uses programmed syntax and content links to point users to the correct source information.

While the IRS endeavors to provide taxpayers with the best customer experience possible, these services must be provided in a way that ensures their accuracy and timeliness while maximizing the use of limited IRS resources. Developing and maintaining an immense public directory for a subject as complex as the Internal Revenue Code and an organization as large and physically dispersed as the over 100,000 employees of the IRS is in no way comparable to the State or Taxpayer Advocate Service examples offered by the National Taxpayer Advocate. Such a public directory for use by as many as 200 million taxpayers would likely prove unwieldy for taxpayers and a very costly administrative challenge for the IRS to maintain. Further, current telephone systems cannot support large-scale public access to employees' personal administrative telephone lines, nor are most non-customer service occupations trained or able to effectively handle any volume of taxpayer calls. Instead, the IRS has taken well-considered and industry-proven steps to service large volume and wide-ranging subject matter inquiries from taxpayers through our web, toll-free telephone, and Taxpayer Assistance Center services.

49 *See* IRS, *Stakeholder Liaison (SL) Local Contacts, at* http://www.irs.gov/businesses/small/article/0,,id=153991,00.html (last visited Dec. 15, 2008).

Taxpayer Advocate Service Comments

Taxpayers are responsible for complying with the Internal Revenue Code in determining their correct tax liability, filing their returns, and paying their taxes. To meet this responsibility, the taxpayer must communicate with the IRS, an agency with over 100,000 employees and a multitude of offices, divisions, and functions. RRA 98 was enacted to ease this process by creating separate units responsible for providing "end to end" service to groups of taxpayers with similar needs and by directing that to the extent practicable and where advantageous to the taxpayer, one IRS employee "shall be assigned to handle a taxpayer's matter until it is resolved."

Assigning employees a badge number that has no directory associated with it does not guarantee that the same employee will handle the taxpayer's matter until it is resolved. The Discovery Directory is searchable by name (which, as noted, may be similar to another employee's name) and SEID, which is not the same as the badge number the employee is required to furnish to the taxpayer. Further, even if the IRS had a database searchable by the badge number actually provided to the taxpayer, IRM directions hinder the congressional mandate to allow the taxpayer access to the employee with whom the taxpayer previously spoke. The IRM directs its employees to encourage the taxpayer to allow the employee who responds to a call to research the account instead. Eventually (only at the taxpayer's insistence), the IRS may arrange for a callback by the employee the taxpayer previously dealt with (under a procedure whose effectiveness may not be measured).

We agree with the IRS that it would be wonderful if only four percent of taxpayers reported access to the IRS as a problem. However, when interpreting data on the issue from TAS's Systemic Advocacy Management System (SAMS), the IRS evidently assumed each SAMS submission represents a single taxpayer. In fact, each SAMS submission relates to multiple taxpayers, often entire segments of the population (hence the "systemic" nature of the problem).

We agree that the IRS provides publicly marketed telephone numbers, but they are scattered as indicated by the IRS in its response. Our recommendation is to consolidate these numbers for reference in one publicly available location. The phone numbers furnished in IRS communications to taxpayers are generally for departments, and not for the employees who may have actually worked on the taxpayers' issues. Practitioners also identified difficulties in using the PPS, such as finding the same IRS employees they spoke with previously.

We applaud the IRS for continuing to improve IRS.gov. Web-based navigation by taxpayers may increase over time, but some taxpayers prefer personal contact by phone or in person and are unlikely to change their preference. Therefore, the IRS also should continue to enhance phone operations.

The IRS's mission is not to "endeavor to provide taxpayers with the best customer experience possible." It is "providing America's taxpayers top quality service." The fact that tax agencies in states or in other countries provide better service means that IRS service is not "top." By describing other states' and countries' experience with helping their constituents navigate bureaucracies, we are not suggesting the IRS blindly adopt those methods. Rather, we are challenging the IRS to think about new ways of helping taxpayers reach the person or program area they need, instead of merely maintaining what it is willing to do. The IRS could learn a great deal about the difficulty taxpayers experience in navigating its system by setting up a learning lab and observing actual taxpayers trying to find their way, unassisted, around our phone system and the Internet. As the tax administrator—the face of government to so many people—the IRS cannot afford to be simply as good as a credit card company or health insurance company – we must be better.

Recommendations

In summary, the National Taxpayer Advocate recommends that the IRS:

1. Revise the IRM to direct its employees to accommodate taxpayer requests to speak to a particular employee, whenever feasible.
2. Create a personnel directory for internal use, searchable by the same employee number that IRS employees give to taxpayers.
3. Create a personnel directory for internal use organized by business function.
4. Adjust the topical tax index on IRS.gov to include telephone numbers of offices associated with each topic.
5. Establish a cognitive learning lab to test and observe taxpayers' experiences in navigating the IRS.

MSP #8 IRS Handling of ITIN Applications Significantly Delays Taxpayer Returns and Refunds

Responsible Official

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division

Definition of Problem

Any individual who has a tax return filing obligation but is not eligible to obtain a Social Security number (SSN) must apply to the IRS for an Individual Taxpayer Identification Number (ITIN).[1] In recent years, the National Taxpayer Advocate has raised concerns over ITIN processing.[2]

IRS problems often cause lengthy delays in assigning ITINs and impose other burdens on taxpayers, including:

- Delayed processing of ITIN applications and associated returns;
- Loss of original taxpayer identification documents;
- Denial of ITINs to decedents; and
- Inadequate tax assistance and information to applicants.

Further, those who apply for ITINs are primarily foreign taxpayers who are least able to navigate the IRS.[3]

ANALYSIS OF PROBLEM

Background

The IRS established the ITIN program in 1996 to facilitate tax return filing by aliens who have U.S. tax filing obligations and are ineligible for SSNs.[4] An ITIN does not establish an

1 Internal Revenue Code (IRC) § 6109; Treas. Reg. § 301.6109-1(d)(3). *See also* Instructions to IRS Form W-7, *Application for IRS Individual Taxpayer Identification Number* (Rev. Feb. 2008). Examples of individuals who need ITINs include:
- Non-resident alien filing a U.S. tax return and not eligible for an SSN;
- U.S. resident alien (based on days present in the United States) filing a U.S. tax return and not eligible for an SSN;
- Dependent or spouse of a U.S. citizen/resident alien; and
- Dependent or spouse of a non-resident alien visa holder.

2 National Taxpayer Advocate 2004 Annual Report to Congress 143; National Taxpayer Advocate 2003 Annual Report to Congress 60.

3 *See also* Most Serious Problem, *Access to the IRS by Individual Taxpayers Located Outside the United States*, *infra*.

4 Certain persons are required to file U.S. income tax returns and pay U.S. income tax regardless of their immigration or residence status. *See generally* IRC §§ 7701, 864, 871; Treas. Reg. §§ 301.7701(b)-1; 864(c)(1)-(4).

identity for the applicant and is to be used only for tax administration purposes.[5] The IRS has assigned over 14 million ITINs since the inception of the program.[6]

The IRS continues to process a very large number of ITIN applications.[7] For the 2008 processing year, the Austin Submission Processing Center (AUSPC) received 1.7 million applications.[8] The ITIN database reflects that the IRS has approved 90 percent of applications over the course of the program.[9] Table 1.8.1 below shows receipts, assignments, and rejects for 2005 through 2008.

TABLE 1.8.1, ITIN Applications Processed 2005 – 2008

Processing Year	2005	2006	2007[10]	2008[11] (Partial Year)
Receipts	1,652,100	1,909,147	2,313,288	1,732,330
Assignments	1,195,397	1,502,441	1,768,902	1,490,405
Rejects	266,471	261,718	580,153	227,005

Although tax return filing is the most common use for ITINs, the IRS may issue them for other legitimate tax administration purposes. For example, an ITIN may be used to open a bank account,[12] for information reporting,[13] or for withholding on the income of foreign investors.[14]

Delays in Processing ITIN Applications Cause Taxpayer Burden.

The IRS Does Not Measure the Time for Processing ITIN Applications.

The IRS does not monitor the time it takes to process ITIN applications, which leaves it unable to accurately measure the timeliness of service provided to these individual taxpayers.

5 IRM 3.21.263.1(6) (Jan. 1, 2008) provides that the ITIN *does not*:
- Qualify the applicant for Earned Income Tax Credit or Social Security benefits;
- Confer a particular immigration status to the applicant; or
- Qualify the applicant's right to work in the United States.

6 IRS, *ITIN Operations Controls Report ITIN4340* (Oct. 25, 2008); total assigned records: 14,235,915; total primary assigned: 7,196,338; total other assigned: 7,040,231.

7 For a detailed discussion of the ITIN processing operation, see National Taxpayer Advocate 2004 Annual Report to Congress 143 (Most Serious Problem, *Processing ITIN Applications and Amended Related Federal Income Tax Returns*).

8 IRS, *ITIN0850 ITIN Receipt Pattern Report* (Sept. 30, 2008).

9 IRS, *ITIN 4340 Controls Report* (Oct. 25, 2008). There were 14,235,915 assigned (accepted) ITIN records out of 15,693,467 total database records.

10 IRS response to TAS information request (July 25, 2008). "Receipts" include applications and other correspondence. "Assignments" means numbers assigned.

11 IRS, *ITIN Report SP001* (Sept. 30, 2008). The final disposition of 14,812 suspended applications could not be determined at the time of the report. 2008 data includes program results for the first nine months of the year. Reject counts include initial and subsequent (re)applications.

12 See Form W-9, *Request for Taxpayer Identification Number and Certification*. *See also* Forms W-8BEN, W-8ECI, W-8EXP, and W-8IMY.

13 Forms W-2 and 1099 and its progeny (*e.g.*, 1099-DIV, 1099-INT, and 1099-OID).

14 *See, e.g.*, Forms 8288, 1042, and 1042-S.

The IRS's goal for processing applications submitted with tax returns is 11 business days; the goal for processing applications without returns is 16 business days.[15] The IRS calculates this time not from the date it receives the applications, but from the batch creation date.[16] Since the batch creation date may be substantially later than the date the application was originally submitted to or received by the IRS, the IRS does not measure the actual length of time that taxpayers must wait for an ITIN.[17] The IRS also does not measure the time required to resolve the hundreds of thousands of applications it suspends for lack of sufficient documentation or information, nor does the IRS measure the delays encountered by those who must resubmit applications.[18]

Absent valid and accurate measurement, IRS inventory control systems cannot monitor applications experiencing delays in processing. The IRS should follow the IRM to measure the time for processing from the original receipt of each and every ITIN application, including those it suspends. The IRS should also measure the rework generated by rejected or suspended applications to assess its own effectiveness in communicating application requirements and processing applications.

The IRS Should Modify Its Requirement to Attach a Valid Tax Return with the ITIN Application.

On December 17, 2003, the IRS announced a significant change to the ITIN application process.[19] From that date on, the IRS required applicants to attach an original valid federal tax return with their Form W-7, *Application for IRS Individual Taxpayer Identification Number*, unless they meet one of the delineated exceptions.[20] Previously, a taxpayer could apply for an ITIN in advance to ensure that he or she received a number from the IRS before filing a return.[21]

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15 IRM 3.30.123.6.10 (Jan. 1, 2008) states that the timeframe should be calculated from IRS received date to the input date into RTS; IRS response to TAS information request (June 20, 2008) specifies that "day" means a non-holiday Monday through Friday. In its response to the National Taxpayer Advocate's 2003 Annual Report to Congress, the IRS committed to processing ITINs within two weeks. *See* National Taxpayer Advocate 2003 Annual Report to Congress 60-79.

16 Effectively, the IRS calculates the time for reviewing batches of applications – that is, the *average time it takes to input the application data into the operating system, without regard to additional time needed to resolve errors or omissions. See* IRS response to TAS information request (June 20, 2008). *But see* IRM 3.30.123.6.10 (Jan. 1, 2008) (requiring the processing to be accomplished within the timeframes from the [first] IRS Received Date to the input in the ITIN Real-Time-System (RTS)).

17 IRS response to TAS information request (June 20, 2008). *But see* IRM 3.30.123.6.10 (Jan. 1, 2008) (requiring processing to be accomplished within the timeframes from the [first] IRS Received Date to the input in RTS)).

18 IRS, *ITIN SP001 Report* (May 19, 2008) reflecting 134,560 suspended; *ITIN SP001 Report* (June 18, 2008) reflecting 85,672 suspended. *See also* IRM 3.21.263.4(10) (Jan. 1, 2008). IRS employees notify affected applicants by letter that their ITIN applications are rejected because the federal tax return was not signed, or did not reflect a filing requirement, or the applicant's name did not appear on the return. A Hard Reject is a complete rejection of both the return and the ITIN application. If the IRS rejects the ITIN application but can accept the return, the IRS processes the return using a temporary Internal Revenue Service Number (IRSN). IRM 3.21.263.4.5 (Jan. 1, 2008).

19 IRS News Release, IRS Announces Revisions to ITIN Applications (Dec. 17, 2003).

20 IRS Pub. 1915, *Understanding Your IRS Individual Taxpayer Identification Number* (Sept. 2007). An example of an exception is opening an interest-bearing bank account.

21 Applicants who are not required to pay income tax but need an ITIN for a purpose other than filing an income tax return, such as to take advantage of a tax treaty provision, may still apply for an ITIN at any time throughout the tax year. IRS Pub.1915, *Understanding Your IRS Individual Taxpayer Identification Number* (Sept. 2007).

By requiring ITIN applicants to attach tax returns to their Forms W-7, the IRS policy causes a wave of ITIN applications at the beginning of each filing season. This policy creates a bottleneck of ITIN applications at the peak of the tax return processing season, placing a seasonal strain on IRS resources. Delays in ITIN processing cause downstream consequences to taxpayers, acceptance agents, and tax preparers.[22] The IRS decision to postpone ITIN applications also impacts state taxing authorities, since the applicants must wait to receive ITINs before filing state tax returns.[23]

The National Taxpayer Advocate recommends that the IRS process ITIN applications throughout the year but retain the requirement that taxpayers demonstrate a tax administration purpose for the number. For example, a primary taxpayer could include a copy of a current pay stub showing withholding of tax.[24]

IRS Rationale for Not Allowing ITIN Applications Before Filing Is Based on Flawed Assumptions.

The IRS stands behind its decision to require taxpayers to attach a valid tax return to the ITIN application. The IRS explains its rationale for the requirement as follows:

> The Service believes that a substantial number of the ITINs that have been issued have subsequently not been used for tax reporting and payment. The Service is fully sensitive to the possible dangers that can arise from the misuse of the ITINs for the purpose of creating an identity, including the possible threat to national security.[25]

The National Taxpayer Advocate is deeply concerned by the implications of this explanation. The IRS implies that the requirement for ITIN applicants to attach a tax return is necessitated by the extensive misuse of ITINs. We do not agree with the premise that ITIN misuse is widespread.

The National Taxpayer Advocate's 2003 Annual Report to Congress included a table showing ITIN use on tax returns. Of approximately 6.9 million ITINs assigned from the inception of the program in 1996 through October 1, 2003, nearly three quarters showed up

22 IRM 3.21.263.3.1(1) (Jan. 1, 2008) defines an acceptance agent as one authorized to assist aliens in obtaining an ITIN. The acceptance agent reviews the required supporting identification documents; the certified acceptance agent authenticates the same documents and provides a "Certificate of Accuracy" and any required supporting exception documentation.

23 For example, the California state income tax return requires an SSN or ITIN. *See* California Resident Income Tax Return 2007, *at* http://www.ftb.ca.gov/forms/07_forms/07_540a.pdf (Feb. 2008).

24 In her 2003 and 2004 Annual Reports to Congress, the National Taxpayer Advocate identified the IRS's failure to timely process ITIN applications as a Most Serious Problem. Specifically, the National Taxpayer Advocate recommended that the IRS allow taxpayers to file ITIN applications without tax returns before the filing season, if the applicants submit documentation showing they are required to file returns. The IRS did not implement this recommendation.

25 IRS response to TAS information request (June 20, 2008).

on returns.[26] The Wage and Investment division (W&I) conducted a subsequent study in 2005, with similar results.[27]

It is disingenuous for the IRS to imply that less than 100 percent usage of ITINs on tax returns is symptomatic of ITIN misuse. In fact, there are many valid reasons why an ITIN may not be used in conjunction with a tax return. Many aliens who obtained ITINs later adjusted their immigration status to permanent resident status, thus becoming eligible for SSNs. Others leave the United States for their home countries when their temporary work or student visas expire. Some foreign investors need an ITIN for a one-time transaction. Some may obtain ITINs for return filing purposes but do not file because their incomes were below the filing threshold. In each of these situations, the ITIN is eventually no longer needed by its owner, but the IRS has no procedures to automatically "retire" or set an expiration date for the numbers.[28] If the IRS prefers to retire unused ITINs, it should do so as a function of post-assignment ITIN administration and not as a pretext for restricting new ITIN assignment.

ITIN Delays Hold Up Tax Return Processing and Refunds.

In 2008, over 95 percent of Forms W-7 were submitted with tax returns.[29] Moreover, according to an IRS study, 83 percent of ITIN tax returns are due refunds, all of which are delayed by ITIN application and paper return processing times.[30] Filing tax returns concurrently with ITIN applications delays processing of the returns and associated refunds because:

- Regardless of whether the ITIN applications are complete or incomplete, the IRS does not forward the attached returns for processing until it either assigns an ITIN or rejects the application;[31]
- The IRS requires the accompanying tax return to be filed only on paper, so the return cannot receive the expeditious processing afforded to e-filed returns;[32] and

26 *See* National Taxpayer Advocate 2003 Annual Report to Congress 66. These figures are based on IRS Modernization & Information Technology Services (MITS) analysis of Individual Master File, Return Transaction File.

27 IRS, *Individual Taxpayer Identification (ITIN) Usage Analysis*, Project 4-05-25-2-023N, 5-6, 11-12, and 14 (Aug. 2005). The W&I study covered tax years 1996 through 2003 (as of Oct. 1, 2003). For example, in 2001 tax return usage was 73.9 percent.

28 If the taxpayer subsequently receives a SSN and notifies the IRS, the IRS will revoke the ITIN and associate all prior tax information under the ITIN with the new SSN. However, taxpayers are not required to notify the IRS. *See* IRS Pub. 1915, *Understanding Your IRS Individual Taxpayer Identification Number* 19 (Sept. 2007). Nor does the IRS receive a notification of status adjustment from the U.S. Citizenship and Immigration Services.

29 66,449 Forms W-7 were filed without returns, compared to 1,517,473 total Forms W-7 filed. *See* IRS, *ITIN0852 Report* (June 18, 2008) (information through June 1, 2008).

30 IRS, W&I Research Group 4, *Individual Taxpayer Identification (ITIN) Usage Analysis for 2004*; Project # 4-06-25-2-051N 6-7 (Mar. 2007).

31 IRM 3.21.263.5.2.8 (1) (Jan. 1, 2008).

32 For example, the IRS issues refunds on electronically filed returns in as little as ten days by direct deposit or in three weeks for a paper check. *See* IRS, Instructions to Form 1040, *U.S. Individual Income Tax Return* (2007). *See also* IRS TAX TIP 2008-29, *Direct Deposit and Split Refund, at* http://www.irs.gov/newsroom/article/0,,id=179041,00.html (last visited Dec. 12, 2008).

- The IRS processes tax refunds due to taxpayers with ITINs only after accepting their ITIN applications and associated paper returns, thus significantly extending processing times.[33]

When the taxpayer files a Form W-7 with the return, the IRS responds to the ITIN application in "8-10 weeks if submitted during peak processing periods."[34] The eight to ten weeks required for the application processing is in addition to the time required for the paper return processing that follows, which takes three to six weeks.[35] By comparison, the IRS processes electronically filed returns in three weeks.[36] In tax year 2005, these delays in ITIN processing affected 280,000 taxpayer refunds totaling over $500 million.[37]

If applicants could apply for and receive ITINs before filing their initial tax returns, the ITIN processing time would not postpone the processing of the returns, and the applicants could file their tax returns electronically. E-filing initial ITIN returns will also help the IRS achieve its goal of having 80 percent of all returns e-filed and reduce its paper return processing costs. Additionally, an ITIN applicant who is compelled to file a paper return cannot benefit from the Free File initiative or the free e-file services of the Volunteer Income Tax Assistance (VITA) program.

IRS Procedures Lead to the Loss of Taxpayer Documents.

The IRS requires ITIN applicants to substantiate their personal identities and foreign status by submitting original documents (or certified or notarized copies) with their applications.[38] Acceptable documentation includes passports, driver's licenses, and civil birth certificates.[39] Because of the difficulty of acquiring certified or notarized copies, applicants frequently submit originals.

Because of this policy, applicants do not have access to their original documents, sometimes for extended periods, while the IRS processes their applications. The subsequent lack of access to these documents can create burden for the applicants, who are advised in the application instructions that if the IRS does not return the original documents after 60 days, the taxpayers can only call the IRS's general help telephone number.[40] An IRS telephone assistor who takes a call from a taxpayer asking for the return of original documents prepares

33 IRS, W&I Research Group 4, *Individual Taxpayer Identification (ITIN) Usage Analysis for 2004*; Project # 4-06-25-2-051N 6-7 (Mar. 2007).

34 IRS, Instructions to Form W-7, *Application for IRS Individual Taxpayer Identification Number* 3(Feb. 2008).

35 IRS Pub. 1084, *IRS Volunteer Site Coordinator's Handbook* (2007).

36 IRM 21.4.1.3(2) (Oct. 1, 2006).

37 IRS, W&I Research Group 4, *Individual Taxpayer Identification (ITIN) Usage Analysis for 2004*; Project # 4-06-25-2-051N Table 6, 6 (Mar. 2007).

38 Instructions to Form W-7, *Application for IRS Individual Taxpayer Identification Number* 2 (Feb. 2008).

39 The instructions to Form W-7 list 13 acceptable documents. The National Taxpayer Advocate previously recommended that the "IRS should discourage the submission of original documents and work to find an acceptable and workable substitute for ITIN applicants." National Taxpayer Advocate 2004 Annual Report to Congress 151.

40 Instructions to Form W-7, *Application for IRS Individual Taxpayer Identification Number* 3 (Feb. 2008). If within the U.S., the applicant is advised to call 1-800-829-1040, not the ITIN operation where the application is processed. If outside the U.S., the applicant is advised to call 215-516-2000 (a toll-charge call).

a paper form reporting the loss of documents and routes it to the AUSPC.[41] If the original documents are permanently lost, the burden on the applicant can be profound, including the inability to establish personal identity until he or she can obtain replacements from the issuing country or office.[42] The loss of documents may also affect individuals' abilities to earn a livelihood or travel within and outside the United States.

Many times, the IRS attempts to send documents back to the applicant, but they are returned to the IRS because the applicant has moved and not provided a forwarding address. The IRS maintains a local database of original documents, including passports, which the Postal Service has returned to the IRS as undeliverable.[43] If an applicant subsequently contacts the IRS to recover the document and the IRS has established a database record for it, the IRS will search for and return the document to the applicant. However, the IRS does not inform applicants when it cannot find their documents. In these cases, applicants do not know that the IRS ever received or acted on their requests to locate a missing document.[44] The IRS should promptly acknowledge all applicant requests for the return of original documents and notify the applicants if it cannot locate them.

Denying ITINs to Decedents Creates Burden.

The IRS policy of not assigning ITINs to decedents[45] causes unwarranted negative tax consequences to their estates or, in the case of a decedent dependent, to the primary taxpayer.[46] The denial of an ITIN to a decedent dependent denies a personal exemption deduction and a possible child tax credit to the taxpayer filing the tax return.[47] The IRS should assign ITINs to decedent aliens who are otherwise entitled to a tax number.

The IRS Provides Inadequate Tax Assistance and Information to Applicants.

More than one million taxpayers submit new ITIN applications each year, challenging the IRS to provide adequate informational assistance to applicants and practitioners in English and foreign languages through publications, forms, IRS.gov postings, live help by telephone, and letter notices. Many applicants rely on the Taxpayer Assistance Centers

41 IRM 3.21.263.4.15 (Jan. 1, 2008). When applicants visit IRS Taxpayer Assistance Centers (TACs) to report the loss of original documents, TAC employees prepare Forms 4442, *Inquiry Referral*, and route them to the AUSPC.

42 For example, in one TAS case the loss of the passport left the applicant unable to travel and reenter the U.S. for the three-month period that was required by his government to replace his passport.

43 IRS response to TAS information request (June 20, 2008). From February 2007 through June 13, 2008, the AUSPC had tracked 3,403 original documents that were undeliverable. *See also* IRM 3.21.263.5.10.4(4) (Mar. 17, 2008).

44 IRS response to TAS information request (June 20, 2008). AUSPC procedural deficiency is identified in Systemic Advocacy Management System (SAMS) Project P0028938.

45 IRM 3.21.263.5.5 (2) (Jan. 1, 2008).

46 IRS, *ITIN Reason Code Count Report* (Sept. 30, 2008). Code R11 (decedents) reflected 150 denials, cumulative from January 1 to September 30, 2008. However, the total also includes unspecified numbers of decedents when a taxpayer's representative notifies IRS of the death of the taxpayer after the ITIN has been assigned and the number is revoked.

47 *See* Pub. 519, 24-26, (2007).

(TACs) for face-to-face help in completing or submitting applications, requiring more IRS resources.

The National Taxpayer Advocate previously recommended that Publication 1915, *Understanding Your IRS Individual Taxpayer Identification Number (ITIN)*, should provide accurate instructions that conform to the actual handling of ITIN applications.[48] The IRS significantly changed Publication 1915 (and the Spanish version) for 2008. Still, during the 2008 processing year, the IRS suspended over 260,000 applications for lack of adequate documentation or information.[49] Moreover, the IRS ultimately rejected over 186,000 of those suspended applications because applicants did not respond timely or provide adequate information.[50]

The National Taxpayer Advocate remains concerned about the availability and adequacy of assistance and information in Publication 1915, including telephone assistance, toll-free and international access, and help from TACs, embassies, consulates, notaries, and acceptance agents.[51] The National Taxpayer Advocate previously recommended that the IRS revise the ITIN application rejection notice to refer to Publication 4134, *Low Income Taxpayer Clinic List*, to make applicants aware of a resource that could help them.[52] However, the CP567 reject notice, the CP566 suspense notice, and the CP569 hard reject notice do not cite Publication 4134.[53]

The IRS should provide the information in Publication 4134 to recipients of the rejection notices. Low Income Taxpayer Clinics (LITCs) are statutorily charged with providing education and outreach to taxpayers who speak English as a second language (ESL),[54] and are excellent resources on the barriers ESL taxpayers face in complying with tax obligations. Therefore, the IRS should not only inform taxpayers about the clinics, so they can obtain assistance when their ITIN applications are denied, but it should also use the LITCs to review related draft documents and publications.

The National Taxpayer Advocate also previously asked the IRS to revise the ITIN database to generate a copy of the notice issued to an applicant to the Acceptance Agent or power

48 National Taxpayer Advocate 2004 Annual Report to Congress 143.

49 IRS, *ITIN Suspense and Reject W-7 Reason Code Count Report* (May 31, 2008). Supporting documentation is unacceptable: 135,591; supporting documentation is not original, certified, or notarized: 52,706; applicant's signature is missing or the signature requirement is not met: 75,011. The total of all suspension code counts is 358,344.

50 IRS, *ITIN Suspense and Reject W-7 Reason Code Count Report* (Sept. 30, 2008). Response to CP566 notice was incomplete: 114,033; No response to CP566 notice: 72,700.

51 For a comprehensive discussion of the problem, *see* Most Serious Problem, *Access to the IRS by Individual Taxpayers Located Outside the United States, infra.*

52 National Taxpayer Advocate 2004 Annual Report to Congress 143.

53 IRM 3.21.263 Exhibits 22-24 do not reference Publication 4134.

54 IRC § 7526(b)(1)(A)(II).

of attorney who submitted the application.[55] We applaud the IRS for implementing this suggestion in January 2007.

The IRS Has Missed Opportunities to Expand Acceptance Agent Services.

The IRS authorizes Acceptance Agents to provide specialized assistance to taxpayers filing ITIN applications. Certified Acceptance Agents are designated to inspect original documents of applicants and certify that the documentation meets IRS standards. This certification eliminates the need for the applicant to forward original documents or notarized copies to the ITIN processing unit. IRS employees at TACs may perform the same document inspection and certification service.

The only form of personal identification for ITIN application purposes that the IRS accepts without supplemental documentation is the passport. However, only 9.9 percent of applicants submitted passports or certified copies (compared to 42.3 percent who provided birth certificates).[56] This figure suggests the preferred method of documentation is unavailable to most applicants because they lack passports or have no means of submitting acceptable certified copies. Because many U.S. jurisdictions (including California, Texas, Illinois, and Florida) prohibit the copying and the subsequent certification of public records by a notary public, taxpayers need a universally workable method for applicants and Acceptance Agents to meet the requirements for submitting copies of documents.[57]

Certified Acceptance Agents can reduce burden on taxpayers by reviewing original documents in the presence of the applicant and immediately returning the documents to their owners. The agent submits a copy of the document with the application to the IRS and attests to its validity. The controlling revenue procedure provides that other federal agencies, banks, colleges, and universities can certify copies of documents, which independent notary publics cannot do.[58] The IRS should promote the Certified Acceptance Agent program and use other federal agencies to perform acceptance agent duties as contemplated in the Treasury Regulation (*e.g.*, the Postal Service performs a similar service in processing passport applications).[59]

Conclusion

IRS policy restrictions and flaws with the ITIN application process significantly delay returns and refunds, and disadvantage affected taxpayers compared to taxpayers with SSNs. Taxpayers who must use ITINs to comply with their tax obligations face significant

55 National Taxpayer Advocate 2004 Annual Report to Congress 143.

56 IRS, *ITIN 9993 Supporting Document Types Submitted with W-7 Report* (Mar. 31, 2008).

57 *See, e.g.*, Tex. Gov't Code Ann. § 406.016 (a)(5).

58 Rev. Proc. 2006-10, 2006-1 C.B. 293, § 4.02(1). Eligible persons include federal agencies, colleges and universities, banking institutions, and foreign persons.

59 Treas. Reg. § 301.6109-1(d)(3)(iv).

difficulties with receiving timely assignment of ITINs, expeditious processing of associated returns and refunds, and timely return of original taxpayer identification documents.

The IRS should consider taking the following actions to streamline the ITIN application process: permit applicants to file an ITIN application without a return prior to the filing season if applicants can document that they are required to file returns; implement adequate timeliness measurements for processing *all* ITIN applications, including applications suspended by the IRS as incomplete; allow new ITIN applicants to file returns electronically; promptly acknowledge all applicant requests for the return of original documents; permit the assignment of ITINs to decedents; provide all applicants a toll-free number that is answered by employees of the ITIN operation; share draft ITIN forms and publications with LITCs on a regular basis; revise ITIN rejection notice with a reference to the LITC publication and webpage; and promote and expand the Certified Acceptance Agent program.

IRS Comments

We appreciate the National Taxpayer Advocate's review of the ITIN program. Since the inception of the ITIN program in 1996, the IRS has assigned over 13.9 million ITINs. During FY 2008 alone, the IRS successfully processed 2.5 million Form W-7 applications, assigned 1.6 million new ITINs, and processed over 1.5 million returns related to these applications.

In 1996, the U.S. Department of the Treasury issued regulations that introduced the ITIN and required foreign persons to use an ITIN as their unique identification number on federal tax returns.[60] These regulations were intended to address the concern by the IRS and Treasury Department that without a unique number taxpayers could not effectively be identified and their tax returns could not be efficiently processed. As a result, ITINs are issued by the IRS to non-resident and resident alien individuals that do not have, and do not qualify for, an SSN. ITINs enable these aliens to comply with U.S. tax laws and provide the IRS a means to effectively process and account for their returns and payments. An ITIN does not authorize work in the U.S., establish immigration status, or provide a valid form of identification outside of the federal tax system. For this reason, the IRS does not apply the same strict standards as agencies that provide genuine identity certification, such as a requirement to apply in person or third-party verification of identity documentation.

In December 2003, in addition to other changes, the IRS adopted a requirement for most ITIN applicants to attach a valid tax return to their Form W-7 application. This procedure was designed to ensure that the ITIN assigned is used for its proper tax administration purpose. Associating the issuance of the ITIN with the filing of a tax return is the only reliable method for IRS to verify the number is being requested for and properly used for tax administration purposes. As a result, ITINs are no longer issued solely based upon a

60 T.D. 8671, 1996-1 C.B. 314.

statement that an applicant requires an ITIN in order to file a return without proof that the individual in fact needs the number to do so.

The IRS continually strives to provide the best possible customer service and agrees with several of the National Taxpayer Advocate's recommendations, as outlined below.

With regard to timeliness measures, our goal for processing applications submitted with tax returns is 11 business days. This timeframe ensures the tax return is processed and refunds are issued timely. Form W-7 applications without tax returns have an established processing period of 16 business days. In order to more accurately reflect the received date, in March 2008, we implemented procedures that set the batch (grouping of applications) date as the actual received date plus two days.[61] This procedure was adopted to identify the date an application was received in the processing center from the applicant and/or their representative. The additional two days account for the time needed for mail to be processed by the Receipt and Control function and batching to be completed by the ITIN clerical function. This more accurately reflects the date applications are input into the ITIN Real Time System (RTS). The IRM allows 45 days for applications that are suspended to be resolved.[62] This timeframe was adopted for notices and is consistent with the timeframes used for processing returns within the interest free period. However, we agree that management information on suspended applications is currently limited on RTS. Contingent on funding availability, we plan to expand and improve the management reports available from RTS to enable the IRS to better monitor the status of suspended applications.

The National Taxpayer Advocate recommends that IRS permit applicants to file an ITIN application without a return prior to the filing season upon establishing a federal tax administration need, such as including a current pay stub. The IRS acknowledges that the majority of ITINs are used on tax returns. However, there are still significant issues that must be addressed to ensure that ITINs are issued and used for their intended purpose. The same ITIN usage statistics cited by the National Taxpayer Advocate in her report reflect that fully a quarter or more of all ITINs issued by IRS have not been used on tax returns.

The IRS motives for requiring the filing of a tax return with the ITIN application are hardly disingenuous, as suggested by the National Taxpayer Advocate. Rather, the IRS had, and continues to have, significant and valid concerns that ITINs were being requested for non-tax purposes, such as for obtaining a driver's license. Because a growing number of states were beginning to accept ITINs for driver's license purposes, in August 2003, the IRS took the unprecedented step of sending letters to all the state departments of motor vehicles to alert them to the risks of accepting ITINs as a form of non-tax identification. In March, 2004, this and related concerns about potential misuse of ITINs were also the subject of a joint hearing before the House Ways and Means Subcommittees on Oversight and Social

61 Procedures implemented by the ITIN Program Office for more effective tracking of applications and processing.

62 IRM 3.21.263 (May 13, 2008).

Security.[63] Indeed, during this hearing the General Accounting Office (GAO, now the Government Accountability Office) testified that it was able to obtain a bogus ITIN and use it for a variety of non-tax purposes that could allow someone to blend into society under a false identity. In light of these concerns, the IRS believes the requirement to attach a return to the Form W-7 ITIN application strikes a reasonable balance between the competing objectives of facilitating compliance with U.S. tax laws and ensuring, to the extent possible, that ITINs are not issued for purposes other than federal tax administration. The National Taxpayer Advocate's suggested acceptance of a pay stub in lieu of the requirement to file a tax return with the ITIN application will not achieve the same degree of assurance.

With regard to the National Taxpayer Advocate's additional concerns that taxpayers who are filing an ITIN application with a tax form are not able to file electronically and may not receive their refunds as quickly as other taxpayers, it is important to note that a taxpayer must apply for and obtain an ITIN only once. As a result, the taxpayer's inability to file electronically and any potential delay in receiving a refund will only occur in the year the ITIN is issued; subsequent years are not affected.

We agree with the National Taxpayer Advocate's recommendation that all applicants' requests for the return of original documents should be promptly acknowledged. We previously identified this as an area for improvement and are actively exploring options for an appropriate format that will acknowledge the applicant's inquiry and advise the taxpayer of the IRS's attempts to locate missing original documents. We expect to have the new procedures in place by 2010.

With regard to issuing decedents an ITIN, these types of situations are infrequent and unusual. The affected applicants represent less than one percent of the total volume of Form W-7 applications with returns that have been processed this year[64] and even less in prior years. We previously evaluated this issue and concluded that it was not prudent to allow ITINs for decedent applicants due to increased vulnerability of fraud, the limited tax purpose (one time use), and the IRS's limited ability to monitor and subsequently revoke the number to eliminate future use. All qualifying applicants must currently provide supporting documentations that proves their identity, foreign status, and continuing existence.[65] However, we are sensitive to taxpayers' need for a taxpayer identification number to comply with federal tax laws in this situation since decedents do not qualify for a temporary taxpayer identification number. As a result, effective for the 2009 filing season we will make every effort to accommodate decedent ITIN applications on a case-by-case basis after a review of the particular circumstances involved in each such application.

63 *Social Security Number and Individual Taxpayer Identification Number Mismatches and Misuse, Joint Hearing Before the Perm. Subcomm. on Oversight and Perm. Subcomm. on Social Security of the H. Comm. on Ways and Means*, 108th Cong. (Mar. 10, 2008).

64 IRS, *ITIN Production Report*, Yearly Comparative Data for week ending Sept. 27, 2008 vs. Sept. 29, 2007; *Suspense and Reject W-7 Reason Code Count Report* (Sept. 30. 2008).

65 IRM 3.21.263.5.3.2 (Feb. 19, 2008).

Regarding the recommendation to provide a toll-free number that is answered by an employee of the ITIN operation, we agree that there is a need for Form W-7 applicants to have telephone access to skilled employees. However, this need is already being met without diverting resources from ITIN processing operations. Form W-7 applicant calls are routed to a special toll-free phone area with adequate resources and proficiency in handling a large volume of calls. We provide the employees in this area with the necessary training and access to appropriate databases to address ITIN customer inquiries. In addition to providing good customer service, we also believe this to be the most effective use of limited IRS resources.

We remain committed to the promotion and expansion of the Acceptance Agent Program. The IRS has an effective marketing and outreach strategy that is evidenced in the growth of the program. The number of Acceptance Agents has increased from 1,400 in August 2004 to 5,044 as of November 2008. The current IRS promotion and expansion strategy includes participation in conferences hosted by community-based organizations and other internal and external stakeholders, such as the LITC Conference, colleges and universities, and professional practitioner organizations. Additionally, we conducted outreach and recruitment workshops for Representative Rangel in February of 2007 and Representative Serrano in September 2007 for their non-profit constituents in New York. Information on the Acceptance Agent program is also shared annually at the IRS-sponsored Nationwide Tax Forums.

With regard to LITCs' opportunity to review ITIN forms and publications, the public and all stakeholders have the same opportunity to make suggestions to simplify forms or publications by e-mailing comments to *taxforms@irs.gov or by writing to Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Avenue NW, IR-6526, Washington, DC 20224. External stakeholders can also e-mail comment or suggestions directly to the ITIN Program Office at ITINProgramOffice@irs.gov.

With regard to the recommendation to revise the ITIN rejection notice, the IRS will add a reference to Publication 4134, Low *Income Taxpayer Clinic List,* and the LITC webpage in notices for FY2010. In the interim, we will include this publication in our outreach activities.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS expresses a commitment to expanding the Acceptance Agent program, acknowledges the need for improvements in its management information system on suspended ITIN applications, and recognizes the need to accommodate applications for decedent taxpayers. We also commend the IRS for taking steps toward prompt acknowledgement of applicants' requests for the return of original documents and its plan to expand and improve the management reports available from the ITIN Real Time System (RTS) to better monitor the status of suspended applications. We will continue to monitor the IRS's progress in resolving these issues. However, the National Taxpayer Advocate is very concerned that the IRS has not considered viable and less burdensome alternatives to its current policy of requiring the filing of a tax return concurrently with the initial application for the ITIN.

The IRS has stated that receiving a return with the application is the *only* reliable way to verify that the ITIN number is being requested and properly used for tax administration purposes. The IRS has offered no rationale for this statement. The IRS permits an exception for ITIN assignment for a taxpayer who owns "an asset that generates income subject to IRS information reporting and/or tax withholding requirements," yet the IRS does not permit the assignment of an ITIN based on a comparable showing of earned income (*e.g.*, a pay stub) until filing a tax return.[66] This inconsistent treatment of unearned and earned income for assigning ITINs essentially ignores the legal requirement to provide the taxpayer identification number regardless of the type of income at issue.[67] The National Taxpayer Advocate has proposed a well-balanced approach to developing a process for the taxpayers to obtain ITINs during the year, prior to filing season, with proof of employment and withholding (or self-employment), *e.g.*, pay stubs, Forms 1099-MISC, *Miscellaneous Income*, etc. Such an approach would help the IRS smooth out its workload during the year, especially the logjam of ITIN applications during the filing season.[68]

The IRS maintains that it had and continues to have concerns that ITINs were being requested for non-tax purposes, and therefore the requirement to file a tax return with the ITIN application strikes a reasonable balance between tax compliance and avoiding improper ITIN assignments. However, IRS data clearly indicates the majority of ITIN holders attempt to file returns and comply with the tax laws. Therefore, the IRS should continue to encourage aliens to obtain ITINs because the numbers are the entry point into the tax

66 IRS Pub. 1915, *Understanding Your IRS Individual Taxpayer Identification Number* 11 (2004).

67 IRC § 6109; Treas. Reg. § 301.6109-1(d)(3).

68 Of the 1,409,903 ITIN applications with tax returns received by September 30, 2008 at the AUSPC, 1,201,109 (or 85 percent) had been received by May 19, 2008. IRS, *ITIN SP001 Reports* (May 19, and Sep. 30, 2008).

system for these taxpayers. By restricting ITIN assignment, the IRS risks pushing alien taxpayers into the cash economy.[69]

The National Taxpayer Advocate is also concerned that denying an ITIN to a decedent, on the premise that the number might later be misused for a non-tax purpose, is unfair to the party that has a legitimate need for the ITIN. The IRS should be able to administer tax identification numbers without transferring the associated costs to the estates of the affected taxpayers. The National Taxpayer Advocate also disagrees that a case-by-case approach would resolve this matter, and serve the purpose of fair and uniform tax administration, because of the discretional character of such action.

The National Taxpayer Advocate encourages the IRS to take greater measures to expand the parameters of the Acceptance Agent program as contemplated by the Treasury Regulations.[70]

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following actions to improve the ITIN application process:

1. Permit applicants to file an ITIN application without a tax return prior to the filing season if applicants can document that they are required to file returns.
2. Allow new ITIN applicants to file returns electronically.
3. Measure the processing time for *all* ITIN applications, including applications suspended by the IRS as incomplete.

69 *Social Security Number and Individual Taxpayer Identification Number Mismatches and Misuse, Joint Hearing Before the Perm. Subcomm. on Oversight and Perm. Subcomm. on Social Security of the H. Comm. on Ways and Means*, 108th Cong. (Mar. 10, 2008) (testimony of Nina E. Olson, National Taxpayer Advocate; Mark Everson, former IRS Commissioner; Raul Yzaguirre, President of the National Council of La Raza; and Linton Joaquin and Marielena Hincapié, National Immigration Law Center).

70 Treas. Reg. § 301.6109-1(d)(3)(iv).

MSP #9

Access to the IRS by Individual Taxpayers Located Outside the United States

Responsible Officials

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division
Frank Y. Ng, Commissioner, Large and Mid-Size Business Division
Jim Falcone, Acting Deputy Commissioner, Operations Support
Frank Keith, Chief, Communications and Liaison

Definition of Problem

The United States taxes the worldwide income of U.S. citizens, resident aliens, and domestic corporations as well as the U.S.-sourced income of nonresident aliens and foreign corporations.[1] The current system of worldwide taxation is extremely complicated and difficult to understand.[2] Individual taxpayers located outside the United States need a venue to seek assistance in complying with their U.S. tax obligations.[3] The IRS provides toll-free customer service to taxpayers within the United States and in some U.S. territories. However, those outside the country generally incur greater communication expenses, such as international telephone charges, transportation, and carrier mailing costs in trying to communicate with the IRS. One of the Wage and Investment (W&I) Operating Division's goals is "to ensure accurate, timely, accessible responses to tax law and tax account inquiries," but the IRS does not provide taxpayers with all the necessary resources.[4] Although the IRS has developed a number of customer service initiatives as a part of its strategy for international tax administration, it does not devote enough resources to meet the needs and preferences of taxpayers outside the United States, jeopardizing the declared goal of improving taxpayer service.[5]

1 *See* Internal Revenue Code (IRC) §§ 1(a), 11(a), 61(a), and 862(a)(5); Treas. Reg. § 1.1-1(b). *See also* IRC §§ 861, 862, 864, 871, and 882.

2 International tax treaties play an important role in international taxation. The U.S. currently has tax treaties with 66 countries. *See* http://www.irs.gov/businesses/international/article/0,,id=96739,00.html (last visited July 21, 2008). These treaties provide for reduced rates and exemptions from U.S. taxes or foreign taxes on certain items of income from U.S. or foreign sources. These reduced rates and exemptions vary among countries and specific items of income, thus increasing the complexity.

3 IRC § 7701(a)(9) defines the term "United States" to include the 50 states and the District of Columbia.

4 IRS, W&I Division, *Wage & Investment Strategy & Program Plan FY 2008 – FY 2009* 33-34.

5 *See* IRS Large & Mid-Size Business Division (LMSB), *Servicewide Approach to International Tax Administration, Strategic Goal 1: Improve Taxpayer Service, at* http://lmsb.irs.gov/international/dir_compliance/global/sis1.asp (last visited Oct. 29, 2008).

Analysis of Problem

Background

Approximately five million American citizens (excluding the military) currently live outside the U.S.[6] In addition, there are about 511,000 U.S. troops stationed in foreign countries.[7] Civilian taxpayers living outside the U.S. filed more than 380,000 tax returns in tax year 2005, while military personnel overseas filed over 205,000 returns.[8] These taxpayers need a venue to contact the IRS for the resolution of their account-specific and tax law inquiries.

Taxpayers Located Outside the United States Have Limited Options to Access the IRS.

Taxpayers receive assisted and self-assisted services from the IRS via telephone, face-to-face meetings, electronic communication, and mail. The IRS provides a toll-free telephone line for taxpayers residing in the United States and some U.S. territories to access multiple tax help topics, or reach a Customer Service Representative with inquiries ranging from tax law questions to adjusting their accounts.[9] However, most taxpayers outside the U.S. cannot access the toll-free number for help with account problems, notices, and bills or to request a publication. These taxpayers must use a regular toll telephone number.[10]

Taxpayers Located Outside the United States Cannot Use Free Services to Pay Their Tax Liabilities.

The IRS advertises that taxpayers may use the Electronic Federal Tax Payment System (EFTPS) free of charge to pay federal taxes via the Internet or phone, 24 hours a day, seven

6 Teleconference with the Office of Policy Coordination and Public Affairs, Bureau of Consular Affairs, U.S. Dept. of State (July 21, 2008). The Department of State estimated 3,784,693 U.S. citizens (excluding U.S. Government (military and non-military) employees and their dependents) resided outside the U.S. in July 1999. *See* General Services Administration, *Federal Citizen Information Center, at* http://www.pueblo.gsa.gov/cic_text/state/amcit_numbers.html (last visited July 21, 2008).

7 Personnel and Procurement Statistics, U.S. Dept. of Defense, *at* http://siadapp.dmdc.osd.mil (last visited July 21, 2008). The total of 510,927 personnel includes 288,627 troops stationed abroad, 196,600 troops deployed in Iraq, and 25,700 troops deployed in Afghanistan (data as of Dec. 31, 2007). The number does not include 43,009 civilian defense employees stationed abroad (July 1, 2008).

8 Compliance Data Warehouse, *Individual Returns Entity Table, Tax Year 2005*.

9 Internal Revenue Manual (IRM) 21.1.1.6, *Customer Service Representative* (CSR) *Duties* (Oct. 6, 2005).

10 Taxpayers must search the IRS.gov website to find the toll number at the Philadelphia Service Center, which is three links deep. Such a search is not easy to complete and may take an extended time. A taxpayer who does not have Internet access or cannot download IRS forms and publications may find it difficult, if not impossible, to figure out how to contact the IRS. Currently, the IRS provides customer service to international taxpayers through toll telephone service at the Philadelphia Accounts Management Center (PAMC).

days a week.[11] However, taxpayers outside the U.S. who do not have access to the Internet may incur international long distance phone charges.[12]

Taxpayers Located Outside the U.S. May Need More Time to Respond to IRS Notices and Requests for Information Documents.

In fiscal year (FY) 2007, the IRS sent more than 770,000 balance due notices, more than 93,000 math error notices, and approximately 2,500 Automated Underreporter (AUR) program notices to military addresses (*e.g.*, APO, FPO) and foreign addresses.[13] More than 17,500 of these notices (sent to foreign locations and some U.S. territories) included a toll-free number that is generally not accessible from these locations.[14] When taxpayers cannot reach the IRS by phone, they have to use foreign postal providers to respond to IRS correspondence.[15] Taxpayers in countries lacking reliable postal systems may experience extended delays receiving time-sensitive documents from the IRS, or may not receive them at all.

The IRS generally grants a 30-day grace period before taking action against taxpayers residing overseas. However, since the IRS counts the period as starting on the date it mails the correspondence, and not on the date the taxpayer receives it, 30 days may be too short a time for the overseas taxpayer to respond.[16] The IRS should consider allowing an additional 60 days for overseas taxpayers to reply to all IRS correspondence, similar to the additional 60 days provided by statute for these taxpayers to respond to notices of

11 The Electronic Federal Tax Payment System is administered by the U.S. Department of Treasury, and enables businesses and individuals to pay all their federal taxes electronically. *See* http://www.irs.gov/efile/article/0,,id=98005,00.html (last visited Nov. 24, 2008).

12 Taxpayers in 25 countries and territories of the total number of 194 countries and 67 territories may use AT&T international access telephone code to connect to the EFPTS system from these locations. Even though, when the taxpayers reach the AT&T toll free line in these locations, the AT&T voice prompt requests a calling card number and PIN before connecting to the EFTPS toll free line (*i.e.* the taxpayers should sign up for an AT&T calling card and may incur international long distance charges). Taxpayers in countries that do not have the code must use the EFTPS direct toll telephone number. *See* U.S. Department of the Treasury, *International Electronic Federal Tax Payment Deposit Instruction Booklet* 18 (Feb. 2006). This booklet, which is not available to the general public in paper form or at the IRS website, was internally provided to TAS in an email communication. *See also* U.S. Department of State Fact Sheet, *Independent Countries of the World, at* http://www.state.gov/s/inr/rls/4250.htm (Mar. 20, 2008); AT&T International Dialing Guide, *at* http://www.business.att.com/bt/dial_guide.jsp (last visited Nov. 4, 2008).

13 APO stands for "Army Post Office" and is associated with U.S. Army or Air Force installations. FPO stands for "Fleet Post Office" and is associated with Navy installations and ships in the United States. Regarding the balance due and math error notices, IRS sent 581,035 to individuals, and 285,916 to entities. W&I response to TAS information request (July 24, 2008). Automated Underreporter notices were sent only to individuals. SB/SE response to TAS information request (June 17, 2008).

14 The IRS sent over 4,400 notices to foreign addresses. Guam and American Samoa taxpayers received more than 13,000 notices, which included a toll-free number generally not accessible by the taxpayers in these territories. W&I response to TAS information request (July 24, 2008).

15 The reasons why taxpayers cannot reach the IRS toll phone number from overseas may range from individual financial difficulties to lack of international long-distance phone service.

16 IRM 3.30.123.5.1 (Jan. 1, 2008) provides suspense purge dates for taxpayer correspondence in response to IRS letters and notices. The time the taxpayer is given to answer generally amounts to 30 calendar days for domestic taxpayers and an additional 30 days for those residing overseas. In trust fund recovery penalty (TFRP) cases, the IRS gives only 15 additional days to taxpayers outside the country to consent to or protest the proposed assessment (75 days to taxpayers outside the U.S.; 60 days to domestic taxpayers). *See* Rev. Proc. 2005-34 § 4.01, 2005-24 I.R.B. 1233; IRM 5.7.6.1.1 (Feb.1, 2007).

deficiency.[17] The IRS should also consider using a delivery confirmation service to verify receipt of correspondence by taxpayers outside the United States.

The IRS Provides Limited Face-to-Face Assistance to Taxpayers Located Outside the United States.

Taxpayers with U.S. filing obligations may reside in 194 countries, and more than 60 territories, colonies, and dependencies of these countries.[18] Table 1.9.1 below lists the top ten countries where Americans reside outside the United States. The IRS, however, has offices in only four foreign nations,[19] and even at these locations, the IRS tax attachés' main responsibilities focus on examinations and exchange of information agreements with foreign governments.[20] While these offices also assist American taxpayers living abroad, only a limited number of employees are assigned to taxpayer service in the foreign posts.[21] The number of phone lines dedicated to customer service averages from two to four per office.[22]

17 IRC § 6213(a) restricts assessment of a deficiency in respect of any tax against "a person outside the United States" until the expiration of 150-day period after the notice of deficiency is mailed (90 days for domestic taxpayers). *See id.; see also* IRM 25.6.5.7.2 (Mar. 1, 2006). In another example, U.S. citizens and resident aliens who file calendar year returns are required to file tax returns by April 15. However, taxpayers located overseas on the due date receive an automatic extension of two months or 60 days (until June 15 for calendar year filers). *See* IRM 3.38.147.3.12, *Extension of Time to File International Returns* (Jan. 1, 2008). Thus, a minimum additional 60-day timeframe for responding to all IRS correspondence by taxpayers outside the country should apply uniformly across the board to all types of IRS correspondence. This would provide taxpayers located overseas an adequate time to respond to IRS inquiries and notices. Currently, Accounts Management allows response times as long as 60 days in some cases (depending on the country in which the taxpayer resides). *See* W&I response to TAS research request (July 23, 2008). LMSB suspense dates for international correspondence are based on the facts and circumstances of the case and examiners/managers use their professional judgment in determining these dates and granting extensions when necessary. *See* LMSB response to TAS research request (July 18, 2008).

18 *See* U.S. Department of State Fact Sheet, *Independent Countries of the World, at* http://www.state.gov/s/inr/rls/4250.htm (Mar. 20, 2008).

19 The IRS posts are located in Frankfurt, Germany; London, United Kingdom; Paris, France; and Beijing, China. *See* IRM 4.30.3, Overseas Posts (Sept. 12, 2006). *See also* IRM 4.30.3.3 (Sept. 12, 2006) for post jurisdictions. The IRS announced the opening of a new tax attaché office in Beijing, China on November 3, 2008. *See* http://lmsb.irs.gov/international/dir_treaty/eoi_overseas/postnews.asp (last visited Oct. 29, 2008). The office in China will serve approximately 65,157 U.S. citizens residing in China. *See* Federal Citizen Information Center, U.S. General Services Administration, *at* http://www.pueblo.gsa.gov/cic_text/state/amcit_numbers.html (last visited July 21, 2008). While the number of overseas posts providing taxpayer service declined from seven to three, the number of overseas posts dedicated to Criminal Investigation (CI) steadily increased. In 2002, the IRS had seven overseas posts of duty (PODs), in Berlin, London, Mexico City, Paris, Rome, Singapore, and Tokyo. CI had Country Attachés stationed in Frankfurt, Mexico City, Bogota, Hong Kong, and Ottawa. *See* IRM 4.30.3.1 (Feb. 1, 2002). In 2004, the IRS added a CI POD in London and reduced the number of tax attachés that provide customer service to three – in Berlin, Paris, and London. *See* IRM 4.30.3.1 (Aug. 1, 2004). Since 2006, the IRS added two more CI PODs, in Baghdad and Barbados, for a total of eight, while the number of PODs dedicated to customer service remained the same. *See* IRM 4.30.3.1 (Sept. 12, 2006).

20 Attachés also work directly with IRS agents in LMSB, SB/SE, TE/GE, and CI who need information about ongoing audits. *See* IRS Today, Vol. 4 No.1, (Jan./Feb. 2008), *A Day in the life of the Paris Tax Attaché, at* http://communications.no.irs.gov/ProductIndex/IRSToday/IRST200801/story10.asp (last visited Aug. 8, 2008). The main purpose of attaches is to exchange information and provide taxpayer assistance to Americans living abroad. *See id.*

21 LMSB response to TAS research request (July 15, 2008). The London office has four Taxpayer Service Specialists, while both the Frankfurt and Paris offices have two Taxpayer Service Specialists.

22 *Id.*

Table 1.9.1, Top Ten Countries Outside the U.S. Where Americans Reside[23]

Country	U.S. Citizens Residing	IRS Post	Customer Service Employees
Mexico	1,036,300	No	0
Canada	687,700	No	0
United Kingdom	224,000	Yes	4
Germany	210,880	Yes	2
Italy	168,967	No	0
Philippines	105,000	No	0
Australia	102,800	No	0
France	101,750	Yes	2
Israel	94,195	No	0
Spain	94,513	No	0

The IRS Provides Limited Internet-based Services to Taxpayers Located Outside the United States.

Taxpayers outside the U.S. rely on the IRS.gov website as the main source of information on international tax matters. The site directs taxpayers to various forms and publications, but the materials do not offer consistent information on how to reach the IRS. For example, Publication 593, *Tax Highlights for U.S. Citizens and Residents Going Abroad*, provides instructions on how to file returns and describes resources for taxpayers seeking assistance. The publication lists three telephone numbers at U.S. embassies and recommends that the taxpayer write to the Philadelphia Service Center (PSC).[24] Surprisingly, the publication does not list the toll number for the PSC. Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad,* does include the number, but only after directing taxpayers to the embassy phone numbers.

To help taxpayers with tax law questions (not account-related), the IRS implemented Electronic Tax Law Assistance (ETLA) in 1996, allowing taxpayers to ask general tax law questions via the Internet. In 2004, however, as the feature became more popular, and the volume of inquires grew, the IRS moved the link "deeper" into its website.[25] This link is now at the very bottom of the International web page and is difficult to find. As a result,

23 *See* Federal Citizen Information Center, U.S. General Services Administration, *at* http://www.pueblo.gsa.gov/cic_text/state/amcit_numbers.html (last visited July 21, 2008).

24 *See* Publication 593, *Tax Highlights for U.S. Citizens and Residents Going Abroad* 11 (Jan. 2008); Publication 54, *Tax Guide for US Citizens and Resident Aliens Abroad* 45 (2007).

25 W&I Research Group 4, *Analysis of Communication Channel Migration in Private Industry Report Project: 4-04-04-2-036N* (Sept. 2004); *see* Joint Operations Center (JOC) ETLA Reports, *at* http://joc.enterprise.irs.gov (last visited Nov. 24, 2008). In the beginning of FY 2004, the IRS had a direct link on the website home page. The increase in web mail volume in the first month of the tax season (Jan. 2004) led the IRS to move the link "deeper" into the site with the only access through the site map (*i.e.*, no links from other pages). *See* IRM 21.2.1.4.24.1.2, *Electronic Tax Law Assistance* (Oct. 1, 2004). The research report concluded that the movement of the link led to the decreased usage by taxpayers.

ETLA usage by taxpayers overseas has dropped by 95 percent from its peak in FY 2003, as evidenced by the table below.[26]

TABLE 1.9.2, ETLA Web Mail FY 1998-2008*

Fiscal Year	Volume Received	Questions from Aliens and U.S. Citizens Abroad
1998	73,901	4,082
1999	249,963	16,145
2000	303,925	15,424
2001	264,458	14,927
2002	176,960	11,106
2003	231,669	18,246
2004	110,813	8,294
2005	30,784	4,909
2006	18,767	3,611
2007	15,357	3,375
2008	16,383	3,483

** Through June 20, 2008.*

Usage by international taxpayers has declined every year since 2003, the last year the ETLA link was easily accessible. International taxpayers need a way to seek assistance, not only for routine tax law inquiries, but also for questions on tax law changes.[27] Prominent display of the ETLA on the IRS International web page would provide taxpayers access to the tax law explanations they need.

The IRS Provides Limited Access to Forms and Publications in Foreign Languages for Persons with Limited or No English Proficiency.

As a part of the federal government's effort to expand and integrate products and services for Limited English Proficient (LEP) taxpayers, the IRS established the Multilingual Initiative program.[28] The IRS committed to help taxpayers understand and meet their tax responsibilities regardless of their inability to understand and speak English. IRS strategic

26 IRS, *Joint Operations Center (JOC) ETLA reports FY 1996 thru FY 2007 and June 2008, at* http://cpmm6.ausc.irs.gov/ETLA/scripts/test/ReportPicker.cfm (last visited Nov. 24, 2008). Some questions may be from resident aliens and taxpayers within the U.S. asking about international issues. However, the number is unknown.

27 One recent example of changes in the international tax law was the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005, which reduced the foreign earned income (and foreign housing costs) exclusion amounts by the aggregate amount of any deductions or other exclusions otherwise disallowed. In many cases, TIPRA increased the federal income tax imposed on U.S. taxpayers residing overseas to an amount greater than it would have been under previous law. *See* TIPRA, § 515, Pub. L. No. 109-222 ,120 Stat 345 (2006); *see also* IRC § 911(f); Notice 2006-87, 2006-43 I.R.B. 766; Notice 2007-25, 2007-12 I.R.B. 760.

28 *See* Executive Order 13166, *Improving Services for Persons with Limited English Proficiency (LEP)*, 65 FR 50121 (2000); *see also* Policy Statement P-22-3, IRM 22.31.1.1.2 (Apr. 1, 2006).

plans include removing impediments for groups with language, cultural, and other barriers, and increasing the scope and accessibility of services offered electronically.[29]

However, the IRS has translated only a limited number of forms and publications into foreign languages.[30] The information in foreign languages is not easily accessible from the IRS website, which lists forms and publications by date and by number, but not by language.[31] Nor does the Spanish version of the site contain all the information and resources available on the main English site.[32] In contrast, the revenue agencies of many other countries translate their entire sites and many tax assistance materials into various languages.[33]

Taxpayers outside the United States may have limited English proficiency and thus experience difficulties in understanding their U.S. tax obligations. As Spanish is the third most common language in the world, the IRS should consider completely translating its website and all forms and publications into Spanish.[34] The IRS should supplement its online resources with a list of easily accessible forms and publications in other widespread world languages.

Taxpayers Located Outside the United States Incur Downstream Costs to Receive the Information or Services They Need to Comply with Federal Tax Laws.

Taxpayers outside the United States incur phone charges when calling the international toll line at the PSC. Overseas taxpayers must navigate through two menus before placement in the queue, and then the average wait time in the queue exceeds five minutes.[35] Taxpayers frustrated with navigating through menus and holding after being placed in a queue often disconnect before reaching an assistor. Those who cannot obtain necessary assistance and face the complexity of international tax laws and regulations may resort to hiring tax practitioners, who pass on their communication costs in reaching the IRS to the same taxpayers.

29 W&I, *Strategy & Program Plan FY 2008 – FY 2009* 33.

30 The MLI provides minimal written translation of vital IRS documents in the following languages: Spanish, Chinese (simplified), Chinese (traditional), Korean, Russian, and Vietnamese.

31 *See* IRS website, *at* http://www.irs.gov/formspubs/index.html (last visited June 26, 2008).

32 *See* http://www.irs.gov/espanol/index.html (last visited Nov. 24, 2008).

33 For example, the Canada Revenue Agency's website is viewable in English and French, *at* http://www.cra-arc.gc.ca/menu-e.html; Mexican Tax Administration website - in Spanish and English, *at* http://www.sat.gob.mx; Netherlands Tax Agency - in Dutch, English, and German, *at* http://www.belastingdienst.nl/; Chinese State Administration of Taxation website - in Chinese and English, *at* http://www.chinatax.gov.cn/n480462/index.html; and the Australian Taxation Office has its website translated into 19 languages other than English, *at* http://www.ato.gov.au/default.asp?menu=6753 (all sites - last visited June 26, 2008).

34 English is the fourth most common language, with 340 million speaking it as a first language. The three most spoken languages are: Chinese - 873 million; Hindi - 370 million; and Spanish - 350 million. *See Top 30 languages of the world*, *at* http://vistawide.com/languages/top_30_languages.htm (last visited June 26, 2008).

35 IRS toll line places taxpayers not connected immediately with a live call center representative in a queue. IRS call center representatives take the calls placed in a queue in the order they were received. JOC FY 2007 Average Speed of Answer (ASA) for International phone number 215-516-2000 was 301 seconds. *See Enterprise Snapshot Report* (Sept. 30, 2007), *at* http://joc.enterprise.irs.gov/etd/snapshots/fy07/snapshotres.asp (last visited Nov. 4, 2008).

The IRS Joint Operations Center (JOC), which monitors calls to the international toll line, reports the number of callers who hang up before placement in the queue has increased by 95 percent from 2004 to 2007, while the number who hang up *after* being placed in the queue has risen 407 percent.[36] The average wait time once in the queue has increased by 125 percent from 2004 to 2007.[37] The IRS should take steps to minimize the wait time for overseas taxpayers reaching the toll line and consider providing alternatives, such as call back and estimated wait time options.[38]

Inefficient Customer Service to Taxpayers Outside the U.S. Contributes to Noncompliance.

Generally, a U.S. citizen or resident residing outside the U.S. must file a U.S. income tax return unless his or her total income, without regard to the foreign earned income exclusion, is below an amount based on filing status.[39] However, a substantial percentage of Americans residing abroad fail to file U.S. tax returns.[40] A General Accounting Office (GAO, now the Government Accountability Office) report concluded that although the scope of noncompliance abroad is largely unknown, evidence suggests that it may be prevalent and the revenue impact significant.[41]

The IRS does not measure the level of noncompliance by U.S. taxpayers abroad that is attributable to ineffective customer service.[42] The IRS recognizes a significant amount of noncompliance is due to tax law complexity, which leads to errors of ignorance, confusion, and carelessness.[43] This problem especially applies to taxpayers outside the country who may experience difficulties with the complexity of international tax laws and regulations, the inability to reach the IRS to obtain assistance, and the unavailability of necessary forms

36 JOC, International Toll Number 215-516-2000, *at* http://joc.enterprise.irs.gov. (last visited Nov. 4, 2008). Telephone abandonment is a call terminated by the taxpayer when he/she hangs up before being routed to the next automated menu topic or before he/she speaks with a Customer Service Representative (Assistor). Thus, primary abandonment refers to termination by the taxpayer before being placed into the "queue." Secondary abandonment refers to termination by the taxpayer after placement in the queue, but before connection to an assistor. A queue is a holding place for incoming calls waiting for an available resource. A queue keeps calls in sequence so they will be answered in the order received.

37 JOC, International Toll Number 215-516-2000, *at* http://joc.enterprise.irs.gov. (last visited Nov. 4, 2008).

38 Participants in a recent toll-free survey rated "the time it took to reach the IRS" the highest in dissatisfaction and the top opportunity for improvement. Telephone charges did not influence the responses from the taxpayers, as they called the toll free number. The survey also piloted an estimated wait time option, that two-thirds (66 percent) of taxpayers heard. Just under one-half (46 percent) of the taxpayers, who heard the estimated wait time message, said that hearing the message had a positive effect on their overall call experience. *See* Pacific Consulting Group, Internal Revenue Service Customer Satisfaction Survey, *Toll-Free National Report* 6 (May 2008).

39 *See* IRC § 6012(a); Treas. Reg. § 1.1-1(b); IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad* 3 (2007). For 2007, the threshold amounts were $8,750 for a single individual under the age of 65 and $17,500 for a married couple filing jointly, both of whom were under age of 65.

40 *See* IRS Information Letter, IRS INFO 2001-0198 (Sept. 28, 2001). U.S. citizens and residents residing abroad have an obligation to file U.S. tax returns while overseas even if they earn less than the excludable amount under IRC § 911.

41 GAO, GAO/GGD-98-106, *Tax Administration Nonfiling Among U.S. Citizens Abroad* 21-22 (May 1998).

42 Department of the Treasury, *Budget in Brief FY 2007* 60, *at* http://cl.no.irs.gov/la/BranchB/Budget/FY07%20irs%20bib.pdf (last visited Nov. 24, 2008).

43 IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance* 6 (Aug. 2, 2007).

and publications. Some individuals may be unaware of their status as U.S. taxpayers with an obligation to file a U.S. tax return.[44]

An Increasing Number of Overseas Taxpayers Seek Assistance from the Taxpayer Advocate Service.

Taxpayers unable to reach the IRS often seek the assistance of the Taxpayer Advocate Service (TAS).[45] TAS case receipts for taxpayers with military and foreign addresses increased 550 percent between FY 2005 and FY 2007.[46] A review of cases involving civilian taxpayers with foreign addresses reveals that 24 percent of the inquiries came from just two countries.[47] Twenty-two percent of all inquiries involved three TAS primary issue codes:

- Form W-7, *Individual Taxpayer Identification Number* (ITIN);
- Original return processing; and
- Reconsideration of assessment (Substitute for Return, IRC § 6020(b), Audit).[48]

The growing confusion of overseas taxpayers who experience difficulty in accessing the IRS customer service from abroad contributes to noncompliance among these taxpayers.[49]

IRS Plans Improvements to International Taxpayer Service.

The W&I division suggests as part of a servicewide approach to international tax administration a number of measures, which, if adopted, will increase the accuracy and speed at which employees respond to international taxpayers calling the toll telephone number at the PSC. These initiatives include:

- Creation of an online reference library to provide research support to IRS employees assisting overseas taxpayers at the Philadelphia Accounts Management (AM) function;[50]

44 For example, an individual who was born outside the U.S. may be a U.S. citizen by reason of his parents' U.S. citizenship and subject to U.S. tax. Similarly, green card holders who no longer reside in the U.S. but have not surrendered their green cards remain subject to U.S. tax. Department of Treasury, Office of Tax Policy, *Income tax Compliance by U.S. Citizens and U.S. Lawful Permanent Residents Residing Outside of the U.S. and Related Issues* 14 (May 1998).

45 IRS has a link on the International Taxpayer web page for the TAS. The link provides several phone numbers for TAS (depending on where the taxpayer resides).

46 Taxpayer Advocate Management Information System (TAMIS) database, FY 2005, FY 2006, and FY 2007.

47 Canada submitted 15 percent of total inquiries, followed by the United Kingdom with nine percent. *Id.*

48 An Audit Reconsideration is the process the IRS uses to reevaluate the results of a prior audit where additional tax was assessed and remains unpaid, or a tax credit was reversed, and the taxpayer does not agree with IRS's determination. It is also the process the IRS uses when the taxpayer contests a Substitute for Return (SFR) determination by filing an original delinquent return. An SFR is a return prepared by IRS for a taxpayer under IRC § 6020(b). The IRS will prepare the return using information they have received from third parties. The return will not include any additional exemptions or expenses. An audit is a return selected for examination.

49 For additional information on ITIN problems, see Most Serious Problem, *IRS Processing of ITIN Applications Significantly Delays Processing of Taxpayer Returns and Refunds, supra.*

50 W&I Strategy Document, *Support for Servicewide Approach to International Tax Administration* 10 (May 9, 2008).

- Review and update of the IRM, the Probe and Response (P&R) Guide, and Technical Communication Documents to include current and accurate guidance that has an impact on international tax and U.S. territory issues;[51]
- Conversion and upgrade of the existing International P&R Guide Tax Law Categories into the Interactive Tax Law Assistant (ITLA) enhanced guidance interface, now underway with a phased approach to continue deployment of ITLA content internally through FY 2009;[52] and
- The Customer On-Line Decision Support Tool (COLDS), releases 1 and 2, is planned for deployment on IRS.gov in FY 2009 and 2010 for use by internal and external customers.[53]

Other planned initiatives to improve customer service for international taxpayers include:

- Exploration of options to improve the quality of IRS outreach materials available to taxpayers outside the U.S;[54]
- Development of an opinion survey to address the unique needs, preferences, and behaviors of overseas taxpayers;[55]
- Focus group discussions with tax practitioners at the FY 2008 Nationwide Tax Forums in Atlanta, Chicago, and San Diego, addressing the services the IRS should provide for international taxpayers;[56] and
- LMSB outreach for the international taxpayer population, including citizen nights, tax assistance tours, tax forum presentations, publications in consular news letters, news circulars, and tax journals, tax pamphlet distribution, and updates to the international section on IRS.gov.[57]

Insufficient Funding May Hinder IRS Plans for Enhancing International Customer Service.

The IRS suspended many prior toll-free initiatives due to the funding constraints that often affect customer service initiatives. Once the IRS develops new initiatives, it submits a budget request to the IRS Oversight Board for approval, then to the Department of Treasury, then to the Office of Management and Budget, and finally to Congress as a part of the

51 *Id.*

52 ITLA is a logic driven, interactive tool that provides the probes, responses, and answers needed for assistors to address customer tax law inquiries in accounts management (AM) and field assistance (FA) functions. W&I, *Customer On-line Decision Support Tool Release* 1 (June 12, 2008).

53 COLDS release 1 will be launched in FY 2009 and upgrade the existing Frequently Asked Questions (FAQ). COLDS release 2 will display an enterprise tax law guide for the internal assistors in both AM and FA functions and for the use of taxpayers and practitioners. The tool will enhance the assistor and taxpayer self service capability by guiding them to accurate answers to tax law questions not addressed by the FAQ section on the web. *Id.*

54 W&I Strategy Document, *Support for Servicewide Approach to International Tax Administration* 14 (May 9, 2008).

55 *Id.* at 15.

56 *Id.* at 8. W&I incorporated questions concerning taxpayer service suggested by TAS. *See id.* at 15.

57 LMSB response to TAS information request (May 25, 2008).

President's budget.[58] Since desirable projects compete for limited resources, the IRS cannot timely fund many of the projects.[59] Unfortunately, funding issues often lead to rejected or delayed initiatives for enhancing customer service.[60]

During the third quarter of FY 2008, TAS joined forces with W&I, LMSB, and the JOC Business Requirements Integration and Deployment Group to develop business requirements for international toll-free telephone access. This effort led the IRS to make a Change Request (CR) to MITS that, if approved for funding, would provide international toll-free telephone access to the AM function in Philadelphia and National Taxpayer Advocate (NTA) toll-free line for U.S. taxpayers in Canada and Mexico. Both TAS and AM functions have requested toll-free access in Canada and Mexico, later followed by expansion to other countries with large U.S. taxpayer populations.[61] The work request went forward as a priority. However, the IRS reported the resources needed to implement this initiative exceed what MITS has available. Another CR has been submitted requesting costing for this initiative, and it is anticipated the initiative may be incorporated in the Modernization Vision and Strategy Process (MV&S).[62]

Conclusion

Insufficient customer service places overseas taxpayers at a clear disadvantage compared to their counterparts located in the United States. These taxpayers face significant difficulties in obtaining the necessary information from the IRS to comply with their tax obligations. International taxpayers need adequate taxpayer service before they file their returns, due to the complexity of international tax law. Such taxpayer service could significantly reduce unintentional errors and improve voluntary compliance. The IRS should provide these taxpayers with adequate options to obtain information, and also to resolve their account issues without additional financial burden.

The IRS should consider taking the following actions to improve customer service for taxpayers overseas: provide international toll-free telephone access to the Accounts Management function in Philadelphia and NTA toll-free line for U.S. taxpayers in Canada

58 SB/SE, *Roles & Input in the IRS Budget Formulation Process: A Framework for Strategy & Finance/Business Unit Collaboration, at* http://sbse.web.irs.gov/SF/Finance/Formulation/Budget_Formulation_Process.pdf (last visited May 6, 2008).

59 IRS, In the Know, *Modernization Vision and Strategy Program Completes FY 2009 IT Portfolio Selection Cycle*, Vol. 3, Issue 13 (June 28, 2007), *at* http://mits.web.irs.gov/NoSearch/M_Communications/IntheKnow/20070628Vol3Iss13/MV&ScompletesITPortfolioSelectionCycle.htm (last visited Nov. 24, 2008).

60 In October 2003, AM initially submitted a Change Request (CR) 2004-009 to Modernization Information Technology Services (MITS) requesting development and implementation of cost-free phone service for U.S. taxpayers residing outside of the continental United States. The request was re-numbered and re-submitted as CR 2007-026 in October 2006. MITS operational and maintenance budgets have been unable to incur additional costs associated with providing this service. W&I response to TAS research request (July 23, 2008).

61 On May 30, 2008, CR 2007-026 was renumbered as CR 2008-115 (International Call Processing – AM). This CR requests access to IRS services via no-cost/low-cost telephone service for customers residing outside the United States with IMF, BMF, EIN, and Tax Law issues. In addition, CR 2008-116 (International Call Processing – TAS) was submitted requesting similar functionality for customers seeking TAS assistance. Ranking for both CRs are high priority (ranked seven and eight out of 29) by the business units. Consideration will be given to both change requests, with other business priorities competing for limited MITS resources and funding. W&I response to TAS research request (July 23, 2008).

62 Conference call with IRS (Sept. 4, 2008).

and Mexico, later followed by expansion to other countries with large U.S. taxpayer populations;[63] provide taxpayers located outside the United States with first access to the Internet Customer Account Services (ICAS) system; prominently display the ETLA on the IRS international web page; and implement Estimated Waiting Time (EWT) functionality on IRS toll customer service lines.

IRS Comments

International tax law can be extremely complex and, as the international community continues to grow, it is essential to enhance the level of assistance to these taxpayers. In 2007, the IRS implemented the Servicewide Approach to International Tax Administration; a far-reaching plan that engages every operating division to strategically address international tax issues. Improving international customer service is a key component of this approach and each division is committed to doing its part.

One of the primary elements of our focus is to provide U.S. citizens living abroad, international taxpayers, and taxpayers in the U.S. territories, with pre-filing assistance that includes clear and accurate information before they file their tax return. A number of strategic initiatives have been adopted or implemented to achieve this goal. For example, an IRS task force is working with the State Department to develop consistent, comprehensive, tax information that will be placed on every U.S. Embassy/Consulate web page in the world. Enhancements have been added or expanded on the IRS.gov website, such as the International Frequently Asked Questions, monthly International Tax Gap Articles, comprehensive information on our tax treaties, and information on the expatriation tax provisions, foreign earned income exclusion, and housing cost limitations. Presentations on "International Tax Issues" were delivered to thousands of tax professionals in six cities at the 2006, 2007, and 2008 IRS Tax Forums. During the 2008 filing season, IRS employees at the London, Frankfurt, and Paris posts assisted over 30,000 taxpayers in countries under their jurisdiction. These employees also delivered nine tax seminars to groups of U.S. citizens residing abroad, and participated in seven American citizen nights where tax questions were answered.

Throughout the years, the IRS has provided a number of customer services to the international taxpayer. Approximately 300 employees in Accounts Management (AM) are dedicated to answer both written and telephone inquiries on international tax law and account related issues. AM partnered with Compliance to develop training tracks and to expand the Probe and Response Guide to include a number of additional international tax issues to increase the scope of questions Accounts Management will address, as well as improve the accuracy of their responses. These new topics will be converted to the Interactive Tax Law Assistant in 2009. Additionally, monthly conference calls are conducted by headquarters

[63] The IRS has already informed TAS that the resources needed to provide toll free-telephone service for taxpayers located outside the United States exceeds the available resources that MITS currently has available. However, we recommend that costing of this initiative be completed, and a business case developed and submitted for prioritization in the MV&S process.

quality analysts with the international tax law department manager, team leaders, and work leads to share information about trends and improvement opportunities related to international telephone service. Other international services provided by the IRS include the U.S. Residency Certification, the International Centralized Authorization File, International Employer Identification Number, the Military Cover-Over program (a government to government program whereby IRS remits to certain U.S. territories taxes paid by former territory residents currently serving in the U.S. armed forces), and the processing of a variety of tax and information returns unique to the international customer.

Generally, online links, such as the Electronic Tax Law Assistant (ETLA), are strategically placed on IRS.gov to encourage the customer to first research and use self-service applications to find answers to their questions before using ETLA. IRS web pages are designed to optimize the self-service resolution of customer inquiries first, and then provide a venue for assisted resolution.

As noted by the National Taxpayer Advocate, there were a total of 251,000 balance due and math error notices sent to foreign addresses during FY 2007. A review of these notices revealed that in some cases the toll-free number was incorrectly listed in the space where the international toll number should have been listed. However, of these notices less than 1,000 erroneously included a toll-free number that cannot be accessed from locations outside the United States and U.S. territories.[64] A programming change will be requested to correct this error.

With regard to the recommendation that the IRS allow an additional 60 days for overseas taxpayers to reply to all IRS correspondence, as noted by the National Taxpayer Advocate, the IRS already allows additional time for overseas taxpayers to respond. This additional time varies depending on the type of correspondence involved. While the IRS will review the timeframes allowed for responses to international correspondence, we are unaware of any data that supports the supposition that current timeframes are inadequate or that the costs associated with using international delivery confirmation services are warranted.

The IRS continually strives to provide optimum customer service to all customers and has continually explored opportunities to provide cost free/low cost telephone service to the international customer segment. However, in addition to the IRS's obligation to provide the best possible service to all customers, there is an equal responsibility to balance that service with the associated costs. The potential financial burden to provide "no cost" telephone service to all international customers is prohibitive and is the primary reason that this service has not been instituted to date. For example, based on FY 2008 international service circuitry occupancy for calls received, and applying the average cost ($1.49) for each minute, the circuitry cost would be roughly $9.8 million for FY 2008. This represents an average circuitry cost of $38.39 per handled call, 79 times higher than comparable circuitry

64 Notice Gatekeeper, *Fiscal Year 2007 Math Error and Balance Due Notices.*

usage charge for domestic calls.[65] This cost estimate is for usage only and does not factor in any Modernization and Information Technology Services (MITS) costs associated with design, operations and maintenance, nor any potential increase to staffing to meet the demand which would likely result from offering international toll-free service. However, as we continue to assess this issue we will explore the most cost effective options on a country by country basis, including the recommended service for Canada and Mexico.

Although the IRS does not provide a toll-free channel for international callers at this time, military personnel stationed overseas can get help with meeting their tax obligations through support services such as Volunteer Income Tax Assistance (VITA) and the Armed Forces Tax Council, which provide assistance to all branches of the Armed Services. Moreover, the Military OneSource online system provides free online tax preparation and filing for members of the armed forces and their families, along with guidance and answers to their tax questions.

We agree that it would be desirable to provide an accurate EWT on current international service lines as we do with many of the toll-free product lines. However, international calls are processed using a different telecommunications platform than toll-free calls and there are technology limitations that affect our ability to accurately project EWT. We do not believe it would be appropriate to provide an EWT for these lines when we can not be confident of its accuracy.

The National Taxpayer Advocate also recommends completely translating the IRS website into Spanish and providing forms and publications in other widespread worldwide languages. Translating the entire IRS website into Spanish would be cost prohibitive, entailing creation of a duplicate Spanish-speaking staff to support IRS.gov. However, the IRS Language Services Council prepared a list of approximately 110 vital documents to be translated into Spanish based on input from internal and external stakeholders. All of these documents have been translated and are currently available on IRS.gov and *El IRS en Español.* A further needs assessment is being conducted to identify additional products and services needed by non English-speaking taxpayers. Current and future translations of forms and publications into languages other than English will be determined using the data from this needs assessment.

Lastly, regarding the recommendation to make My IRS Account or MIRSA, previously known as Internet Customer Accounts Services (ICAS), available to international taxpayers, a recent business decision was made to indefinitely suspend this project in light of continuing security concerns and competing modernization priorities.

65 AT&T JOC, *Fiscal Year 2008 Snapshot Product Line Report.*

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for the implementation of the Servicewide Approach to International Tax Administration, and offers TAS assistance in this important effort. We are both appreciative of and pleased with the initiatives to improve taxpayer service described in the IRS comments, especially free tax help provided to the members of the armed forces and their families through VITA and the Armed Forces Tax Council. We also applaud the IRS for changing the IRS.gov website to prominently display ETLA as the first link on the IRS international web page,[66] and for adding the missing PSC toll number for international taxpayers in Publication 593.[67]

However, the National Taxpayer Advocate believes the IRS should and can do more toward meeting its number one strategic goal of improving taxpayer service.[68] The complexity of international tax law calls for free and effective customer service to taxpayers located outside the United States. The IRS provides substantially fewer resources to such taxpayers compared to those in the U.S., effectively putting international taxpayers at a disadvantage and jeopardizing voluntary compliance. In many situations, *e.g.*, responding to IRS correspondence or inquiring about the information needed to file compliant returns, international taxpayers may have a vital need to speak with a live IRS customer service representative. In the absence of a toll-free line, such taxpayers must call the IRS toll telephone number, incurring an average cost of $1.49 per minute (according to the IRS comments). This cost places a significant financial burden on international taxpayers who are making every effort to comply with their tax obligations. It is disingenuous for the IRS to state that providing toll-free access for individual taxpayers outside the U.S. is cost prohibitive while it requests over $116 million for international enforcement initiatives in FY 2010, including increased examinations of individual taxpayers, compared to the $9.8 million needed to establish international toll-free telephone lines for these taxpayers.[69]

The National Taxpayer Advocate is also concerned about the 17,565 balance due and math error notices sent to foreign addresses and addresses in some U.S. territories, including Guam and American Samoa, which listed the international toll-free number that is inaccessible from those locations.[70] We hope the IRS will promptly resolve the associated programming error.

66 *See* IRS public website, International Taxpayer web page, *at* http://www.irs.gov/businesses/small/international/index.html (last visited Nov. 24, 2008).

67 *See* Publication 593, *Tax Highlights for U.S. Citizens and Residents Going Abroad* 12 (Dec. 10, 2008).

68 *See* IRS LMSB, *Servicewide Approach to International Tax Administration, Strategic Goal 1: Improve Taxpayer Service, at* http://lmsb.irs.gov/international/dir_compliance/global/sis1.asp. (last visited Oct. 29, 2008).

69 *See* FY 2010 Proposed Resource Initiative – Pending in Treasury, *Reduce the Tax Gap Attributable to Globalization* (last visited Nov. 24, 2008).

70 Notices with the toll-free number were sent to 2,628, 1,763, and 61 taxpayers outside the U.S., *i.e.* total of 4,452. A total of 13,113 of these notices were also sent to taxpayers in Guam and American Samoa, which cannot generally access a toll-free number or incur a long distance charge. W&I response to TAS information request (July 24, 2008).

We agree that the IRS has broad discretion in establishing the time periods allowed for international taxpayers to respond to various IRS inquiries. Such timeframes may vary from 60 to 15 days. The National Taxpayer Advocate believes the IRS should allow a uniform 60-day grace period for overseas taxpayers to reply to all IRS correspondence before taking action, similar to the additional 60 days provided by statute for these taxpayers to respond to notices of deficiency.[71] The IRS needs to look beyond the mere legal requirements and "focus on the taxpayer's experience ...walk a mile in the taxpayers' shoes and help them navigate the system."[72] It is obvious that the taxpayers residing in some foreign countries may need additional time to respond to IRS letters and notices because of common delays in mail delivery. In such cases, we recommend the IRS design a test to determine what mail delivery delays the taxpayers experience in particular international locations and implement specific timeframes accordingly.[73]

The IRS has stated it cannot accurately project estimated wait times for international callers because the calls are processed using a different telecommunications platform. However, the average wait time for international taxpayers, incurring international phone charges at an average rate of $1.49 per minute, has increased 125 percent from 2004 to 2007.[74] The IRS should update the telecommunications platform to allow EWT functionality and reduce the wait time for overseas taxpayers, adhering to its strategic goal of improving service to the international taxpayers.

The National Taxpayer Advocate fundamentally disagrees with the IRS's statement that translating the IRS website into Spanish would "entail creation of a duplicate Spanish-speaking staff to support IRS.gov, making it cost prohibitive." In light of the additional $116 million requested for international enforcement initiatives, and absent the estimated cost for the translation, we find it difficult to understand why providing essential tax information in Spanish on the website would be cost prohibitive. As stated above, many countries and U.S. states translate their entire websites into Spanish and other languages.[75] The IRS should reconsider the need for a complete translation of IRS.gov into Spanish. TAS offers its assistance and experience in developing this and other multilingual products

71 *See* IRC § 6213(a); *see also* IRM 25.6.5.7.2 (Mar. 1, 2006). *Cf.* IRM 3.30.123.5.1 (Jan. 1, 2008); Rev. Proc. 2005-34 § 4.01, 2005-24 I.R.B. 1233; IRM 5.7.6.1.1 (Feb.1, 2007).

72 IRS Commissioner Douglas Shulman, *Remarks Before Tax Analysts Conference on Ten-Year Anniversary of the IRS Restructuring and Reform Act of 1998, at* http://www.irs.gov/newsroom/article/0,,id=184857,00.html (last visited Dec. 11, 2008).

73 *E.g.*, taxpayers residing in countries with efficient postal systems, such as France, Germany, or the United Kingdom, may be subject to a 30-day grace period, while those residing in distant locations, such as Australia, New Zealand, or South Africa, or in locations with underdeveloped infrastructure, such as Mongolia, Somalia, or Uzbekistan, may need extended timeframes of 60 days or more to respond to IRS correspondence.

74 JOC, International Toll Number 215-516-2000, *at* http://joc.enterprise.irs.gov (last visited on Nov. 4, 2008).

75 Spanish currently is the third most populous language in the world with 350 million speaking it. Population projections for the U.S. alone expect the Hispanic population (already the largest minority group) to triple in size by 2050, and comprise 29 percent of the U.S. population. Pew Hispanic Center, U.S. Population Projections: 2005-2050 (Feb. 11, 2008).

and services as part of the federal government's effort to expand and integrate products and services for Limited English Proficient (LEP) taxpayers.[76]

The IRS has stated that security concerns and competing modernization priorities have made it necessary to indefinitely suspend the "My IRS Account" (formerly ICAS). Tax agencies in other countries and many states have overcome the security issues and instituted customer-friendly applications similar to the suspended "My IRS Account."[77] Taxpayers compare the service they receive from the IRS with the service they receive from other organizations, where accessing account information, resolving problems, and sending and receiving information 24 hours a day with minimal inconvenience and cost have become the norm. Suspension of the "My IRS Account" project is a huge step backward for both the taxpayers and the IRS, and adversely affects the declared strategic goal of improving taxpayer service. The National Taxpayer Advocate is concerned that abandonment of this project will leave international taxpayers without an alternative, no-cost tool to comply with their U.S. tax obligations, in the absence of a toll-free access to the IRS. We urge the IRS to resolve the security issues with this application and reinstate this vital initiative.

Recommendations

The National Taxpayer Advocate recommends that the IRS consider taking the following actions to improve customer service for taxpayers overseas:

1. Provide international toll-free telephone access to the Accounts Management function in Philadelphia and the National Taxpayer Advocate (NTA) toll-free line for U.S. taxpayers in Canada and Mexico, followed by expansion to other countries with large U.S. taxpayer populations.
2. Resolve the security issues with the Internet Customer Account Services (ICAS) system and reinstate the "My IRS Account" application, providing taxpayers outside the United States with online access to their accounts.
3. Translate the complete IRS website content into Spanish, followed by expansion of IRS forms and publications available in other languages.
4. Implement Estimated Waiting Time (EWT) functionality on IRS toll customer service lines and reduce the wait time for international taxpayers at the Accounts Management function.

[76] *See* Executive Order 13166, *Improving Services for Persons with Limited English Proficiency (LEP)*, 65 FR 50121 (2000); *see also* Policy Statement P-22-3, IRM 22.31.1.1.2 (Apr. 1, 2006). *E.g.*, TAS employees have participated significantly in the production of the Basic Tax Responsibility DVD in Russian in partnership with the recently established Multilingual Initiative Program.

[77] *See* Canada Revenue Agency, *at* http://www.cra-arc.gc.ca/eservices/tax/individuals/myaccount/vrtltour/menu-e.html, and U.S State tax agencies such as Pennsylvania, *at* http://www.doreservices.state.pa.us/Individual/default.htm; California, *at* http://www.ftb.ca.gov/online/myacct/index.asp; Colorado *at* https://www.myincometax.state.co.us/status/login.asp; Illinois, *at* http://www.revenue.state.il.us/Individuals/index.htm; and Michigan, *at* http://www.michigan.gov/taxes/0,1607,7-238-43513---,00.html (all sites last visited Nov. 24, 2008).

MSP #10

Customer Service Within Compliance

Responsible Officials

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self Employed Division
Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division
Frank Y. Ng, Commissioner, Large and Mid-Size Business Division
Sarah Hall Ingram, Chief, Appeals

Definition of Problem

IRS business strategies and measures do not adequately emphasize a balanced approach between taxpayer service and enforcement within the IRS's compliance organizations. Current strategies and standards fail to integrate, recognize, and promote the concept of customer service within compliance activities in order to achieve long-term voluntary taxpayer compliance. Even though each IRS operating division (OD) has a customer service component in its mission statement, no division evaluates its compliance performance based on the level of "world class" customer service provided. At every level, the IRS rates operational performance against business measures focused on efficiency (*e.g.*, cycle time, case closures, average call time), instead of measuring operational effectiveness (*i.e.,* did the IRS's actions achieve the desired voluntary compliance results?).

Simply stated, the IRS gets what it measures. When a phone assistor is rated based on time utilization, he or she will not risk a poor performance appraisal to take the additional time necessary to address all issues apparent on a taxpayer's account.[1] By focusing only on the efficiency of a phone call, the IRS loses sight of whether the contact was effective.[2] Similarly, if an employee's successful performance is based on how much mail she or he opens and not whether she or he associates it with the right case, the IRS gains efficiency but loses effectiveness.

The downstream consequences of not considering both efficiency and effectiveness in performance standards can be severe and costly to taxpayers and the government. Taxpayers who cannot obtain the information or services they need to comply with federal tax laws, or to resolve an issue on the first attempt, can generate additional budget costs for the IRS and expenses for themselves. Potential downstream costs may include repeat contacts

1 Internal Revenue Manual (IRM) 1.4.16.3.4.1 and 1.4.16.3.4.2 Average Time/Value to Monitor Efficiency and Average Handle Time (Jan. 4, 2008). *See also:* http://core.publish.no.irs.gov/trngpubs/pdf/20287f08.pdf (last visited on Nov. 24, 2008).

2 Wage and Investment (W&I) Division, *Fiscal Year (FY) 2008 Accounts Management Program Letter, at* http://win.web.irs.gov/accountsmgmt/amdocs/FY08_Program_Letter_Measures/FY%202008%20Program%20Letter.doc (last visited on Nov 24, 2008).

on the same issue, errors on returns, the need for Taxpayer Advocate Service assistance, revenue loss, and possibly the costs of activities such as audits, collection activity, appeals, and litigation.[3]

Analysis of Problem

Background

The IRS Restructuring and Reform Act of 1998 (RRA 98) dramatically changed the way the IRS conducts and reviews its business operations. Congressional concern arose in part from the IRS's use of performance goals based on standards such as dollars assessed per hour, number of seizures, and assets sold, which were potentially driving inappropriate actions by employees and decisions by managers. To address this concern, RRA 98 mandated that the IRS strengthen its performance management system by establishing goals for individual, group, and organizational performance consistent with the IRS's performance planning procedures, and consider deficiencies noted in customer service surveys.[4]

RRA 98 represented a major step toward recognizing the importance of customer satisfaction. For the first time, the IRS encouraged employees to think of the individuals and businesses they serve as *customers*. Congress directed the IRS to place "greater emphasis on serving the public and meeting the taxpayer's needs."[5] Congress challenged the IRS to "develop a procedure under which, to the extent practicable and if advantageous to the taxpayer, one Internal Revenue Service employee shall be assigned to a taxpayer's matter until it is resolved."[6] In response, every IRS OD and function developed mission and/or vision statements:

Small Business/Self-Employed (SB/SE) Mission: To provide Small Business/Self-Employed customers with top-quality service by educating and informing them of the tax obligations, developing educational products and services, and helping them understand and comply with applicable laws and to protect the public interest by applying the tax law with integrity and fairness to all.[7]

Tax Exempt and Government Entities (TE/GE) Mission: To provide Tax Exempt and Government Entities customers top-quality service by helping them understand and

3 IRS, *2007 Taxpayer Assistance Blueprint, Phase II*, at 53.

4 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle C, § 1204, Basis for evaluation of Internal Revenue Service employees, § 9508 General Workforce performance management system (a)(2), 3525.

5 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 1002, Internal Revenue Service Mission to Focus on Taxpayers' Needs, 3504.

6 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No 105-206, Title V, Subtitle H, § 3705, Internal Revenue Service Employee Contact, 3580.

7 SB/SE, *About SB/SE, at* http://mysbse.web.irs.gov/AboutSBSE/default.aspx (last visited on Sept 9, 2008).

comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all.[8]

Large and Mid-Size Business (LMSB) Vision Statement:

- We are a world-class organization responsive to the needs of our customers in a global environment while applying innovative approaches to customer service and compliance.
- We apply the tax laws with integrity and fairness through a highly skilled and satisfied workforce, in an environment of inclusion, where each employee can make a contribution to the mission of the team."[9]

Wage and Investment (W&I) Mission: To provide Wage and Investment customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all.[10]

Office of Appeals Mission: To resolve tax controversies, without litigation, on a basis which 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 Service.[11]

While each area of the IRS addresses service to taxpayers within its mission or vision statement, the function or OD does not support these pronouncements with quantifiable customer service measures at every level or in every program. The failure to establish and provide adequate customer service measures within compliance functions could lead to disparate treatment of taxpayers.[12]

Efficiency vs. Effectiveness

IRS Commissioner Douglas Shulman highlighted the importance of being both efficient and effective from the taxpayer's perspective in a July 9, 2008, e-mail communiqué:

> In order to make voluntary compliance easier, we must not only meet legal requirements, but must walk a mile in the taxpayers' shoes and help them navigate the system.[13]

Efficiency and effectiveness are not mutually exclusive. If the IRS focuses solely on the efficiency of compliance activities, it can lose its effectiveness. The IRS recently set the

8 TE/GE, *About TE/GE, at* http://tege.web.irs.gov/templates/TEGEHome.asp?MWContent=/content/TEGEMainWindow/linkedHTMLDocuments/about_tege.htm(last visited on July 14, 2008).

9 LMSB, *Field Focus Guide 2008, at* http://core.publish.no.irs.gov/docs/pdf/33972j07.pdf (last visited on Nov. 24, 2008).

10 W&I, *Wage and Investment Mission and Goals, at* http://win.web.irs.gov/aboutus/aboutus_goals.htm (last visited on July 14, 2008).

11 IRS Office of Appeals, *About Appeals, at* http://appeals.web.irs.gov/about/about.htm (last visited on July 14, 2008).

12 Each OD does conduct "Customer Satisfaction Surveys" but those are not customer service measures.

13 IRS Commissioner Douglas Shulman, e-mail to all IRS employees (July 9, 2008).

efficiency goal of reducing the processing time for correspondence audit cases.[14] W&I reduced Earned Income Tax Credit (EITC) correspondence audit processing time by approximately three percent between 2006 and 2007, but did so by tightening electronic case processing timeframes and accelerating notices without properly considering taxpayer correspondence.[15] The use of a computerized batch system helped achieve the stated goal.[16] Because of batch processing, however, the IRS did not properly associate or consider taxpayer correspondence and prematurely issued 90-day notices of deficiency.[17] What should have been considered in the audit process had to be reviewed downstream by Appeals, in the Audit Reconsideration process, TAS, and at times, the United States Tax Court.[18]

The best business measurement standard will address both efficiency and effectiveness. The National Taxpayer Advocate has noted the IRS has an "increased tendency to look for *efficient* approaches to tax administration (from the perspective of IRS resources) and a resistance to undertaking analysis from the taxpayer's perspective."[19]

You Get What You Measure

Each division sets fiscal year strategic initiatives to support the OD's mission statement and establish operational goals.[20] Progress toward strategic initiatives rolls into the IRS Business Performance Review (BPR). In addition to highlighting current performance, the BPR addresses goals for the future, including Level of Service (LOS) metrics.[21] The majority of these goals represent efficiency measures such as case closures, phone calls answered, correspondence contacts, currency of years under examination, proper use of levy actions, and the number of taxpayers served at a Taxpayer Assistance Center (TAC). Achieving strategic initiatives determines the "success" of the OD. While some initiatives for compliance functions have a customer satisfaction component, this component does not assess the effectiveness of contacts, promote efforts to strengthen service to taxpayers, or measure the impact on future compliance by taxpayers.

14 W & I, *Strategy & Program Plan Document 11622, FY 2008-2009* 90 (Sept. 2007).

15 W & I, *Business Performance Review* 21- 23 (May 20, 2008).

16 IRM 4.19.20.1, Batch Processing Overview: Batch Processing is an IRS-developed, multifunctional software application that fully automates the initiation, aging, and closing of certain EITC and non-EITC cases. Using the batch system, Correspondence Exam can process specified cases with minimal to no tax examiner involvement until a taxpayer reply is received. Because the batch system will automatically process the case from creation to closing, it eliminates tax examiner involvement on no-reply cases.

17 National Association of Enrolled Agents, Letter Regarding Concern over Recent Enforcement Actions by IRS (Nov. 28, 2007) *at* http://www.naea.org/MemberPortal/Advocacy/Comments/letter_nov_28_2007.htm (last visited June 4, 2008); W&I, *Business Performance Review* 21 (May 20, 2008).

18 For a detailed discussion of the impact of the batch system on taxpayer correspondence in the examination process, *see* Most Serious Problem, *The IRS Correspondence Examination Process Promotes Premature Notices, Case Closures, and Assessments, infra.*

19 National Taxpayer Advocate 2006 Annual Report to Congress, Preface X.

20 *See, e.g., W & I, Strategy & Program Plan Document 11622, FY 2008-2009* (Sept. 2007) at 63 where W&I sets the operational priority of identifying efficiencies; *and* SB/SE Plan: 2008-2009 Plan at 57 where SB/SE sets the goal of exploring methods to align inventory with resources to maximize efficiencies.

21 Metrics quantify how processes are working in comparison with goals.

Pursuant to RRA 98 §1204, the IRS evaluates employees under a "Balanced Measure" system including the following critical job elements (CJEs):[22]

- Employee Satisfaction;
- Customer Satisfaction - Knowledge;
- Customer Satisfaction - Application;
- Business Results -Quality; and
- Business Results - Efficiency. [23]

In addition to CJEs, quality measures apply to every division's work product.[24] As noted in *Organizational Performance Management and the IRS Balanced Measurement System:*

> The quality measures provide information about how well IRS operating units developed and delivered their products and services. The quality measures are determined based upon a comparison of a sample of work items handled by certain functions or organizational units against a prescribed set of standards that incorporate the customers' point of view. Additional quality measures will gauge the accuracy and timeliness of the products and services provided.[25]

By definition, quality review measures incorporate the taxpayer's point of view. In practice, however, the measures do not deliver on the promise of a taxpayer-centric strategy. Moreover, the underlying aspects of these CJEs and the quality standards fail to measure the desired outcome of voluntary compliance expressed in the IRS mission. Employees have little incentive to educate taxpayers on how to avoid errors in the future or to address the taxpayers' unrelated tax issues, and are not encouraged to determine the basis for the taxpayers' original non-compliant behavior. CJEs, which drive employee behavior, focus on the efficiency of work, not its effectiveness.

For example, in SB/SE Collection balance due cases, SB/SE expects the revenue officer (RO) to prepare a financial analysis of the taxpayer's ability to pay and secure a payment agreement with the taxpayer as a basic task of the taxpayer contact. The RO's analysis should include the taxpayer's current financial position and the business practices leading the taxpayer to balance delinquencies.[26] Current operational, critical, and quality measures demonstrate the IRS field collection achieved an 84 percent quality score for fiscal year

22 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No 105-206, § 1204.

23 IRS, *Organizational Performance Management and the IRS Balanced Measurement System*, *at* http://www.irs.gov/pub/irs-pdf/p3561.pdf 3 (Dec. 1999) and http://www.irs.gov/pub/irs-regs/td8830.pdf (last visited on Sept 17, 2008).

24 IRM 21.10.1.2.5 (Oct. 1, 2008), and 5.13.1(Sept. 1, 2007).

25 IRS, Organizational Performance Management and the IRS Balanced Measurement System, *at* http://www.irs.gov/pub/irs-pdf/p3561.pdf 3 (Dec. 1999) and http://www.irs.gov/pub/irs-regs/td8830.pdf (last visited on Sept 17, 2008).

26 IRM 5.15 (May 9, 2008).

(FY) 2007.[27] However, 22 percent of payment agreements defaulted and TAS has received more than 4,500 cases where the payment amounts were too high, leading to rework and increased taxpayer burden.[28] The addition of an outcome measure for the program, such as the percentage of taxpayers fulfilling their payment agreement and remaining compliant for a given period, would direct the IRS's strategies toward developing a taxpayer-centric approach.

Consider the case of a levy, filed due to nonpayment of a tax deficiency, which creates a hardship for the taxpayer.[29] TAS cases reflect numerous instances where the IRS refers the taxpayer to TAS to obtain a lien or levy release instead of securing the information needed to simply resolve the case and the hardship at the first point of contact with the IRS, *i.e.,* provide one-stop service.[30] The business plan measures the number of levies and liens successfully completed, giving the employee no incentive to release the levy and provide relief to the taxpayer.[31]

Current Measurement Pitfalls

The National Taxpayer Advocate's previous Annual Reports to Congress highlighted opportunities to improve the effectiveness of IRS correspondence exam processes.[32] For example, when the IRS sends taxpayers math error notices that are hard to understand, taxpayers may find it difficult to reach someone at the IRS to answer questions. While the notices may be a very effective way to correct a tax return, the IRS misses the opportunity to educate taxpayers on how to avoid this problem in the future.[33] The IRS should also track the types of math errors made to develop proper educational efforts for taxpayers and IRS employees, and ultimately increase effectiveness.[34]

From the IRS standpoint, correspondence examination is very efficient at assessing tax. The effectiveness of the overall program is called into question, however, when considering the outcome of EITC cases.[35] When TAS case advocates became involved, the taxpayers

27 *See* http://sbse.web.irs.gov/SF/PPM/OPR/BPR/FY08_2ndQ_BPR.pdf 17(May 2008). This is on a 100-point scale.

28 Collection Activity Report for IADEFAULT for cycle 39. Rates are increasing as indicated by the 2006, 2007, and 2008 rates of 18.26, 19.75, and 22.31 percent respectively. Business Performance Management System indicates for FY 2007 that TAS received more that 4,525 cases under PCI code 759 in which the installment agreement payments were too high. Taxpayer Advocate Management Information System (TAMIS) Primary Core Issue Code 759 indicates Installment Agreements, Other.

29 IRC § 6343 (a)(1)(d) and IRM 5.11.2.2.1 (Jan 1, 2006).

30 TAMIS research indicates over 11,000 referrals from IRS employees. *See also* IRM 5.10.3.5(8) (Sept. 7, 2007).

31 IRS *SBSE Business Performance Review, Performance Data Tables Only, 26 Aug 2008; at* http://sbse.web.irs.gov/SF/PPM/OPR/BPR/FY08_3rdQ_BPR_Perf_Data_Tables.pdf. The measure actually serves to undermine instead of promote efficiency. If the RO released the levy on the first taxpayer contact, the taxpayer would experience seamless, efficient, and effective service. Since the current measure does not incorporate effectiveness, a taxpayer will contact TAS when the RO does not provide relief, then TAS will refer the case to the RO, creating extra steps and lower efficiency for both the IRS and the taxpayer.

32 *See* National Taxpayer Advocate 2006 Annual Report to Congress 289-310 and National Taxpayer Advocate 2003 Annual Report to Congress 87-98 and 135-144.

33 *See* National Taxpayer Advocate 2001 Annual Report to Congress 34.

34 *See* National Taxpayer Advocate 2002 Annual Report to Congress 19-31.

35 *See* National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 10, 35.

received on average two personal contacts (either letters or calls) to request documentation, and achieved significantly better audit results than in cases where the correspondence exam unit used letters as the only method of contact.[36] This is an excellent example of how failure to establish and provide adequate customer service measures within Compliance functions leads directly to disparate treatment of taxpayers, as well as incorrect audit results.[37]

The IRS similarly misses the opportunity to consider the organizational effectiveness of the offer in compromise (OIC) program. The IRS bases the success of the program solely on efficiency standards relating to processing times and case standards. By reviewing cases where it rejected or returned the OIC, the IRS could compare the amount of the rejected or returned offer versus the amount the IRS ended up collecting.[38] By establishing a program measure focusing on the long-term compliance of the taxpayer, the IRS could assess the effectiveness of the program and determine whether it is in the government's benefit to settle on a lesser amount of money via an offer, or allow a balance due to be lost because the statutory period for collecting the tax has expired.[39]

Services Provided by Other Taxing Authorities

Strengthening customer service to improve compliance is not new. Tax agencies from around the world have addressed this issue. Inland Revenue Service, New Zealand's tax agency, completed a business plan for 2006 – 2011 entitled "Our Way Forward."[40] The plan outlined the following goals:

- Target and tailor activities through understanding the customers;
- Optimize organizational efficiencies and reduce compliance cost over time;
- Create an environment that promotes compliance; and
- Continually invest in people and the tools to deliver future outcomes.[41]

Inland Revenue's use of a customer-focused proactive approach, along with legislative changes, improved the climate for voluntary compliance initiatives. "Our Way Forward" strives to make taxpayer obligations as easy as possible for those who wish to comply, and as difficult as possible to avoid for those who purposefully do not comply.[42]

36 National Taxpayer Advocate 2004 Annual Report to Congress *vol. 2*, 10, 35.

37 *Id.*

38 *See* IRS, *Offer in Compromise: Analysis of Various Aspects of the OIC Program* (Sept. 2004).

39 IRM 5.19.1 (Apr. 28, 2008). IRC § 6503 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).

40 New Zealand Inland Revenue Service, *Our Way Forward, at* https://www.ird.govt.nz/resources/file/eb3c8201af5d6c8/way-forward-2006.pdf (last visited on Aug 22, 2008).

41 *Id.*

42 *Id.*

Inland Revenue uses a system to measure outcome achievement and studies the impact of the intervention selected. Employing a research-based approach, the agency determines both the impact and cost-effectiveness of actions taken.[43] In addition, Inland Revenue established performance measures relating to different activities and aspects of performance. Performance evaluation is designed to be viewed in the aggregate due to the interrelated nature of the performance measures.[44]

In the United Kingdom, Her Majesty's Revenue and Customs (HMRC) established benchmarks for the high level of service taxpayers should expect when dealing with HMRC.[45] The world's taxing agencies monitored the success of the program, and IRS representatives recently visited the United Kingdom to learn more. HMRC built upon the success of the initial program by developing a taxpayer-centered vision for small businesses.[46] The vision calls for a "Whole Customer View," which includes a single point of contact for taxpayers or their representatives to obtain information on tax forms, receive better help and support, and improve compliance by using real-time data. The taxpayer will have a "single customer account" showing all liabilities and payments as well as enabling taxpayers to make monthly payments on accounts.[47] Future HMRC plans include designing a strategy to target the right support to the right business at the right time.[48]

The Swedish Tax Agency focuses on behavioral attitudes of taxpayers impacting compliance with tax laws. The agency's strategic plan states: "It is important to treat people fairly, with respect, to listen to them and explain decisions."[49] The Swedish Tax Agency focus moved from a focus on control to a focus on service.

The Australian Tax Organization's Strategic Statement for 2006-2010 shifted its emphasis from revenue collection to optimizing voluntary compliance by creating the right environment for people to pay taxes.[50] Australia provides customer service by way of "three Cs": Consultation, Collaboration, and Co-design.[51]

In the United States, Missouri's Department of Revenue established goals for its 2005-2009 Implementation Plan to:

43 New Zealand Inland Revenue, *Statement of Intent 2006-2009* 19-21.

44 *Id. at* 46-47.

45 Inland Revenue, *The Government's Expenditure Plan, 1999/2000-2001/2002*, March 1999 *at* http://www.hmrc.gov.uk/pdfs/dptrpt99.pdf (last visited on Sept 15, 2008).

46 HMRC, *Making the New Relationship a reality: HMRC's response to small businesses' priorities for reducing the administrative burden of the tax system* 5 (Nov. 2005).

47 *Id.* at 6 (Nov. 2005). In contrast, the IRS systems are module based and employees must look at separate systems to construct a global view of the taxpayer's account. Taxpayers may not access their accounts on their own.

48 *Id.*

49 Swedish Tax Agency, *Right from the Start, Research and Strategies 46 (Aug. 2005) (translated version), at* http://www.skatteverket.se/download/18.612143fd10702ea567b80002569/rapport200501_eng.pdf.

50 M. McKerchar, University of New South Wales, *Tax Complexity and its Impact on Tax Compliance*, The IRS Research Bulletin, Proceedings of the 2007 IRS Research Conference 196-197.

51 *Id.* at 198.

> Accurately define and benchmark effective customer service, customer satisfaction, and performance measures and to use those benchmarks to improve customer satisfaction by clearly articulating them to our employees and holding every employee accountable for meeting his or her customer service benchmark.[52]

The changes involved renaming the agency's business unit, changing the leadership, and establishing benchmarks for evaluating the performance of employees.[53]

Emphasis Placed on Enforcement

The National Taxpayer Advocate has expressed concern that the IRS has been emphasizing tax law enforcement at the expense of taxpayer service in recent years. After the administration issued its FY 2008 budget proposal last year, the Government Accountability Office (GAO) analyzed recent IRS funding trends. Over the five-year period FY 2004 through FY 2008, it concluded that funding for enforcement had increased substantially while funding for taxpayer services had been reduced. Based on the administration's proposal for FY 2008, the GAO pointed out that funding over the FY 2004 through FY 2008 period would have increased by 19.4 percent for enforcement while funding for taxpayer services would have declined by 3.8 percent.[54] The final appropriations bill for FY 2008 made a modest adjustment to the administration's proposal, providing about $46.9 million more for taxpayer service and $145.5 million less for enforcement.[55]

However, the IRS budget proposal for FY 2009 continued the trend of spending relatively more on enforcement. The president's proposal would have increased enforcement spending by $490 million (7.0 percent), while increasing spending for taxpayer services by only $23 million (0.6 percent).[56] Thus, after inflation, the proposal would reduce taxpayer services spending still further.

Moreover, the broad budget category titles "Taxpayer Services" and "Enforcement" do not tell the full story. Of the $2.2 billion in the "Taxpayer Services" category, only $645 million, or six percent of the IRS budget, is currently allocated for "Pre-filing Taxpayer Assistance and Education."[57] A significant majority of funds under the "Taxpayer Services" category is allocated for "Filing and Account Services," which largely covers the processing of tax returns. Returns processing is hardly a pure service activity. While it does enable the IRS to issue tax refunds, it is an internal processing function that also constitutes the first step

52 Missouri Department of Revenue, *Strategic Plan, 2005-2009*, 6.

53 *Id.* at 12.

54 Government Accountability Office, GAO-07-673, *Internal Revenue Service: Interim Results of the 2007 Tax Filing Season and the Fiscal Year 2008 Budget Request* 27 (April 2007). These numbers are apparently not adjusted for inflation. GAO reported that overall IRS funding would increase, on an inflation-adjusted basis, by a mere 0.5 percent from FY 2004 to FY 2008 under the Administration's proposals. *Id.* at 26.

55 *Compare* H.R. 2764 110th Cong. § 6 (2007) *with* Department of the Treasury, *FY 2008 Budget in Brief* at 55.

56 Department of the Treasury, *FY 2009 Budget in Brief* at 54. These dollar amounts include the allocation of the Operations Support budget to the Taxpayer Services and Enforcement categories.

57 *Id.* at 53.

in screening returns for audit. It is far removed from the type of taxpayer service that informs taxpayers about their tax obligations and assists them in complying with the laws. Notably, the IRS budget proposal for FY 2009 would have reduced this relatively low level of funding for taxpayer assistance and education from $645 million to $617 million – a reduction of over 4.3 percent in nominal terms and a larger reduction after taking into account inflation.[58]

Compliance Opportunities Promoted by the IRS

The 2008-2009 IRS Strategic Initiative includes the goal to "*Improve service to make voluntary compliance easier.*"[59] This goal has four objectives:

- Incorporate taxpayer perspectives into all service interactions;
- Expedite and improve issue resolution across all interactions with taxpayers;
- Make it easier to navigate the IRS, provide targeted, timely guidance and outreach to taxpayers; and
- Strengthen partnerships with tax practitioners, preparers, and other third parties to ensure effective tax administration.[60]

The IRS needs to determine how to measure its accomplishments toward these goals, including the performance of the ODs and the employees. The IRS has the opportunity to establish taxpayer-centric measures to encompass effectiveness as well as efficiency components to accomplish strategic goals. Previous Annual Reports to Congress included these suggestions for improving OD performance:

- Create a cognitive learning lab where the IRS conducts research with taxpayers to discover what actions or initiatives drive the desired compliance behavior;[61]
- Conduct comprehensive taxpayer surveys addressing taxpayer needs and preferences;[62]
- Involve TAS, as the voice of the taxpayer, in discussions about designing and developing programs; and

58 Department of the Treasury, *FY 2009 Budget in Brief* at 54. These dollar amounts include the allocation of the Operations Support budget to the Taxpayer Services and Enforcement categories. *Id.* at 53.

59 IRS, *2008-2009 Strategic Initiative*.

60 IRS, *I will* (handout for IRS executives at Commissioner's meeting on FY 2009 Strategic Initiative) (Aug. 2008).

61 *See* National Taxpayer Advocate 2007 Annual Report to Congress Most Serious Problem, *Taxpayer Service and Behavioral Research*, 156-161 and Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, National Taxpayer Advocate 2007 Annual Report to Congress, *vol. 2*, 138-180.

62 *See* National Taxpayer Advocate 2004 Annual Report to Congress, Most Serious Problem, *Education and Outreach Issues*, 51-66; National Taxpayer Advocate 2007 Annual Report to Congress, Most Serious Problem, *Exempt Organization Outreach and Education*, 197-209; IRS, *Taxpayer Assistance Blueprint: Phase I* (April 16, 2006); and IRS, *Taxpayer Assistance Blueprint: Phase II* (2006).

- Research the causes of taxpayer noncompliance, similar to the research the Swedish government conducted.[63]

The IRS should focus on quality measures to drive employee behavior toward the goal of a seamless taxpayer experience. Quality measures should address, at a minimum:

- Were all related tax issues addressed during the taxpayer contact?
- Was one employee able to resolve all the taxpayer's issues?
- Has the employee incorporated the taxpayer's perspective in resolving the tax issue(s)?

Missed Opportunities

Failure to educate taxpayers about the causes of their problems is a missed opportunity to bring about long-term voluntary compliance. For example, in 2007 IRS assessed nearly $276 million and then abated over $211 million in penalties that related to charities not including a specific form with their original tax returns.[64] Once the organization submits the form, the IRS abates the penalties, but does little to educate the charity on how to comply with the requirements and may find itself assessing and abating the same penalty each year.[65]

The Automated Underreporter (AUR) unit sends notices to taxpayers concerning underreported income. Every year, the IRS issues more than ten percent of these notices to repeat underreporters,[66] but fails to review their accounts to determine if they received similar notices in previous years, and does not send the notices timely, thereby missing the chance to educate the taxpayer on how to avoid errors.[67] The IRS thus creates a greater burden on taxpayers and expends resources in a continuous cycle of rework.

Conclusion

The IRS faces a complex challenge in balancing service and enforcement. Current measures do not promote customer service and may ultimately lead to noncompliant behavior by taxpayers.

63 See Swedish Tax Agency, *Right From the Start and Leslie Book, The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003), *citing*, Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 Taxpayer Compliance 57 (1989).

64 IRS, *Enforcement Revenue Information System (ERIS) for EO returns*, 2007 Daily Delinquency Penalty assessed during 2007 and abated as of March 2008.

65 National Taxpayer Advocate 2005 Annual Report to Congress 299.

66 IRS, *AUR Two Year Study Profile*, 2005, *at* http://win.web.irs.gov/Research/resdocs/4-05-07-2-025N_%20AUR_Two_Year_Profile.doc 19 (last visited on Sept. 15, 2008).

67 *Id.*

The National Taxpayer Advocate believes the IRS should balance enforcement and customer service. In 2005, the Deputy Commissioner for Operations Support identified "one-stop customer service" as a priority for the organization.[68] The four goals were:

- To have a single point of entry accountable for customer requests;
- To collaborate within and between support functions;
- To communicate effectively with customers; and
- To redesign internal processes to expedite service.[69]

Recognizing the importance of one-stop customer service reinforces the mandate of RRA 98 to meet the needs of the taxpayer and provide the taxpayer with one IRS employee to resolve their issues wherever possible.[70]

By failing to establish business strategies or measures addressing customer service within compliance, the IRS fails to balance its approach to tax compliance. The current metrics support efficiency, not effectiveness. These measures do not drive the behavior needed for IRS employees to educate taxpayers or to provide the taxpayer with the tools to prevent non-compliant activity.

Each OD needs consistent strategic initiatives and mission statements to allow the taxpayer to address all issues with a single point of contact. Each division must also establish specific goals with the same emphasis on effective customer service as well as employee performance. While serving different taxpayer populations, all ODs and functions should share the common goal of achieving a seamless taxpayer experience.

The IRS should consider taking the following actions to strengthen customer service within compliance: create an IRS Cognitive Learning Lab;[71] review its programs to identify opportunities for taxpayers to work with one employee from start to finish; involve TAS in program design discussions to incorporate the taxpayer perspective in any proposed programs; and incorporate effectiveness measures in the ODs' quality reviews or other program reviews to address long-term taxpayer compliance and identify areas for improvement in service.

IRS Comments

In this Most Serious Problem, the National Taxpayer Advocate suggests that the IRS does not establish goals or measures for its compliance programs that adequately evaluate their

68 E-mail from Deputy Commissioner, Operations Support to all Operation Support Employees, *One-Stop Customer Service Efforts* (Jan. 11, 2005).

69 *Id.*

70 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No 105-206.

71 *See* National Taxpayer Advocate 2007 Annual Report to Congress 156-161 (Most Serious Problem: Taxpayer Service and Behavioral Research) and *vol. 2*, at 158-167 (Research Report: Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers).

performance or long-term effects on voluntary compliance from the taxpayer's perspective. In support of this hypothesis, numerous anecdotal examples are offered by the National Taxpayer Advocate of where the IRS fails in this regard. The IRS disagrees with these examples and has already addressed most of them in responses to prior National Taxpayer Advocate Annual Reports to Congress or elsewhere in response to this year's report.[72]

However, the IRS completely agrees that it must drive its operations and customer services through a balanced set of measures that address business results, employee satisfaction, and customer satisfaction. With regard to the latter, for the IRS functions that directly interact with taxpayers, including compliance organizations, the customer is the taxpayer. All such organizations currently have metrics specifically geared to measuring taxpayer satisfaction and that are used to continually improve the IRS' performance in the eyes of the taxpayer. These measures are established as part of the IRS Strategic Planning and Budgeting process and included in IRS budget submissions. They are communicated to the IRS Oversight Board and reported on regularly for IRS Business Performance Reviews, the Department of Treasury, the President's Office of Management and Budget, and other external stakeholders.

For example, the LMSB division measures Customer Satisfaction at the division level for Coordinated Cases and it is measured all the way down to the Director of Field Operations level for Industry Cases. The scores are included in the Balanced Measure scorecards that are distributed monthly down to the Territory level. SB/SE division field and campus compliance functions measure customer satisfaction monthly using survey data and improvement goals are set each year. In the W&I division, feedback from campus compliance customer service surveys has been used to revise letters and tax forms to make them clearer and to revamp procedures to improve the taxpayer's experience.

As importantly, as alluded to in the National Taxpayer Advocate's report [73] the IRS is embarking on a new Strategic Plan for FY 2009-2013 that has a taxpayer focus at its core. The intent is to foster individual and organizational ownership of the taxpayer experience to make compliance as easy as possible. This plan will encourage all employees, not just those who are customer facing, to look for ways to provide taxpayers, partners and stakeholders with information that will be helpful and understandable by addressing questions such as "How would I feel if I were in the taxpayers' shoes?" and "Who will be using this material and what will they need?" The IRS is already making progress in socializing the goals

72 See for example IRS response at: National Taxpayer Advocate 2001 Annual Report to Congress 37, with regard to EITC notices; National Taxpayer Advocate 2002 Annual Report to Congress 28, with regard to math error authority; National Taxpayer Advocate 2004 Annual Report to Congress 330, with regard to offers in compromise; National Taxpayer Advocate 2004 Annual Report to Congress 60, with regard to education and outreach; National Taxpayer Advocate 2005 Annual Report to Congress 115, with regard to EITC examinations; National Taxpayer Advocate 2005 Annual Report to Congress 309, with regard to penalties; National Taxpayer Advocate 2007 Annual Report to Congress 204, with regard to Exempt Organizations outreach and education; National Taxpayer Advocate 2007 Annual Report to Congress 159, with regard to behavioral research; and National Taxpayer Advocate 2008 Annual Report to Congress, Most Serious Problem: The Correspondence Examination Process Promotes Premature Notices, Case Closures, and Assessments, with regard to the batch processing system and the alleged premature issuance of notices of deficiency.

73 *See* footnote 60, *supra.*

and themes around which the new plan will be focused and managers and employees are already beginning to have conversations about how they can contribute to an improved customer experience.[74] Once the new strategic plan is finalized, all IRS functions will evaluate and, as needed, revise or create new measures that support the goals that will be expressed in the new IRS Strategic Plan. The National Taxpayer Advocate's views will be considered during this process.

The National Taxpayer Advocate's report also surfaces several issues that warrant specific rebuttal. The National Taxpayer Advocate implies that taxpayer default on installment agreements (IAs) is attributable to IRS employees failing to properly establish the agreements or setting the payments too high. In fact, approximately 97 percent of all IAs are streamlined. This allows taxpayers to reach payment agreements with minimum intrusion by IRS employees, and may also allow the taxpayer to make substantial payments until he or she is in a better position to make full payment, or take advantage of other options for resolving the case. IRS employees give taxpayers the opportunity to provide additional financial information when they indicate they cannot meet the terms of a proposed streamlined IA. The IRS believes its responsibility for each case is to take the right action at the right time. This includes taking actions to correct the balance due through an adjustment or declaring the account currently uncollectible.

Further, the National Taxpayer Advocate postulates that "(t)he business plan measures the number of levies and liens successfully completed, giving the employee no incentive to release the levy and provide relief to the taxpayer." Although IRS tallies the number of liens filed and levies served at a high level, these data are not measures, nor are they associated with targets or goals. These numbers cannot be tracked back to individual employees and no compliance employee is evaluated using the number of liens or levies issued. In fact, IRS Collection employees, whether Revenue Officers or Collection Representatives, are all expected to determine cause and cure for each case and to resolve that case at the earliest opportunity, including release of a lien or levy when appropriate. In further support of this allegation, the National Taxpayer Advocate refers to "numerous instances where the IRS refers the taxpayer to TAS to obtain a lien or levy release instead of securing the information needed to simply resolve the case and the hardship at the first point of contact...." In this regard, the IRS notes that IRS employees must refer cases to TAS when they meet TAS criteria. This is a requirement whenever a taxpayer requests TAS assistance or the IRS employee is unable to take steps to resolve the taxpayer's issue within 24 hours, including hardship cases in the collection stream.[75]

74 IRS Commissioner Douglas Shulman e-mail to all IRS employees July 9, 2008, stating, among other things: "First, in every interaction, every transaction we conduct with a taxpayer, we should think about it from the outside-in – from the taxpayer's point of view, even though we may not ultimately agree with the taxpayer. Taxpayers will be judging their interactions with the IRS and the government based on their most recent experiences with other world-class service organizations. This should be our standard." And, "While there are many critical components to taxpayer service; there are two I'd like to highlight today. First, we should aim to resolve any open issues at the earliest moment possible. This will save both the IRS and the taxpayer extra work down the line. Second, if a taxpayer deals with more than one business group within the IRS, we should coordinate with each other so the hand-off is quick and trouble-free."

75 *See* IRC § 7803(c)(2)(C)(ii) and IRM 13.1.7.

With regard to the assertion and abatement of exempt organizations penalties for failure to include a specific form with their original tax returns, the National Taxpayer Advocate implies the IRS failed to educate taxpayers about the causes of their problems which resulted in a missed opportunity to bring long-term voluntary compliance. To the contrary, part of the process in educating taxpayers is communication. Before the IRS assesses a penalty, it communicates with the charity by sending two letters explaining the required information and that the return is not considered complete until the information is provided. These letters include a dedicated toll-free number should the organization have questions or need to speak with a specialist. There is also information available in publications, the tax return instructions, and on the IRS website to inform and educate tax exempt organizations regarding the penalties for filing incomplete returns. These charitable organizations are given ample opportunity to correct their filings. In most cases, the organizations respond to the first or second letter with the required information. If there is no response to either of the letters the IRS issues a penalty notice, again explaining the missing or incomplete information and giving the filer yet another opportunity to supply the required form. There is nothing in IRS records to support the National Taxpayer Advocate's conjecture that the IRS "may find itself assessing and abating the same penalty each year."

With respect to the National Taxpayer Advocate's specific recommendation to establish an IRS Cognitive Learning Lab, the IRS responded to this same issue for the NTA's 2007 Annual Report to Congress.[76] As noted in that response, the Taxpayer Assistance Blueprint (TAB) project has begun the process of assembling what is known in this area and supplementing that work with original survey research focused on the needs and desires expressed by individual taxpayers about the services they would like to be able to access. More recently, the President's FY 2008 Budget Request included a $5 million initiative specifically aimed at improving and understanding the link between provision of services to taxpayers and their impact on taxpayer compliance. This initiative allowed the IRS to embark on a multi-year research agenda that could eventually pay large dividends through improved voluntary compliance. However, these results may or may not validate the National Taxpayer Advocate's proposal that utilizing a cognitive and behavioral lab would be an effective strategy for advancing research in this area. Because of the extensive research already completed for the TAB, the IRS now knows more than ever before about taxpayer needs, preferences and behaviors. The IRS is evaluating these studies and it should lead to a better understanding of the role of complexity in service, and how complexity contributes to taxpayer errors and misunderstanding that result in taxpayer burden and noncompliance. At this point, the IRS believes a cognitive learning lab would be redundant in light of the research efforts already underway.

With regard to the recommendation to identify opportunities for taxpayers to work with one employee from start to finish, the National Taxpayer Advocate also raises this issue

[76] National Taxpayer Advocate 2007 Annual Report to Congress 159.

elsewhere in this year's report.[77] In response, the IRS stated that it has taken well-considered and industry-proven steps to service large volume and wide-ranging subject matter inquiries from taxpayers through its web, toll-free telephone, and TAC services. Further, the IRS strives, to the extent possible, to allow taxpayers to address all issues with a single point of contact; and more importantly, with one contact. For example, field and office examinations are conducted by one Revenue Agent or one Tax Compliance Officer and the taxpayer has an immediate opportunity to pay the deficiency at the conclusion of the examination without the need for referral to the Collection function. The Automated Collection System is designed to close the balance due account in one contact. Taxpayers contacted by IRS in the AUR program can often fax in needed documents and resolve the AUR issue while on the phone. As another example, W&I correspondence examination telephone operations have implemented universal call routing to facilitate taxpayers' one-stop telephone interactions with the IRS by allowing them to talk to the next available examiner on any case, rather than having to wait and connect only with the examiner assigned to their case.

The National Taxpayer Advocate also recommends that the IRS involve the Taxpayer Advocate Service in program design discussions. The IRS regularly solicits, and always welcomes the National Taxpayer Advocate's perspective on new or ongoing programs, and will continue to do so. In this regard, the IRS acknowledges the National Taxpayer Advocate's many helpful contributions, such as her insightful suggestions for addressing cancellation of debt income issues discussed in more detail elsewhere in this report. However, because the views and recommendations of the Taxpayer Advocate Service are unconstrained by considerations of business, staffing, or budgetary limitations, on occasion the IRS is unable to adopt or fully accept the National Taxpayer Advocate's suggestions for IRS programs.

Finally, regarding the suggested incorporation of effectiveness measures in OD quality reviews, IRS quality reviews already include metrics that are designed to incorporate the taxpayer's point of view. For example, embedded quality reviews, tied to employee CJEs, assist in driving employees' behavior toward the goal of a quality taxpayer experience. Technical employees are held accountable for these quality measures, as are managers through performance expectations to provide feedback to their employees and to use these quality attributes to improve operations. The National Taxpayer Advocate's report gives the example of a phone assistor being measured on time utilization and states that "(b)y focusing only on the efficiency of a phone call, the IRS loses sight of whether the contact was effective." Time utilization is an appropriate measurement in the telephone assistance environment. However, it does not stand alone and is but one of a number of evaluative factors, including effectively addressing the taxpayer's issues and appropriately tailoring calls to meet the needs of the taxpayer.

77 *See* Most Serious Problem: *Navigating the IRS*, *supra*.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS intends to focus on the perspective of the taxpayer in its upcoming Strategic Plan. Creating a culture where employees think about the needs of the taxpayer is an important step towards effective customer service.

However, several aspects of the IRS response raise concerns.[78] First, the National Taxpayer Advocate specifically recommended the creation of a Cognitive Learning Lab in the 2007 Annual Report to Congress.[79] The IRS provided a nearly identical response last year to the suggestion of creating a Cognitive Learning Lab. While we are pleased that the IRS is studying the results of the Taxpayer Assistance Blueprint, we are disturbed that in a year's time the IRS has not been able to provide any further information from its review of the TAB research on the merits of establishing a Cognitive Learning Lab. Further, the National Taxpayer Advocate disagrees with the IRS's assessment that the lab would be redundant to efforts currently underway. A Cognitive Learning Lab would provide the IRS with an environment to effectively test new forms and publications, outreach and education efforts, and to evaluate aspects of IRS actions and initiatives that make voluntary compliance difficult for the taxpayer. Through such a comprehensive understanding of how taxpayers perceive the IRS, use its resources, and interact with the agency and its employees, the IRS could better understand taxpayer behavior and make voluntary compliance easier.

Second, perhaps we were not clear in our treatment of effectiveness versus efficiency measures; however, the IRS seems to confuse customer satisfaction measures with effective customer service measures. *Effective customer service is not synonymous with customer satisfaction, and to treat the two as such does a disservice to the taxpayer.* The IRS needs to establish measures that reach the effectiveness of the service in order to determine if taxpayers are receiving the information and products they need to voluntarily comply with the tax laws. Customer service effectiveness measures should be part of the IRS strategic planning and budgetary process.

Finally, the IRS states "the views and recommendations of the Taxpayer Advocate Service are unconstrained by considerations of business, staffing, or budgetary limitations..." as a rationale for not implementing or fully accepting the National Taxpayer Advocate's suggestions. The IRS can implement many of these suggestions within current staffing and budgetary constraints so long as the IRS is willing to prioritize taxpayer service. Congress has previously shown significant support for customer service efforts within the IRS. Instead

78 Elsewhere in this report we address IRS responses to specific programs, including offers in compromise, installment agreements, liens, levies, and penalty abatements. With respect to the IRS's assertion that it must refer a case to TAS whenever the IRS employee is unable to take steps to resolve the taxpayer's issue within 24 hours, we agree with that statement. However, we fail to see how a collection employee, once he or she determines that the taxpayer is experiencing economic hardship, cannot take steps within 24 hours to resolve that hardship, especially since TAS ultimately will refer the case back to the collection employee for action anyway. Collection's failure to address the economic hardship at the first point of contact simply represents a shirking of its responsibility to the taxpayer and a serious lapse of taxpayer service.

79 National Taxpayer Advocate 2007 Annual Report to Congress 156-61.

of decrying the lack of resources available to taxpayer service initiatives (including those within compliance), the IRS can and must make a business case to the incoming Congress to demonstrate the need for further improvements.

Recommendations

The National Taxpayer Advocate recommends the IRS take the following steps to provide taxpayers with service within compliance:

1. Create a Cognitive Learning Lab to study the behavior and attitudes of taxpayers as they interact with IRS products, services, and compliance or enforcement initiatives.
2. Incorporate effectiveness measures in the operating divisions' quality reviews or other program reviews to address long-term taxpayer compliance and identify areas for improvement in service.
3. Review its programs to identify opportunities for taxpayers to work with one employee from start to finish.
4. Involve TAS early in program design discussions to incorporate the taxpayer perspective in any proposed programs.

MSP #11 Local Compliance Initiatives Have Great Potential but Face Significant Challenges

Responsible Officials

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division

Definition Of Problem

Over 15 years ago, the IRS acknowledged it could be more effective in improving tax compliance if it understood and addressed the local reasons for noncompliance.[1] Local organizations (*e.g.*, small business groups) and local sources of information (*e.g.*, local government lists of license or permit holders) can help the IRS identify, understand, and address noncompliance at the local level. Research suggests that concentrated IRS activity to reverse noncompliance norms among local businesses may have a greater "ripple effect" on voluntary compliance by other taxpayers than seemingly random examinations.[2] In addition, the IRS can learn about what works and what does not work by conducting and documenting small-scale compliance initiative projects (CIPs) at the local level. CIPs are projects that allow IRS employees to address a specific compliance problem using examinations or alternative treatments, such as outreach, education, form changes, legislative or regulatory changes, or agreements with the states.[3] As a result, local CIPs have the potential to improve voluntary compliance, reduce the tax gap, and significantly contribute to the IRS's store of knowledge.[4]

However, the IRS's Wage and Investment Division (W&I) does not use CIPs and the Small Business/Self-Employed Division (SB/SE) CIP Program faces significant challenges.[5] The IRS does not have adequate measures to evaluate the CIP program as a whole. Even if employees identify local areas of noncompliance that the IRS should address using a local CIP, the IRS's organizational structure, CIP approval process, and focus on examination productivity metrics may discourage them from proposing alternative treatments, such as

1 *See, e.g.*, IRS, Document 9102, *Compliance 2000*, Orientation Guide (July 1993) (describing dozens of projects to proactively improve local compliance).

2 *See, e.g.*, Jon S. Davis, et al., *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 Acct. Rev. 39 (2003).

3 *See* IRM 4.17.4.4.1 (Feb. 1, 2004).

4 The "tax gap" is the amount of tax that is imposed by law for a given tax year, but not voluntarily and timely reported and paid.

5 Our discussion focuses on small business taxpayers, which are the responsibility of SB/SE, for several reasons. First, unreported business income (rather than non-business income) is responsible for the largest portion of the tax gap. *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress vol. II (A Comprehensive Strategy for Addressing the Cash Economy). The IRS needs additional tools to address this problem because unincorporated business income is subject to little information reporting and is difficult to detect using traditional enforcement tools. *Id.* Second, local CIPs may be less useful in addressing noncompliance among large businesses with a nationwide footprint, which are the responsibility of the Large and Midsize Business Division (LMSB). Third, the Tax Exempt and Government Entities Division (TE/GE) structures its program somewhat differently and it may not face the same challenges discussed below. Finally, although IRM 4.17.2.4 (Feb. 1, 2004) suggests that W&I has a CIP program, W&I does not currently use CIPs. IRS response to TAS information request (Oct. 8, 2008).

education and outreach, to proactively address them. Moreover, the IRS should do more to capture, analyze, distribute, and work with IRS research to follow up on the lessons it learns from local CIPs.

Analysis of Problem

Background

Historically, the IRS's Geographic Organization Had More Local Focus.

Before the IRS reorganized in the early 2000s, a single local office at the IRS – the District Director's office – had information about local noncompliance and the incentive and authority to act on that information (*e.g.*, the authority to allocate examination, collection, research, and communication resources) by making local IRS functions work together to address local compliance problems.[6] In the early 1990s, the IRS attempted to leverage its geographically based organization using a strategy called *Compliance 2000*, with the goal of increasing voluntary compliance.[7]

The premise of *Compliance 2000* was that because noncompliance is often inadvertent, the IRS could efficiently increase voluntary compliance by focusing on removing barriers to compliance and reserving expensive enforcement tools for situations where less expensive approaches would not be effective. With the assistance of a District Office of Research and Analysis (DORA), the districts were supposed to measure the effect of *Compliance 2000* projects on voluntary compliance rather than narrower examination metrics.[8] The IRS ultimately abandoned *Compliance 2000*, primarily because it was difficult to quantify the effects of its projects on voluntary compliance.[9] However, *Compliance 2000* achieved some instructive successes.

As an example, in the early 1990s, the IRS initiated a *Compliance 2000* project to address noncompliance by commercial fishermen in Alaska resulting from confusion as well as community norms and attitudes.[10] With the assistance of local authorities, the IRS merged

6 *See, e.g.*, General Accounting Office, GAO/GGD-98-39, *IRS's Use of Information Gathering Projects* 8 (Feb. 1998) (noting that the IRS consolidated its 63 district offices into 33 in 1994); IRM 1.1.2 (Feb. 2, 1999) (describing the most recent IRS reorganization); Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2003-10-134, *The Structures of the Internal Revenue Service and the National Treasury Employees Union Are Not Effectively Aligned* (June 2003) (same). *See also*, IRM 4568.1 (Mar. 27, 1999) (describing the pre-reorganization process); IRM 45(12)(5) (June 27, 1989) (same); IRM 4568.4 (Mar. 27, 1999) (same).

7 Unless otherwise indicated, the discussion of *Compliance 2000* is drawn from the following documents: *IRS Strategic Business Plan FY 1992 and Beyond*, IRS Document 7382 (Sept. 1991); IRS, *Compliance 2000: Orientation Guide*, Doc. 9102 (Rev. 7-1993); IRS Research, ELN-2003730103820-617, *Compliance 2000 Focus Group Report* (May 1, 1992); Government Accountability Office (GAO), GAO/GGD-96-109, *TAX RESEARCH, IRS Has Made Progress but Major Challenges Remain* (June 1996).

8 *See, e.g.*, GAO, GAO/GGD-96-109, *TAX RESEARCH, IRS Has Made Progress but Major Challenges Remain* (June 1996) (noting, however, that DORA personnel who were supposed to measure *Compliance 2000* results sometimes lacked proper training, were hampered by delays to IRS computer systems upgrades, and did not systematically design or track their research results). *See also* IRM 1.7.4.4(2) (Nov. 1, 2007) (describing the reorganization of the IRS research function).

9 *See, e.g.*, GAO, GAO/GGD-96-109, *TAX RESEARCH, IRS Has Made Progress but Major Challenges Remain* (June 1996).

10 Memorandum from District Director, Anchorage District, to Chief Compliance Officer, Western Region, *Compliance 2000 – Prototype Completion* (Aug. 23, 1994).

a list of fishing permit and license holders with existing IRS data to identify nonfilers. It used a mass summons to obtain information about the recorded value of their catches – information unavailable to the IRS's automated nonfiler programs – to generate substitute returns for the nonfilers. The IRS worked with state and local officials to identify payments from local fish processors, state-issued fishing rights, and other payments that it could levy. Local IRS officials also proposed changes to federal and state laws to reduce confusion, promote compliance, and facilitate collection.[11]

The IRS simultaneously launched extensive outreach and education efforts in remote fishing villages and on fishing vessels, preparing returns and training local volunteers to assist taxpayers. The IRS also enlisted the help of local community organizations, which hired a full-time Yupik-speaking individual to help local residents with tax problems, provided loans of up to $30,000 to help fishermen pay delinquencies, and helped to publicize the IRS's compliance initiatives. These efforts brought in over 1,000 unfiled returns, approximately $4.6 million in new assessments, and ten guilty pleas. More importantly, the project significantly improved voluntary compliance among the target population, reducing nonfiling from 13.1 percent in tax year 1990 to 9.2 percent in tax year 1992.

The IRS Currently Addresses Local Compliance Problems Using Local Compliance Initiative Projects.

As noted above, the IRS now uses CIPs to address specific compliance problems rather than *Compliance 2000* projects.[12] The primary differences between a CIP and a *Compliance 2000* project are that the IRS does not try to measure the effect of a CIP on voluntary compliance, and CIPs go through a different approval process that reflects the IRS's current organizational structure.[13]

A limited "Part One" CIP – a CIP involving 50 or fewer taxpayers (or 100 or fewer in Collection or Service Center Examination) generally requires concurrence or approval at five levels, including "other affected function(s)," if any.[14] A larger "Part Two" CIP in SB/SE generally requires additional justification and concurrence or approval of the same parties as a Part One CIP plus four more.[15] Unlike *Compliance 2000* projects, the success or failure of a CIP is measured by traditional examination metrics, such as proposed adjustment

11 The state passed a law to allow for involuntary transfers of fishing permits. Memorandum from District Director, Anchorage District, to Chief Compliance Officer, Western Region, *Compliance 2000 – Prototype Completion* (Aug. 23, 1994). At the federal level, small fishing crews were exempt from FICA and FUTA, a source of confusion that the IRS proposed to address. *Id.*

12 *See* IRM 4.17.4.4.1 (Feb. 1, 2004).

13 We do not suggest that it was easier for a local employee to initiate a *Compliance 2000* project in the past than it is to initiate a Part I CIP today. Obtaining the District Director's approval was likely more difficult. Nor do we suggest that CIPs should be subject to less oversight.

14 *See, e.g.*, Compliance Initiative Projects, Central Area Desk Procedures (Nov. 14, 2006); Compliance Initiative Projects, Western Area Desk Procedures (Oct. 16, 2006); Memorandum for All Examination Area Directors From Director, Examination Planning and Delivery, SBSE-04-0608-037, Interim Guidance on Part I Compliance Initiative Project: Taxpayer Contact Increase (June 12, 2008) (increasing the number of taxpayers that may be examined pursuant to a Part I CIP). These procedures supplement IRM 4.17.4.3 (Feb. 1, 2004).

15 *See, e.g.*, Compliance Initiative Projects, Central Area Desk Procedures (Nov. 14, 2006); Compliance Initiative Projects, Western Area Desk Procedures (Oct. 16, 2006). *See also* IRM 4.17.4.4.4.1 (Feb. 1, 2004).

dollars per hour and the rate at which an examination results in no changes (called the "no-change" rate), rather than its impact on voluntary compliance.[16]

Local CIPs Are an Important Tool for Increasing Voluntary Compliance.

Local CIPs Can Help the IRS Focus Its Efforts in Areas Where National Return Selection Formulas Are Ineffective.

Taxpayer compliance varies from one region to another, as does the IRS's ability to detect it using the Discriminant Index Function (DIF), a return selection algorithm that does not incorporate data regarding specific local compliance problems.[17] For example, in fiscal year (FY) 2007, individual returns selected using DIF and examined by Revenue Agents produced a 36 percent no-change rate in SB/SE's North Atlantic Area but only a 25 percent no-change rate in its Gulf States Area.[18] Similarly, corporate returns selected using DIF and examined by Revenue Agents had a 55 percent no-change rate in the Gulf States but a 41 percent no-change rate in the North Atlantic.[19]

Especially in areas where noncompliance is high and the DIF is least effective, it is important for the IRS to develop good local CIPs, which can sometimes use local data that the IRS has not incorporated into DIF or other return selection programs. For example, through one recent CIP the IRS identified unreported income using information provided by the local government, which was not available on a nationwide basis.[20] Thus, CIPs enable the IRS to take advantage of such local information and partnerships.

Concentrated Compliance Activities Resulting from Local CIPs Can Have Greater "Indirect" Effects on Voluntary Compliance Than Seemingly Random Audits.

When the IRS focuses on particular taxpayer segments within a local community, especially small business segments (*e.g.*, construction contractors in a given city), word of the IRS activity spreads. Tax practitioners have observed this creates a ripple effect, driving the entire segment of the community, including many taxpayers who are not under audit, to seek out practitioners to help them comply. Those good compliance habits may remain long after IRS activity ceases, at least if the IRS is not perceived as going away (*i.e.*, continues some activity in the community), creating a "halo" effect. IRS researchers have

16 *See, e.g.*, Compliance Initiative Projects, Western Area Desk Procedures 5 (Oct. 16, 2006). Although § 1204 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685, 713 (1998) and 26 C.F.R. § 801.3T(e), prohibit the IRS from using "records of tax enforcement results" (*e.g.*, dollars per hour) to evaluate individual employee performance, such measures can be used to evaluate initiatives and programs.

17 *See, e.g.*, Jon S. Davis, et al., *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 Acct. Rev. 39 (2003) (citing literature that observed geographic variations in compliance rates); Kim M. Bloomquist and Zhiyong An, *Geographic Variation in Schedule H Filing Rates: Why Should Location Influence the Decision To Report "Nanny" Taxes?*, Proceedings of the Annual Conference on Taxation (2005), *at* http://www.irs.gov/pub/irs-soi/05bloom.pdf (concluding that variations in Schedule H filing rates likely reflect geographic variations in compliance and that geographic differences in compliance with the nanny tax rules can be explained, in part, by local economic, cultural, and behavioral factors).

18 IRS response to TAS information request (Apr. 28, 2008) (providing Table 37 data for FY 2007).

19 *Id.* (providing Table 37 and local CIP examination results by area for FY 2007). These areas had only marginally better results using CIPs. In FY 2007, the local CIP no-change rate for all types of returns was 34.3 percent in the Gulf States Area and 43.2 percent in the North Atlantic Area. *Id.* However, the CIP results may not be comparable since they do not necessarily reflect results from corporate returns.

20 IRS response to TAS information request (Apr. 28, 2008) (Compliance Initiative Project Termination Report for Project 514).

estimated that indirect effects of an examination on voluntary compliance are between six and 12 times the amount of the proposed adjustment.[21]

In contrast, seemingly random examinations (*e.g.*, examinations of returns selected using DIF or other national criteria) of taxpayers in different communities who do not communicate or compete with each other may not have the same indirect effects. In such cases, taxpayers are less likely to hear that more than one of their friends, associates, or competitors are working to get into compliance in response to the IRS's activities. As a result, they may believe the IRS is not very likely to audit them and may be less likely to take additional steps to become compliant.

Tax compliance research supports these intuitive notions. Researchers have suggested that local tax "morale" – non-rational factors and motivations, such as social norms, personal values and various cognitive processes – strongly affects an individual's voluntary compliance and his or her response to IRS enforcement activities.[22] Other researchers have concluded that once the IRS focuses on a geographic area and improves compliance norms and habits within that community, high levels of compliance will persist even after the IRS reduces (but does not abandon) its compliance activity.[23] Thus, the IRS could probably improve both examination results and voluntary compliance by initiating more good local CIPs.

CIPs Could Allow Multifunctional Teams to Maximize the Effect of IRS Activities on Voluntary Compliance.

CIPs could allow IRS employees in a given geographic area to assemble multifunctional teams, including Examination, Collection, Communications, and Taxpayer Advocate Service (TAS) employees, to collaborate with local stakeholders to identify and address the root causes of local compliance problems.[24] As illustrated by the example above, such a multifunctional approach could be more effective in improving voluntary compliance than a single IRS function could achieve on its own. For example, the Communications & Liaison (C&L) function could help educate taxpayers so the IRS does not need to conduct as many examinations. The Collection function could help to ensure that the IRS promptly collects any examination assessments. TAS could voice the taxpayer's perspective in planning the CIP and help taxpayers and the IRS resolve complex problems that result from it. This multifunctional approach could maximize the ripple effect of the CIP on voluntary compliance.

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21 Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz and Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax*, 1977-1986, 43 Nat. Tax J., 395, 396, 405 (1990).

22 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress vol. II 138 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*).

23 Jon S. Davis, et al., *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 Acct. Rev. 39 (2003).

24 Under the old district structure, the District Offices of Research formed Compliance Planning Councils (CPC) to build district support for compliance research, oversee district compliance programs, and provide a multifunctional group to oversee district compliance workload. GAO, GAO/GGD-96-109, *IRS Has Made Progress but Major Challenges Remain* 9 (June 1996). Similarly, the IRS could use CIPs to promote more multifunctional coordination at the local level.

Local CIPs Can Generate Valuable Information.

The IRS generally does not select returns pursuant to a CIP using random methods that would allow it to reliably project the results to a larger population. Each local CIP is nonetheless similar to a small research study. The IRS identifies a compliance problem, identifies a target population, proposes an approach to address the noncompliance, and when the CIP ends, the CIP Coordinator writes a termination report that describes the results.[25] Such information about what works and what does not is a valuable resource. The IRS could use this information to develop effective CIPs to use in other communities or to identify areas where it needs to focus additional research.

The IRS Faces Challenges in Addressing Local Compliance Problems Using CIPs.

The CIP Program Has an Increasingly National Focus.

As noted above, the IRS has eliminated its geographically based district structure and formed operating divisions focused on national taxpayer segments. Today, the IRS only has seven offices (rather than the 33 or 63 it previously had) that coordinate CIPs – called Planning & Special Programs Offices (or PSPs) – one in each of the seven areas.[26] PSPs allocate examination resources to ensure the areas meet national examination goals, and participate in the local CIP submission and approval process.[27] The PSP representatives that we spoke with believe they retain a sufficiently local focus.[28] However, consolidating the PSP offices – making them more centralized and less local – may have reduced the IRS's ability to identify local compliance problems, at least in the absence of additional outreach to local employees.[29]

Indeed, the IRS approved only seven local Part Two CIPs in 2006-2007,[30] and two of those were prompted by the need to generate work for displaced IRS employees rather than a local compliance problem. Thus, the IRS does not appear to be using local CIPs very frequently.

Moreover, a recent operational review of the CIP program suggests a primary goal of the program is to develop local CIPs that the IRS can replicate nationwide, rather than to

25 *See generally* IRM 4.17.4 (Feb. 1, 2004).

26 On October 1, 2000, the IRS consolidated its 33 PSP offices into 16, one in each area, and on October 1, 2004, it consolidated these into only seven areas. IRS response to TAS information request (Apr. 28, 2008).

27 *See generally* IRM 4.1.1 (Oct. 24, 2006); IRM 4.1.2 (Oct. 24, 2006); IRM 4.1.3 (Oct. 24, 2006); IRM 4.1.4 (Oct. 24, 2006).

28 Teleconference with three PSP Territory Managers and SB/SE HQ personnel (July 8, 2008).

29 *See, e.g.*, IRM 1.7.4.4 (Nov. 1, 2007). Interviews with PSP Territory Managers and IRS Research employees who were employed before the reorganization, as well as TAS employees with similar backgrounds, suggest that in most cases the IRS Research function has never played a very active role in most CIPs or *Compliance 2000* projects. Teleconference with three PSP Territory Managers and HQ personnel (July 8, 2008). However, the role of IRS research employees varied from one district to another and their input could be very useful in some cases. *Id.* For a general discussion of centralization, see Most Serious Problem, *The Impact of IRS Centralization on Tax Administration, infra.*

30 We requested five approved Part Two local CIPs for FY 2006 and FY 2007, selected as randomly as possible. TAS information request (July 15, 2008). However, the IRS provided only seven for 2006 and 2007 because "the Areas were working the National Office Part Two CIPs." IRS response to TAS information request (Aug. 4, 2008).

improve voluntary compliance at the local level.[31] While nationwide CIPs are important, they may not generate the same ripple effects as local CIPs.[32]

There Are No Good National Measures for the CIP Program.

On average, local CIPs generate seemingly unimpressive results based on traditional examination metrics. The IRS is supposed to terminate a CIP if returns selected for audit as a result of the CIP do not produce better examination results than those selected by computer using the DIF.[33] While some local CIPs are better than others, over the last ten years, on average, they have had higher no-change rates than returns selected using DIF.[34] CIPs are similarly unimpressive when evaluated based on the dollars per hour the IRS generates auditing CIP-selected returns. For example, in FY 2007, the Western Area had a higher percentage of CIPs that exceeded the area DIF results based on the dollars per hour metric than any other area.[35] Even so, only 14 out of 25 of its CIPs (or 56 percent) exceeded the dollars per hour generated by DIF-selected returns in that area.[36] Moreover, DIF-selected return results are likely to improve in comparison to CIP results as the IRS updates the DIF formulas to incorporate data from the IRS's National Research Program.[37] There are a number of possible explanations for the seemingly poor CIP results.

Comparisons of CIP and DIF results aggregated above the local level may be misleading. The IRS generally evaluates CIP results at the area level,[38] and area CIP results vary widely.[39] However, national and area comparison of CIP and DIF examination results may be misleading if the IRS uses CIPs to select returns in localities where DIF does not work very well. If so, CIP results could exceed the DIF results at the *local* level, even if not at the area or national levels.

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31 IRS response to TAS information request (June 1, 2008) (stating in the November-December 2007 operational review of the CIP program: "when you identify a Part I CIP with attractive results, is it viable as a Part II CIP for national consideration? You should always be asking this question which demonstrates the need to be proactive in culling through the Part I's looking for the next National CIP." The review does not mention the benefit of looking for CIPs that may significantly improve voluntary compliance at the local level.).

32 Relatively few Part I CIPs become Part II CIPs. From FY 2005 through May of FY 2008, about eight percent of all Part I CIPs became Part II CIPs. IRS response to TAS information request (Apr. 28, 2008). This may suggest either that the field employees could benefit from additional guidance or training about how to identify a good CIP or that the IRS should reexamine how it evaluates Part II CIP applications.

33 IRM 4.17.4.7 (Feb. 1, 2004).

34 AIMS Database (September 2008) (excluding correspondence and training examination results).

35 IRS response to TAS information request (Apr. 28, 2008) (response to item 1h, excluding training returns).

36 *Id.* In comparison, only seven out of 29 (or 24 percent) of the CIPs in the Gulf States Area exceed the area DIF on the dollars per hour measure. *Id.*

37 SB/SE Research – Philadelphia, Project # PHL0026, *4-Model Workload Selection System Comparison to the New DIF Formulas* (May 2007) (indicating that the IRS implemented revised DIF formulas in January 2007).

38 IRS response to TAS information request (Apr. 28, 2008) (providing DIF and local CIP examination results by area for FY 2007).

39 For example, in FY 2007 the Western Area apparently developed better CIPs than other areas based on no-change metrics. In FY 2007, the local CIP no-change rate for the Western Area was 10.2 percent as compared to 43.2 percent for the North Atlantic Area. IRS response to TAS information request (Apr. 28, 2008) (providing DIF and local CIP examination results by area for FY 2007). In comparison, DIF-selected returns in the Western Area examined by Revenue Agents in FY 2007 resulted in a 29 percent no-change rate for individuals and a 51 percent no-change rate for corporations. *Id.* (file 206999T372009 on pages 3 and 4 of 35). Individual DIF-selected returns examined by Tax Auditors or Tax Compliance Officers resulted in a 17 percent no-change rate in the Western Area during FY 2007. *Id.* (file 206999T372009 on page 2 of 26). However, DIF-selected returns in the North Atlantic Area examined by Revenue Agents in FY 2007 resulted in a 36 percent no-change rate for individuals and a 41 percent no-change rate for corporations. *Id.* (file 201999T372009 on page 3 and 4 of 35). Individual DIF-selected returns examined by Tax Auditors or Tax Compliance Officers resulted in a 14 percent no-change rate in the North Atlantic Area for FY 2007. *Id.* (file 206999T372009 on page 2 of 26).

Comparisons of CIP and DIF examination results may also be misleading if the examinations do not involve the same types of IRS examiners and the same types of returns. Tax Compliance Officers (*i.e.*, employees who generally conduct office audits of individuals and businesses) generally produce better examination results than Revenue Agents (*i.e.*, employees who generally conduct field audits of businesses) simply because they audit different types of tax returns using different methods.[40] Tax Compliance Officers and Revenue Agents may audit CIP and DIF selected returns in different proportions. As a result, if Revenue Agents examine more CIP-selected returns, DIF may appear to generate better results than CIPs, even if the CIP would generate better results for a specific type of taxpayer or audit using these metrics.

More importantly, examination measures are imperfect because they do not capture the effect of CIPs on voluntary compliance. These difficulties leave the IRS with few good ways to measure the overall success or failure of the CIP program at the national level.[41] Thus, it should consider ways to measure, recognize, and encourage success at the local level.

In addition, the IRS should not lose sight of the fact that because CIPs are experimental (*i.e.*, the first stage of a test) even good ones will not always initially produce better results than DIF – the IRS's state-of-the-art return selection algorithm. Ideally, there should be multiple stages. First, the IRS should use CIPs to test theories about local compliance problems and solutions without the expectation that they will always exceed DIF return examination results. Second, the IRS should update its CIP return selection criteria and outreach methods to incorporate learning from its initial activities. Finally, if the IRS wants a more accurate measure of CIP results, it may need to conduct a study to evaluate the immediate and long-term effects of the CIP (or its methods) on voluntary compliance.

The Incentive for Local IRS Employees to Identify Local Compliance Problems May Need to Be Strengthened.

Local examination managers, area Coordinators, and area PSP managers are the types of local IRS employees who most often propose CIPs to national decision makers.[42] Some of these decision makers are not responsible for compliance in any particular locale and some are not in the same chain of command as the employee making the submission.[43] In some areas, the PSP or CIP Coordinator may encourage local employees to submit CIPs and send

40 For example, in FY 2007, DIF-selected return examination results varied by type of examiner as follows: Revenue Agents auditing individual returns produced $333 per hour and had a 30 percent no-change rate, but Tax Compliance Officers auditing individual returns produce $477 per hour and had a 12 percent no-change rate. IRS response to TAS information request (Apr. 28, 2008) (providing Table 37 examination results by area for FY 2007). This data does not suggest that Tax Compliance Officers are better than Revenue Agents, only that they audit different types of returns using different methods.

41 Although the IRS can generate reports showing CIP examination results at various levels, it does not include CIP results on the same internal reports used to report other types of examination results. IRS response to TAS information request (Apr. 28, 2008) (showing that "Table 37" – the internal IRS report that shows examination results from returns selected by various methods, including DIF – does not break out results for CIP selected returns as it had in prior years). As noted above, however, aggregated comparisons above the local level may be misleading.

42 IRM 4.28.1.3(5)(c) (Apr. 1, 2004); IRS response to TAS information request (Apr. 28, 2008).

43 For example, cross-divisional CIPs require the approval of the applicable Division Commissioner or his/her delegate. IRM 4.17.4.9.4 (Feb. 1, 2004).

a memo of thanks to those that do.[44] However, PSPs do not manage most of these field employees. Such encouragement is probably less motivating than helping a District Director, a person in the field employee's direct chain of command, achieve one of his or her primary objectives – to improve compliance in the employee's community – as was the case prior to the reorganization.[45]

No Resources Are Specifically Allocated to Allow Local IRS Employees to Identify and Work Local CIPs.

Pursuant to the national examination plan, each IRS area is required to examine a specific number of returns of various types of taxpayers each year.[46] The plan does not allocate resources to pursue new CIP work identified during the year.[47] Because the plan does not give CIP selected returns priority, and most IRS areas feel they are already fully utilizing all available resources,[48] area managers are less likely to encourage employees to seek out more work by proposing a CIP, especially if that work does not fit into the national examination plan. In a sample of 14 CIP termination reports that we reviewed, three indicated the CIP was abandoned in part because it did not fit the national plan.[49] These factors likely reduce the incentive for field employees to identify good CIPs.

Although the IRS Has Streamlined the CIP Approval Process, It Is Still Lengthy.

A 2002 report by the Treasury Inspector General for Tax Administration (TIGTA) indicated the length of time and number of approvals required to initiate CIPs discouraged IRS employees from recommending them.[50] The IRS has since automated the process so employees can submit CIPs for approval electronically. The raw number of local CIPs generating examination results has increased in recent years, from 22 in FY 2005 to 81 in FY 2007, perhaps because of steps taken to address the 2002 report.[51] As noted above, however, the IRS still approved only seven local Part Two CIPs during 2006-2007. According to the IRS, it has reduced the median time to approve a Part Two CIP from 105 days in FY 2006 to 93 days in FY 2007, but a delay of 93 days (or three months) may still be enough to discourage some employees from submitting a CIP.[52] These figures suggest the IRS should consider additional ways to streamline the approval process, while maintaining appropriate

44 Compliance Initiative Projects, Central Area Desk Procedures 3 (Nov. 14, 2006); Compliance Initiative Projects, Western Area Desk Procedures 3 (Oct. 16, 2006); Teleconference with three PSP Territory Managers and SB/SE HQ personnel (July 8, 2008).

45 We do not suggest here that the IRS should revert to its old District structure.

46 *See generally* IRM 4.1.1.1 (Oct. 24, 2006).

47 IRS response to TAS information request (Apr. 28, 2008) (FY 2008 exam plan).

48 The areas generally responded to the proposed FY 2008 IRS examination plan by explaining why existing resources were insufficient to meet proposed targets. IRS response to TAS information request (Apr. 28, 2008) (area responses to FY 2008 exam plan).

49 IRS response to TAS information request (Apr. 28, 2008) (a FY 2005 CIP termination report stated: "no returns were examined due to the Area's focus on only examining returns from the Strategic Priorities Program;" a FY 2006 termination report stated: "No returns were examined under this CIP. Work plan accomplishments for flow-through work were met through other means of workload selection;" a FY 2007 termination report stated: "The ATAT Coordinator has indicated that PSP has sufficient SEP inventory…").

50 *See* TIGTA, Ref. No. 2002-30-171, *Controls Over Compliance Initiative Projects Have Improved, but Use of the Process Is Limited* (Sept. 2002).

51 IRS response to TAS information request (Apr. 28, 2008) (providing local CIP examination results by area for FY 2005 – FY 2007).

52 IRS response to TAS information request (June 13, 2008). The average approval time for FY 2007 was 79 days, down from 114 in FY 2006. *Id.*

oversight. For example, it could establish a written approval process that provides for reasonably short deadlines at each level. Alternatively, if the IRS established additional guidelines and training about how to develop good CIPs and made additional research resources available for drafting them, approvers might receive better-developed CIPs that take less time to approve.

Another Challenge Is to Ensure That CIPs Utilize Alternative Treatments – Such as Education and Outreach – In All Appropriate Instances.

The Internal Revenue Manual (IRM) states that because audits are the most expensive way to improve compliance, the IRS should consider "alternative treatments" such as outreach and education, revisions to forms or publications, legislative or regulatory changes, and agreements with state or local business licensing authorities.[53] While the Part One CIP approval form does not mention alternative treatments, the Part Two CIP approval form requires submitters to discuss them.[54] In addition, all Part Two CIPs require approval of the Area Manager, Stakeholder Liaison Field, who is supposed to provide guidance and suggestions on alternative treatments.[55] The PSP is also supposed to ensure the CIP authorization request includes the "proper" alternative treatments.[56] Yet the IRS does not track the number of CIPs that propose such treatments.[57] As a result, it may be difficult for the IRS to evaluate the extent to which employees are using them.

The 2002 TIGTA report found that CIP submissions often missed opportunities to include alternative treatments.[58] We reviewed seven local Part Two CIP submissions that the IRS approved in FY 2006 - 2007. Of these seven, four suggested alternative treatments, but none proposed any concrete plans to implement them.[59] Some CIP submissions may omit alternative treatments because CIPs proposing them require concurrence by the division commissioner of the "other affected functions," which could further delay or even prevent implementation of the CIP.[60] Those other affected functions are also juggling competing priorities, so in some cases they may not concur with a CIP proposal for alternative treatments solely because it would require significant resources.

More importantly, the benefits of proactive alternative treatments that could be included in a CIP do not show up in IRS examination metrics. As a result, field examination employees

53 IRM 4.17.4.4.1 (Feb. 1, 2004).

54 Form 13502, *Compliance Initiative Project Authorization, Part One* (2003); Form 13498, *Compliance Initiative Project Authorization* (2003).

55 *See, e.g.*, Compliance Initiative Projects, Central Area Desk Procedures (Nov. 14, 2006); Compliance Initiative Projects, Western Area Desk Procedures (Oct. 16, 2006); Memorandum for All Examination Area Directors, from Director, Examination Planning and Delivery, Interim Guidance on Part I Compliance Initiative Project: Taxpayer Contact Increase (June 12, 2008); IRM 4.17.4.3 (Feb. 1, 2004); IRM 4.17.2.7 (Feb. 1, 2004).

56 IRM 4.17.2.5 (Feb. 1, 2004).

57 IRS response to TAS information request (Apr. 28, 2008); IRS response to TAS information request (June 26, 2008).

58 *See* TIGTA, Ref. No. 2002-30-171, *Controls Over Compliance Initiative Projects Have Improved, but Use of the Process Is Limited* (Sept. 2002).

59 IRS response to TAS information request (Aug. 4, 2008).

60 IRM 4.17.4.9.4 (Feb. 1, 2004). Although all Part Two CIPs require approval of the Area Manager, Stakeholder Liaison Field, this approval is not required for a Part One CIP, unless Stakeholder Liaison is an "affected function." The IRS may be less likely to include alternative treatments such as education in a Part Two CIP approval request if the treatment was not included in the Part One CIP.

may have less of an incentive to propose using alternative treatments to prevent noncompliance as part of a CIP, even if such solutions would ultimately be more efficient for the IRS and less burdensome for taxpayers. Thus, it may be appropriate for the IRS to take additional measures to ensure that CIPs use alternative treatments in all appropriate cases. It may be helpful for the IRS to revise the Part One CIP approval form so that submitters need to consider alternative treatments. Tracking these treatments and their results would also help the IRS obtain a more complete picture of the effectiveness of a given CIP.

The IRS Needs to Do More Follow-Up on CIPs to Identify, Document, and Disseminate Lessons Learned from Them.

As a successful CIP addresses a local compliance problem, it may become less productive over time (based on traditional examination metrics), until the IRS eventually discontinues it.[61] IRS procedures call for the CIP Coordinator to write a CIP termination report addressing the CIP examination results, whether the results justified the time and resources, what difficulties the IRS encountered and how they were resolved, and successful procedures and audit techniques.[62] These CIP termination reports should contain a good deal of useful information.

However, the quality of the CIP termination reports varies widely. After reviewing a sample of 14 reports from FY 2005 through FY 2007, we found most of them to be perfunctory, often leaving questions blank or providing one-sentence answers.[63] Moreover, SB/SE was unable to locate any CIP termination reports for years before FY 2005.[64] Nor does SB/SE regularly analyze them, summarize them, use them as the basis for further research, or make them widely available on the IRS intranet.[65] It should consider doing so.

IRS Researchers Could Help in Formulating and Evaluating Local CIPs.

Like a good CIP termination report, a good CIP submission includes extensive documentation and analysis. For example, according to IRS guidance it should describe the issue, how it was identified, the impact on compliance, the objectives and expected results, and information from a search for similar projects or data, if applicable.[66] The CIP approval form also asks the submitter to identify measures to evaluate noncompliance for purposes of monitoring and follow-up, as well as the costs and benefits of the project.[67] As noted

61 Employees must provide a special justification to continue a CIP beyond a two-year period. IRM 4.17.4.1 (Feb. 1, 2004). We note that the IRS may need to continue some level of activity among the target population even after it reduces CIP activity so it can extend the halo effect of the CIP on voluntary compliance and prevent noncompliance from increasing again.

62 IRS Form 13497, *Compliance Initiative Project Termination Report* (Aug. 2003).

63 IRS response to TAS information request (Apr. 28, 2008) (providing five termination reports for FY 2007, five termination reports for FY 2006, and four for FY 2005).

64 IRS response to TAS information request (Apr. 28, 2008). The IRS explained: "Information is consistently available only from 2005 forward due to the many reorganizations that took place in the PSP/Area offices." IRS response to TAS information request (June 6, 2008).

65 Teleconference with three PSP Territory Managers and SB/SE HQ personnel (July 8, 2008).

66 *See, e.g.*, IRM 4.17.4.3 (Feb. 1, 2004).

67 Form 13498, *Compliance Initiative Project Authorization* (2003).

above, we reviewed all seven of the Part Two CIPs approved in 2006 - 2007.[68] Only one included specific quantitative data from the Part One CIP or any other source to justify its approval. Although four identified possible alternative treatments, none of the submissions proposed to measure the results from any alternative treatments or evidenced any intent to implement them.[69] Thus, CIP submissions might improve if IRS researchers played a more active role in helping to formulate and evaluate CIPs in appropriate circumstances.

Conclusion

The CIP program has the potential to be a more valuable tool for improving voluntary compliance. The IRS should consider taking the following actions to improve the program:

- Update the IRM and CIP forms to provide additional guidance regarding when to propose CIPs, how to implement alternative treatments, approval timeframes, reasons for involving the IRS research or other functions, and how to measure and report CIP results.
- Provide local areas the flexibility to work good CIPs that do not necessarily fit into the categories currently reflected in the examination work plan. Consider modifying the examination plan to require each area to devote some resources to identifying and addressing local problems, working with local partners, and local sources of data; or at least allow the areas to divert resources from plan work to complete CIPs that are producing good results at the local level with appropriate national approval.
- Generate reports that show a better apples-to-apples comparison of CIP and DIF selected return results (and alternative treatment results) at the local level using both traditional measures, and to the extent practical, measures of the impact of these activities on voluntary compliance.
- Work with the IRS research function to develop better measures of the impact of CIPs and traditional examinations on voluntary compliance.
- Provide additional training or recognition to employees aimed at improving the quality of CIP submissions and CIP termination reports.
- Compile, analyze, follow-up on, and disseminate the results of local CIPs (including the impact of CIPs on voluntary compliance measures) on a regular basis to preserve for future decision makers, stakeholders, and researchers, the benefits of any lessons learned.[70]

68 IRS response to TAS information request (Aug. 4, 2008).

69 We understand the IRS Research function was never very involved in the CIP process (or the predecessor of the CIP process). *See, e.g.*, GAO, GAO/GGD-96-109, *TAX RESEARCH, IRS Has Made Progress but Major Challenges Remain* (June 1996) (noting that DORA personnel sometimes lacked proper training, were hampered by delays to IRS computer systems upgrades, and did not systematically design or track their research results).

70 TE/GE posts some of its compliance initiative program reports on the IRS website. *See, e.g.*, TE/GE, Resource Materials – Compliance Initiatives for Tax-Exempt Organizations, *at* http://www.irs.gov/charities/article/0,,id=162493,00.html (last visited Dec. 8, 2008); TE/GE, Political Activities Compliance Initiative (2008 Election), at http://www.irs.gov/charities/charitable/article/0,,id=181565,00.html (last visited Dec. 8, 2008).

IRS Comments

The IRS agrees that CIPs possess an increasingly national focus. However, most CIPs begin at the local level. When we identify issues that are common across the country, we leverage that knowledge to expand the local CIP to a national CIP. This process serves to improve voluntary compliance, reduce the tax gap, and significantly contribute to the IRS's store of knowledge.

Each Area monitors the success of a CIP by comparing Area CIP results against Area DIF results at the Tax Compliance Officer (TCO) and Revenue Agent (RA) level. Part I CIPs are designed to allow a small number of returns to be examined to test compliance using the key measures we utilize for our overall inventory. This provides the best measure to make appropriate resource decisions.

Our CIP approval process includes multiple levels of concurrence to ensure there is transparency and accountability in the CIP process. We need to ensure we are using our resources effectively, treating taxpayers fairly, and appropriately addressing areas of non-compliance. We agree that alternative treatments should be utilized when warranted and will continue to work with our Communication and Liaison employees to further explore outreach and education opportunities.

Our examiners take pride in the identification of a unique issue and are encouraged to consider the applicability of identified issues to multiple taxpayers. The IRS has several current CIPs that were referred by local field employees. The Area CIP coordinators have responsibility for indentifying new areas of noncompliance and encourage field employees to contact them with referrals. Coordinators make presentations at group meetings where they receive recommendations from field employees for possible CIPs. In the FY 2009 Examination Program letter, Areas are specifically encouraged to use CIPs to help identify egregious areas to close the tax gap.

CIPs are discussed during monthly teleconferences between headquarters and the Areas and best practices are shared to improve submissions. Lessons learned upon the CIP's conclusion are captured on Form 13497, *Compliance Initiative Termination Report*. This form is currently being revised to provide more detailed information. We will continue to take steps to ensure we have proper follow-up on CIP results.

In her report, the National Taxpayer Advocate makes six specific suggestions to improve voluntary compliance. We are taking, or have taken, the following actions with respect to these issues:

The IRS is in the process of finalizing the revision to the IRM section on CIPs (IRM 4.17). The revised CIP IRM addresses how to implement alternative treatments, authorization approval timeframe guidelines, and methods to measure and report CIP results.

The returns examined under CIPs are considered discretionary work. The national examination plan and each area plan contain allocations for discretionary work. In the FY 2009 Examination Program letter, Areas were specifically encouraged to use CIPs to help identify egregious areas of noncompliance in order to close the tax gap.

Reports comparing local CIP results against local DIF results are generated and analyzed. The CIP results are further broken down to the RA and TCO level and then compared against the DIF results for each at the local level. This provides a valid comparison of CIP and DIF selected return results. Although a further analysis of the deterrent affects on noncompliance of alternative treatments may be helpful, we have not found a meaningful way to measure this effect.

We currently have research focusing on tax gap issues and measures, such as evaluating the effectiveness of the Form 1040 DIF scores, to enable selection of the most productive inventory for audit. Research, Analysis and Statistics and the National Research Program (NRP) are responsible for updating the voluntary compliance measure and updating the tax gap data. The Form 1040 NRP is now conducted annually, with yearly data updates to the voluntary compliance information. Concentrating our research efforts in this manner is the best way to efficiently focus our resources.

CIP training for the Area coordinators is in the planning stages, pending budgetary restrictions. The topics of the CIP training will include properly preparing CIPs, preparing timely and thorough CIP Termination Reports, and exploring alternative treatments. This training will be a train-the-trainer session so the Area CIP Coordinators can train field employees. The CIP coordinators encourage the field employees to call them with ideas for CIPs or to submit completed CIP authorization requests for review and approval.

We agree to perform a more thorough analysis of CIP results than currently conducted. Information on CIPs can be found on the CIP web page, which is available internally to all business units. From the web page, there is access to the CIP database, which describes current and terminated CIPs. The CIP coordinators for each CIP are listed and can provide detailed information on individual CIPs as necessary.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased the IRS plans to:

- Update its CIP IRM (IRM 4.17) to address how to implement alternative treatments, establish approval timeframe guidelines, and ways of measuring and reporting CIP results;
- Revise Form 13497, *Compliance Initiative Termination Report*, to provide more detailed information;
- Annually update Form 1040 compliance research and evaluate the effectiveness of the Form 1040 DIF scores;
- Train the Area Coordinators in preparing CIPs, writing CIP termination reports, and exploring alternative treatments; and
- Perform a more thorough analysis of CIP results.

The National Taxpayer Advocate also commends the IRS for including language in its FY 2009 Examination Program Letter encouraging the local areas to use CIPs. In general, the IRS comments suggest that TAS and the IRS largely agree on the areas in need of improvement, if not all of the specific steps. However, some areas of disagreement remain.

National Focus

The comments suggest the IRS plans to continue to focus on identifying national CIPs, rather than local ones. These comments do not address the fact that local business groups, local IRS staff from other functions, and local sources of information can sometimes help the IRS identify, understand, and address noncompliance at the local level more effectively than national groups and national sources of data. As noted above, research suggests concentrated IRS activity to reverse noncompliance norms among local businesses may have a greater "ripple effect" on voluntary compliance by other taxpayers than seemingly random examinations.[71] We acknowledge it is useful for the IRS to identify local CIPs that it can replicate at the national level, but the IRS should not ignore the benefits of local CIPs that it cannot necessarily replicate nationwide. The two types of CIPs are not mutually exclusive. The National Taxpayer Advocate believes both are essential components of effective tax administration.

Measures

The IRS's comments confirm that it measures local CIP results using traditional measures (*e.g.*, no change rates and dollars per hour) at the area level, but IRS areas may encompass a multi-state footprint, which may be too large for valid comparisons against returns selected using other selection criteria. Moreover, the IRS has no good national measures for the

71 *See, e.g.*, Jon S. Davis, et al., *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 Acct. Rev. 39 (2003).

program. We recognize the difficulty the IRS faces in designing measures for the CIP program and gauging the success of alternative treatments at both the local and national levels, but the IRS's comments suggest it has given up on designing better measures.[72] Because employees focus on measures, the IRS's efforts will not be as efficient or effective if it does not at least try to measure the impact of its activities (including CIPs) on the goal it wishes to achieve – increasing voluntary compliance. Moreover, the IRS will continue to struggle to identify and use effective alternative treatments if it does not try to measure whether and how employees use them.

Examination Plan

The IRS's comments suggest it included language in its FY 2009 Examination Program Letter encouraging the local areas to use CIPs.[73] However, the letter does not give the areas any specific resources to work CIPs.[74] According to the comments, CIPs are "discretionary" work and the examination plans provide resources for discretionary work. The plans have a discretionary component in the sense that they do not require the IRS areas to select all of the returns they audit using specific return selection criteria (*e.g.*, DIF selected returns), but contain no specific resource allocation for "discretionary" work. Rather, the examination plans require the areas to examine a certain number of returns from various types of taxpayers each year, so the areas only have enough resources to examine CIP generated returns as part of their discretionary workload if the CIP generates the right types of returns.[75] As noted above, in the sample of 14 CIP termination reports we reviewed, three indicated the IRS abandoned the CIP in part because it was not generating returns that fit into the categories required by the examination plan. Thus, without specifically allocating resources for CIPs or imposing a requirement that the areas use CIPs, the language in the 2009 Examination Program Letter is likely to have an important but limited impact.

Analysis of CIP Results and Access to Termination Reports

The IRS plans to revise the termination report form and provide additional training to CIP Coordinators about how to prepare these reports. In addition, the IRS pledges to "perform a more thorough analysis of CIP results." These are steps in the right direction. The IRS comments suggest, however, that it is not inclined to initiate additional research to analyze CIP results. Nor does the IRS propose to make its CIP Termination Reports more widely available. It may be difficult for the IRS to make the most of the lessons it has learned from CIPs without taking these simple steps.

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72 It is obviously possible to measure local changes in voluntary compliance by analyzing samples of the target population over time. As illustrated in the Alaskan *Compliance 2000* project (above), in past years the IRS did, in fact, develop and use various measures (*e.g.*, increases in the number of filers, decreases in the penalty rate, etc.) to evaluate the impact of local projects on voluntary compliance.

73 According to the FY 2009 Examination Program Letter:
> Areas are encouraged to identify egregious activities through Compliance Initiative Program (CIP) returns. Inclusion of these types of cases supports our strategy for addressing egregious non-compliance and our efforts to provide for balanced coverage. Returns with offshore tax issues, identified through CIPs, will be worked during FY 2009. SB/SE, Examination Program Letter for FY 2009 (Oct. 27, 2008).

74 *See generally* IRM 4.1.1.1 (Oct. 24, 2006).

75 IRS response to TAS information request (Apr. 28, 2008) (FY 2008 exam plan).

Recommendations

The National Taxpayer Advocate recommends the IRS:

1. Require each area to devote some resources to identifying and addressing local problems using local CIPs (*e.g.*, by working with local partners and local sources of data), or alternatively establish procedures to allow the areas to divert resources from plan work to complete local CIPs with appropriate national approvals;
2. Track the identification and implementation of alternative treatments in connection with all CIPs;
3. Work with the IRS (or SB/SE) research function to develop better measures of the impact of CIPs (including alternative treatments) and traditional examinations on voluntary compliance;
4. Make CIP termination reports more widely available to IRS employees and researchers (*e.g.*, by adding links to them on the CIP intranet website) to preserve the benefits of any lessoned learned; and
5. Meet with the IRS (or SB/SE) research function regularly to identify CIP results that merit additional research and analysis.

MSP #12

Customer Service Issues in the IRS's Automated Collection System

Responsible Officials

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

Definition of Problem

The Automated Collection System (ACS) is an important component of the IRS Collection operation. In fiscal year (FY) 2008, ACS units closed nearly 2.1 million cases, collected $2.4 billion in delinquent taxes, and issued nearly 2.3 million levies on taxpayer's assets.[1] While the ACS succeeds in collecting significant amounts of delinquent tax dollars, TAS frequently hears complaints from taxpayers, tax professionals, and Local Taxpayer Advocates (LTAs) about lapses in ACS customer service. Despite these complaints, the ACS's own assessment of its service reflects high customer satisfaction survey results and quality review scores. However, these measures do not adequately address taxpayer satisfaction in important areas, including:

- The failure of ACS customer satisfaction surveys and internal quality reviews to identify and measure several areas that are critical to taxpayers;
- The failure to promptly release ACS levies for economic hardship, installment agreements (IAs), and other situations in which the law requires prompt levy release;[2]
- The failure of ACS managers to timely respond to taxpayer requests to speak with them;
- Lengthy delays before a taxpayer's call is properly routed to a Customer Service Representative (CSR) who can handle that call;[3]
- The inability to work with the same ACS employee, even when the taxpayer must call ACS more than once in complex cases;
- Restrictive use of fax machines as a way for taxpayers to provide supporting documentation; and

1 In FY 2008, the IRS routed taxpayer delinquent accounts (TDAs) for over 3.1 million taxpayers to the ACS for resolution. As of September 30, 2008, over 2.5 million taxpayer accounts involving unpaid taxes were in the ACS open inventory of TDAs, which included over $18.2 billion in delinquent taxes. IRS, *Collection Activity Report, NO-5000-2, Taxpayer Delinquent Account Cumulative Report* (Sept. 2008). IRS, *Collection Workload Indicators (C23) Report* (Oct. 7, 2008).

2 Internal Revenue Code (IRC) § 6342(a)(1); *see also* Treas. Reg. § 301.6343-1(b)(4).

3 IRS, Customer Satisfaction Survey, ACS, SB/SE National Report, April through June 2008 (Aug. 2008). IRS, Customer Satisfaction Survey, ACS, W&I National Report, October through December 2007 (Feb. 2008). Nationwide Tax Forums, ACS Focus Groups (July 2008, Aug. 2008, Sept. 2008).

- Inconsistent and unclear documentation requirements that burden ACS's customers.

The IRS has been aware for many years of the need to improve the customer service the ACS provides. In June 1998, the IRS completed an analysis of the system in an ACS Redesign Project.[4] Many of the issues raised in the 1998 report continue to contribute to customer service problems today.

Analysis of Problem

Background

Brief Overview of the ACS

The ACS is primarily a call center collection operation that interacts with taxpayers responding to IRS notices of tax delinquency and notices of levy and liens for the purpose of addressing and resolving delinquent tax accounts. Depending on the nature of delinquency and the circumstances of the taxpayer, ACS telephone assistors can take financial information from the taxpayers, arrange payment alternatives, secure delinquent tax returns, and place accounts in abeyance.[5] The Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) divisions are responsible for operating the 17 ACS units in 15 locations throughout the country.[6] In FY 2007, the ACS units answered 5.4 million incoming calls and placed 1.9 million outgoing calls, for a total volume of 7.3 million calls.[7] The ACS's mission is:

> To collect delinquent taxes and tax returns through the fair and equitable application of the tax laws, including use of enforcement tools where appropriate, and provide education to customers to ensure future compliance.[8]

4 IRS, *Automated Collection System (ACS) Redesign Project* (June 1998).

5 ACS handles balance due and nonfiler cases that may require telephone contact. ACS employees review taxpayer data, and issue notices, liens, or levies to resolve delinquent tax cases. The IRS implemented ACS in 1983-1984 to replace its Collection Office function, which was a more paper-oriented operation. ACS is the middle stage of what is essentially a three-tier IRS collection pyramid: collection begins with notices, then moves to the ACS, and ultimately escalates to the IRS's field functions. The IRS uses Automated Collection System Support (ACSS) units to support ACS. ACSS handles much of the ACS paperwork, such as mailing notices, responding to taxpayer correspondence, processing Collection Due Process (CDP) hearing requests, mailing transcripts, and resolving diagnostic and error listings. *See* Internal Revenue Manual (IRM) 5.19.5.2.1 (Dec. 1, 2007) and IRM 5.19.6.1 (July 8, 2008).

6 W&I's seven units are in Atlanta, Austin, Buffalo, Fresno, Jacksonville, Guaynabo (Puerto Rico), and Seattle. SB/SE's six units are in Brookhaven, Denver, Detroit, Nashville, Oakland, and Philadelphia. W&I ACSS units are located at the Fresno and Kansas City campuses; SB/SE ACSS units are located at the Cincinnati and Philadelphia campuses. *See* IRM 5.19.6.1(2) (July 8, 2008).

7 *See* Government Accountability Office, GAO-08-728, *Tax Debt Collection: IRS Has a Complex Process to Attempt to Collect Billions of Dollars in Unpaid Tax Debts* 3 (June 2008). In FY 2008, the ACS units answered nearly 4.1 million incoming calls and placed approximately 250,000 outgoing calls for a total volume of 4.3 million. Additionally, the ACS answered 3.9 million Economic Stimulus calls which diverted resources from collection efforts. *See* IRS response to TAS research request (Dec. 18, 2008). ACS makes many outbound calls using the predictive dialer system technology in which calls are placed using an attending agent on the originating telephone line. If the dialer makes contact, it transfers the calls along with the other pertinent case data to a waiting IRS representative. When a busy signal or no answer is received, the dialer updates the account and reschedules the case to the predictive dialer queue for another attempt. *See* IRM 5.19.5.4.1 (Dec. 1, 2007) for a more detailed explanation of the process.

8 *See* http://pccc.web.irs.gov/acs%20callsite.htm (last visited Dec. 5, 2008).

Customer service is one of the balanced measures upon which the IRS, including the ACS, is evaluated.[9] Despite its significant involvement with taxpayers and practitioners over the phone, the ACS is falling short of delivering quality customer service to all taxpayers.

ACS Customer Satisfaction Surveys and Internal Quality Review Processes Fail to Identify and Measure Critical Taxpayer Concerns

The ACS customer satisfaction survey results indicate that 92 percent of taxpayers are satisfied with the ACS customer service while only three percent are dissatisfied.[10] While these results may reflect good customer service for some subset of the population of taxpayers interacting with the ACS, the manner in which the survey is conducted does not capture the full picture. For example, the ACS only administers its customer satisfaction survey to a sample of taxpayers who have completed their calls.[11] Thus, taxpayers whose calls terminate before their cases are resolved (*e.g.*, those who end the calls out of frustration) are not given the opportunity to participate in the survey. Moreover, ACS telephone assistors are notified by a "tone" over their headsets as to which taxpayers will be asked to participate in the survey *while the call is still in process.*[12] Thus, the sampling method raises potential bias in two respects: first, by excluding taxpayers who may have reason to be dissatisfied with the service received; and second, since telephone assistors may be aware which taxpayers are being offered the survey, it is possible to shape the level of service depending on whether the taxpayer will be surveyed.

The timing of the ACS customer satisfaction survey during the life cycle of the taxpayer's interaction with the ACS may also impact the perception of the ACS's level of service. In other words, a taxpayer may be very satisfied on any individual call with the ACS when it appears that his or her request for relief was granted or is being considered, but that perception can change if the subsequent relief does not meet the taxpayer's expectations. The survey tends to measure a "snapshot" of ACS service rather than the overall picture by taking into consideration 16 customer service related attributes that exclude taxpayer

9 IRM 21.10.1.4.2.3 (Oct. 1, 2003) provides:

> ACS Phones will be measured for Timeliness, Professionalism, Customer Accuracy, Regulatory/Statutory Accuracy, and Procedural Accuracy. These are the measures that are available and may be reported under the Balanced Measurement System.

10 IRS, Customer Satisfaction Survey, ACS, SB/SE National Report, April through June 2008 (Aug. 2008). IRS, Customer Satisfaction Survey, ACS, W&I National Report, April through June 2008 (Aug. 2008).

11 IRM 21.10.1.9.4.2 (Oct. 1, 2006).

12 IRM 21.10.1.9.4.4(1) (Oct. 1, 2008). The ACS uses monitors who listen to taxpayer calls to determine whether the call is from a taxpayer actually seeking the services that ACS provides. If the call is ACS related, the monitor notifies the ACS representative that the caller will be offered an opportunity to take the customer satisfaction survey. *See generally* IRM 21.10.1.9.4.2 (Oct. 1, 2006). Despite encouraging the monitors to provide the "tone" to the ACS telephone assistors later in the call, neither W&I nor SB/SE has issued written guidance to their monitors on when the "tone" should be provided to the assistors. The lack of procedures to determine when the "tone" is given to the assistors further reduces the reliability of the customer satisfaction survey.

feedback about the entirety of the ACS experience, including overall satisfaction with the final outcome of the case.[13]

In contrast to the ACS survey, the Collection Field function (CFf) surveys customer satisfaction for cases worked by revenue officers through a mailed questionnaire only *after* the cases are closed so the entire picture is available (*i.e.*, satisfaction with how the case was resolved and impressions of customer service in light of that resolution). The revenue officer is never notified that his or her case was selected for the customer satisfaction survey. As a result, the survey contains no inherent sampling bias. While the overall customer satisfaction rating for revenue officers is significantly lower than that of the ACS (61 percent favorable rating compared to at least 92 percent),[14] reaction from tax professionals indicates a strong preference for working with revenue officers in the field rather than telephone assistors in the ACS.[15] Thus, the ACS's perception of its customer service does not reconcile with taxpayers' and their representatives' perception of that service.

The ACS also conducts internal quality assessments of its service based on analysis of recorded taxpayer calls. These reviews measure quality in timeliness, customer accuracy, and

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13 The 16 attributes are:
- Amount of time given to follow up with the IRS;
- Clarity of IRS notice, bill or invoice;
- Tone of IRS notice, bill or letter;
- Ease of understanding of the Automated Answering System (AAS) menu and instructions;
- After you reached representative, time to complete call;
- Time to get through to the IRS;
- Representative's description of non-compliance;
- Description of what was expected of you;
- Representative's authority to make decisions;
- Reached the right person;
- Representative's flexibility in handling your issue;
- Knowledge of representative;
- Getting all the information you needed during the call;
- Fairness in treatment;
- Friendliness of representative; and
- Representative's willingness to help with your issue.

See IRS, Customer Satisfaction Survey ACS, SB/SE, April through June 2008 (Aug. 2008); IRS, Customer Satisfaction Survey, ACS, W&I, April through June 2008 (Aug. 2008).

14 IRS, Customer Satisfaction Survey, Compliance Services Collection Operation (CSCO), SB/SE National Report, January through March 2008, with Annual Results (July 2008).

15 A number of prominent tax treatises contain advice to practitioners such as: "In most cases, ACS should be avoided." Arthur H. Boelter, 1 Rep. Bankr. Taxpayer, IRS Tax Collection System: Automated Collection System, § 3.38 (2008), noting problems when dealing with the ACS, including:
- In the ACS it takes two weeks for correspondence to be loaded into the ACS computers;
- The ACS is very stratified, such that the person answering the call will not be the person doing research if the underlying tax is questioned; and
- The ACS levies within four days if the taxpayer promises to make a payment immediately and it is not received within four days.

See also Robert E. McKenzie, 1 Rep Before Collection Division of the IRS, § 2:29, (2008), noting "In most instances, it is better to go to an IRS local area office or local office and deal with one of the Customer Service Representatives instead of attempting to phone the Automated Collection System." In discussing customer service related feedback about the ACS, members of the American Institute of Certified Public Accountants (AICPA) voiced the preference for dealing with revenue officers rather than the ACS. TAS dialogue with AICPA regarding ACS Customer Service (May 18, 2008).

professionalism by considering 77 attributes, such as whether the employee's greeting was professional, the taxpayer's issues were identified and addressed, and the taxpayer's name and address were verified.[16] While a small number of these attributes measure events following the initial contact with the ACS,[17] the ACS quality review criteria generally do not reflect a number of issues that appear to be very important to ACS customers, such as whether a levy was released in a timely fashion or whether a manager returned a call from a taxpayer or tax professional.

The National Taxpayer Advocate is concerned that significant service-related concerns consistently raised by taxpayers, tax professionals, and TAS case advocates are not reflected in IRS measures designed to track ACS customer satisfaction or quality.[18] Consequently, the IRS may not recognize these issues as problem areas and target them for improvement.

ACS Procedures That Are Unnecessarily Burdensome

Over the past year, the National Taxpayer Advocate and her staff have met with tax professionals who routinely interact with the ACS, including representatives from the American Bar Association (ABA), American Institute for Certified Public Accountants (AICPA), the National Association for Enrolled Agents (NAEA), as well as Low Income Taxpayer Clinics (LITCs) and LTAs in TAS. A sample of these ACS customer service issues is set forth below.

The ACS Does Not Promptly Release Levies Under Certain Circumstances

> "The taxpayers are now in an installment agreement, but the levy release was mailed instead of faxed and taxpayers' next check is scheduled to be deposited tonight. Only one taxpayer is working and the other is disabled. They are three months behind on their mortgage. They need this money to live."[19]

The ACS plays a significant role in the IRS's enforcement function. For example, of the 2.63 million levies issued against taxpayer assets in FY 2008, the IRS issued 86 percent (or 2.26 million) of them through the ACS.[20] The IRS also must release levies in some

16 ACS, *Quality Job Aid* (Oct. 1, 2007).

17 For example, one attribute measures whether after the call the IRS employee made the right decision to levy a taxpayer's assets. ACS, *Quality Job Aid* (Oct. 1, 2007).

18 Tax professionals from the AICPA, NAEA and LITCs met with TAS employees to discuss their concerns with ACS customer service (May 2008). Representatives from TAS also conducted focus groups on ACS customer service at the IRS sponsored Nationwide Tax Forums (July 2008, Aug. 2008, Sept. 2008). The results of the focus groups at the Tax Forums mirrored the complaints the National Taxpayer Advocate has heard from her own staff; however, the feedback from these focus groups and professional organizations is anecdotal and not intended as a statistically representative sample of all taxpayer experiences with the ACS.

19 Description by TAS case advocate of a type of case she has seen where the levy release is delayed and the IRS takes an extra garnishment.

20 *See* IRS, *Collection Workload Indicators (C23) Report* (Oct. 7, 2008).

circumstances.[21] The IRS must release the levy promptly upon the occurrence of a levy release event (*e.g.*, the statutory period for collection expires), if the taxpayer enters into an IA, or if the taxpayer has an economic hardship.[22] However, the ACS has resisted adopting procedures that would result in more prompt releases by:

- Failing to disclose to taxpayers that the IRS has an expedited levy release policy that allows releases to be faxed to third parties (such as employers) rather than being mailed; and
- Imposing an additional hurdle on taxpayers who are persistent enough to uncover the expedited process by requiring taxpayers to prove they truly need faxed levy releases.

If the IRS agrees to release a levy based on a determination of economic hardship under IRC § 6343(a)(1)(D), the IRS must send a release of levy to the taxpayer's employer so the employer will stop remitting the taxpayer's wages to the IRS. The IRS's standard procedure is to mail the levy release to the employer, which can take seven to ten days, however the tax practitioner community has commented that it can take longer than ten days.[23] Because of penalties imposed under IRC § 6332, the employer will continue remitting payments to the IRS, despite the hardship, until the employer receives the release.

The IRS can easily stop these unnecessary levy payments by faxing the levy release to the employer. In fact, the IRS has an "expedited levy release" procedure, but does not tell taxpayers this procedure is available unless the taxpayer knows about internal IRS processes or happens to ask the telephone assistor the right questions.[24] Moreover, if the taxpayer learns of the expedited procedure and asks for a faxed levy release, the IRS imposes another hurdle by requiring the taxpayer to provide additional information to validate that his or her situation warrants a levy release.[25] A taxpayer who has already been determined to have an economic hardship should not have to provide still more information to merit a levy release being faxed instead of mailed.

The result of the ACS's approach is that taxpayers needlessly experience additional wage garnishments. The National Taxpayer Advocate addressed this problem in her 2005 Annual Report to Congress. At that time, the IRS would not agree to either inform taxpayers of

21 IRC § 6343(a)(1) requires levies be released in the following situations:
(A) the liability for which such levy was made is satisfied or becomes unenforceable by reason of lapse of time;
(B) release of such levy will facilitate the collection of such liability;
(C) the taxpayer has entered into an agreement under section 6159 to satisfy such liability by means of installment payments, unless such agreement provides otherwise;
(D) the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer; or
(E) the fair market value of the property exceeds such liability and release of the levy on part of such property could be made without hindering the collection of such liability.

22 *See* Treas. Reg. § 301.6343-1(b)(4).

23 IRM 5.19.4.4.10 (Sept. 24, 2008).

24 *Id.*

25 IRM 5.19.4.4.10(1) (Sept. 24, 2008).

the availability of the expedited process or modify its policy to reflect the fact that the cost of an extra levy to taxpayers in economic distress significantly outweighs the administrative inconvenience, if any, to the IRS of having to fax more levy releases rather than mail them.[26]

ACS Managers Fail to Return Calls When Taxpayers Ask to Speak with Managers

> "I cannot get a response when you ask to speak to a supervisor. Employees will not identify their supervisor. Supervisors are supposed to call back within a certain period and they do not call back."[27]

Taxpayers and their legal representatives have an administrative right to speak with an IRS employee's manager in case of a dispute with the employee.[28] When a taxpayer or practitioner invokes this right, the IRS employee is required to inform the caller that the manager will call back. TAS has received complaints that ACS managers do not regularly return calls to taxpayers and tax professionals.[29] One LITC director reported that after asking to speak to a manager more than a dozen times over a period of two and one-half years, he had never received a callback.[30]

The failure of managers to return calls erodes taxpayer confidence in the IRS and should be a measure of the service taxpayers receive. While important taxpayer publications and some portions of the Internal Revenue Manual (IRM) refer to the taxpayer's right to speak to a manager, the ACS procedures contain no such reference.[31] The IRS does not track the number of manager callbacks requested and completed each year by the ACS and has no plans to develop such a process.[32] Nor does the IRS hold managers accountable by making the timely completion of callbacks a requirement in their performance plans each year (*i.e.*, by tying this aspect of performance to the manager's bonus and pay).

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26 *See* National Taxpayer Advocate 2006 Annual Report to Congress 110; National Taxpayer Advocate 2005 Annual Report to Congress 209; *See also* http://www.irs.gov/pub/irs-utl/2005_arc_report_card_v2.pdf (last visited Dec. 5, 2008)

27 Nationwide Tax Forums, ACS Focus Groups (Atlanta Forum, July 2008).

28 IRM 3.0.273.7(Jan. 1, 2008) provides:

> "(1) As directed by the Taxpayer Bill of Rights 1 & 2, managers must be sure employees know and observe the rights of taxpayers. Taxpayers have the right to prompt, courteous and impartial treatment. In dealing with taxpayers:
>
> a. Assume each taxpayer wants to comply;
> b. Put yourself in the taxpayer's position;
> c. Identify the taxpayer's problem;
> d. Resolve the immediate problem and at the same time prevent future problems;
> e. Resolve the taxpayer's problem without referring him or her elsewhere;
> f. **Allow the taxpayer to speak to your supervisor if he or she feels your decision is unfair** (emphasis added); and
> g. Approach each taxpayer in a businesslike and professional manner."

29 Nationwide Tax Forums, ACS Focus Groups (July 2008, Aug. 2008, Sept. 2008).

30 Tax professionals from the AICPA, the NAEA, and LITCs met with TAS employees to discuss their concerns with the ACS (May 2008).

31 IRS Pub. 1, Your Rights as a Taxpayer (May 2005); IRS Pub. 594, The IRS Collection Process (July 2007). *See generally* IRM 5.19.5 (Dec. 1, 2007) and IRM 5.19.6 (July 8, 2008) (where there is no mention of manager callbacks). *See also* IRM 3.0.273.7 (Jan. 2008) (where reference is made to the manager contact right in the IRM for the Submission Processing function). *But see* IRM 1.4.20.1(2)h (Jan. 1, 2006) (where reference is made to manager contact by the operations and department manager for the Filing and Payment Compliance function, which includes the ACS).

32 W&I and SB/SE response to TAS research request (July 17, 2008).

Taxpayers Experience Lengthy Delays and Call Routing Problems Before Reaching Customer Service Representatives

> "When you do get through to the ACS, you may be placed on hold for extended periods by an automated answering system." [The author has experienced waits of more than 30 minutes.][33]

Both the W&I and SB/SE customer satisfaction surveys demonstrate that wait time continues to be a problem.[34] The wait time attribute received the lowest customer service ratings of all of the 16 attributes, with only 48 percent of ACS customers being satisfied with the time it takes to talk to an assistor in both W&I and SB/SE.[35] Even though the wait time attribute received the lowest customer satisfaction ratings, the survey administrator did not recommend any improvement opportunities for the wait time attribute for W&I but recommended that SB/SE focus improvement efforts on reducing wait time.[36]

Taxpayers also complain about being routed from one function to the next in the ACS. The ACS utilizes an automated routing system that filters out non-ACS cases and routes ACS callers to the first available assistors. However, because not all assistors can handle complex cases, ACS must transfer taxpayers to those capable of dealing with their requests. Consequently, if a taxpayer does not qualify for a basic IA because the delinquency exceeds the threshold for a basic IA, the taxpayer will again be transferred until he or she reaches an assistor who can conduct the analysis.[37] The ACS offers no direct-dial option for large dollar cases, so even when callers know they need to speak with the large dollar unit, they must still go through the main ACS extension.[38] Such delays cause frustration and in some cases create a loss of service because the customers cannot continue to hold and must hang up, only to try again later. We have identified at least five distinct applications within the ACS that contribute to this problem.[39]

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33 Robert E. McKenzie, 1 Rep Before Collection Division of the IRS, § 2:29 (2008).

34 IRS, Customer Satisfaction Survey ACS, SB/SE, April through June 2008 (Aug. 2008); and IRS, Customer Satisfaction Survey, ACS, W&I, October through December 2007 (Feb. 2008).

35 *See* IRS, Customer Satisfaction Survey ACS, SB/SE National Report, April through June 2008, Appendix E-1 (Aug. 2008).

36 *See* IRS, Customer Satisfaction Survey ACS, SB/SE, April through June 2008 (Aug. 2008); IRS, Customer Satisfaction Survey, ACS, W&I, April through June 2008 (Aug. 2008).

37 The most basic IA is known as a "guaranteed IA" because it is statutorily guaranteed to taxpayers under IRC § 6159(c) provided the amount of the delinquency does not exceed $10,000 and the taxpayer has been otherwise compliant for the last five years. The IRS also administratively established another basic agreement known as the "streamlined IA" for accounts in which the delinquency is not greater than $25,000. IRM 5.19.1.5.4.4(8) (Apr. 28, 2008). Installment agreements for amounts above $25,000 require financial analysis of the taxpayer's income, expenses, assets, and liabilities. IRM 5.19.1.5.4.8 (Apr. 28, 2008).

38 IRM 5.19.1.6.6 (Apr. 28, 2008).

39 The ACS uses agent groups to route customers to the correct applications for assistance. The ACS has five distinct agent groups: Alaska Perma Fund, Large Dollar, High Income Non-Filer, Practitioner Priority Service, and Regular ACS. IRS, Seven-Day Comments to Most Serious Problem, *Customer Service Issues in the IRS's Automated Collection System* (Nov. 10, 2008). Some taxpayers may be transferred from application to application (because the first application was not the right "gate" to solve the taxpayer's problems), causing additional wait time and frustration.

The Inability to Work with the Same ACS Employee in Cases Requiring Multiple Contacts

> "Each time I talk to the IRS, the individual tells me something different. They ask me to fax information, then do not act on it or enter the information into the system. I then call back to make sure that the case is noted, and the new person claims that there is nothing noted in the account. This is a systemic problem, since the IRS has no accountability or consistency in its call centers."[40]

A common complaint of taxpayers and tax professionals involves the inability to continue working with the same ACS employee in collection cases that require more than one contact to resolve.[41] The ACS does not provide for extension dialing, or offer phone numbers for individual employees. Cases that require more than one contact rely on the documentation of prior contacts to provide ongoing service and continuity in case development. However, tax professionals have informed TAS and the IRS that missing, incorrect, or inadequate documentation of previous contacts with the ACS is common.[42] Consequently, taxpayers and tax professionals often need to invest considerable time in repeating conversations that have already occurred or correcting information that has been captured incorrectly when working with ACS employees on subsequent contacts.

Historically, the IRS has said it is impractical to maintain toll-free extensions that would allow ACS employees to work inventories. However, the SB/SE ACS sites in Memphis and Nashville are testing the Corporate Approach to Collection Inventory (CACI) ACS Hybrid initiative. This system incorporates transferring calls for individual case assignment to ACS assistors into the processing of cases that ACS would typically transfer to the CFf due to the complexity of the issues involved. The National Taxpayer Advocate applauds the IRS for testing individual case assignment as part of this hybrid initiative and looks forward to reviewing the results. The National Taxpayer Advocate believes the IRS should also consider establishing teams of employees who are responsible for cases, and permit extension dialing, to increase the likelihood that a subsequent telephone assistor will have access to the information the taxpayer has already provided. Further, at a minimum, IRS customer satisfaction surveys and internal quality reviews should capture this taxpayer preference.

40 Systemic Advocacy Management System (SAMS) Issue 29765 (July 2008).

41 Issue Management Resolution System (IMRS) 06-0000184-Contacting ACS Employees submitted in 2006, *at* http://www.irs.gov/businesses/small/article/0,,id=168260,00.html (last visited June 5, 2008).

42 IRS, *Income Statements*, *at* http://www.irs.gov/businesses/small/article/0,,id=168260,00.html (last visited Sept. 30, 2008).

Taxpayers Complain the Current Form 433-F, Collection Information Statement, Causes an Understatement of Expenses

> "No one will listen. I am telling you that this form does not have any space for the taxes I pay, so now I am in an installment agreement that is at least 30 percent more than I should be paying."[43]

TAS has received complaints from taxpayers about the IRS's financial analysis forms. For example, ACS employees either send Form 433-F, *Collection Information Statement*, to the taxpayers to complete and send back with the required documentation, or they take the information during phone calls and enter it onto the 433-F screen on their systems. Taxpayers have told TAS they are obligating themselves to pay IAs they cannot afford because Form 433-F does not capture their federal, state, and local tax obligations. While an earlier version of the form (August 2005) did provide a space for the taxpayers to claim these obligations, the new version (June 2008) omits the space. TAS raised this issue with the IRS in the spring of 2008 but has not received a response.

The Restrictive Use of Facsimile (Fax) Technology and the Use of Standard Mail Place an Unnecessary Burden on Taxpayers

> "If you have more than ten pages, you cannot fax substantiation to the ACS – the ACS needs to use reason. If you have 12 pages, you should be able to fax 12 pages."[44]

The ACS's reluctance to use fax machines is again evident in its policy of restricting taxpayers from faxing more than ten pages per case.[45] While an exception exists for taxpayers with a levy on their assets that cannot be released without the documentation, other taxpayers and practitioners must mail their information and wait for it to be entered into the ACS's data system to engage the IRS on the documentation's contents.[46] The IRS processes mailed documentation at the four ACS support sites (ACSS), which have at least 30 days to process correspondence before contacting the taxpayers. Although there are procedures for expedited cases, the 2008 training guide did not address actions to take on such cases.[47] Further, tax professionals and taxpayers have complained that the support sites often lose or misplace mailed documents, which must then be resubmitted, increasing the time needed to resolve cases.[48]

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43 Taxpayer complaint to TAS representative after trying to work with the IRS to reduce an IA payment established by the ACS because taxes were not factored into the taxpayer's expenses. Ultimately, the agreement was reduced by an amount equal to the taxpayer's federal, state, and local tax obligations.

44 IRS Nationwide Tax Forum, Focus Groups on ACS (Las Vegas Forum, Aug. 20, 2008).

45 *See* IRM 5.19.1.6.3 (Apr. 28, 2008).

46 *See id.*

47 IRS Policy Statement P-6-12 requires a final response to the taxpayer be initiated within 30 calendar days of the earliest IRS received date. If a final response cannot be initiated within 30 calendar days, an interim response will be initiated by the 30th calendar day from the IRS received date. *ACSS 2008 Instructor Guide for Continuing Professional Education, Course 10341-201*.

48 IRS Nationwide Tax Forum, Focus Groups on ACS (Las Vegas Forum, Aug. 20, 2008). Tax professionals from the AICPA, the ABA, the NAEA, and LITCs met with TAS employees to discuss their concerns regarding ACS customer service issues (May 2008) and (Sept. 2008).

Inconsistent and Unclear Documentation Requirements Burden ACS Customers

> "There is inconsistent treatment within ACS varying by assistor, manager, location, etc."[49]

> "Without consistency across the country, you can't understand the rules and come to an agreement."[50]

The National Taxpayer Advocate has received complaints from taxpayers about inconsistent treatment from one ACS site to another and from one ACS employee to another at the same site, such as one site accepting a particular type of document as substantiation while another does not.[51] This inconsistency also extends to differences between the ACS and the CFf approaches to what documentation is required for taxpayers to obtain basic IAs. For example, taxpayers with delinquencies of $25,000 or less are supposed to qualify for the streamlined IAs without the IRS performing financial analysis.[52] Recently, the ACS added to the burden of taxpayers seeking to qualify for streamlined agreements by requiring those who appear to have some equity in their assets (*i.e.*, a primary residence), to seek out a loan and present a loan denial letter to the ACS.[53] Revenue officers in the field do not place this requirement on taxpayers, thereby creating inconsistency in the way similarly situated taxpayers are treated.[54] This new requirement will affect a substantial number of taxpayers. Of the 3.6 million tax accounts disposed by ACS in FY 2008, 38 percent were placed into IAs, 94 percent (or 1.2 million) of which were streamlined agreements.[55] Because of the current home lending crisis, individuals without cash or excellent credit often do not qualify for home loans.[56] The loan denial requirement is an additional exercise in futility for the taxpayers and a clear waste of IRS resources.

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49 IRS Nationwide Tax Forum, Focus Groups on ACS (Atlanta Forum, July 2008).

50 IRS Nationwide Tax Forum, Focus Groups on ACS (Chicago Forum, July 2008).

51 For example, a tax professional needed to provide documentation to the ACS to support a request for a non-streamlined IA for more than one client. One ACS employee advised him he needed to submit two months of pay stubs while the other ACS employee advised him he needed six months of stubs. Tax professionals from the AICPA, the NAEA, and LITCs met with TAS employees to discuss their concerns with the ACS (May 2008); IRM 5.19.1-14 (Apr. 28, 2008) requires the taxpayer to submit the prior three months of wage statements. TAS employees, taxpayers, and tax professionals have also complained that the ACS rejects documentation that does not match its concept of how it should look. For example, a utility shutoff notice provided to substantiate a hardship was rejected by an ACS employee because it was a checkbox form and the ACS employee believed it was not authentic. Analysis and case examples provided by TAS Internal Technical Advisor Program technical advisors regarding ACS customer service issues (July 17, 2008). *See* IMRS 06-0000229 – Income Statements, *at* http://www.irs.gov/businessess/small/article/0,,id=168260,00.html –(last visited Dec. 19, 2008).

52 IRM 5.14.1.5 (July 12, 2005).

53 IRM 5.19.1.5.4.2 (Apr. 28, 2008).

54 IRM 5.14.1.5 (July 12, 2005).

55 IRS, *Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Sept. 30, 2008); IRS, *Installment Agreement Cumulative Report, NO-5000-6* (Sept. 30, 2008).

56 Louis Uchitelle, *Pain Spreads as Credit Vise Grows Tighter*, New York Times (Sept. 19, 2008); David Ellis, *The Credit Crunch: Loans Out of Reach*, CNNMoney.com (Sept. 25, 2008).

Other Concerns of Tax Professionals About Dealing with the ACS

As described above, TAS asked tax professionals about the ACS in focus groups at the IRS-sponsored 2008 Nationwide Tax Forums. The sessions included general questions and detailed questions designed to spur discussion (but not to suggest specific answers or concerns or generate a particular type of feedback). The responses do not reflect a statistically representative sample of all taxpayers served by the ACS; yet they provide important practitioner feedback, which is very limited in ACS customer satisfaction surveys.[57] Accordingly, a sample of two questions asked and responses is provided below:

Question: *How would you describe your overall experience in working with the ACS during the past year?*

Sample Responses:

> "The phone system is horrible, keep getting put on hold. Workers are apprehensive to make decisions and need more training."
>
> "I have dealt with one or two individuals that were quite easy to deal with. It is unusual to deal with the same person when you call in more than once and to have the case followed through to resolution."
>
> "I have had problems with the ACS. It seems like they request information in a short timeframe, and then might take six months to review the material I send in – if they can find it. I have started sending everything certified, so at least I have a record that I send it and someone signed for it. In the meantime, my client continues to receive collection notices."
>
> "They lose files, paperwork, and claim they do not receive faxes. I have problems using the practitioner priority line regarding ACS issues, I usually get transferred and cut off."
>
> "They are definitely collection people, they do not provide assistance. Even if I use the PPS [Practitioner Priority Service], they tell me to call the number on the notice. You have to go through too many prompts/menus to get to ACS."

Question: *What, if any, advantages do you see occurring with the discussions and/or investigations that are conducted through ACS?*

[57] Of the respondents for the ACS Customer Satisfaction Surveys, practitioners accounted for nine percent for SB/SE and three percent for W&I. IRS, Customer Satisfaction Survey, ACS, SB/SE National Report, April through June 2008 (Aug. 2008); IRS, Customer Satisfaction Survey, ACS, W&I National Report, April through June 2008 (Aug. 2008). W&I has informed the National Taxpayer Advocate that it is pursuing the development of a tax practitioner survey as part of its ACS customer satisfaction surveys. IRS, *Seven-Day Comments to Most Serious Problem, Customer Service Issues in the IRS's Automated Collection System* (Nov. 10, 2008).

Sample Responses:

> "I personally see some advantages, if the issues are simple. You can usually handle these over the phone and get them resolved. I have completed installment agreements over the phone and faxed documents to get issues resolved in one call."
>
> "Small, simple cases seem to work well."
>
> "None."

Question: *What, if any, disadvantages do you see occurring with the discussion and/or investigations that are conducted through the ACS?*

Sample Responses:

> "I am often put on hold for a long time – and the music is terrible."
>
> "Levies don't come off with an IA [installment agreement], even if ACS says they will release the levy."
>
> "ACS refused to talk to me [practitioner] because I was on a speaker phone with the taxpayer present. ACS insisted on talking to the taxpayer and having the taxpayer write notes to me [practitioner] to get answers."

This is a small sample of questions and answers. The groups yielded some positive comments about the ACS, but most comments suggest that the ACS has substantial room to improve its customer service. The National Taxpayer Advocate will share these responses with the IRS in hopes that the ACS will appreciate that its customer service surveys and internal reviews do not provide a full picture of the public's perception of its service, and will take action on these taxpayer service shortcomings.

Conclusion

The ACS serves a large number of taxpayers, who deserve and desire excellent customer service.[58] The National Taxpayer Advocate has heard widespread complaints about ACS service and has experienced reluctance on the part of the ACS to change its practices. While the information used for this analysis is largely anecdotal, it is consistent across the board. It appears that taxpayers and tax professionals believe the ACS serves taxpayers well in "simple cases." When cases become more complex (*e.g.,* when more than ten pages must be faxed to resolve a case quickly), the ACS becomes less oriented toward customer service.

58 ACS's inventory was 1,568,674 for W&I and 935,410 for SB/SE. *See* Footnote 1, *supra.* IRS, *Collection Activity Report, NO-5000-2, Taxpayer Delinquent Account Cumulative Report* (Sept. 2008).

The ACS spends considerable resources on its customer satisfaction surveys to "identify what ACS staff and managers can do to improve customer service."[59] These efforts measure important customer observations but ignore some of the most important aspects of ACS service (*i.e.*, the downstream impact on taxpayers dealing with the ACS). When the ACS listens to this information, it will be more apt to change policies that unnecessarily burden taxpayers.

The IRS should consider taking the following actions to improve the ACS program: explain to taxpayers that a levy release will occur sooner if the taxpayer faxes substantiation to ACS and ACS faxes the release while on the call; establish extension dialing capability for cases that require more than one contact with the taxpayer to improve case continuity; develop procedures and measures to track the number of manager callbacks requested by taxpayers and completed by the ACS managers; revise Form 433-F, *Collection Information Statement,* to provide fields to include federal, state and local taxes; establish a comprehensive fax policy that will allow taxpayers and practitioners to fax any and all documentation to the IRS including documentation that must be mailed under current procedures; eliminate the requirement that a taxpayer provide a loan denial letter when the taxpayer cannot obtain a home loan to pay his or her tax liabilities; provide taxpayers useful information and change the repetitive music they must listen to while on hold; develop a customer satisfaction survey that records taxpayer concerns about the overall handling of their cases; and implement a customer satisfaction survey specifically for tax practitioners.

IRS Comments

Quality customer service is a top IRS priority and our ACS employees take pride in providing the highest level of service to all taxpayers. Obviously, improvements can always be made to fully ensure that all taxpayer concerns are addressed.

We believe our Customer Satisfaction Survey (CSS) and internal quality reviews are adequate to gauge the level of our success in providing this quality service. The current ACS CSS rating is 92 percent favorable. The survey is conducted and verified by an independent third party, Pacific Consulting Group (PCG). Pacific Consulting Group uses statistically valid sampling to ensure the survey is unbiased and representative of the entire ACS customer base. Through the survey, PCG identifies key areas for improvement. These areas are identified as the *Top Improvement Priorities for ACS Customers* and *Top Improvement Priorities for Customer Service Representatives.* We concentrate on these key areas by focusing on them in operational reviews and throughout the year as we monitor call site performance.

The IRS has taken numerous actions in response to issues raised by the National Taxpayer Advocate in the 2005 and 2006 Annual Reports to Congress. We have also taken actions in

[59] IRS, Customer Satisfaction Survey ACS, SB/SE, October through December 2007 (Feb. 2008); IRS, Customer Satisfaction Survey, ACS, W&I, October through December 2007 (Feb. 2008).

response to recommendations made by IRS employees and the public through the Systemic Advocacy Management System (SAMS).

In July 2008, ACS implemented a reduction in the time it takes to generate the LP68, ACS levy release, and a reduction in the mail-out timeframes from seven days to five days. Additionally, ACS has been pursuing the use of e-fax services for all ACS call sites and support sites. This project is in its early stages and implementation of this initiative is contingent on future funding.

In her report, the National Taxpayer Advocate makes eight suggestions to improve the ACS program. Descriptions of the many actions the IRS has taken or is taking to improve ACS are provided below.

The IRS agrees, and it has always been our policy, that levy releases should be expedited to prevent over-collection and be responsive in resolving hardship situations and we have taken numerous improvement actions in this area. We have revised the IRM 5.19.4.4.10 to provide additional guidance for faxing levy releases and provided more examples in training materials. ACS is also pursuing technological alternatives to improve our efficiency in releasing levies.

In January 2008, the TAS Collection Levy Team (TCLT) was formed to address concerns TAS had with issues raised in the 2005 and 2006 Annual Reports to Congress. The team is comprised of analysts from Collection Policy, ACS, and TAS. One of the issues being addressed is the expedite release procedures. There continues to be discussions as to which situations require an expedite levy release and a resulting faxed levy release. Currently, there are expedite levy release procedures and all taxpayers are afforded the same rights as it pertains to levy releases. SB/SE and W&I currently have a joint effort in process as part of an initiative to look at collection processes that might be impacted by current economic conditions. As part of that effort IRM guidelines are currently under review to ensure levy release actions are expedited when appropriate. In addition current year financial analysis CPE will address hardship indicators and include scenarios to ensure IRS assistors are aware of the options available to expedite levy release action.

While ACS does not have a unique toll-free number for different applications, the technology of Enhanced Business Operating Division Routing (EBR) requests the taxpayer identification number (TIN) of the taxpayer, identifies Large Dollar calls by Business Operating Division (BOD), and routes the call accordingly. In effect, this provides direct-dial service. Callers who do not provide a TIN are default routed to a regular ACS tax examiner for assistance, which may ultimately require a manual transfer to an appropriately skilled tax examiner. Our call routing system does not allow us to direct a caller to a specific agent. Given the large number of ACS employees across the country, to provide extension dialing capabilities, or have the system successfully connect a large volume of callers to specific employees, would not provide timely quality service due to time zones, leave, breaks, hours worked, or various other activities of our employees that take them off the phones.

The IRS acknowledges there may be situations where a taxpayer requests to speak with an ACS manager and the manager is unsuccessful in returning the call. The IRM 1.4.20.1(2)(h) and IRM 5.19.8.4.16.4 provide clear guidance for both the ACS employees and managers. Guidance is also provided on the Electronic Automated Collection Service Guide (E-ACSG) on handling taxpayer requests for a manager callback. To address this issue and identify improvement opportunities, a random sampling of calls will be conducted on a quarterly basis and increased emphasis will be placed on this issue during operational reviews.

The IRS is working to add a field for taxes on Form 433-F, *Collection Information Statement*. In the interim, IRM 5.19.1.6.3(12) provides clear and concise guidance on determining a taxpayer's disposable income. Federal, state, and local tax obligations are automatically allowed as a deduction from gross pay, as well as FICA, Medicare, other mandatory retirement programs, and health insurance. Additionally, the Desktop Integration (DI) financial screen used by employees to enter financial information provided by the taxpayers automatically subtracts taxes from gross wages to arrive at a net wage amount.

The IRS is committed to providing the highest level of service to all taxpayers and ACS routinely uses fax machines to receive documentation needed to resolve issues. Due to capacity and resource limitations, the IRS established limits on the number of incoming facsimile pages to ten.[60] This limitation is to ensure that all callers receive prompt service without experiencing lengthy delays, either by taxpayers holding on the line while waiting for the IRS to receive their facsimiles or by callers waiting to speak to a representative.

ACS call sites have limited fax machines, which are not co-located, for the assistors to use. In general, call sites do not have high-speed fax machines capable of handling high volumes. It is challenging for assistors to provide service to customers when phone lines are tied up with taxpayers on hold waiting for their facsimile transmissions. The page limitation is merely a guide to promote equity and efficiency for both the taxpayer and the site. As more resources become available, we will revisit this issue.

Currently, ACS is designed to systemically generate a levy release when it recognizes the account is full paid. This promotes efficiency and equitable treatment for taxpayers. We recognize that systems have their limitations. It is, therefore, our policy to fax a levy release *any time* a mailed release will not be received by the levy source and processed in time to prevent additional monies from being submitted. We do not limit this policy to hardship situations.

Over the past several years, ACS has worked with Collection Policy to ensure the consistent treatment of taxpayers requesting an installment agreement. The IRM 5.19.1 has been updated to resolve the appearance that ACS and the CFf have different procedures for tax-

60 IRM 5.19.1.6.3. The IRM procedure regarding the number of fax pages provides guidance to our employees to ensure all taxpayers receive prompt service without experiencing lengthy delays while on the phone. The IRM instructions generally limit the number of faxed pages; however, the IRM removes the limit for special situations, including hardship.

payers to obtain a basic installment agreement. The requirements for streamlined installment agreements have been revised to make it clear that loan denial letters are not required as part of the necessary documentation for such agreements.[61] In fiscal year 2007, over 97 percent of the installment agreements granted by the IRS were streamlined installment agreements.

The music taxpayers hear while on hold is an enterprise-wide service and is not specific to the ACS operation. The routing system optimization planned in FY 2009 is addressing this issue with the intent of making overall improvements to the queue structure including what music is played, the volume, and what messages are integrated with the music based on relevancy.

ACS utilizes objective and unbiased data collected through our CSS to improve operations. The survey is available for all ACS phone applications, including the Tax Practitioner Line. A tone is heard, generally at the end of a call, to indicate selection to participate in the survey. The IRM 21.10.1.4.2 is being updated to stipulate that the "tone" will be heard near the end of the call. We believe our survey and internal quality reviews are adequate to gauge the level of our success in providing quality service.

In addition to the CSS, correspondence is also received from taxpayers and their representatives expressing either their satisfaction or dissatisfaction of how the IRS handled their situation. All complaints received, through any venue, are thoroughly researched, addressed, and, whenever possible, resolved. The use of Contact Recording has afforded the IRS an opportunity to listen to the actual call that led to the complaint, ensuring management has an accurate portrayal of what occurred during the call. Contact Analytics will be in place within a year and will help us to further identify areas that need improvement.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for continuing to make quality customer service a top priority, and acknowledges the pride ACS employees take in striving to provide the highest level of service to all taxpayers. She also appreciates the IRS's candor in its realization that it can also make improvements to fully address taxpayer concerns. The National Taxpayer Advocate is encouraged by the IRS's use of Contact Recording to listen in on actual taxpayer calls and obtain an accurate portrayal of what occurred, and looks forward to learning more about the IRS's Contact Analytics initiative to identify areas for further improvement. Moreover, she acknowledges the IRS's recent efforts to work closely with TAS and to evaluate her prior Annual Reports to Congress for recommendations to improve ACS as being steps in the right direction.

61 IRM 5.19.1.5.4.2 (Nov. 19, 2008).

Customer Satisfaction Survey and Quality Review Concerns

The IRS's belief that its Customer Satisfaction Survey and internal quality reviews are adequate is somewhat disconcerting in light of what TAS has heard and continues to hear from LTAs, taxpayers, and practitioners. As previously noted, TAS's main concern is that the IRS's survey process is too narrow in scope and fails to adequately measure the entire ACS experience. Under current survey procedures, the taxpayer may not receive the opportunity to properly rate the overall outcome, but rather is only able to assess a "snapshot" in time (*i.e.*, the ACS employee's behavior on a particular call). The National Taxpayer Advocate reiterates that the IRS needs to continue to explore ways of measuring the most important aspects of ACS service (*i.e.*, the downstream impact on taxpayers dealing with the ACS).

Restrictive Use of Fax Technology and Timely Release of Levy

The National Taxpayer Advocate is pleased to learn that the IRS is pursuing e-fax services for all ACS sites and that, in the interim, it has reduced the levy release generation times, as well as the mail-out timeframes from seven to five days. Reducing the waiting time between the IRS's levy release determination and the time the release is actually received will help to minimize taxpayer burden or hardship. We also agree that the revision of IRM 5.19.4.4.10 should further improve this area.

However, we respectfully disagree with the IRS's claim that its expedited levy release procedures are adequate. The National Taxpayer Advocate recognizes the ACS handles a large number of cases with limited resources. However, the ACS continues to send millions of levies on an annual basis. The IRS must stop and consider the downstream consequences of this type of enforcement activity, particularly in light of today's difficult economic times. While we agree that expedited procedures are listed in the applicable IRM sections, we continue to hear complaints that taxpayers are still not being advised of this option, unless they specifically request it. As a result, the National Taxpayer Advocate urges the IRS to include a required discussion of this option in all applicable IRM sections related to levy release. It is not so much a matter of increasing IRS employees' awareness of the existing procedures as it is to require employees to increase taxpayer awareness of this option. The National Taxpayer Advocate believes the IRS should fax or expedite a levy release *any time* it determines a *significant hardship is present.* The IRS should consider establishing a centralized ACS or ACS support unit that is dedicated to faxing levy releases and would not detract from a contact employee assisting the next customer.

Lack of Extension Dialing Capability

The National Taxpayer Advocate appreciates the IRS's explanation of its EBR technology, as this helps to better understand how the ACS routes calls. However, she disagrees with the IRS's assertion that the current large dollar case routing procedures in effect serve as direct dialing. In its explanation, the IRS states that when a taxpayer or practitioner with a large dollar case contacts the ACS and provides the taxpayer identification number, the call will

be immediately routed to the large dollar case unit. The National Taxpayer Advocate does not consider this to be direct dialing since the caller must wait on hold, speak to someone, and then be routed. The National Taxpayer Advocate believes the IRS should provide true extension dialing capability, at a minimum, for specialized units to enhance customer service.

ACS Manager Callbacks

The National Taxpayer Advocate applauds the IRS for recognizing that its managers are not following through with the managerial callback policy and for proposing quality reviews of these procedures. These efforts should go a long way toward addressing the concerns raised by many of the practitioners TAS spoke with earlier this year. We look forward to hearing more about the methodology to be used for tracking adherence with the IRS's stated policy.

Problems with Collection Information Statement, Form 433-F

The National Taxpayer Advocate is pleased to learn of the IRS's plans to revise the current Form 433-F, *Collection Information Statement*. The revision will greatly benefit taxpayers by allowing them to include the correct amounts for their local, state, and federal tax obligations when determining their monthly expenses. The National Taxpayer Advocate looks forward to the actual publishing of the form. Moreover, she believes the revision will further strengthen the guidance in the IRM and on the Desktop Integration intranet page for ACS employees helping taxpayers to provide the correct information.

Inconsistent IA Policies

The National Taxpayer Advocate commends the IRS on its recent decision to revise the ACS's streamlined IA procedures and make them consistent with those of the CFf. No longer requiring a loan denial letter as part of the necessary documentation will allow for much more efficient processing of a streamlined IA and will benefit all parties.

ACS's Fax Policies

The National Taxpayer Advocate recognizes the capacity and resource limitations that preclude the IRS from accepting high volumes of faxed pages. She also appreciates the IRS's response that this "is to ensure that all callers receive prompt service without experiencing lengthy delays." However, the National Taxpayer Advocate is disturbed by the IRS's argument that it is "equitable" and "fair" to refuse faxes based on a ten-page limit when accepting 20 pages by fax might possibly resolve a case for a taxpayer. When a taxpayer is forced to end a call because the assistor will not accept the appropriate number of faxed pages, the ACS unduly burdens the taxpayer by making him or her call back, wait on hold, and expend additional time (if the ACS assistor is unable to locate the mailed correspondence). Providing taxpayers with immediate assistance and resolution is fair and equitable and promotes customer service. The IRS should make co-locating fax machines and investing

in high-speed fax machines a priority to allow for more prompt case resolution and fewer taxpayer contacts. Moreover, if the IRS does not have the appropriate resources to provide world class service to its taxpayers, such as being able to receive 20 pages of faxed documents and answer a phone at the same time, then it should raise the issue to Congress and seek additional funding.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Develop specific guidance, for inclusion in all IRM sections related to levy releases, requiring employees to inform taxpayers of their option to obtain a faxed levy release.
2. Adopt a comprehensive fax policy, and obtain the necessary equipment, that will allow taxpayers and practitioners to fax any and all documentation to the IRS, including documents that must now be mailed.
3. Develop a customer satisfaction survey that records taxpayer concerns about the overall handling of their cases and develop and implement a survey specifically for tax practitioners.
4. Develop a tracking mechanism to identify and monitor situations where the taxpayer has requested to speak with an ACS manager, in order to evaluate the degree to which IRS's stated policy is being followed.

Did You Know?

- As early as 2004, the tax gap[1] attributable to small businesses doing business over the Internet was estimated to be as high as $1 billion per year and rising.[2]
- According to one poll, 38 percent of American adults play computer or console games, and among those, 44 percent play games over the Internet.[3]
- Over 16 million people are estimated to have active subscriptions to Internet-based multiplayer environments called "virtual worlds,"[4] many of which have their own economies and currencies.[5]
- As early as 2001, an economist estimated that time spent by "players" in one of the many virtual worlds generated about $3.42 per hour, which represented a gross national product (GNP) of about $135 million and a per capita GNP of about $2,266 – roughly equivalent to Russia and higher than in many developing countries.[6]
- In 2005, about one billion real dollars changed hands in virtual worlds.[7]
- In 2006, about 3,100 "residents" of one of the smaller virtual worlds, called "Second Life," who generated a net profit in virtual transactions had average revenues of $20,000 in real U.S. dollars.[8]
- Some businesses now accept virtual dollars in exchange for real property or services.[9]
- Second Life charges a value added tax (VAT) on certain transactions between European Union residents and Second Life.[10]

1 The "tax gap" is the amount of tax on legal transactions for a given year that is not paid voluntarily and timely.

2 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-30-010, *The Internal Revenue Service Is Making Progress in Addressing Compliance Among Small Businesses Engaged in Electronic Commerce* (Nov. 2004).

3 The Associated Press/America Online Poll, Gaming Study, Conducted by IPSOS Public Affairs, Project No. 81-5139-64, *at* http://surveys.ap.org/data/Ipsos/national/2007-10-22%20Gaming%20Study.pdf (Nov. 12, 2007).

4 A "virtual world," described in greater detail below, is a computer-based simulated environment, which allows multiple users to interact using graphical representations of themselves (called "avatars"), typically over the Internet.

5 *See* Bruce Sterling Woodcock, *Total MMOG Active Subscriptions*, Version 22.0, *at* http://www.mmogchart.com/Chart4.html (Feb. 12, 2008).

6 *See* Edward Castronova, *Virtual Worlds: A First-Hand Account of Market and Society on the Cyberian Frontier*, CESifo Working Paper No. 618, 33, *at* http://papers.ssrn.com/abstract=294828 (Dec. 2001).

7 Heather M. Rothman, *As Congress Considers Online Game Taxes, Linden Lab Contends Law Already Clear*, 210 DTR G-2 (Oct. 31, 2006).

8 Robert D. Hof, *My Virtual Life, Business Week, at* http://www.businessweek.com/print/magazine/content/06_18/b3982001.htm?chan=g1 (May 1, 2006). According to Second Life, about 531 unique users had positive monthly in-world cash flow worth more than $2,000 in the month of April 2008. *See* Second Life, Economic Statistics http://secondlife.com/whatis/economy_stats.php (last visited May 12, 2008). Although still one of the smaller worlds, Second Life was recently estimated to have 93,219 "active subscriptions" and more than 12 million "registered users," the vast majority of whom are in the United States. *See* Bruce Sterling Woodcock, *Total MMOG Active Subscriptions*, Version 22.0, *at* http://www.mmogchart.com/Subscriptions.xls (Feb. 12, 2008) (showing active subscriptions on sheet 4); Robin Sidel, *Cheer Up, Ben: Your Economy Isn't As Bad as This One*, Wall Street Journal, page A1, Jan. 23, 2008 (reporting registered users).

9 *See* Fistpitch, *Pizza Enters the Virtual World of Second Life, at* http://www.fastpitchnetworking.com/pressrelease.cfm?PRID=8734 (Apr. 21, 2007).

10 *See* Second Life, Value Added Tax, *at* http://secondlife.com/corporate/vat.php (last visited May 12, 2008).

MSP #13 The IRS Should Proactively Address Emerging Issues Such as Those Arising from "Virtual Worlds"

Responsible Officials

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Clarissa Potter, Acting Chief Counsel

Definition of Problem

A "virtual world" is a computer-based simulated environment, which allows multiple users to interact using graphical representations of themselves (called "avatars"), typically over the Internet. Economic activities associated with virtual worlds may present an emerging area of noncompliance, in part, because the IRS has not issued guidance about whether and how taxpayers should report such activities.[11] To proactively address the tax gap and improve voluntary compliance, when the IRS learns of an emerging economic activity that receives no clear tax treatment under existing guidance, it should quickly promulgate clear rules and enforce them consistently.

The remainder of this discussion illustrates some of the confusion taxpayers may face in reporting economic activities associated with virtual worlds. However, the broader challenge for the IRS is to identify any emerging economic activities with tax implications that taxpayers, especially unsophisticated ones, are likely to misreport without additional guidance, and to issue clarifying guidance quickly.

Analysis of Problem

What is a virtual world?

As noted above, we use the term "virtual world" to refer to a computer generated environment that people can access simultaneously and remotely to interact with each other as well as other features of the environment, generally for a monthly subscription.[12] Participants are represented graphically as "avatars," and may "own" virtual property, such as clothing, tools, weapons, or real estate, which is also graphically represented in the environment. Virtual worlds operate continuously and retain the location of an avatar and other items, even if the person represented by the avatar has shut off his or her computer.[13]

11 Heather M. Rothman, *As Congress Considers Online Game Taxes, Linden Lab Contends Law Already Clear*, 210 DTR G-2 (Oct. 31, 2006) (quoting an IRS spokesman as acknowledging that "we have recognized it as an emerging area of noncompliance.").

12 Some virtual worlds generate income primarily from advertising revenue.

13 Because virtual worlds were first developed as games, they are sometimes called "massive multiplayer online games" or "MMOGs."

One category of virtual world, exemplified by the World of Warcraft (WoW), is game-like, has defined objectives, and a significant amount of operator-developed content. WoW describes itself as follows:

> World of Warcraft enables thousands of players from across the globe to come together online - undertaking grand quests and heroic exploits in a land of fantastic adventure.... Like most other role-playing games, World of Warcraft lets you advance in level as you gain experience. Experience can be gathered by killing monsters, exploring new destinations, and completing quests.... Nearly all quests give sizeable experience rewards. Many quests also provide material rewards, such as cash, potions, food, magic items, armor, and weapons.[14]

Another category of virtual world, exemplified by Second Life, is unstructured, utilizes more user-created content, and is more geared toward commercial and social interaction. Second Life describes itself as follows:

> Second Life is a 3-D virtual world entirely created by its Residents... [p]erhaps you'll find a perfect parcel of land to build your house or business. You'll also be surrounded by the Creations of your fellow Residents. Because Residents retain the rights to their digital creations, they can buy, sell and trade with other Residents. The Marketplace currently supports millions of U.S. dollars in monthly transactions. This commerce is handled with the in-world unit-of-trade, the Linden dollar, which can be converted to U.S. dollars at several thriving online Linden Dollar exchanges.[15]

Google is also reportedly planning to launch a virtual world based on its extensive satellite photos and maps of the real world.[16] Any such platform could greatly expand the economic activity associated with these worlds.

What type of economic activity goes on in virtual worlds?

In addition to buying virtual property, such as clothing or tools, a person's avatar can "steal," "make," or "find" it, or pick it up after defeating the prior owner. In some worlds, he or she can gamble for virtual money.[17] Users can sell or exchange virtual property with other players for different property or in-world currency – gold in WoW or Linden Dollars in Second Life. The "terms of service" (TOS) or "end user license agreement" (EULA) contract

14 *See* http://www.worldofwarcraft.com/info/basics/guide.html (last visited May 12, 2008).

15 *See* http://secondlife.com/whatis/ (last visited May 12, 2008).

16 *See, e.g.*, Chris Taylor, *Google Moves into Virtual Worlds, by Combining Satellite Maps and 3-D Software, Google Earth Is Turning into a Virtual Online Playground*, CNNMoney.com, *at* http://money.cnn.com/2006/05/11/technology/business2_futureboy_0511/ (Dec. 14, 2006); Tom Smith, *Google's Virtual World Could Be Business Answer To Second Life*, the Information Week, *at* http://www.informationweek.com/blog/main/archives/2007/09/googles_virtual.html (Sept. 25, 2007).

17 Linden Labs, the operator of Second Life, recently banned gambling and unlicensed banking activities. *See, e.g.*, Eric Reuters, *UPDATE 3 - Linden Bans Second Life Banks, Reuters Second Life News Center, at* http://secondlife.reuters.com/stories/2008/01/08/breaking-linden-bans-second-life-banks/ (Jan. 8, 2008).

typically states that the operator may turn off the virtual world or cancel a participant's account without compensation at any time and for any reason, retains ownership of all accounts and virtual property (*i.e.*, the participant is merely licensing use of the game and has no property interest in virtual items or accounts), and may prohibit the transfer of accounts or virtual property for "real" money.[18] However, at least some of these limitations may not be enforceable under state law.[19]

Even if virtual property and avatars are not determined to be "property" under state law, they are valuable and can be sold for real dollars or in-world currencies, which can often be converted into real dollars. For example, in early 2008 a person could sell 1,000 WoW gold pieces for between $12 and $22 (an exchange rate of between 83.33 and 45.45 gold pieces per U.S. dollar).[20] A person could also sell 1,000 Linden Dollars on an in-world currency exchange for about $3.75 (an exchange rate of 266 Linden Dollars per U.S. dollar).[21]

You've got to be kidding: Is this economic activity significant?

The economic activity in virtual worlds is significant. As early as 2001, an economist estimated that time spent in one of the many "virtual worlds" generated about $3.42 per hour, which represented a gross national product (GNP) of about $135 million and a per capita GNP of about $2,266 – roughly equivalent to Russia and higher than in many developing countries.[22] Since $3.42 is a decent wage in some developing countries, people in such countries reportedly spend long hours in a virtual world to acquire virtual property and create avatars with favorable attributes that the entrepreneur can sell for real dollars.[23] In

18 For example, WoW's TOS provides:

> BLIZZARD MAY SUSPEND, TERMINATE, MODIFY, OR DELETE THE ACCOUNT AT ANY TIME WITH ANY REASON OR NO REASON, WITH OR WITHOUT NOTICE.... Blizzard does not recognize the transfer of Accounts. You may not purchase, sell, gift or trade any Account, or offer to purchase, sell, gift or trade any Account, and any such attempt shall be null and void. Blizzard owns, has licensed, or otherwise has rights to all of the content that appears in the Program. You agree that you have no right or title in or to any such content, including the virtual goods or currency appearing or originating in the Game, or any other attributes associated with the Account or stored on the Service. Blizzard does not recognize any virtual property transfers executed outside of the Game or the purported sale, gift or trade in the "real world" of anything related to the Game. Accordingly, you may not sell items for "real" money or otherwise exchange items for value outside of the Game. *See* WoW TOS § 7-8, *at* http://www.worldofwarcraft.com/legal/termsofuse.html (last visited May 12, 2008).

Second Life's TOS allows participants to "retain... intellectual property rights with respect to Content you create in Second Life." Second Life, TOS § 3, *at* http://secondlife.com/corporate/tos.php (last visited May 12, 2008). However, the TOS also grants Linden Labs a "perpetual, irrevocable, non-exclusive right and license" in any creations and provides that Linden Labs retains ownership of a person's account and related data. *Id.*

19 *See, e.g.*, Joshua Fairfield, *Virtual Property*, Indiana Law No. 50, *at* http://ssrn.com/abstract=807966 (Oct. 2005); Erez Reuveni, *On Virtual Worlds: Copyrights and Contract Law at the Dawn of the Virtual Age*, 82 Ind. L.J. 261, 290-294 (2007) (discussing various arguments that could result in virtual property rights, notwithstanding the terms of the EULA or TOS). When Linden Labs exercised its right to deny a person access to virtual property, a court found the TOS arbitration clause to be unenforceable. *See Bragg v. Linden Research, Inc.*, 487 F. Supp. 2d 593 (E.D. Pa. 2007).

20 *See, e.g.*, http://www.mmopawn.com/sell-1.html (last visited Feb. 28, 2008). The actual price may depend on supply and demand conditions on the particular server hosting the part of the virtual world where the transaction will take place as well as the number of WoW gold pieces you are attempting to sell. An online chat on February 28, 2008, revealed that www.mmopawn.com would have paid $14 for 1,000 WoW gold pieces on the "Aegwynn US – A" server.

21 *See* http://secondlife.com/whatis/economy-market.php (last visited Mar. 5, 2008).

22 *See* Edward Castronova, *Virtual Worlds: A First-Hand Account of Market and Society on the Cyberian Frontier*, CESifo Working Paper No. 618, 33, at http://papers.ssrn.com/abstract=294828 (Dec. 2001).

23 Eli Shayotovich, *Taxing Virtual Earnings – Seriously, at* http://www.businessweek.com/print/innovate/content/may2006/id20060502_832540.htm (May 2, 2006).

2006, one person was reported to have become a millionaire by developing and selling virtual real estate in Second Life,[24] and about 3,100 "residents" of Second Life who earned a net profit were reported to have generated average annual revenues of $20,000 in real U.S. dollars.[25] Real world businesses such as Dell, Mazda, Adidas, Coca Cola, CNET, Major League Baseball, Harvard University, American Apparel, H&R Block, and Reuters have established a presence in Second Life.[26] The American Cancer Society reportedly raised about $118,000 via a virtual "Relay for Life" in which over 1,000 avatars participated by "walking" through representations of real-life places.[27] In other words, by participating in these worlds, a significant number of people are creating real economic income. Where there is economic income, there is likely to be tax due from someone.[28]

When people generate virtual income and property, whose property is it?

The federal income tax consequences of a transaction generally depend on what property rights are created or transferred under local law.[29] As noted above, most virtual world contracts provide that players obtain no property rights by playing the game, but since players or residents are creating significant value, scholars have speculated that such agreements might not be upheld.[30] Even if someone else owns the virtual property under state law, however, a person who creates valuable virtual property or turns it into "real" property or

24 *See* Daniel Terdiman, *Big-shot Economist to Advise Teen Virtual World*, CNET News.com, Sept. 17, 2007. *See also* http://acs.anshechung.com/ (last visited May 12, 2008).

25 Robert D. Hof, *My Virtual Life*, Business Week, *at* http://www.businessweek.com/print/magazine/content/06_18/b3982001.htm?chan=g1 (May 1, 2006).

26 *See* www.secondlife.com; Second Life, Brand Promotion, *at* http://secondlifegrid.net/how/brand_promotion (last visited Mar. 10, 2008). *See also*, Tim Beyers, *IRS to Tax Your Second Life?* The Motley Fool, *at* http://www.fool.com/server/printarticle.aspx?file=/investing/high-growth/2006/10/16/irs-to-tax-your-second-life.aspx?terms=IRS%20to%20Tax%20Your%20Second%20Life (Oct. 16, 2006). H&R Block has started to offer tax advice in Second Life and is accepting Linden Dollars in exchange for a new tax preparation product. *See* H&R Block Launches First Virtual Tax Experience in Second Life, *at* http://www.hrblock.com/presscenter/articles/secondrelease.jsp (last visited Mar. 10, 2008). It is also paying "residents" in Linden Dollars for helping to market its product on their own virtual property. *Id.* Even the IRS has studied the utility of virtual worlds as a communication and training tool, concluding the IRS could use them to recruit new employees and provide taxpayer service, for example, through "Virtual Tax Days" where the IRS answers tax questions inside a virtual world. Wage and Investment, Strategy and Finance, Program Evaluation and Risk Analysis (PERA), *Virtual Worlds*, Project No. 7-03-16-2-024 (Apr. 2003).

27 American Cancer Society, Second Life Relay for Life, *at* http://www.cancer.org/docroot/GI/content/GI_1_8_Second_Life_Relay.asp (last visited May 12, 2008) and Second Life, Philanthropy and Fundraising, *at* http://secondlifegrid.net/how/philanthropy_and_fundraising (last visited Mar. 10, 2008).

28 The European Union subjects Second Life transactions between the operator and EU residents to VAT taxes. *See* Second Life, *Value Added Tax, at* http://secondlife.com/corporate/vat.php (last visited Mar. 10, 2008).

29 *See, e.g., Morgan v. Comm'r*, 309 U.S. 78, 80 (1940) ("State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed."). The EULA or TOS typically provides that a specific jurisdiction's laws will apply. For example, the Second Life TOS provides: "This Agreement and the relationship between you and Linden Lab shall be governed in all respects by the laws of the State of California without regard to conflict of law principles or the United Nations Convention on the International Sale of Goods." Second Life, TOS § 7.1, *at* http://secondlife.com/corporate/tos.php (last visited May 12, 2008).

30 *See, e.g.*, Joshua Fairfield, *Virtual Property*, Indiana Law No. 50, *at* http://ssrn.com/abstract=807966 (Oct. 2005); Erez Reuveni, *On Virtual Worlds: Copyrights and Contract Law at the Dawn of the Virtual Age*, 82 Ind. L.J. 261, 290-294 (2007) (discussing various arguments that could result in virtual property rights, notwithstanding the terms of the EULA or TOS). As noted above, when Linden Labs exercised its right to deny a person access to virtual property, a court found the TOS arbitration clause to be unenforceable. *See Bragg v. Linden Research, Inc.*, 487 F. Supp. 2d 593 (E.D. Pa. 2007).

value is likely to wonder if he or she is nonetheless subject to tax on income from services, prizes, or winnings.[31]

What are some of the tax issues that virtual worlds raise?

Virtual world transactions raise a number of tax questions. For example, is a person subject to tax each time he or she acquires virtual property? How about when the person exchanges one virtual property for another, or for virtual currency? How about when the user sells the virtual property or his or her account (and avatar) for real money? What, if any, information reporting, withholding, backup withholding, and recordkeeping requirements apply to these transactions? Similarly, difficult questions may arise in connection with the tax obligations of virtual world operators.

Why might a taxpayer be confused about whether transactions involving virtual property should be reported as taxable income?

Income, broadly defined, is subject to tax.

Although the IRS has not issued any guidance directly addressing these difficult questions, a person is generally taxed immediately upon "all income from whatever source derived."[32] Income is defined broadly as any "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[33] Moreover, a person is generally subject to tax upon finding or earning money or treasure, winning a lottery, prize or award, stealing property, or trading one piece of property for another, potentially leading some to conclude that transactions involving virtual property are or should be subject to tax.[34]

The receipt of prizes, winnings, and barter exchange "trade credits" are all subject to tax, information reporting, and withholding.

If the in-world sale or exchange of virtual property for other virtual property or in-world currency is analogous to barter (*i.e.*, trading), which generates taxable income, then each

31 At least for foreign persons, there is also a question about whether the person may be subject to tax in the United States, especially if the server is located in the United States. *See generally*, Richard L. Reinhold, *Some Things That Multilateral Tax Treaties Might Usefully Do*, 57 TAXL 661 (Spring 2004) (discussing the role of server location in determining if a corporation has a "permanent establishment" in the U.S.); Richard L. Doernberg, *Electronic Commerce: Changing Income Tax Treaty Principles A Bit?*, 89 Tax Notes 1625 (Dec. 18, 2000) (same). In addition, the location of the parties and the computer server may affect a state's authority to require the parties to an online-transaction to collect or pay sales or use tax. *See, e.g.*, Paula K. Royalty, *Tax Implications of Using Out-of-State Computer Servers*, 1 Shidler L.J. Com. & Tech. 5 (Feb. 2, 2005).

32 IRC § 61 (defining gross income). Some taxpayers are not even aware that Internet transactions are subject to tax. The press surrounding the "Internet Tax Moratorium," which temporarily prohibits local governments from levying taxes on Internet connections may contribute to this misperception. *See, e.g.*, Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110–108, 121 Stat. 1024 (Oct. 31, 2007).

33 *Comm'r. v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554 (1991) further clarified that the exchange of substantially similar mortgages gave rise to "realization" under IRC § 1001 of any gain or loss because the mortgages embodied "legally distinct entitlements." Thus, some may conclude that the exchange of one virtual item for another or for virtual currency triggers a "realization," which they may also conclude is taxable in the absence of a clearly applicable nonrecognition provision.

34 *See, e.g.*, IRC § 74 (including in income prizes and awards); IRC § 83 (including in income property transferred in connection with the performance of services); Treas. Reg. § 1.61-14(a) (noting: "Illegal gains constitute gross income. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession"); Rev. Rul. 80-52, 1980-1 C.B. 100 (noting members of a barter club had income from services in "the taxable year in which the [barter] credit units are credited to their accounts"); *Cesarini v. U.S.*, 428 F.2d 812 (6th Cir. 1970) (holding that cash discovered inside a piano purchased at auction is gross income in the year of the discovery).

transfer of virtual property could also generate taxable income.[35] In a barter exchange, one member provides goods or services to another in exchange for other goods or services or for trade credits, which can be used to acquire goods or services from other members. Since barter exchange operators are obligated to issue information returns (Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*) to each of their members, reporting each transaction[36] in excess of $1,[37] some virtual world operators may be concerned that the IRS might assert they should be sending these information returns to their customers each year, as certain commentators have suggested.[38]

Taxpayers have a similar duty to report any prizes or awards in excess of $600.[39] Virtual world operators may also be concerned that if the virtual property "paid" to participants in virtual worlds is sufficiently analogous to taxable prizes (*e.g.*, a prize for completing a quest), then the IRS could assert the operators need to report the prizes on information returns. In such cases, the virtual world operator might also be required to withhold against the prize if the player was either a foreign person or failed to provide a tax identification number.[40] Such withholding would be difficult since the prize – the virtual property – is not paid in cash.

However, many taxpayers may not be certain that virtual worlds are analogous enough to barter exchanges or that virtual currency is sufficiently analogous to prizes to be subject to such rules, at least before a taxpayer cashes out his or her virtual items for real dollars. Pursuant to various technical rules, tax is often deferred until after an item is transferred for value, as further described below.[41]

35 *See, e.g.*, Rev. Rul. 80-52, 1980-1 C.B. 100.

36 *See generally* Treas. Reg. §§ 1.6045-1(a)(4); 1.6045-1(e), 1.6045-1(f); IRS Publication 525, *Taxable and Nontaxable Income* (2007). The barter exchange regulations notably tax the receipt of barter exchange credits or scrip at its face value (unless the Commissioner determines another value), even though pursuant to the regulations, "property does not include a credit or scrip." Treas. Reg. § 1.6045-1(f)(5)(iii).

37 Notice 2000-6, 2000-1 C.B. 315 (providing a *de minimis* $1 exception).

38 *See* Dustin Stamper, *Taxing Ones and Zeros: Can the IRS Ignore Virtual Economies?*, 114 Tax Notes 149 (Jan. 15, 2007) (reporting that Professor Bryan Camp and Tim McDowel, executive director of the National Association of Trade Exchanges, both indicated that virtual world operators could be subject to the barter exchange reporting requirements).

39 IRC §§ 6041(a), 6041(d); IRC § 6041A(a), 6041A(e); Instructions for Form 1099-MISC (2008) (box 7); Instructions to Form W-2 G (2008). Although "brokers" are subject to similar information reporting rules under IRC § 6045, Internet auction sites such as eBay contend they are not brokers. *See, e.g.*, E-mail from Margaret M. Richardson to Eric Soloman and Michael Desmond (Apr. 16, 2007), *reprinted as*, Margaret M. Richardson, *Individual Comments on Third-Party Information Reporting for Online Commerce*, 2007 TNT 80-24 (Apr. 25, 2007).

40 *See generally* IRC §§ 3406(a)(1), 3406(h)(2), 1441(a), 1442(a).

41 For a detailed discussion of why certain income is not taxed, see generally, Lawrence Zenenak and Martin McMahon, *Professors Look at Taxing Baseballs and Other Found Property*, 84 Tax Notes 1299 (Aug. 30, 1999); Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the "Claim of Right Doctrine" to Found Objects, Including Record-Setting Baseballs*, 4 Fla. Tax. Rev. 685 (2000); Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 Hastings L. J. 1 (Nov. 2007); Leandra Lederman, *"Stranger than Fiction:" Taxing Virtual Worlds*, 82 NYU L. Rev. 1620 (Mar. 2007).

The production of property is not subject to tax.

A person is not immediately subject to tax when he or she creates property. For example, a farmer is not taxed on the crops he grows and harvests before selling or exchanging them.[42] A taxpayer may wonder if creating virtual items or setting out to obtain them is similar enough to farming and harvesting crops that such acquisitions are not taxable.

The receipt of property that is difficult to value is not always subject to tax.

A person is not immediately subject to tax when he or she acquires property that has no reasonably ascertainable fair market value. This is so even if the property could easily be valued if it were not subject to a contingency that affects its value.[43] For example, if a taxpayer sells stock in exchange for a right to receive an amount of money that is contingent on the outcome of pending litigation, the taxpayer might not be taxed until the litigation is resolved.[44] Such "open transaction" treatment also applies to payments for services in the form of nonqualified stock options that have no reasonably ascertainable fair market value. Such payments are not taxable until the options are exercised or transferred.[45] Similarly, payments for services made in the form of stock are not taxable even if the stock is easy to value, provided the stock is subject to a substantial risk of forfeiture (*e.g.*, the taxpayer forfeits the stock if he or she terminates employment before it "vests") until the stock is transferred or the risk of forfeiture (*i.e.*, the contingency) lapses.[46]

Although some virtual property is relatively easy to value because it is listed for sale on virtual property auction websites, other virtual property is not so easy to value. Some virtual property is not transferable under the TOS. Moreover, all virtual property is arguably subject to forfeiture at the discretion of the virtual world operator. The virtual world operator could cancel the taxpayer's account, shut down the virtual world, or change the world in a way that eliminates the value of the virtual item. Thus, a taxpayer may wonder if such contingencies make the in-world acquisition and sale or exchange of virtual property nontaxable.

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42 *See Morris v. Comm'r*, 9 B.T.A. 1273, 1277-1278 (1928), *acq.*, C.B. VII-2, 28 (1928); *Tatum v. Comm'r*, 46 T.C. 736, 739 (1966), *aff'd*, 400 F.2d 242 (5th Cir. 1968) (describing crops as representing an "unrealized appreciation"); *Strong v. Comm'r*, 91 T.C. 627 (explaining the general rule). *See also* Rev. Rul. 56-496; 1956-2 C.B. 17; IRC § 631; Treas. Reg. § 1.631-1(d) and (e). Scholars have distinguished a farmer's harvest, a fisherman's catch, and a miner's diamonds, which a person sets out to obtain with the investment of labor or capital, from similar items that a taxpayer may find unexpectedly. *See* Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the "Claim of Right Doctrine" to Found Objects, Including Record-Setting Baseballs*, 4 Fla. Tax. Rev. 685, 696-697 (2000) (observing that no similar deferral applies to income from found items, which are generally taxable upon receipt).

43 *See generally Burnet v. Logan*, 283 U.S. 404, 51 S. Ct. 550 (1931).

44 *See, e.g.*, Rev. Rul. 58-402, 1958-2 C.B. 15; *In re Steen*, 509 F.2d 1398, 1403-1405 (9th Cir. 1975); Treas. Reg. § 1.1001-1(g)(2).

45 *See* Treas. Reg. § 1.83-7.

46 *See* IRC § 83(a); Treas. Reg. § 1.83-1.

Merely exercising the right to use someone else's property is not subject to tax.

In certain circumstances, we do not tax the acquisition of the right to use another person's property even if the use itself is valuable.[47] For example, one academic has observed that when vacationers on a cruise ship reallocate deck chairs which are all owned by the cruise operator, they are not subject to tax.[48] Each vacationer has purchased a right to use any of the chairs in the public areas of the cruise ship. So redistributing actual possession of the chairs among passengers who have the right to use them does not result in taxable income, even though there may be such a shortage of a given type of chair that one passenger may be willing to pay another to use it. Similarly, by paying to play the game, a taxpayer has the legal right to use any virtual property or virtual dollars that he or she could acquire inside the virtual world. Thus, a taxpayer may wonder if the acquisition and sale of virtual property for virtual dollars is nontaxable because it is similar to acquiring and trading the right to use a deck chair – a right that he or she acquired by paying to play the game.

Winnings are not always taxed immediately.

A gambler is generally not taxed after each winning hand of poker provided he or she does not leave the table or cash in his or her chips.[49] Thus, a taxpayer may wonder if the acquisition and sale of virtual property for virtual dollars is nontaxable because it is similar to winning a hand of poker before leaving the table or cashing out.

The IRS sometimes decides not to tax certain transactions.

In some cases, the IRS does not tax transactions that fall into a grey area, especially if the public widely believes they are not taxable and a contrary result might be difficult to administer. For example, academics have suggested the IRS's policy of not taxing the receipt of frequent flier miles was more a product of political pressure than of technical analysis.[50] Commentators have said the same thing about the IRS's decision not to tax a baseball fan who catches a record-breaking ball and immediately returns it.[51] Similarly, many Internet

47 The tax treatment of transactions on Second Life could differ from the treatment of transactions on other virtual worlds because according to the TOS Second Life Residents retain certain intellectual property rights to their virtual creations. Second Life, TOS § 3, *at* http://secondlife.com/corporate/tos.php (last visited May 12, 2008).

48 *See* Leandra Lederman, *"Stranger than Fiction:" Taxing Virtual Worlds*, 82 NYU L. Rev. 1620, 1654 (Mar. 2007).

49 *See* Rev. Proc. 77-29, 1977-2 C.B. 538 (suggesting that to properly substantiate gains and losses in "table games," which are typically played using chips, a taxpayer should record the gambling results at a given table rather than after each hand). *See also Zarin v. Commissioner*, 916 F.2d 110, 114 (3rd Cir. 1990) (holding, in part, that casino chips were not "property" in the hands of a gambler, but rather "nothing more than an accounting mechanism... designed to facilitate gambling in casinos where the use of actual money was forbidden"). *But see* PLR 200532025 (May 3, 2005) (concluding an online gaming site operator must report online credits to a taxpayer's gaming account, where the credits performed the same function as casino chips even if the taxpayer had not exchanged the credits for cash or property).

50 *Compare* Ann. 2002-18, 2002-1 C.B. 621 (declaring "[T]he IRS will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer's business or official travel.... The relief provided by this announcement does not apply to travel or other promotional benefits that are converted to cash") *with* Dominic L. Daher, *The Proposed Federal Taxation of Frequent Flyer Miles Received from Employers: Good Tax Policy But Bad Politics*, 16 Akron Tax J. 1 (2001) (suggesting that the receipt of frequent flyer miles is taxable under current law and that the IRS's announcement was the result of political pressure).

51 *Compare* IR-98-56 (Sept. 8, 1998) *with* Darren Heil, *The Tax Implications of Catching Mark McGwire's 62nd Home Run Ball*, 52 Tax. Law 871 (Summer 1999) (arguing that a taxpayer should be taxed even if he or she returns the ball because he or she exercises dominion and control over it and suggesting that because the IRS's press release was the product of political pressure it may not reflect the correct interpretation of existing law).

users and virtual world operators believe that in-world transactions are not and should not be subject to tax, in part because of the administrative difficulties that taxation would present.[52] Thus, a taxpayer may conclude that when the IRS gets around to providing guidance on the taxation of in-world transactions, it will likely reach the same conclusion, especially since it has not issued any guidance to the contrary even though the tax issues presented by virtual worlds have received significant publicity.

Why would it be difficult to administer the taxation of in-world transactions?[53]

Aside from possibly having to analyze and litigate each of the questions described above, administering the taxation of in-world transactions would present significant challenges for taxpayers and the IRS, such as those described below.

Tracking and reconstructing many small transactions would be burdensome.

Most in-world sales or exchanges involve low value items of virtual property. For example, according to Second Life, in February 2008, its residents engaged in about 16 million transactions, 85 percent of which were for 199 Linden Dollars or less.[54] Since the exchange rate at that time was about 265 to 266 Linden Dollars to the U.S. dollar,[55] these statistics suggest that most transactions on Second Life are for less than $1 and would not be subject to information reporting, even if the IRS treated Second Life as a barter exchange. Thus, residents and the IRS might need to track and document millions of small transactions without the benefit of information reporting.

Valuing virtual transactions would present challenges.

A related and potentially more serious problem would be valuing each of the virtual transactions. Although it might be relatively easy to value in-world currency (assuming we ignore any discount to account for the possibility the virtual world operator may take action that would reduce its value) if the currency is readily convertible into real dollars on an organized exchange, many virtual currencies are not traded that way.[56] Moreover, the value of a virtual currency on any given day could be very difficult for the IRS or a taxpayer to reconstruct years later in connection with an IRS audit. While valuing in-world transactions conducted in virtual currency would be burdensome, especially in light of the small dollar amounts typically involved, valuing in-world trades of other types of virtual property

52 *See, e.g.*, Heather M. Rothman, *Tax Policy: As Congress Considers Online Game Taxes, Linden Lab Contends Law Already Clear*, 210 DTR G-2 (Oct. 31, 2006).

53 Commentators have pointed out a number of policy arguments for and against the taxation of in-world transactions. *See, e.g.*, Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 Hastings L. J. 1, 44-71 (Nov. 2007); Leandra Lederman, *"Stranger than Fiction:" Taxing Virtual Worlds*, 82 NYU L. Rev. 1620, 1641-1672 (Mar. 2007); Steven Chung, *Real Taxation of Virtual Commerce: Has Second Life Crossed the Line?*, Spring 2007 (unpublished manuscript, on file with Hastings LJ). However, our discussion is limited to administrative considerations.

54 Second Life, Economic Statistics, *at* http://secondlife.com/whatis/economy_stats.php (last visited Mar. 10, 2008).

55 Second Life, LindeX Market Data, *at* http://secondlife.com/whatis/economy-market.php (last visited Mar. 10, 2008).

56 For example, there is no currency exchange for WoW gold. Different Internet vendors buy and sell WoW gold at different rates which are not always publicly disclosed. The value of WoW gold depends on the size of the transaction and its location (*e.g.*, the server on which it is located).

might be nearly impossible. For example, how would we value a trade of virtual armor for a virtual sword or the income from picking up a virtual sword?

IRS guidance could improve taxpayer compliance even if it simply clarified that in-world transactions are not taxable.

Internet-based transactions are a potential area of noncompliance, particularly when they are not subject to information reporting. Yet, the IRS sometimes responds to questions from taxpayers who want to comply with the rules, which the IRS has not adequately explained or written down, by asking the taxpayer to request a private letter ruling at significant personal expense.[57] In 2005, for example, when a taxpayer asked the IRS how to report the acquisition, exchange, and sale of virtual property, IRS employees gave him two different answers and one advised him to submit a private letter ruling request.[58] The taxpayer later published a book describing the situation, as well as his discussion with the IRS.

Some people are likely to conclude that if the rules are so complicated that the IRS cannot even figure them out, it is unreasonable for the government to expect taxpayers to do so.[59] They might also use such reasoning to justify noncompliance in other areas. Moreover, our system of voluntary compliance will break down if it demands that taxpayers report income that is impossible to report, pay tax on "virtual" income that cannot be used to pay real taxes, or makes taxpayers feel like "chumps" if, perhaps mistakenly, they do pay tax on such virtual income.[60] Thus, promulgating guidance would likely promote voluntary compliance even if it exempts in-world transactions from tax.[61]

57 The greatest expense associated with a private letter ruling request is likely to be the cost of hiring a tax practitioner to submit the request. However, the IRS's fee for a private letter ruling is: $625 for taxpayers with gross income less than $250,000, $2,100 for those with gross income between $250,000 and $1 million, and $11,500 for those with gross income of $1 million or more. Rev. Proc. 2008-1, 2008-1 I.R.B. 1. For a discussion of the IRS's difficulty in evaluating the impact of potential user fees on its ability to achieve its mission, see National Taxpayer Advocate 2007 Annual Report to Congress 66 (Most Serious Problem, *IRS User Fees: Taxpayer Service for Sale*).

58 *See* Julian Dibbell, *Play Money, or, How I Quit My Day Job and Made Millions Trading Virtual Loot*, 303-311 (2006) (describing discussions with one IRS employee at a Taxpayer Assistance Center and his conclusion that in-game transactions involving virtual property are not taxable, and a follow up call to an IRS business assistance line where the IRS employee expressed the opinion that such transactions are taxable, but recommended that the taxpayer obtain a private letter ruling, for a fee, to get a more authoritative answer).

59 *See generally* David J. Mack, ITAX: *An Analysis of the Laws and Policies Behind the Taxation of Property Transactions in a Virtual World*, 60 Admin. L. Rev. 749, 759 (Summer 2008) (urging the IRS to issue guidance on the taxation of virtual transactions, in part, to avoid creating "a society of unintentional tax cheats").

60 Imposing unreasonable recordkeeping burdens on taxpayers, as taxing in-world transactions might do, has long been thought to decrease voluntary compliance. *See, e.g.*, Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 Tax L. Rev. 121, 166–67 (1989).

61 Some commentators have suggested that from a tax policy perspective in-world transactions in Second Life should be subject to tax, but in-world transactions in other worlds should not. *See, e.g.*, Leandra Lederman, *"Stranger than Fiction:" Taxing Virtual Worlds*, 82 NYU L. Rev. 1620, 1625 (Mar. 2007) (concluding "transactions in game worlds, such as WoW, should not be taxed unless the player engages in a real-market trade (a cash-out rule)... [and] that in intentionally commodified virtual worlds, such as Second Life, federal income tax law and policy counsel that in-world sales of virtual items be taxed"); and Steven Chung, *Real Taxation of virtual Commerce: Has Second Life Crossed the Line?* 14, 20 (Spring 2007) (unpublished manuscript, on file with Hastings LJ) (concluding that "imposing a taxable event at the in-world level would be fairer, would not create excess burdens and is not complex" but later clarifying "this article does not advocate taxing in-world transactions within Second Life").

To its credit, the IRS has recently identified a number of issues presented by Internet auctions of virtual property and other aspects of virtual worlds.[62] However, the IRS should consider doing more to help taxpayers comply with their tax obligations by quickly issuing guidance addressing how to report economic activities in virtual worlds, as well as in other emerging areas of economic activity.[63]

IRS Comments

The IRS recognizes the need to address the tax aspects of new e-business activities. For example, the IRS formed the E-Business and Emerging Issues (EBEI) policy group in 2003 to address emerging issues resulting from the growth and expansion of business activities, advances in computer technology, and new developments in the use of e-business technology. This technology includes the advent of Internet-based "virtual world" games that may involve a "virtual economy" for game participants.

The EBEI group has partnered with IRS business units to provide a consistent strategy to address e-business tax issues. The IRS is engaged in the identification of tax issues resulting from new Internet-related activities and recommendation of appropriate strategies to address those issues. Such strategies include internal and external communications such as issuance of interim guidance memoranda, updates to the Internal Revenue Manual (IRM), IRS publications, and website postings.[64] We also had specific workforce training, research projects, proposals for published guidance, and IRS compliance initiative projects.

The IRS has issued guidance in the past on other activities that raise similar issues to those of "virtual world" game activities.[65] For example, guidance related to online auctions, bartering, and electronic businesses states that if a taxpayer spends more money on an activity than received, the taxpayer cannot claim a loss on an income tax return. If a taxpayer receives more money from an activity than spent, then the taxpayer may be required to

62 SB/SE Examination Policy, Reporting Compliance, *Internet Online Gaming an E-Business & Emerging Issues (DRAFT) Discussion Paper on the Compliance Impact of Internet Online Gaming* (May 2007). As early as 2004, the IRS conducted a Compliance Initiative Project to address noncompliance by Internet auction sellers. SB/SE Reporting Compliance, Compliance Improvement Project, *Internet Auction Sellers & Auction Brokers* (Feb. 25, 2004). By contrast, according to SB/SE Compliance it "has not identified any known examinations involving Internet Online Gaming and the sale of virtual game items." SB/SE Examination Policy, Reporting Compliance, *Internet Online Gaming an E-Business & Emerging Issues (DRAFT) Discussion Paper on the Compliance Impact of Internet Online Gaming* 4 (May 2007).

63 TIGTA also recently found that the IRS could improve the accountability of its guidance process. *See* TIGTA, Ref. No. 2008-10-075, *The Published Guidance Program Needs Additional Controls to Minimize Risks and Increase Public Awareness* (Mar. 4, 2008).

64 Communications include: IRS, *Retail Industry ATG - Chapter 3: Examination Techniques for Specific Industries (Electronic Business, Online Retail), at* http://www.irs.gov/businesses/small/article/0,,id=141491,00.html (Aug. 2005); IRS, *Online Auction Sellers, at* http://www.irs.gov/businesses/small/industries/article/0,,id=163622,00.html (last visited Dec. 8, 2008); IRS, *Bartering Income, at* http://www.irs.gov/businesses/small/article/0,,id=187904,00.html (last visited Dec. 8, 2008); IRS, *Electronic Business, at* http://www.irs.gov/businesses/small/article/0,,id=108188,00.html (last visited Dec. 8, 2008); IRS, *Tax Responsibilities of Bartering Participants, at* http://www.irs.gov/businesses/small/article/0,,id=188095,00.html (last visited Dec. 8, 2008).

65 Guidance includes: IRS, *Tax Tip 2008-02, Gambling Winnings and Losses, at* http://www.irs.gov/newsroom/article/0,,id=172190,00.html (last visited Dec. 8, 2008); IRS, *Tax Topic 419, Gambling Income and Expenses, at* http://www.irs.gov/taxtopics/tc419.html (last visited Dec. 8,. 2008); Transcript for Business or Hobby, *at* http://www.irs.gov/businesses/small/article/0,,id=187331,00.html; IRS Pub. 525, *Taxable and Nontaxable Income, at* http://www.irs.gov/pub/irs-pdf/p525.pdf (2007) (analogous to gambling, found property, prizes & awards, bartering, hobbies, etc.).

report taxable income. This guidance should be helpful in assisting taxpayers who have questions about the tax consequences of their online "virtual world" game activities.

The IRS will continue to prioritize our guidance to meet taxpayer needs. Virtual world e-business issues and implementation of communication and compliance strategies will continue to be addressed through the EBEI policy group.

Taxpayer Advocate Service Comments

While the National Taxpayer Advocate is pleased the IRS has formed an E-Business and Emerging Issues policy group, provided guidance, and initiated training, research projects, and compliance initiative projects, she finds the IRS comments largely unresponsive to the concerns outlined above. The IRS guidance on barter, online auction sellers, gambling income, found property, etc. described in the IRS comments is helpful. However, this guidance mostly restates existing rules, addressing the relatively easy questions for which clear answers already exist.[66]

As the tax administrator, the IRS has a duty to answer all of the basic questions about transactions undertaken regularly by significant numbers of taxpayers, such as those involving virtual items (described above), especially if the questions are difficult for taxpayers to answer on their own.[67] It may be unfair to expect the IRS to answer these questions before state property and contract laws have evolved far enough to provide clear guidance about when a transfer of virtual items is a transfer of property rights. These very difficulties, however, support the conclusion that the IRS should issue guidance. If the tax experts at the IRS cannot figure out what the rules are or should be, unsophisticated taxpayers who participate in the virtual economy have little hope of doing so. The IRS could at least make an administrative pronouncement about how taxpayers should treat these transactions in the interim as it studies the issue and the state law rules evolve.

More broadly, the IRS needs to produce specific early guidance on difficult issues confronted by taxpayers on a regular basis in emerging areas of economic activity. Otherwise, it risks turning these taxpayers into unintentional tax cheats, establishing noncompliance norms in the industry, and leaving IRS employees without clear guidance about how to do their jobs.

66 For one of the most recent suggestions by a commentator regarding how the IRS could answer some of the difficult questions, see Theodore P. Seto, *When is a Game Only a Game?: The Taxation of Virtual Worlds*, Loyola-LA Legal Studies Paper No. 2008-24, at http://ssrn.com/abstract=1220923 (Aug., 12 2008).

67 The South Korea and Swedish tax agencies have issued some guidance in this area. *See, e.g.*, Flora Graham, *Slapping a Tax on Playtime*, BBC News, *at* http://news.bbc.co.uk/2/hi/technology/7746094.stm (Nov. 25, 2008). Although the Swedish pronouncement was not promulgated in English, it reportedly stated that "in-game transactions may incur liability for both value-added tax as well as income tax under Swedish law." Vili Lehdonvirta, *Sweden Moves to Tax In-Game Transactions*, Virtual Economy Research Network, *at* http://virtual-economy.org/blog/sweden_moves_tax_-game_transactions (Apr. 16, 2008).

Recommendations

The National Taxpayer Advocate recommends the IRS:

1. Work with the Office of Chief Counsel and the Treasury Department to issue guidance addressing how taxpayers should report economic activities in virtual worlds (or at least ask the Office of Chief Counsel to put it on the priority guidance plan) along with other emerging issues; and
2. Invite the Taxpayer Advocate Service to appoint a representative to the E-Business and Emerging Issues policy group.

MSP #14

Suitability of the Examination Process

Responsible Officials

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

Definition of Problem

The IRS Restructuring and Reform Act of 1998 refocused the IRS mission from enforcement to a "greater emphasis on serving the public and meeting taxpayers' needs."[1] Current law provides for "simple and nontechnical" processes and procedures for examining, or auditing, taxpayers' returns.[2] The Internal Revenue Manual (IRM) and IRS publications provide opportunities for the IRS to meet taxpayer needs and preferences throughout the examination process.[3] These needs and preferences may vary from choosing a method for conducting an examination (face-to-face versus correspondence) to requesting a telephone discussion of an audit issue with the examiner, and even include setting up a payment agreement for any taxes owed as a result of the audit. The IRS often fails to meet taxpayer needs and preferences due to limited resources or policy reasons. The resulting unsuitability of the process deviates from the IRS's commitment to provide "top quality" taxpayer service and can lead to taxpayer complaints and tax controversies.[4]

Because the IRS does not consistently meet taxpayer needs and preferences, the tax assessed sometimes reflects the taxpayer's inability to navigate the audit process rather than the amount truly owed. This is evidenced by the following disparities in audit and customer satisfaction results:

- Taxpayers audited in an office setting experience lower assessments and higher agreement rates;[5]

1 IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, Title I, Subtitle A, § 1002, 112 Stat. 690 (July 22, 1998). *See also* IRS Mission Statement, Internal Revenue Manual (IRM) 3.0.273.2 (Jan. 1, 2008); IRS Pub. 1, *Your Rights as a Taxpayer* (May 2005).

2 RRA 98, Pub. L. No. 105-206, Title III, Subtitle F, § 3503, 112 Stat. 771 (July 22, 1998).

3 For example, IRM 4.10.3.16.9 (Mar. 1, 2003) requires the IRS to honor a taxpayer's request for a face-to-face interview. Such needs and preferences may include face-to-face meetings, relief requests under repetitive audit procedures, or correspondence audit issue discussions via telephone with a tax examiner.

4 Taxpayers may use various avenues to express dissatisfaction with the examination process ranging from requests for TAS assistance and Audit Reconsiderations to protests to the Appeals function and U.S. Tax Court.

5 Automated Information Management System (AIMS) from the Compliance Data Warehouse (CDW), Individual Tax Returns for Tax Periods 2005-2008 (Sept. 2008). *See also* Chart 1.14.1, Examination Closures, *infra.*

- Taxpayers audited by correspondence are more likely to be subject to repetitive audits;[6] and
- Taxpayers who are able to discuss their correspondence audit by telephone with their tax examiner express very favorable comments.[7]

The National Taxpayer Advocate is very concerned about these disparities, which could jeopardize the fairness and uniformity of tax administration.

Analysis of Problem

An Introduction to IRS Examinations

Internal Revenue Code (IRC) § 7602(a)(1) authorizes the IRS to examine any books, papers, records, or other data that may be relevant to ascertain the correctness of any return.[8] IRC § 7605(b) prevents the IRS from conducting unnecessary examinations of taxpayer's "books of account" more than once for each taxable year.[9] As a practical matter, the "one inspection" rule has numerous limitations and applies only to the taxpayer's own records.[10] For example, as part of the audit process, an examiner will inspect (*i.e.*, look at) taxpayer's prior and subsequent year tax returns to identify related issues or matters of concern.[11] An inspection of a tax return under these circumstances does not constitute an inspection of "books of account."[12] Similarly, the IRS has taken the position that other IRS contacts with taxpayers (*e.g.*, to resolve mathematical or clerical errors,[13] unreported income or non-filing issues such as Automated Underreporter (AUR), (also called document matching)

6 For a detailed discussion on the frequency and likelihood of a Correspondence Examination, see Most Serious Problem, *The IRS Correspondence Examination Program Promotes Premature Notices, Case Closures, and Assessments, infra.*

7 Pacific Consulting Group, *Compliance Center Examination (CC Exam) SB/SE National Report, January Through March 2008* 10, 19 (July 2008).

8 IRC § 7602.

9 IRC § 7605(b); 26 C.F.R. § 301.7605-1(h).

10 The courts interpret the "one inspection" rule very narrowly, holding that a subsequent examination does not constitute a second inspection in many situations. *See Application of Magnus*, 299 F.2d 335 (2d Cir. 1962) (subsequent IRS third-party inquiry as a part of a continuing investigation "not a further examination"); *Dahl v. Comm'r*, T.C. Memo. 1974-190, *aff'd*, 526 F.2d 552 (9th Cir. 1975) (IRS reexamination of information contained in a prior audited return for the purpose of determining the correct tax liability for the year under examination not a second inspection); *Estate of Maceo v. Comm'r*, T.C. Memo. 1964-46 (IRS examination of new matters introduced by an amended tax return not a second examination when taxpayer failed to timely object); *U.S. v. Kendrick*, 518 F.2d 842 (7th Cir. 1975) (second examination applicable to a different type of tax); *U.S. v. Omohundro*, 619 F.2d 51 (10th Cir. 1980) (IRS subsequent examination of corporate records after examining the records of an individual taxpayer not a second examination); *Spell v. U.S.*, 907 F.2d 36, 38 (4th Cir. 1990) (transfer of the case to Criminal Investigation (CI) for further investigation after completing a routine audit not a second inspection).

11 IRM 4.19.3.30.7.1 (Nov. 8, 2005).

12 *See Curtis v. Comm'r*, 84 T.C. 1349, 1350 (1985).

13 *See generally* IRC § 6213(g).

inquiries,[14] and Automated Substitute for Return (ASFR) entries[15] do not constitute more than one inspection under IRC § 7605(b).[16]

The IRS audit program relies on one-on-one examination contact with a taxpayer and includes three types of examinations: correspondence examinations, examinations conducted in IRS offices, and field examinations typically held in a taxpayer's home or place of business.[17] These examinations range from a mailed notice asking for clarification of a single tax return item to a full, face-to-face interview and review of the taxpayer's records.

The number of individual income tax returns examined has continuously increased since 2000.[18] During fiscal year (FY) 2000, the IRS audited 617,765 such returns. By FY 2007, this figure more than doubled, with the IRS examining 1,384,563 individual returns. Examinations completed by correspondence accounted for 83 percent of all individual taxpayer audits,[19] and IRS campus offices conducted slightly more than 71 percent of the correspondence examinations.[20]

The Expanded Use of Correspondence Examinations

Correspondence examinations focus on a limited number of specific, clear-cut issues that would not normally require a full-scale field audit.[21] Over the years, the number of examinations conducted by correspondence increased dramatically, focusing largely on economies of scale rather than taxpayer needs and preferences.[22] The regulations refer to the convenience of a taxpayer; however, the current correspondence examination process is driven mainly by time and issue instead.[23] For example, although the IRM prescribes that IRS employees honor a taxpayer's request for a face-to-face examination, many taxpayers do not make this request, simply because they are unaware of this option.[24] Further, taxpayers who do know about the option may not fully realize how a face-to-face examination might better suit the issue and their needs.

14 The AUR program automatically matches the items reported on a tax return with information reported by third parties on information returns.

15 ASFR relies on data from information returns or prior year returns to prepare substitute returns and assessments for individuals who fail to file after the IRS sends them a notice.

16 *See* IRM 1.2.13.1.1, Policy Statement 4-3(3) (Dec. 21, 1984). This policy statement specifically states that any inspection of the taxpayer's books of account, to the extent necessary to resolve a discrepancy between the taxpayer's return and a broad category of informational returns, will not be considered an inspection of books and records within the meaning of IRC § 7605(b). *See also* IRS Chief Counsel Advisory 200009045 (Mar. 3, 2000) (request for information to taxpayers in Coordinated Examination Program not an examination of taxpayer's books); Field Service Advice FSA 199916004 (Apr. 22, 1999) (IRS compliance with a request from a foreign country for tax information on a U.S. taxpayer pursuant to a tax treaty not a second examination).

17 *See* Treas. Reg. §§ 601.105; 301.7605-1. *See also Statistics of Income (SOI) Tax Stats - IRS Tax Compliance Activities, at* http://www.irs.gov/taxstats/compliancestats/article/0,,id=117875,00.html (last visited Aug. 27, 2008).

18 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2008-30-095, *Trends in Compliance Activities Through Fiscal Year 2007* 8 (Apr. 18, 2008).

19 *Id.*

20 *Id.* at 7

21 IRM 4.10.3.16 (Mar. 1, 2003) and IRM 4.19.1.2.3 (Oct. 1, 2001).

22 General Accounting Office (GAO), GAO/GGD-99-48, *IRS Audits – Weaknesses in Selecting and Conducting Correspondence Audits* (Mar. 1999).

23 Treas. Reg. § 601.105(b)(2)(ii).

24 *See* IRM 4.10.3.16.9 (Mar. 1, 2003).

For FY 2009, the IRS plans to maintain the current level of correspondence examinations by initiating 1,122,554 individual audits.[25] Taxpayers contacted by the IRS regarding a math error notice, AUR, or SFR inquiry could still face an audit for the very year in question because the IRS does not consider these other programs to be examinations.[26]

The General Accounting Office (GAO, now the Government Accountability Office) expressed concern about the suitability and volume of correspondence audits in a 1999 study.[27] The GAO found more than 50 percent of the taxpayers audited by correspondence did not respond to the IRS's letters. When asked why, the IRS indicated it had not studied the issue but speculated taxpayers may be overwhelmed or intimidated by the letters and may not be comfortable with responding; some may not understand the letters or know how to respond; and others may know they owe additional tax but hope their non-responsiveness discourages the IRS from trying to collect the tax.[28]

More than 70 percent of the Earned Income Tax Credit (EITC) taxpayers surveyed for a TAS Research study indicated that, if given a choice, they would prefer to conduct their examinations in person, rather than through correspondence.[29] Perhaps most notably, more than 25 percent of the respondents indicated they were not even aware the IRS was auditing their returns.[30] The National Taxpayer Advocate is concerned about the suitability of these audits for correspondence examinations.[31]

Meeting Taxpayer Needs Positively Impacts Tax Compliance

The importance of conducting applied research on taxpayer needs and preferences should not be underestimated. Many scholars have studied the link between "tax morale"[32] generated by meeting needs, preferences, and expectations, and tax compliance. Some believe tax compliance is driven by a psychological tax contract between citizens and tax

25 IRS Enterprise Plan Summary (June 19, 2008).

26 IRM 1.2.13.1.1., Policy Statement 4-3(3) (Dec. 21, 1984). This policy statement specifically states any inspection of the taxpayer's books of account, to the extent necessary to resolve a discrepancy between the taxpayer's return and a broad category of informational returns will not be considered an inspection of books and records within the meaning of IRC 7605(b).

27 GAO, GAO/GGD-99-48, *IRS Audits – Weaknesses in Selecting and Conducting Correspondence Audits* (Mar. 1999).

28 *Id.*

29 National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 95. This study, conducted with W&I Research, indicated only about half of the respondents involved with Earned Income Credit audits said they clearly understood what they needed to do to comply with IRS requests for information.

30 National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 94-95, 103-104. *See also The 2008 Tax Return Filing Season, IRS Operations, FY 2009 Budget Proposals, and the National Taxpayer Advocate's 2007 Annual Report to Congress, Hearing Before the Subcomm. on Oversight, H. Comm. on Ways and Means*, 110th Cong. (Mar. 13, 2008) (testimony of Nina E. Olson, National Taxpayer Advocate).

31 For a detailed discussion of the Correspondence Examination Process, *see* Most Serious Problem, *The IRS Correspondence Examination Program Promotes Premature Notices, Case Closures, and Assessments, infra.*

32 Tax morale is a broad concept, which encompasses internal motivations and perceptions (*e.g.*, I am a law-abiding person). Feld and Frey define tax morale "as a complicated interaction between taxpayers and the government establishing a fair, reciprocal exchange that involves giving and taking of both parties." *See* Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Resolution*, 2007 Law & Policy 102.

authorities,[33] which is influenced by government policy and the behavior of the authorities. The psychological tax contract and the resulting tax morale presuppose that the taxpayer and the tax authority treat each other like partners, with mutual respect and honesty.[34] In the simplest terms, fair and respectful treatment raises tax morale, and authoritarian treatment undermines tax morale.[35]

This approach is similar to the National Taxpayer Advocate's view of taxation as a social contract between the government and its taxpayers, with attendant rights and responsibilities on each party to that contract.[36] Taxpayer behavior and motivations play a vital role in determining individual taxpayer compliance.[37] If the IRS fails to recognize this process, it risks turning compliant taxpayers into noncompliant ones.[38]

Taxpayer Needs and Preferences

In 2006, the National Taxpayer Advocate published a comprehensive analysis of taxpayer needs, preferences, and willingness to use IRS services, using data from several studies conducted by the IRS and other organizations as part of the Taxpayer Assistance Blueprint (TAB) initiative. TAS defined *taxpayer needs* as the collection of services taxpayers require to comply with their tax obligations and the requirement that these services be delivered in a manner that allows the taxpayer to correctly use them without unreasonable burden. *Preferences* are taxpayers' favored methods for obtaining services.[39] The results of this analysis and their relevance to the examination process are discussed below.

33 Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*, Literature Review and Recommendations for the IRS Regarding Individual Taxpayers, 2007 National Taxpayer Advocate Annual Report to Congress vol. 2, 138.

34 Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Resolution,* 2007 Law & Policy 102.

35 Example offered by Feld & Frey: "The tax officials can choose between these extremes in many different ways. For instance, when they detect an error in the tax declaration, they can suspect intent to cheat, and impose legal sanctions. Alternatively, the tax officials may give the taxpayers the benefit of the doubt, and inquire about the reason for the error. If the taxpayer in question indeed did not intend to cheat but simply made a mistake, he or she will most likely be offended by the disrespectful treatment of the tax authority. The feeling of being controlled in a negative way, and being suspected of tax cheating, tends to crowd out the intrinsic motivation to act as an honorable taxpayer and, as a consequence, tax morale will fall. In contrast, if the tax official makes an effort to locate the reason for the error by contracting the taxpayer in a courteous way, the taxpayer will appreciate this respectful treatment and tax morale will be upheld." *Id.*

36 2007 National Taxpayer Advocate Annual Report to Congress 478 (Key Legislative Recommendation, *Taxpayer Bill of Rights and De Minimis "Apology" Payments). See also Hearing on the 2008 Tax Return Filing Season, IRS Operations, FY 2009 Budget Proposals, and The National Taxpayer Advocate's 2007 Annual Report to Congress*, Hearing Before the Subcomm. on Oversight, H. Comm. on Ways and Means, 110th Cong. (Mar. 13, 2008) (testimony of Nina E. Olson, National Taxpayer Advocate).

37 According to Joshua Rosenberg, in an ideal system (from the government perspective), "[people] would pay their taxes and feel good about it... [They] would feel about tax laws the same way they feel about criminal laws, contract laws, and property laws– that they are an important part of government and are enacted for our benefit. [People] would believe that others pay their fair share, would expect them to do so, would be disturbed when they did not, and would do what they could to ensure that the tax laws were properly enforced and that the IRS had all the information it needed." Joshua D. Rosenberg, *Narrowing the Tax Gap: Behavioral Options*, 117 *Tax Notes* 517 (2007).

38 National Taxpayer Advocate Keynote Address, American Bar Association Tax Section (May 5, 2006).

39 National Taxpayer Advocate 2006 Annual Report to Congress, vol. 2, 3.

Importance of Personal Communication during the Examination Process

Numerous studies highlight the need and preference for personal communication to resolve examination issues. When using IRS services, taxpayers overwhelmingly indicate they prefer in-person assistance.[40] Low income taxpayers (with annual incomes less than $35,000) stated they prefer in-person assistance and would visit an IRS office if one were nearby.[41] In 2006, the Treasury Inspector General for Tax Administration (TIGTA) reported increased personal interaction with taxpayers would allow more taxpayers timely access to the information they need to resolve discrepancies and reach agreement on tax matters.[42]

According to the TIGTA report, easy phone access to the IRS helps resolve cases and issues. TAS-moderated practitioner focus groups showed that, while practitioners had difficulty contacting IRS auditors, they often successfully resolved outstanding issues after a telephone conversation with the auditor familiar with the case.[43] To address accessibility issues highlighted in the report and in customer satisfaction surveys, the IRS plans to switch to a universal call routing system that will automatically direct a call to the first available examination employee. While this change might meet the taxpayer's *need* to discuss a correspondence audit with an examiner, it does not address the taxpayer's *preference* and possible need to speak to someone *familiar* with his or her particular case.

A face-to-face audit may not be necessary if the IRS assigns the examination to one tax examiner with whom the taxpayer establishes a relationship. Through personalized, one-on-one communications, the examiner gains familiarity with the taxpayer's particular circumstances, while the taxpayer can share concerns and address any questions. Data compiled by the Pacific Consulting Group for SB/SE Correspondence Examination reflects very favorable results and comments from taxpayers who are able to contact their assigned correspondence examiner, make a personal connection, and discuss their case in detail.[44]

Verbatim comments such as, "*I was impressed by how friendly and courteous the IRS employees were. The representative I spoke with was very friendly and understanding of my circumstance. She was helpful and knowledgeable and understood that these matters can be confusing for the taxpayer such as myself,*" and, "*The woman who handled my case was a delight to work with. Her grasp of the tax code was excellent. She treated me in a professional manner, but was very fair and pleasant,*"[45] showcase positive interactions during correspondence examinations. Unfortunately, the ease of getting through to the right person,

40 IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey Special Report* (Nov. 2006), 2006 Service Channels Survey, vii – viii.

41 National Taxpayer Advocate 2006 Annual Report to Congress, vol. 2, 6.

42 TIGTA, Ref. No. 2006-40-138, *The Wage and Investment Division Automated Underreporter Telephone Operations Could Improve Service to Taxpayers* 6 (Sept. 13, 2006).

43 The National Taxpayer Advocate's Findings from the Earned Income Tax Credit (EITC) Examination and Document Requirements Focus Groups, IRS Tax Forums, June – September 2005 (Dec. 2005).

44 Pacific Consulting Group, *Compliance Center Examination (CC Exam) SB/SE National Report, January Through March 2008* 10 (July 2008).

45 Pacific Consulting Group, *Compliance Center Examination (CC Exam) SB/SE National Report, 2007 Verbatim Customer Satisfaction Comments.*

and the length of time to get through by phone, are still the areas with the most room for improvement in correspondence examination.[46]

Taxpayers may need to request face-to-face meetings to resolve outstanding examination issues for a number of reasons, including language barriers, the inability to communicate clearly in writing, complexity of the tax law, and the volume of records required for verification.[47] For example, the state sales tax deduction, while very straightforward, could require numerous receipts for substantiation. Similarly, substantiating employee business expenses for an over-the-road truck driver may require the submission of a driver's log, which is not easily copied or duplicated.

The IRS is updating IRM 4.19.13.14, *Transfers to Area Office Examination or Appeals Office*, to provide examples of how to assist taxpayers who may request a transfer due to voluminous records.[48] While the IRM gives employees a method of sampling records, it does not offer examples of when to transfer a case to a local office. Examples of appropriate transfers would be useful for employees and would help promote consistent treatment of taxpayer cases.

IRS publications may lead taxpayers to believe that if they prefer to have a face-to-face meeting, all they have to do is ask. Publication 1, *Your Rights as a Taxpayer*,[49] informs taxpayers that they may "respond by mail or you can request a personal interview with an examiner." Similarly, Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refunds*, goes on to state that "if your return can be examined more quickly and conveniently in another area, such as where your books and records are located, you can ask to have the case transferred to that area."[50] The public statements regarding the ability to have a face-to-face meeting simply do not agree with the internal processes in place to facilitate this request.

Whether the taxpayer's request is based on need or preference, the IRS rarely grants taxpayers a face-to-face meeting once a correspondence examination is underway. Complaints from taxpayers to TAS have revealed that even though IRS publications advertise taxpayers' right to a face-to-face conference, the IRS seldom honors taxpayer requests for in-person examinations.[51] The IRS denies many such requests based on geographic inconvenience and the unavailability of premises for a face-to-face meeting. Further, the structure of the IRS makes it difficult to transfer a case from a campus correspondence exam unit to the field. This is because the Wage and Investment (W&I) Operating Division conducts most

46 Pacific Consulting Group, *Compliance Center Examination (CC Exam) SB/SE National Report, January Through March 2008* (July 2008).

47 National Taxpayer Advocate 2006 Annual Report to Congress 333.

48 IRM 4.19.13.14 (clearance copy Aug. 2008).

49 IRS Pub. 1, *Your Rights as a Taxpayer* (May 2005).

50 IRS Pub. 556, *Examination of Returns, Appeal Rights, and Claims for Refund* (May 2008).

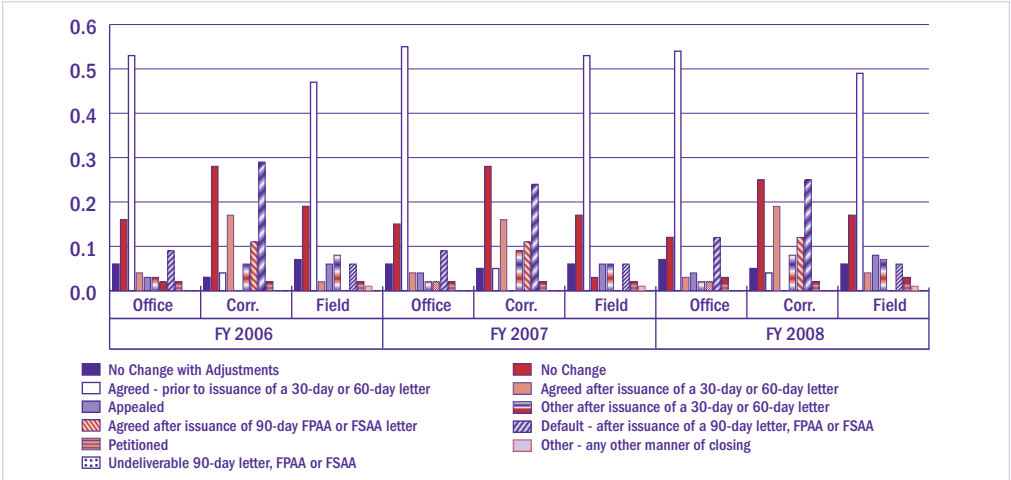
51 IRS Pub. 1, *Your Rights as a Taxpayer* (May 2005). *See also* I.R.M. 4.10.3.16.9 (Mar. 1, 2003) (providing that a taxpayer request for a face-to-face interview "should be honored.") *See also* Systemic Advocacy Project P0027246, created after TAS received numerous complaints from taxpayers regarding the failure of the IRS to honor requests for face-to-face examinations.

correspondence audits while Small Business/Self-Employed (SB/SE) division employees handle office audits, and the examination inventory system does not facilitate easy transfers between divisions.

The IRS conducts slightly more than 71 percent of correspondence examinations at campus offices, which are often not located in the taxpayer's geographic area.[52] Even if a campus is nearby, security measures prohibit walk-in traffic and face-to-face meetings.

TAS focus groups of practitioners expressed concern about problems with the practical application of correspondence audits. They indicated face-to-face audits were faster, cheaper, and provided a "better" result for the taxpayer.[53] While the definition of "better" is clearly subjective, the analysis of examination closures illustrated in Chart 1.14.1 below confirms that face-to-face audits produce a higher agreement rate.[54] This disparity jeopardizes the fairness and uniformity of tax administration. The use of various IRS examination processes should not influence the result of an audit.

CHART 1.14.1, Examination Closures



Based on the disparity in these figures, the IRS should consider a test group of similar audits and compare the results for taxpayers going through an office examination versus a correspondence examination. The study should cover the full consideration of audit issues and barriers, including response rates, agreement rates, dollars assessed, and dollars collected. Further, the IRS should survey this controlled group of taxpayers at the conclusion of their audits to evaluate the examination through their eyes. Only through research

52 TIGTA, Ref. No. 2008-30-095, *Trends in Compliance Activities Through Fiscal Year 2007* 7 (Apr. 18, 2008).

53 The National Taxpayer Advocate's Findings from the Correspondence Examination Focus Groups, IRS Tax Forums, June – September 2005 (Jan. 2006).

54 Automated Information Management System (AIMS) from the Compliance Data Warehouse (CDW), Fiscal Years 2006 – 2008 (Sept. 2008).

such as this can the IRS fully assess whether the venue for an audit has an impact on the determination of true and correct tax.

When the IRS electronically transfers an examination case from correspondence audit to a field office, it faces a shortage of personnel in the field to provide in-person assistance. As of the end of FY 2007, the IRS had only 1,060 Tax Compliance Officers to hold face-to-face meetings.[55] The IRS lacks the staffing to honor these requests and does not factor case transfers from correspondence audit into the field into its enterprise work plans.

Repetitive Audits of the Same Issue

Current law restricts unnecessary IRS examinations and investigations and allows only one inspection of the taxpayer's "books of account" per year without a notice.[56] Neither taxpayers nor the IRS benefit from repetitive audits of the same issues, year after year, that do not result in an assessment of additional tax liability. Therefore, the IRM allows an auditor to close a case without examination when the issues under audit were examined in either of the two preceding years and IRS transcripts confirm the audit resulted in either a small or no change to the taxpayer's liability. Ambiguity in the IRM, however, has led some correspondence auditors to believe repetitive audit procedures only apply to face-to-face examinations.[57]

> ***Example***: A taxpayer found the correspondence audit process unsuitable due to repetitive audits of the same issue. The taxpayer deducts alimony paid to his ex-wife every year. When the IRS audited this taxpayer by correspondence in 2005, he verified that he was entitled to the deduction and the IRS closed the case with no change to his tax. Subsequently, the IRS selected this taxpayer's 2006 return for audit for the same issue. The taxpayer does not feel the IRS needs to audit him every year just because his wife chooses not to report the alimony payments on her return. He would prefer that the IRS find a way of confirming he has already verified his entitlement to this deduction without initiating an audit.[58]

Impact of Combination Letters on Tax Morale

In 1998, the IRS created the combination letter to reduce the duration of correspondence examinations.[59] The "combo" letter merged the initial contact letter and the official examination report into one mailing.[60] As opposed to an initial contact letter, where the IRS indicates it is reviewing a deduction or tax issue, the combo letter presumes the deduction

55 TIGTA, Ref. No. 2008-30-095, *Trends in Compliance Activities Through Fiscal Year 2007* 6 (Apr. 18, 2008).

56 IRC § 7605(b).

57 IRM 4.10.2.8.5 (Aug. 1, 2007).

58 Systemic Advocacy Management Submission (SAMS) Issue No. 29054.

59 The IRS began using the Combo Letter in March 1999. *IRS, Electronic Publishing, at* http://publish.no.irs.gov/catp.cgi?catnum=27226 (last visited Dec. 15, 2008).

60 National Taxpayer Advocate 2007 Annual Report to Congress 292.

or tax issue is incorrect and attaches a report reflecting additional tax due. While the IRS eliminated the use of combination letters for EITC audits in 2005 at the request of the National Taxpayer Advocate, it still uses the letter for other discretionary work where the assessment of additional tax is considered "very likely." Two audit areas using the combo letter involve self-employment tax and deductions for the child tax credit.

In the case of self-employment tax audits, the correspondence exam function reviews income items reflected on Form 1040, *Individual Income Tax Return*, Line 21, *Other Income*, that appear to be subject to self-employment tax but were not included in the computation on the original return. The IRS issues a combo letter with a report proposing the assessment of self-employment tax on the pre-identified income items. Results for FY 2008 (through April) indicate that of the 5,519 self-employment combo letter audits initiated, the IRS closed 57 percent with no change to tax liability. Of the 3,954 child tax credit combo letter audits initiated, the IRS closed 45 percent with no change to liability.[61] The results indicate the additional tax the IRS presumed to be "very likely" has not materialized. These cases can have a negative impact on tax morale based on "guilty until proven innocent" treatment. In addition, the combo letter does not adequately explain taxpayers' appeal rights, creating a possible abridgement of these rights in violation of the IRS Restructuring and Reform Act of 1998.[62] TAS is pleased to report SB/SE and W&I have revisited its use of the Combo Letter in correspondence examinations and plans on limiting its use.[63] We encourage IRS to eliminate the use of combination letters in all situations.

Downstream Consequences of IRS Inability to Suit the Examination Process to Taxpayer Needs and Preferences

When taxpayers cannot obtain the information or services they need to work through a compliance issue, they often experience additional costs and burdens. A taxpayer may feel a need to pay for representation, or file a petition with the United States Tax Court to protect his or her rights, due to a breakdown in the correspondence examination process. The taxpayer is not the only one to experience these burdens. The IRS must also expend additional costly resources such as repeat contacts on the same issue, errors on returns, TAS assistance, revenue loss, and, possibly, enforcement costs – such as additional audits, collection activity, and appeals.[64]

To address these issues, SB/SE convened a Correspondence Examination Taxpayer Satisfaction Improvement Team in June 2008. The purpose of the team is to improve customer satisfaction results by better meeting the expectations, needs, and preferences of the

61 W&I response to TAS research request (June 30, 2008).

62 RRA 98; Pub. L. No. 105-206, Title III, Subtitle F, § 3465, 112 Stat. 767 (July 22, 1998). *See also* National Taxpayer Advocate 2007 Annual Report to Congress 292-300; National Taxpayer Advocate 2006 Annual Report to Congress 296-297; National Taxpayer Advocate 2004 Annual Report to Congress 177-179; National Taxpayer Advocate 2003 Annual Report to Congress 87-98; National Taxpayer Advocate 2002 Annual Report to Congress 57-61.

63 SB/SE and W&I have submitted a Unified Work Request requesting a systemic change to move certain excise penalty cases, Self-Employment Tax cases, Alimony cases, and non-EITC DUPTIN cases from the Combination Letter program to an Initial Contact Letter.

64 2007 Taxpayer Assistance Blueprint, Phase II, at 53.

taxpayer from the beginning of the correspondence examination process through final case closure. Using customer satisfaction data compiled by the Pacific Consulting Group, the team reviewed in depth the following four areas where taxpayer concerns and complaints showed the greatest room for improvement:

- Ease of getting through to the right person;
- Overall length of correspondence exam process;
- Providing consistent information about case; and
- Length of time to get through by phone.

The team is working on a number of recommendations, including:

- "Just a Phone Call Away from Great Customer Service" – an integrated approach for providing IRS employees with taxpayer comments, updated IRM guidance, and training regarding the importance of phone contact;
- "Exam Express" – an innovative program that will fast-track certain issues through the audit process;
- "First Read Improvements" – combining updated scanning technology and experienced tax examiners in the receipt and control process will improve the ability of correspondence examination functions to control, acknowledge, and address correspondence in a timely manner.

Early in the process, the team recognized that if the initial contact letters were improved, many complaints about the process could be resolved. For example, nearly three-quarters of EITC audited taxpayers personally call or visit the IRS in response to their initial contact letter, and 60 percent of those who contact the IRS are seeking guidance on what documentation is needed.[65] An initial contact letter that fully explains the correspondence examination process, the length of the process, and includes a tailored documentation request for each individual taxpayer might reduce the number of incoming calls to the IRS about these issues. The team is sending its data recommendations for improvement to the Commissioner's Taxpayer Communications Taskgroup (TACT) for consideration and implementation.

Limited English Proficiency and Examination Suitability

Many taxpayers have limited English proficiency and thus experience difficulties in understanding their U.S. taxpayer rights and obligations, which may cause inaccurate audit results and further consequences for such taxpayers. The IRS established the Multilingual Initiative (MLI) program to help taxpayers understand and meet their tax responsibilities

65 National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 95.

regardless of their inability to understand and speak English.[66] IRS strategic plans include removing impediments for groups with language, cultural, and other barriers, and increasing the scope and accessibility of services.[67] The IRS should consider expanding the MLI program by offering foreign language assistance during the audit process. For example, the IRS could allow taxpayers to check a box on their returns indicating they prefer correspondence in another language – including Braille.[68] The National Taxpayer Advocate suggested the outside of the envelope could be in Braille to alert the reader to the importance of this document. This level of accommodation and assistance will provide the IRS with the most accurate information and assist taxpayers to overcome language, cultural, and accessibility barriers.[69]

Conclusion

The importance of providing service from the taxpayer's perspective was highlighted in a July 9, 2008, e-mail communiqué from IRS Commissioner Douglas Shulman, stating,

> I also believe that we need to excel at both service and enforcement to meet our mission. It isn't an either/or proposition. We need to do both. I would like to talk today a little about service and give you some of my thoughts on how we can drive continuous improvement to the service we deliver. First, in every interaction, every transaction we conduct with a taxpayer, we should think about it from the outside in – from the taxpayer's point of view, even though we may not ultimately agree with the taxpayer.

The IRS should consider taking the following actions to address problems with the suitability of the examination process: substantially increase the focus of the examination process toward meeting taxpayer needs and preferences when determining the nature of an examination and completing an audit; develop and implement appropriate and consistent guidance specific to correspondence audit; test the results of correspondence audits compared to face-to-face audits for similar issues; stop using combination letters in all situations; and implement the suggestions made by the Customer Satisfaction Initiative Team (including the proper consideration of MLI initiatives in correspondence). By doing so, the IRS will live up to the Commissioner's expectation that IRS employees consider the taxpayer's experience in everything the employees do.

66 *See* Executive Order 13166, *Improving Services for Persons with Limited English Proficiency (LEP)*, 65 FR 50121 (2000). *See also* Policy Statement P-22-3, IRM 22.31.1.1.2 (Apr. 1, 2006).

67 W&I, *Strategy & Program Plan FY 2008 – FY 2009* 33.

68 The Braille code, developed by Louis Braille (1809 – 1852), was first introduced in the United States in 1869 and was adopted as the Standard English Grade Two Braille code in 1932.

69 *See* 2006 National Taxpayer Advocate Annual Report to Congress 333 (Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Language and Cultural Barriers to Tax Compliance*).

IRS Comments

The IRS conducts well over a million correspondence examinations each year – examinations that focus on a limited number of specific, clear-cut issues that do not normally require a full-scale, face-to-face audit of the taxpayer's books and records. In comparison to other types of audits, correspondence examinations require fewer resources from either the IRS or taxpayers, are considerably less invasive for taxpayers, and effectively contribute to the tax administration objectives of fostering voluntary compliance and reducing the Tax Gap. Use of correspondence examinations is only one of the ways in which the IRS serves the public and meets taxpayer needs, as emphasized by the IRS Restructuring and Reform Act of 1998 (RRA 98).

Through various outreach activities, the IRS continually strives to increase taxpayer awareness of tax law requirements, taxpayer-related responsibilities, and taxpayer rights. Information on contacting the IRS and the examination process is available on IRS.gov and in IRS publications. While the IRS is responsive to taxpayer requests for face-to-face assistance, the IRS designs and manages its examination programs based on the audit streams most appropriate for the issues involved. In addition, the inherent nature of correspondence examinations generally makes face-to-face assistance unnecessary because these audits involve a limited number of issues and usually require the submission of fewer documents by taxpayers to substantiate the items reported on their returns.

The National Taxpayer Advocate notes that according to a TIGTA report, easy telephone access to the IRS helps resolve cases and issues. The National Taxpayer Advocate also refers to IRS use of the universal call routing system. In this regard, the IRS is moving forward with a vision for corporate inventory for much of its correspondence examination work that has the potential to dramatically improve telephone access while meeting taxpayer needs and preferences.

The W&I division has completely eliminated extension routing on all cases. Universal call routing now facilitates taxpayers' telephone interactions with the IRS by allowing them to talk to the next available examiner. Taxpayers no longer have a need to connect with the particular IRS employee assigned to their case since all return data, letters, reports, and work papers are now available to all W&I examiners. In addition, it should be noted that survey results confirm that most taxpayer calls regard case status, documents needed to resolve the audit, and routine questions about the tax issue that can be readily addressed by any examiner.[70]

The IRS has also implemented the self-assign feature that allows any tax examiner that answers the toll free number to assign an unassigned case to him or herself and make the final determination on the case if the information provided by the taxpayer is sufficient. A

[70] W&I October 2008 telephone survey results indicate that 70 percent of the taxpayers called for an explanation of the letter from the IRS while 11 percent wanted to let the IRS know they mailed records or wanted to provide other information.

Unified Work Request for programming has been submitted to expand this flexibility to cases in 90-day status as well. Other planned improvements include intelligent call routing, which will route calls to the most appropriate examiner based on the tax issues involved in the case. We are also moving forward with the correspondence imaging development project, which will eventually add taxpayer correspondence to the system, making the entire file, including taxpayer correspondence, available to any examiner at any site.

Telephone survey results reflect very favorable taxpayer feedback. For example, the W&I October 2008 survey reflects that 84 percent were satisfied with the time it took to reach IRS on the phone and 95 percent were satisfied with the length of time they spent with an examiner after they were connected. Further, 90 percent were satisfied with the ability of the examiner to make a decision on their case.

The National Taxpayer Advocate notes with approval the changes the IRS has made to reduce the use of combination or "combo" letters. We will also consider the National Taxpayer Advocate's suggestion to eliminate the use of that letter for other correspondence examination audit streams. However, the IRS disagrees with the National Taxpayer Advocate's allegation that use of these letters may abridge taxpayer rights in violation of RRA 98 by providing inadequate appeal rights. The combo letter, by definition, merges the initial contact letter and the 30-day letter into a single document that includes specific reference to the taxpayer's right to file an administrative appeal. The combo letter also includes a copy of Publication 3498-A, *The Examination Process (Examinations by Mail)*. This publication discusses taxpayer rights, explains appeals procedures, and further outlines ways the IRS can assist taxpayers in the correspondence examination process in full conformance with RRA-98 requirements.

We are also pleased that the National Taxpayer Advocate endorses the work of the Correspondence Examination Taxpayer Satisfaction Improvement Team, which is considering the ease of contacting the right person at the IRS, overall length of the correspondence examination process, providing clear and consistent information, and length of time to get through by telephone. With regard to the National Taxpayer Advocate's proposal that the IRS implement the recommendations made by the Team, deliberations are still ongoing and when the team issues its final report, its recommendations will be forwarded to the Commissioner's Taxpayer Correspondence Taskgroup for consideration and approval.

The National Taxpayer Advocate also recommends that the IRS test the results of correspondence audits compared to face-to-face audits. The IRS is currently working to develop such a test. The National Taxpayer Advocate also notes, and we agree, that appropriate and consistent guidance specific to correspondence audits is vital. In this regard, the IRS works to continuously improve its guidance to correspondence examiners and telephone assistors.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for significantly improving telephone access to meet taxpayer needs and preferences. We applaud the IRS for implementing the self-assign feature, which allows any examiner who answers the toll-free number through universal call routing to make the final determination on the taxpayer's case if the information provided by the taxpayer is sufficient. The National Taxpayer Advocate also supports the extension of this feature to all audit cases, including those where the IRS has issued the statutory notice of deficiency. We encourage the IRS to proceed with intelligent call routing and correspondence imaging, which will further enhance communications and better suit taxpayer needs and preferences during the examination process. The National Taxpayer Advocate appreciates the efforts of the Correspondence Examination Taxpayer Satisfaction Improvement Team to improve taxpayer service during the examination process, and is pleased with the IRS's agreement to test the results of correspondence audits compared to face-to-face audits for similar issues. Such testing will help the IRS to improve its guidance regarding correspondence examinations and "focus on the taxpayer's experience."[71]

We are pleased the IRS is planning to conduct the test comparing correspondence and office exam results with respect to similar cases. This study should show whether particular taxpayer populations (*e.g.*, EITC taxpayers) are better able to understand what is required and bring in better information when conveyed in a face-to-face environment. If the test results confirm what TAS's survey results show, IRS should plan for and offer office examinations as an option in certain cases initially established as correspondence exams.

Although the National Taxpayer Advocate is pleased with the SB/SE and W&I plans to limit the use of the combo letter in some situations,[72] she remains concerned about the use of the letter in all other situations because it potentially abridges taxpayer appeal rights. While the letter includes a copy of IRS Publication 3498-A, *The Examination Process (Examinations by Mail)* (Dec. 2006), both the publication and the letter fall short of adequately informing the taxpayers of their appeal rights as mandated in RRA 98 § 3465.[73] The National Taxpayer Advocate fundamentally disagrees with the joining of the 30-day timeframe to submit information with the 30-day timeframe to appeal. These two administrative

71 IRS Commissioner Douglas Shulman, *Remarks Before Tax Analysts Conference on Ten-Year Anniversary of the IRS Restructuring and Reform Act of 1998, at* http://www.irs.gov/newsroom/article/0,,id=184857,00.html (last visited Dec. 11, 2008).

72 SB/SE and W&I have submitted a Unified Work Request requesting a systemic change to move certain excise penalty cases, Self-Employment Tax cases, Alimony cases, and non-EITC DUPTIN cases from the Combination Letter program to an Initial Contact Letter.

73 RRA 98, Pub. L. No. 105-206, Title III, Subtitle F, § 3465, 112 Stat. 767 (July 22, 1998). Letter 566-B-EZ (SC), *Simplified Service Center ICL/30 Day Combo Letter* (Feb. 2005), does not contain clear, upfront direction to the taxpayers about the right and ability to appeal. The letter instructs the taxpayer in one paragraph that, "If you do not agree with all the changes listed on Form 4549-EZ, please send us the following information by [date]: A letter telling us what item(s) you disagree with an why, and; Clear photocopies of the records, information, and/or supporting documents, listed on the enclosed Form(s)." It is not until the second page that the letter finally informs the taxpayers about the right to appeal, referring to explanations in the publication: "After we review what you've sent us, we will contact you with the result. If you still disagree with our findings, you have the right to file an administrative appeal as explained in the enclosed Publication 3498-A, *The Examination Process (Examinations by Mail)*." *See id.*

processes should remain separate. Accordingly, the National Taxpayer Advocate urges the IRS to eliminate all and any use of combination letters in the examination process.

Recommendations

The National Taxpayer Advocate recommends that the IRS takes the following specific actions to meet taxpayer needs and preferences during the examination process:

1. In consultation with TAS Research, conduct a research study that compares the results of correspondence audits with face-to-face audits for similar issues, with respect to agreements, adjustments, employee and customer satisfaction, taxpayer educational opportunities, and cycle time.
2. Immediately eliminate the use of combination letters in all situations during the examination process.
3. Finalize and promptly implement the suggestions made by the Customer Satisfaction Initiative Team, including the proper consideration of multilingual initiatives in correspondence, the integration of phone skill training, and the roll-out of updated documentation and substantiation protocol and resources.

MSP #15

The IRS Correspondence Examination Program Promotes Premature Notices, Case Closures, and Assessments

Responsible Officials

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

Definition of Problem

The correspondence examination program plays a vital role in the IRS mission of promoting voluntary compliance with the tax law. Correspondence audits focus on a limited number of specific, clear-cut issues that would not normally require a face-to-face examination.[1] These audits, conducted exclusively by mail, should help the IRS leverage its compliance resources, increase audit coverage, and minimize taxpayer burden.[2] Instead, the program as currently designed experiences problems that increase taxpayer burden. These problems include the mishandling of taxpayer correspondence (receipt, control, and response); a lack of one-on-one contact with taxpayers in resolving their inquiries and disputes; and inconsistent, sometimes ignored policies and procedures that cause premature and incorrect assessments of tax, penalties, and interest. Among the problems that limit the IRS's ability to operate an effective correspondence examination program are:

- An automated process that curtails examinations and leads to premature notices, case closures, and assessments;
- A lack of one-on-one contact with taxpayers, which results in premature enforcement actions;
- A focus on closing cases rather than helping taxpayers to resolve their problems; and
- A dramatic increase in the amount of overage discretionary correspondence mail.[3]

These problems significantly affect a taxpayer's experience with the correspondence examination process. The IRS's failure to communicate effectively with taxpayers; its preoccupation with closing cases rather than resolving issues; and its perpetual delays in responding to taxpayer correspondence all increase the likelihood of misunderstandings.[4]

1 Internal Revenue Manual (IRM) 4.10.3.16 (Mar. 1, 2003). In addition to applying to field examiners, this IRM also applies to tax compliance officers (office auditors), tax examiners (correspondence examination), and audit accounting aides. *See also* IRM 4.19.1.2.3 (Oct. 1, 2001).

2 For a detailed discussion of the suitability issues relating to correspondence audits, *see* Most Serious Problem, *Suitability of the Examination Process*, *supra*.

3 Wage and Investment Division (W&I), Compliance Measures (June 2008). Correspondence examinations do not include related compliance programs (*e.g.*, Automated Underreported (AUR), Substitute-for-Return, (SFR), CP 2000, or Math Error programs). The discretionary correspondence examination mail figures are exclusive of any of the other compliance programs and reflect a 242 percent increase in overage correspondence.

4 National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 107.

Analysis of Problem

Background

In fiscal year (FY) 2007, the IRS examined 1,384,563 individual income tax returns (Forms 1040), conducting 83 percent of these audits by correspondence.[5] IRS Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* explains to taxpayers that the agency conducts *some* examinations entirely by mail.[6] However, IRS data reveals correspondence examinations represent the largest segment of the examination program, comprising more than 71 percent of all FY 2007 examinations (individuals and businesses).[7] In FY07, the IRS examined one in every 118 individual income tax returns by correspondence, but examined only one in every 561 individual returns face-to-face.[8]

The correspondence examination program has grown dramatically in recent years. In FY 2007, the IRS examined 1,144,596 Forms 1040 through correspondence,[9] an increase of 160 percent over the 439,734 Forms 1040 examined by correspondence in FY 2000.[10] The following chart illustrates the growth in correspondence examinations since FY 2000, in contrast to face-to-face examinations, which grew less than 35 percent over the same period (from 178,031 returns in FY 2000 to 239,967 in FY 2007).[11] In addition to routine correspondence audits, such as Earned Income Tax Credit, (EITC), the program also includes audits of non-filers, return preparers, high-income taxpayers,[12] and other types of inventory at the discretion of local managers.[13] The IRS contends correspondence audits increase voluntary compliance and reduce taxpayer burden.[14]

5 Treasury Inspector General for Tax Administration (TIGTA), Ref. No.2008-30-095, *Trends in Compliance Activities Through Fiscal Year 2007* 35, 45 (Apr. 18, 2008).

6 IRS Pub. 556, *Examination of Returns, Appeals Rights, and Claims for Refund*, 3 (Rev. May 2008).

7 TIGTA, Ref. No.2008-30-095, *Trends in Compliance Activities Through Fiscal Year 2007*, 7 (Apr. 18, 2008).

8 *Id.* at 8.

9 *Id.* at 35.

10 *Id.*

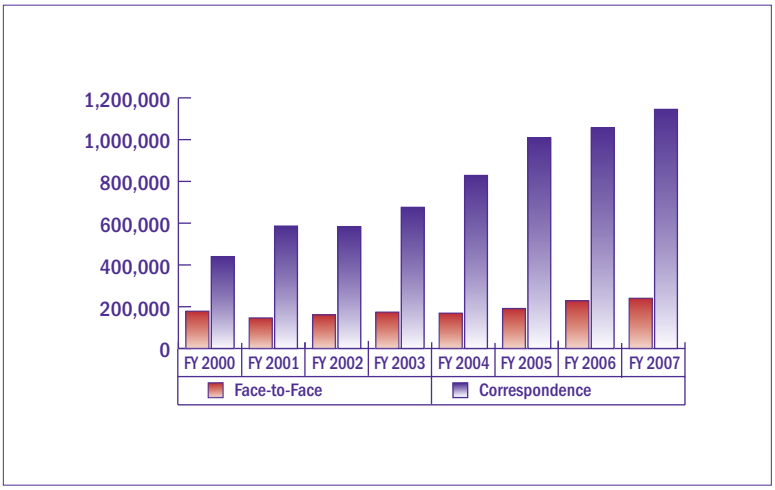
11 *Id.*

12 IRM 4.19.13.1 (Jan. 1, 2007). In FY 2007, the IRS changed the definition of high-income nonfilers from greater than $100,000 in income to greater than $200,000 in income; TIGTA, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* (July 2006), 6. *See also* National Taxpayer Advocate 2006 Annual Report to Congress 292.

13 IRM 4.10.3.16.9 (Mar. 3, 2003); IRS, *Strategic Plan, 2005-2009, 19; Tax Fairness: Policy and Enforcement: Hearing Before the Subcomm. on Financial Services and General Government, H. Comm. on Appropriations*, 110th Cong. (Mar. 5, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

14 National Taxpayer Advocate 2006 Annual Report to Congress 302.

CHART 1.15.1, Growth in Correspondence Vs. Face-To-Face Examinations



Source: *Analysis of Examination Closed Case Database and IRS Data Book*[15]

Chart 1.15.1 above contrasts the growth in correspondence examinations and face-to-face audits for each year from FY 2000 through FY 2007.

This upward trend may be a cause for concern in view of an earlier General Accounting Office (GAO, now the Government Accountability Office) study that reported over 50 percent of taxpayers examined by correspondence failed to respond to the IRS's letters.[16] Since the IRS routinely issues Statutory Notices of Deficiency in all of its no-reply audits, this statistic implies that half of all taxpayers examined by correspondence receive deficiency notices automatically.[17] Moreover, the Treasury Inspector General for Tax Administration (TIGTA) recently reported that correspondence examinations may do little to improve compliance because they are less comprehensive than face-to-face audits.[18]

Evolution of the Correspondence Examination Process

General Overview of the Examination Program

The IRS accepts most federal income tax returns as filed but examines (or audits) a certain number each year to determine whether taxpayers are reporting their income, deductions, and credits completely and accurately. The agency typically conducts examinations in one of three ways: (1) field audits, (2) office audits, and (3) correspondence audits. The IRS identifies returns for examination using various methods, including computer scoring and document matching programs. Once selected for examination, the type of return

15 TIGTA, Ref. No. 2008-30-095, *Trends in Compliance Activities Through Fiscal Year 2007* 35 (Apr. 2008).

16 General Accounting Office, GAO/GGD-99-48, IRS Audits, Weaknesses in Selecting and Conducting Correspondence Audits 3 (Mar. 1999); National Taxpayer Advocate Fiscal Year 2009 Objectives Report to Congress xxxix (Jun. 30, 2009). *See also* National Taxpayer Advocate 2007 Annual Report to Congress 301. The National Taxpayer Advocate made a recommendation to identify effective uses of locator and other Internet based address search options.

17 IRM 4.19; National Taxpayer Advocate 2003 Annual Report to Congress 135.

18 TIGTA, Ref. No. 2008-30-095, *Trends in Compliance Activities Through Fiscal Year 2007* 3 (Apr. 2008).

(individual, business, or tax-exempt), the size of the entity, and the nature of the inquiry usually determine which IRS operating division will conduct the audit.[19]

The Large and Mid-Size Business Division (LMSB) employs revenue agents, who conduct audits at the taxpayer's place of business. Most LMSB taxpayers are high-asset corporations, whose returns involve large-dollar, complex tax issues, requiring an extensive review of their books and records.[20] Similarly, the Small Business/Self-Employed Division (SB/SE) employs revenue agents who conduct audits at the taxpayer's place of business. SB/SE field audits generally include smaller corporations, partnerships, and the larger sole proprietorships.[21] SB/SE tax compliance officers, in contrast, conduct their audits in an office setting, where individual taxpayers typically bring their records for inspection.[22] At the end of FY 2007, the IRS had 10,121 revenue agents and 1,060 tax compliance officers on staff.[23]

The General Audit Process

Generally, the IRS follows the same approach in all of its income tax examinations (field, office, correspondence). At the start of an examination, the IRS sends an initial contact letter, notifying the taxpayer of the impending examination. The letter is accompanied by IRS publications that explain the taxpayer's rights during the examination, including appeal rights.[24] In both field and office audits, a document request accompanies the initial contact letter. The letter establishes an appointment with the taxpayer to begin the audit. In office and correspondence audits, the initial contact letter also identifies the issue(s) in the examination, and describes the documentation needed to resolve the disputes. The initial contact letter in correspondence audits may include a report proposing adjustments of items on the return that the IRS believes to be questionable.

Taxpayers who disagree with any of the proposed adjustments may request an informal conference with a supervisor. If this discussion does not resolve the taxpayer's concerns, he or she may request an independent review by the Appeals function, generally within 30 days. Those who are not satisfied after conferring with Appeals may take their cases to the U.S. Tax Court. In these situations, taxpayers must petition the court within 90 days

19 IRS Pub.1, *Your Rights as A Taxpayer* (Rev. May 2008); IRS Pub.556, *Examination of Returns, Appeals Rights, and Claims for Refund*, 2-3 (Rev. May 2008); IRS Pub 3498-A, *The Examination Process (Examinations by Mail)* (Dec. 2006).

20 IRM 4.46.1 (Mar. 1, 2006); IRM 4.46.2 (Mar. 1, 2006); IRM 4.46.3 (Mar. 1, 2006).

21 IRM 4.10.2 (Aug. 2007); IRM 4.10.3 (Mar. 2003).

22 *Id.*

23 TIGTA, Ref. No. 2008-30-095, *Trends in Compliance Activities Through Fiscal Year 2007*, 6 (Apr. 2008). Recent findings from a GAO study suggests that increasing the enforcement efforts of field agents (in face-to-face audits) would be among the most effective steps the IRS could take to address the tax gap, though by no means the only step needed. One participant made the point that compliance efforts have a ripple effect and may have a larger impact on compliance than the actual audits; however, in spite of an IRS statistic revealing a 4:1 return on audit expenditures, "...the IRS will not be able to audit itself out of the tax gap." *See* GAO, GAO-08-703SP, *Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential 7* (June 20, 2008).

24 *See* IRS Pub.1, *Your Rights as a Taxpayer* (Rev. May 2005); IRS Pub. 1, *Your Rights as a Taxpayer* (Rev. May 2008); IRS Pub. 5, *Your Appeal Rights and How to Protest if You Don't Agree* (Jan. 1999); IRS Pub 3498-A, *The Examination Process (Examinations by Mail)* (Dec. 2006) (which combines Pub.1 and Pub. 5).

from the date the IRS mails the Statutory Notice of Deficiency (90-day letter).[25] If taxpayers do not respond to (or "default") the 30-day letter,[26] the IRS issues a Statutory Notice of Deficiency. During the ensuing 90-day period, taxpayers are free to discuss their cases with the IRS. However, such discussions will not serve to extend the 90-day period to petition the court.

IRS Use of the Combination Letter Truncates the Correspondence Examination Process

Before 1999, the IRS sent an initial contact letter at the start of each correspondence examination, notifying taxpayers of the impending examination, informing them of the specific items under review, and requesting documentation to resolve the items in question. Taxpayers generally had 30 days to provide the information. The IRS would review the information, and if necessary, issue a 30-day letter with a report presenting the proposed adjustment(s).[27]

In 1999, the IRS began using a combination or combo letter, replacing two distinct letters that the IRS previously issued at different times in the audit process, effectively merging the initial contact letter and the 30-day letter into a single document. The combo letter currently comprises the initial contact letter, document request, *and* audit report (30-day Letter).[28] The National Taxpayer Advocate has repeatedly voiced concerns that the combo letter in correspondence examinations is confusing to taxpayers and frequently results in either preemptive "protective" appeals and court petitions, or defaults where the tax is assessed after the IRS does not receive a response.[29] The letter also tells taxpayers they must first provide relevant information to the contact person named in the letter before Appeals will hear their cases. This instruction may result in taxpayers not requesting an appeal because they fear reprisal from the examiner and a worse result.

The combo letter not only combines two separate stages of the audit, thus truncating the audit process, but also conflates the examiner's document requests and preliminary audit findings with the final audit report and Appeals notification. For many taxpayers, 30 days is simply not enough time to produce the myriad of documents requested by tax examiners, such as birth certificates, marriage licenses, Social Security cards, and school records,

25 IRS Pub. 556, *Examination of Returns, Appeals Rights, and Claims for Refund* 5 (Aug. 2005). Taxpayers that do not respond to the 30-day letter (defined next) receive a 90-day letter, also known as a Statutory Notice of Deficiency.

26 IRS Pub. 556, *Examination of Returns, Appeals Rights, and Claims for Refund* 4-5 (Aug. 2005). Taxpayers that do not agree with the examiner's proposed changes will receive a letter (known as a 30-day letter) notifying them of their right to appeal the proposed changes within 30 days. The letter is accompanied by a copy of the examiner's report, an agreement or waiver form, and a copy of Pub. 5, *Your Appeal Rights and How to Prepare a Protest if You Don't Agree*.

27 IRM MT 4200-619 (Oct. 25, 1996). *See* IRM 4252 (2) (Apr. 29, 1991); IRM 4253.4 (Jan. 1, 1991); IRM 4253.5 (June 29, 1992); IRM 4253.6 (Mar. 28, 1988); IRM 4254.3 (Nov. 2, 1981); IRM 4255.1 (May 25, 1988).

28 IRM 4.19.10.1.6 (Jan. 1. 2006); The IRS began using the Combo letter, Letter 566-B (SC/CG) in March 1999, *at* http://publish.no.irs.gov/catp.cgi?catnum=27226 (last visited Oct. 13, 2008).

29 The Commissioner recently established a Taxpayer Communications Taskgroup (TACT) to review all taxpayer correspondence and work to eliminate those notices and letters that create confusion. TAS is represented on the TACT.

and may result in a hardship.[30] Moreover, without timely notification of whether tax examiners have received, reviewed, and accepted the taxpayers' information, the 30-day period may lapse without taxpayers knowing if they should provide different documents or request an appeal.[31] In its efforts to streamline the correspondence audit process by using the batch processing system, the IRS may inadvertently prompt numerous taxpayers to file protective appeals requests or court petitions. It can be confusing to taxpayers when in one communiqué the IRS proposes adjustments, asks for additional documentation, and offers Appeal rights that should be exercised within the same 30-day period.[32] The combo letter causes unnecessary burden and frustration for taxpayers, and results in costly downstream re-work for the IRS.[33]

An Automated Process that Curtails Examinations and Results in Premature Notices, Case Closures, and Assessments

In recent years, external stakeholders have raised concerns that the IRS is issuing 90-day letters in correspondence examinations without first considering taxpayer correspondence.[34] These concerns may arise from the way the IRS conducts correspondence examinations. The most striking difference between correspondence and face-to-face examinations is the strict timeline to which tax examiners must adhere in managing their inventories using the automated batch processing mechanism.

Once the IRS engages the batch system, cases move through the examination process automatically. Each step in the process has a pre-established period programmed into the system. Files are not created or examiners assigned to the cases until the IRS receives and controls a taxpayer's correspondence.[35] If a taxpayer fails to furnish the requested documentation precisely within the prescribed period, the case automatically moves to the next phase in the process.

The issuance of premature 90-day letters has been attributed to the inflexibility of this process.[36] Because the batch system automatically processes a case from its creation through the issuance of a Statutory Notice of Deficiency and subsequent closing, the IRS has effectively eliminated the need for human involvement in every case in which a taxpayer does

30 National Taxpayer Advocate 2007 Annual Report to Congress, vol.2, 103-107.

31 National Taxpayer Advocate 2007 Annual Report to Congress 292; National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 103.

32 Letter 566-B, Service Center ICL/30 Day Combo Letter.

33 National Taxpayer Advocate 2006 Annual Report to Congress 296; National Taxpayer Advocate 2003 Annual Report to Congress 87.

34 National Association of Enrolled Agents, Letter Regarding Concern over Recent Enforcement Actions by IRS (Nov. 28, 2007), *at* http://www.naea.org/MemberPortal/Advocacy/Comments/letter_nov_28_2007.htm (last visited June 4, 2008); W&I, *Business Performance Review* 21 (May 20, 2008).

35 IRM 4.19.13.6(1) (Jan. 24, 2006).

36 When it issues an initial contact letter, which grants a taxpayer 30 days to furnish the requested documentation, the batch system suspends the file to await the taxpayer's response. If the taxpayer fails to reply within 45 days, which includes a 15-day period for mail and handling delays, the file is purged on the 45th day for preparation of the proposed report. If the initial contact letter (566B-EZ, 525, etc.) included an audit report, the file is purged for the issuance of a Statutory Notice of Deficiency. National Taxpayer Advocate FY 2009 Objectives Report to Congress, xxix-xl; W&I response to TAS inquiry (May 28, 2008).

not reply in a timely fashion.[37] If a taxpayer does respond, the tax examiner considers that response and reintroduces the case back into the batch system for automated closing.[38]

The automated batch system enables the IRS to process correspondence examinations with little or no involvement by tax examiners until taxpayers reply to notices. However, the automated nature of the process can contribute to premature notices, case closures, and assessments, because it is geared primarily toward closing cases or moving them along, and may not provide taxpayers sufficient time or assistance to respond to IRS requests for information. The automated process limits the ability of taxpayers to engage in a meaningful dialogue with tax examiners, to ask questions about the process and the issues, and to resolve problems that invariably arise during the course of an examination.

The National Taxpayer Advocate recently reported that a review of the correspondence examination process W&I conducted at one campus found that 9.52 percent (or 3,086) of the 32,422 cases it reviewed were prematurely forwarded for issuance of a Statutory Notice of Deficiency.[39] In her 2007 Annual Report to Congress, the National Taxpayer Advocate once again encouraged the IRS to allow more time to associate and consider taxpayer documentation before issuing a notice of deficiency.[40]

In 2008, IRS campus analysts identified a problem with a computer program that affects the suspense period for taxpayer responses. The IRS had lost the ability to stop issuing notices when cases were forwarded to the National Print Site for the printing of 90-day letters.[41] The IRS had not updated the programming to account for the time between the requests to generate the notice and the notice being sent. While W&I indicated the problem has not caused any premature deficiency notices, the division admitted it does make it difficult to stop a statutory notice even when mail is received timely.[42]

Overage Mail Delays Contribute to Premature Notices.

In 2006, the National Taxpayer Advocate reported that the IRS all too often does not respond to taxpayer correspondence in a timely fashion. In FY 2005, the IRS issued 2.9 million "interim" letters[43] 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. Correspondence delays generate additional follow-up contacts from concerned taxpayers, including duplicate return filings, duplicate correspondence, calls to the IRS's toll-free line,

37 IRM 4.19.20.1 (Jan. 1. 2008).

38 *Id.*

39 National Taxpayer Advocate FY 2009 Objectives Report to Congress, xxix-xl; W&I response to TAS inquiry (May 28, 2008).

40 National Taxpayer Advocate 2007 Annual Report to Congress 299; W&I response to TAS inquiry (May 28, 2008).

41 W&I, *Business Performance Review* 21 (May 20, 2008).

42 *Id.*

43 National Taxpayer Advocate 2006 Annual Report to Congress 222; IRS, Office of the Notice Gatekeeper, Correspondex Letter Volumes; IRM 3.0.273.19.4.1 (Jan. 1, 2006).

and Taxpayer Advocate Service referrals, all of which result in unnecessary re-work for IRS employees.[44]

Tax practitioners have commented that the IRS frequently requests additional information prior to reviewing all relevant case information. In addition, the sheer volume of the documentation requested is often overwhelming. Moreover, practitioners continue to express concern about the IRS's failure to acknowledge receipt of correspondence, explaining that these circumstances make for an inefficient and frustrating examination process. This lack of acknowledgement also leads to more phone calls to the IRS to check on the status of documents.[45]

A recent W&I FY 2008 Compliance Report underscores the National Taxpayer Advocate's growing concern, revealing that during the one-year period ending June 30, 2008, the IRS experienced a 242 percent increase in its overage discretionary correspondence examination mail.[46]

A Lack of One-On-One Contact with Taxpayers Contributes to Premature Enforcement Actions.

The IRS's failure to actually locate and contact taxpayers when conducting a correspondence examination can result in premature notices, assessments, and case closures. If mail associated with a correspondence examination comes back to the IRS as undeliverable, the tax examiner must use the Social Security numbers for the account on the Integrated Data Retrieval System (IDRS) to search for a new address on information documents filed with the IRS.[47] If the examiner finds a new address, the IRS reissues the mail. However, if they find no new addresses, examiners continue with the process and issue all letters and reports to the taxpayers at their last known addresses of record even though they know the mail is not reaching the taxpayers. The same concern exists for mail that does not have the most current address but is not returned as undeliverable, *e.g.,* where mail forwarding has lapsed, or where taxpayers are transient and have no permanent address. This situation also could occur where taxpayers are avoiding non-IRS creditors, ex-spouses, etc. Ultimately, the IRS assesses the tax liability without the taxpayers realizing an examination has taken place.[48]

Conversely, revenue agents and tax compliance officers conducting face-to-face examinations must actually locate taxpayers to make their initial contacts. If the initial contact

44 National Taxpayer Advocate 2006 Annual Report to Congress 232.

45 IRM 3.0.273.19.4.1 (Jan.1, 2006); National Taxpayer Advocate 2006 Annual Report to Congress 222, 232, 294-295; The National Taxpayer Advocate, Findings from Correspondence Examination Focus Groups, IRS Tax Forums (June – Sept. 2005).

46 W&I Compliance Measures (June 2008). Correspondence examinations do not include related compliance programs, such as the AUR, Substitute-for-Return (SFR), CP 2000, or Math Error Programs. Accordingly, correspondence examination mail is accounted for separately from Accounts Management mail, which has been directly impacted by the Economic Stimulus Payment initiative.

47 *See* Legislative Recommendation, *Sending "Are You There? Letters to Credible Alternate Addresses, infra.*

48 IRM 4.19.13.13 (Oct. 1, 2001). *See also Examination Procedural Job Aid for Tax Examiners* 48 (Jan. 2008).

letter is returned, field and office auditors must try to find a more current address.[49] Auditors who cannot reach taxpayers by telephone or letter follow the same requirements as a tax examiner and use the Social Security numbers for the account on IDRS to search for a new address on information documents. However, they also must perform additional research such as employing an asset locator service, issuing a postal tracer, contacting the taxpayer's employer, internet research, and querying the Currency Banking Retrieval System (CBRS). If the examiners still cannot locate the taxpayers, they must confer with their managers to decide whether the examination should continue.[50] The disparity in these two processes increases the likelihood of inaccurate default assessments in correspondence examinations, which harm taxpayers and generate costly downstream work such as audit reconsiderations and TAS involvement.

A Focus on Closing Cases Rather than Helping Taxpayers to Resolve their Problems

The IRS's focus has shifted from assisting taxpayers in understanding their tax obligations and resolving audit problems to closing cases and reducing examination cycle time. This approach is shortsighted and counterproductive. It causes faulty tax assessments, premature enforcement actions, and unnecessary burden and anxiety to the affected taxpayers.

The impact of this approach on taxpayers is significant, and was clearly stated in a letter to Acting Commissioner Linda Stiff, dated November 28, 2007, in which the President of the National Association of Enrolled Agents (NAEA) voiced growing concerns about a disturbing trend in IRS enforcement efforts.[51] The IRS in the situations described issued a quick succession of notices without allowing adequate time to review and act on taxpayers' responses to requests for information, which culminated in premature deficiency notices. The National Taxpayer Advocate has repeatedly urged the IRS to allow more time to associate and consider taxpayer documentation before proceeding with enforcement. Although the IRS has acknowledged that it issues notices prematurely, it insists such occurrences are isolated.[52]

At the heart of these problems lie the government's burgeoning tax gap and the IRS's Strategic Plan, operational priorities, and performance measures. The Strategic Plan calls for the reduction of audit cycle time as a key component in improving audits and audit coverage.[53] This strategy drives IRS managers to focus too heavily on closing cases and reducing examination cycle time, without considering existing, well-defined quality standards and a highly publicized commitment to customer service.

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49 *Id.*

50 IRM 4.10.2.7.2 (Aug. 1, 2007).

51 National Association of Enrolled Agents Letter Regarding Concern over Recent Enforcement Actions by IRS (Nov. 28, 2007), *at* http://www.naea.org/MemberPortal/Advocacy/Comments/letter_nov_28_2007.htm (last visited June 4, 2008).

52 National Taxpayer Advocate FY 2009 Objectives Report to Congress, xxix-xl; W&I response to TAS inquiry (May 28, 2008).

53 IRS, *Strategic Plan 2005-2009* 19; W&I, *Strategy & Program Plan, FY 2008 – FY 2009* 8, 89; *Small Business/Self-Employed Plan FY 2008 – FY 2009* 8, 34.

In one instance, W&I reported accomplishments indicating it achieved a discretionary closure rate 25 percent higher than its year-to-date plan. [54] In the same report, W&I also reported that its discretionary cycle time was down by 14.2 percent.[55] Yet, in a separate report, W&I disclosed a disturbing 242 percent increase in its overage discretionary correspondence mail.[56] This disparity demonstrates that the focus on shortened cycle time may translate into the IRS not properly considering taxpayer correspondence and issuing incorrect and premature notices of deficiency.

Existing IRS Safeguards are Effective Only if Followed by all Employees on a Consistent Basis.

To its credit, the IRS has safeguards and procedures in place to encourage and assist tax examiners in conducting quality examinations. Except for the abbreviated procedures used in attempting to locate taxpayers and the use of the combo letter, present guidelines require tax examiners to observe the same procedures and standards followed in face-to-face examinations. Examiners must review the classified issues and prepare the initial contact letters. In communicating with taxpayers, they may use only nationally developed letters that the IRS has approved for content and clarity. Tax examiners must recognize and adhere strictly to prescribed procedures and times for each letter and report, and must be sure taxpayers understand their appeal rights. Moreover, they may not assert penalties without written approval from their supervisors. If taxpayers request face-to-face interviews, the examiners must confer with their managers, who make the final decisions about whether to honor the requests.[57]

These safeguards and procedures do little good unless IRS employees and managers adhere to them consistently. For example, IRM provisions direct tax examiners to call taxpayers if they need additional information to evaluate correspondence and less than 15 days remain until default. [58] However, TIGTA reported tax examiners rarely attempted to contact taxpayers by phone when they needed additional information to complete the audits, even though taxpayers provided their phone numbers for this purpose.[59] Failure to follow the procedure and contact taxpayers by telephone to resolve correspondence examinations

54 W&I, *Business Performance Review* 27 (Feb 21, 2008).

55 *Id.*

56 W&I, *Compliance Measures* (June 2008). Correspondence examinations do not include related compliance programs, (*e.g.*, AUR, SFR, CP 2000, or Math Error Programs). The discretionary correspondence examination mail figures are exclusive of any other compliance program.

57 IRM 4.19.19.3(1) (Jan.1, 2007); IRM 4.10.3.16.1 through 4.10.3.16.8 (Mar. 1, 2003); IRS Pub 3498-A, *Report Writing; The Examination Process (Examinations by Mail)*, says, "IRS employees will explain and protect your rights as a taxpayer throughout your contact with us." It explains that taxpayers may have someone represent them in correspondence and phone calls, that help may be available from a Low Income Taxpayer Clinic, that taxpayers may request the examination be conducted in person rather than through correspondence and that taxpayers have the same rights whether the examination is conducted by mail or in person.

58 IRM 4.19.19.3(1) (Jan.1, 2007).

59 TIGTA, Ref. No. 2002-040-034, *Implementation of the Remote Examination Toll-Free Telephone Program Is Ongoing* 4. TIGTA notes that "When examiners do not attempt to contact taxpayers by telephone when additional information is needed to complete the audit, they are bypassing an opportunity to further the Remote Examination Toll-Free Telephone Program goal of improved customer service through the more expeditious completion of the audit process."

creates needless re-work and taxes the IRS's already limited resources. In response to a recent TAS inquiry, W&I and SB/SE indicated they encourage tax examiners to contact taxpayers by telephone, as provided in the IRM, and noted SB/SE added this procedure to its Operating Guidelines in FY 2007.[60]

Conclusion

The IRS should consider taking the following actions to improve the correspondence examination program: implement processes and procedures to associate and consider taxpayer correspondence timely; move forward with systemic restrictions to limit the reduction of suspense periods in the batch processing system; issue a Servicewide Electronic Research Program (SERP) Alert covering IRM 4.19.3.1, *Outgoing Calls*, to emphasize the importance of effective use of the telephone in resolving correspondence examinations; eliminate the use of the Examination Procedural Job Aid, and follow the guidance in IRM 4.19.19, *Telephone Contacts*; align the procedures used by tax examiners in locating taxpayers and handling undeliverable mail in IRM 4.19.13, *Liability Determination – General Development and Resolution*, with the procedures used by tax compliance officers in IRM 4.10.2, *Examination of Returns – Pre-contact Responsibility*; and stop using the combo letter in all correspondence examinations, and revert to the pre-1999 examination procedure of issuing a preliminary audit report, followed by a traditional 30-day letter, at a later stage in the audit.

IRS Comments

As acknowledged by the National Taxpayer Advocate, correspondence examinations play a vital role in promoting voluntary compliance with the tax law and in closing the Tax Gap. During FY 2008, the IRS examined 1.1 million returns and assessed over $6.7 billion through its correspondence examination programs. These programs include EITC and non-EITC programs, such as Schedule A tax issues, non-filers, premature IRA distribution, education credits, and child tax credit. The examination of these issues through correspondence, rather than through a field or office audit, requires fewer resources from either the IRS or taxpayers, and are considerably less invasive for taxpayers.

We do not agree that the automated correspondence examination process leads to premature assessments. Most EITC and some discretionary audits use an automated batch processing system. This is an excellent system that prevents, rather than causes, premature notices. Cases cannot move through the system until programmed timeframes have expired. When taxpayer correspondence is received and entered on the system, all actions cease until an examiner considers this correspondence. In this regard, the National Taxpayer Advocate cites a November 28, 2007, letter from the National Association of Enrolled Agents as an example of a situation culminating in premature issuance of

60 IRM 4.19.13.9.1 (Mar. 3, 2006); W&I and SB/SE Response to TAS Inquiry (June 27, 2008).

deficiency notices. The letter from NAEA voiced concerns regarding the timing of IRS notices and indicated the IRS was issuing subsequent follow-up notices too rapidly. The IRS works with the NAEA and others in the practitioner community to solicit feedback and identify improvement opportunities. In this case, the IRS promptly reviewed and adjusted the suspense dates for printing these notices, which served to address the NAEA's concern. The National Taxpayer Advocate's report also states that 9.52 percent of cases at one campus had premature statutory notices issued. This was caused by a clerical error in calculating the suspension period in which the statutory notices were issued an average of three days earlier than the designated suspension period. Immediate actions were taken to correct this error.

We also do not agree with the National Taxpayer Advocate's contention that an increase in overage correspondence contributes to premature notices and assessments. While the IRS makes every effort to track and timely consider all taxpayer correspondence, from time to time heavy volumes prevent us from doing so. However, as noted above, once mail is received and entered into the system, all notices stop, except systemic interim letters, until the mail is considered. This applies to all mail, including overage. Further, in her report, the National Taxpayer Advocate repeatedly cites an overage mail percentage increase for W&I Discretionary Exam of 242 percent from 2007 to 2008. This figure is not presented in context and actually represents the difference from a June 2007 overage percentage of 11 percent compared to a June 2008 overage percentage of 17 percent.[61] By the end of FY 2008, the overage percentage was reduced to less than eight percent.

The National Taxpayer Advocate's report also states that the IRS focuses on closing cases rather than helping taxpayers to resolve their problems. While we disagree with the statement, we agree we need to continually focus on helping taxpayers understand and resolve their tax issues. It is our intent to conduct a correspondence examination program that promotes the IRS mission and we realize that responding to the needs of taxpayers in this process is vital. In this regard, the IRS created a Taxpayer Communication Task Group to evaluate all IRS notices and explore communications improvement opportunities. In addition, the IRS works very closely with the tax practitioner community to identify specific opportunities for improvement in the correspondence examination program. Based on practitioner focus group feedback, we have initiated or planned changes such as the issuance of letters to acknowledge receipt of taxpayer correspondence and implementation of uniform and adequate notice suspense timeframes. We are also working with the National Taxpayer Advocate to address her concerns with the combination, or "combo" letter. Use of this letter is being eliminated for all but a few programs, such as Criminal Investigation referrals and non-filer cases, where the chance of the returns being adjusted are highly likely. These changes will be implemented during 2010.

61 IRS tracks mail that is overage compared to total mail. In June 2007, there were 627 pieces of mail overage out of a total inventory of 5,787. The comparable figures for June 2008 were 2,146 out of 12,500.

With regard to telephone contacts, the IRS is taking actions to move toward a vision for corporate inventory for much of this work. The W&I Division has implemented a self assign feature that allows a taxpayer to provide information to any tax examiner that answers our toll free number on an unassigned case. If the information the taxpayer provides is sufficient, the examiner can immediately assign the case to himself or herself and make the final determination on the case. A Unified Work Request for a programming change has also been submitted to expand this flexibility to cases in 90-day status. In addition, W&I has completely eliminated extension routing on all cases. Universal call routing now facilitates taxpayers' telephone interactions with the IRS by allowing them to talk to the next available examiner on any case. This process eliminates the need for the taxpayer to connect with the particular IRS employee assigned to his or her case, since all return data, letters, reports, and work papers are available to all examiners. In addition, an October 2008 telephone survey reflects that 70 percent of taxpayers called for an explanation of the letter from the IRS and another 11 percent called to inform the IRS that they mailed records or wanted to provide other information; issues that can easily be addressed by any examiner.

The IRS has received very favorable feedback from taxpayers regarding these changes to our telephone operations. For example, the W&I October 2008 telephone survey indicates 84 percent of taxpayers were satisfied with the time it took to reach a tax examiner on the phone and 95 percent were satisfied with the length of time they spent with the examiner after they were connected. Further, 90 percent were satisfied with the ability of the examiner to make a decision on their case. Other planned improvements include intelligent call routing, which will route calls to the most appropriate examiner based on the tax issues involved in the case. We are also moving forward with the correspondence imaging development project which will electronically add taxpayer correspondence to our frontline employees' desktops. This will allow for faster responses to taxpayer mail and reduce overage inventory.

Comments regarding the National Taxpayer Advocate's specific recommendations follow.

The National Taxpayer Advocate recommends that the IRS implement processes and procedures to timely associate and consider taxpayer correspondence. The IRS believes the standardization of timeframe guidance and related systems changes have already addressed the concerns raised by the NAEA. However, we will continue to work toward reducing overage correspondence and improving the timeliness of our responses to all taxpayer correspondence.

The National Taxpayer Advocate recommends that the IRS move forward with systemic restrictions to limit reduction of suspense periods in the batch processing system. The IRS has already submitted a Uniform Work Request to program RGS/CEAS to automatically populate the suspense period whenever a case is updated into a new letter status. In addition, system changes have already been made to standardize the suspense periods for

cases in Status 22. Cases are updated to Status 22 when the 30-day letter is issued to the taxpayer. The 30-day letter includes an audit report with proposed adjustments which is issued prior to the statutory notice.

The National Taxpayer Advocate recommends that the IRS issue a SERP Alert covering IRM 4.19.3.1 to emphasize the importance of effective use of the telephone. While we agree our employees should follow this IRM, we do not believe issuance of a SERP alert is the most effective way to ensure these provisions are being adhered to. Rather, we plan to address this area by evaluating the case reviews included in an ongoing study. The results will allow us to provide site-specific feedback for managers and employees regarding their performance in this area.

The National Taxpayer Advocate recommends that the IRS eliminate use of the Examination Procedural Job Aid and follow the guidance in IRM 4.19.19, *Telephone Contacts*. Correspondence examination telephone assistors are already required to follow IRM 4.19.19, which provides technical guidance that is not superseded by any locally generated procedural job aids. However, we will ensure that any such job aids do not contain instructions to staff that are inconsistent with the IRM. Further, W&I Examination has a Toll-Free Telephone Assistance Guide in SERP which contains hyperlinks to various IRM and other references for quick access to guidance for examiners to assist in the handling of taxpayer telephone calls.

The National Taxpayer Advocate recommends the that IRS align the procedures used by tax examiners in locating taxpayers and handling undeliverable mail in IRM 4.19.13 with the procedures used by tax compliance officers in IRM 4.10.2. During notice generation at the campus level, the address is systemically referenced against the most current IRS Master File address data for the taxpayer. In addition, when the notice is received at the National Print Site for mailing, another check is performed on the address to determine if it is a valid postal address prior to the mail-out. These procedures are fully consistent with the law and we believe they ensure that a majority of all correspondence reaches its intended recipient. IRS data indicates that currently only about six percent of correspondence examination notices are undelivered.[62] Further, much of the guidance in IRM 4.10.2 that applies to more complex office and field examinations, such use of third party contacts, postal tracer services, etc., are impractical in the campus correspondence examination environment.

Finally, the National Taxpayer Advocate recommends that the IRS stop using the combo letter in all correspondence examinations. As noted above, Uniform Work Requests for programming that will eliminate use of the combo letter in all but a few situations are in the implementation process. The IRS will also evaluate discontinuing the use of these letters for the remaining cases.

62 Audit Information Management System (AIMS) September 2008 database.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for its commitment to improving the correspondence examination program, for its innovation in the development of new customer service delivery systems, and for its willingness to work collaboratively with TAS and the practitioner community to improve customer service while seeking ways to reduce costs and burdens faced by taxpayers in complying with the law. The IRS's proactive approach to addressing the concerns of the NAEA, and its willingness to rethink its position on the use the combo letter are good examples of this commitment. The creation of a Taxpayer Communications Task Group, along with the aggressive use of focus groups, customer surveys, and national phone forums all serve to enhance the notice improvement process and improve communications with taxpayers. The advent of Universal Call Routing holds the promise of transforming IRS call sites into world class operation centers. Despite these system enhancements and service improvements, the National Taxpayer Advocate remains concerned that the unregulated growth in correspondence examinations is undermining the agency's ability carry out its mission and is burdening taxpayers.

The IRS's reliance on a rigid automated system for conducting examinations eliminates flexibility, a crucial element of the exam process. Adhering to the expiration of automated timeframes to move cases through the process could prematurely push cases forward, because taxpayers may not have sufficient time or assistance to respond to IRS requests for information. The automated process limits the ability of taxpayers to engage in a meaningful dialogue with tax examiners, to ask questions about the process and the issues, and to resolve problems that invariably arise during the course of an examination. While the National Taxpayer Advocate is pleased the IRS is communicating with stakeholders, such as the NAEA, the examples these stakeholders share continue to illustrate the type of problems that can arise when relying on an automated system to conduct examinations.[63]

The National Taxpayer Advocate applauds the IRS's efforts to improve the control and tracking of unassociated correspondence and understands the challenges heavy volumes of mail can create. It is important to note the batch system cannot be effective unless correspondence is properly controlled and recorded upon receipt. Additionally, it is unacceptable for the IRS to send 2.9 million "interim" letters advising taxpayers to expect delays of 30 days or more in processing their correspondence, which is over and above the IRS's acceptable 30-day initial processing period.[64] These correspondence delays create additional follow-up contacts from concerned taxpayers, such as duplicate return filings, duplicate correspondence, calls to the IRS's toll-free line, and TAS referrals: all of which

63 National Association of Enrolled Agents Letter Regarding Concern over Recent Enforcement Actions by IRS (Nov. 28, 2007), *at* http://www.naea.org/MemberPortal/Advocacy/Comments/letter_nov_28_2007.htm (last visited June 4, 2008).

64 National Taxpayer Advocate 2006 Annual Report to Congress 222; IRS, Office of the Notice Gatekeeper, Correspondex Letter Volumes; IRM 3.0.273.19.4.1 (Jan. 1, 2006).

result in unnecessary rework for IRS employees.[65] In regard to the 241 percent figure, this number accurately represents the challenges the IRS is experiencing in addressing taxpayer correspondence in a timely fashion as compared to the increase in discretionary examinations in 2007 to 2008. No matter what percentage may be used, it is clear overage mail remains an issue.[66]

The National Taxpayer Advocate acknowledges that the IRS is often under extraordinary pressure to do a number of tasks, including conducting examinations. However, in the past several years, the IRS has shifted from assisting taxpayers in understanding their tax obligations and resolving audit problems to closing cases and reducing examination cycle time. The IRS relies too heavily on moving cases along through an automated system, rather than considering all taxpayer correspondence and making sure the taxpayer understands his or her obligations. This approach may cause faulty tax assessments, premature enforcement actions, or unnecessary burden and anxiety to the affected taxpayers.

Comments Regarding IRS Response to TAS Recommendations

In addressing systemic restrictions that would operate to limit the reduction of the suspense periods in the automated batch processing system, the IRS indicates it has submitted a uniform work request to modify its programming to automatically populate the proper suspense period at each stage in the audit process. The National Taxpayer Advocate commends the IRS for this important step in the right direction, but also reminds the IRS that the system will only work if correspondence is properly controlled and recorded into the system upon receipt. In designing this system, the National Taxpayer Advocate urges the IRS install safeguards to protect taxpayers against the inadvertent circumvention of internal controls, and to improve the oversight of managers and examiners who are required to adhere to the agency's long-standing audit quality standards in conducting correspondence examinations.

The National Taxpayer Advocate supports the IRS's plans to conduct case reviews as part of an ongoing study to promote the effective use of the telephone in resolving correspondence examinations. Particular emphasis should be placed on adherence to IRM 4.19.13.9.1, which requires examiners to make telephone contact with taxpayers to resolve issues and clarify information needed *before* issuing a request for additional information. The National Taxpayer Advocate also urges the IRS to consider issuing a SERP alert to emphasize the importance of telephone contact, to mandate its use, and to stress the importance of adherence to IRS policy. A separate alert will reinforce and direct employees' attention to the IRM instruction. The IRS should also develop training materials for tax examiners covering telephone examination techniques.

65 National Taxpayer Advocate 2006 Annual Report to Congress 232.

66 W&I, *Compliance Measures* (June 2008). Correspondence examinations do not include related compliance programs (*e.g.*, AUR, SFR, CP 2000, or Math Error Programs). The discretionary correspondence examination mail figures are exclusive of any other compliance program

The National Taxpayer Advocate disputes the IRS contention that merely satisfying the letter of the law represents an adequate attempt to contact taxpayers for the purpose of conducting examinations, especially in view of the high default rates and future downstream rework generated by audit reconsiderations. Moreover, the IRS has not presented data to support its contention that the use of postal tracers and third party contacts, typically used to contact taxpayers in office and field audits, is impractical for use in the context of correspondence examinations. The National Taxpayer Advocate believes the IRS should make a greater effort to locate and contact taxpayers before issuing a statutory notice of deficiency on "no reply" cases.

The National Taxpayer Advocate has long advocated for the IRS to stop using the combo letter in all correspondence examinations, and is pleased to report the IRS has agreed to eliminate the combo letter in all but a few examination programs, *e.g.*, non-filers and criminal investigations referrals that have high potential for audit adjustments, beginning in 2010. While the National Taxpayer Advocate would urge this action without delay, she commends the IRS for its willingness to consider the complete elimination of the combo letter and looks forward to working with the IRS in exploring this possibility.

Recommendations

The National Taxpayer Advocate recommends the IRS take the following actions to improve the correspondence examination process:

1. Implement processes and procedures to associate and consider taxpayer correspondence timely; move forward with systemic restrictions to limit the reduction of suspense periods in the batch processing system;
2. Issue a Servicewide Electronic Research Program (SERP) Alert covering IRM 4.19.3.1, *Outgoing Calls*, to emphasize the importance of effective use of the telephone in resolving correspondence examinations;
3. Eliminate the use of the Examination Procedural Job Aid and follow the guidance in IRM 4.19.19, *Telephone Contacts* and align the procedures used by tax examiners in locating taxpayers and handling undeliverable mail in IRM 4.19.13, *Liability Determination – General Development and Resolution*, with the procedures used by tax compliance officers in IRM 4.10.2, *Examination of Returns – Pre-contact Responsibility*; and
4. Stop using the combo letter in all correspondence examinations and revert to the pre-1999 examination procedure of issuing a preliminary audit report, followed by a traditional 30-day letter at a later stage in the audit.

MSP #16

The Impact of IRS Centralization on Tax Administration

Responsible Officials

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division
Frank Y. Ng, Commissioner, Large and Mid-Size Business Division
Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division
Sarah Hall Ingram, Chief, Appeals

Definition of Problem

Over the years, the IRS has centralized essential functions and programs involving taxpayer contact and interaction. The centralization of major programs significantly changes their organizational structure, management, work processes, and the quality of interaction between the IRS and taxpayers.

While centralization has its benefits, it can also harm taxpayers if the IRS fails to consider the true impact of centralization on taxpayer service and compliance. The IRS needs to do a better job of evaluating the downstream consequences to taxpayers when assessing the true cost of centralization.

Analysis of Problem

Background

In 1998, the IRS was comprised of 33 districts and ten campuses (then called service centers). Each of these 43 organizations reported to a director who was charged with administering the entire tax code for every kind of taxpayer – from low income individuals to high income businesses, with simple and complex problems – within his or her district or campus. All of these units were geographically based and functionally separate, with multiple management layers. Four regional offices and a national office conducted oversight of these districts.[1]

Congressional hearings in late 1997 uncovered a wide array of inconsistencies, inefficiencies, and deficiencies in taxpayer service, which Congress attributed in part to the geographically based structure of the IRS.[2] The hearings prompted the enactment of the

1 Internal Revenue Manual (IRM) 1.1.2 (Feb. 26, 1999).

2 *See Report of the National Commission on Restructuring the Internal Revenue Service: A Vision for a New IRS* (June 25, 1997); *Hearing Before Subcomm. on Oversight of the H. Comm. on Ways and Means on the Report of the National Commission on Restructuring the Internal Revenue Service* (July 24, 1997); *IRS Restructuring: Hearings Before the Committee on Finance, United States Senate*, 105th Cong. (Jan. 28-29, 1998; Feb. 5, 11, and 25, 1998).

IRS Restructuring and Reform Act of 1998 (RRA 98)[3] and served as the impetus for the most significant IRS reorganization since 1952. RRA 98 codified the need for modernization and required the IRS to move from its geographically based system to a flatter management structure, in an effort to become a more customer-focused organization.[4]

Prior to the reorganization, the IRS was a "stovepipe" operation. In this type of structure, functional units (such as Accounts Management, Submission Processing, Exam, Collection, and Appeals) set and implemented their own priorities and objectives, which might be disconnected from the other functions and the organization as a whole. Under this arrangement, the IRS looked like a conglomeration of unconnected parts rather than an integrated organization moving toward a common goal. For example, if a taxpayer received a notice from the IRS and called the toll-free number to inquire about it, the customer service representative might not be able to help because he or she lacked the information needed to settle account problems.

The IRS subsequently reorganized into four major divisions based on the type of taxpayer served by each division:

- Wage and Investment (W&I), serving individual taxpayers with wage and investment income only;
- Small Business/Self-Employed (SB/SE), serving small businesses and fully or partially self-employed individuals;
- Large and Mid-Size Business (LMSB), serving corporations with assets of more than $5 million;[5] and
- Tax Exempt and Government Entities (TE/GE), serving a wide range of customers including small community organizations, major universities, pension funds, state governments, and Indian tribal governments.

Each of these divisions was given end-to-end responsibility for serving a particular group of taxpayers with similar needs. In this manner, the IRS hoped to better serve the American public by reorganizing into specialized units focused on taxpayer needs, rather than on its own internal needs. The reorganization was intended to eliminate stovepipes, reduce management levels, and bring decision-making close to the front line.[6] Although the agency has made progress in breaking down stovepipe barriers, it has not done away with them as intended.

3 Internal Revenue Service Reform and Restructuring Act of 1998 (RRA 98), Pub. L. No. 105-206 (1998).

4 Pub. L. No. 105-206 § 1002 (1998).

5 The threshold for LMSB casework is now $10 million in assets. *See Large & Mid-Size Business Division At-a-Glance, at* http://www.irs.gov/irs/article/0,,id=96387,00.html (last viewed Sept. 22, 2008).

6 *See Report of the National Commission on Restructuring the Internal Revenue Service: A Vision for a New IRS* (June 25, 1997).

Within a few years of the reorganization, the IRS moved away from providing end-to-end service to taxpayers and began to centralize functions at the campuses in an effort to realize efficiencies. For example, all Submission Processing, whether it affects individual or business taxpayers, now falls under W&I. LMSB never offered end-to-end account services for LMSB taxpayers; SB/SE handles these services instead.[7] In TE/GE, the toll-free customer service phones are now answered by W&I rather than TE/GE employees.[8]

The IRS Has Achieved Certain Benefits by Centralizing Programs.

The IRS can take different approaches to centralization. Under a *programmatic* approach, separate functions are not centralized, but a central office coordinates their activities. In a *functional* approach to centralization, a specialized unit deals with the taxpayer from start to finish. In a third approach, one unit completes tasks on a case but is not responsible for the case from start to finish.

There are many valid, taxpayer-friendly reasons to centralize a program. Through centralization, an organization can identify inconsistencies that can be immediately resolved, reduce redundancies, and create efficiencies that might not be apparent if performed by separate units. Centralization allows for greater focus on coordination, standardization, and consolidation of equipment, processes, and technology.

However, the IRS may be harming taxpayers by centralizing processes without factoring in the impact on taxpayer service and taxpayer interaction with each process or program. Taxpayer-centric issues that the IRS should consider when deciding whether to centralize a program include:

- Can a remote centralization structure be designed to minimally affect the needs of the taxpayer population involved?
- Does the structure meet the needs of taxpayers and provide service that is more convenient?
- Does centralization include adequately staffed, competent, and trained personnel who understand taxpayers' business and individual needs?
- Does the IRS measure efficiency and productivity benefits to taxpayers along with the risks?
- Is the proposed centralization based on lessons learned, responses received, and taxpayer trends identified from past or similar centralization efforts?
- Can taxpayers locate, navigate, and effectively communicate with the centralized program?

7 *See* IRM 1.1.24 (Nov. 1, 2006).

8 Initially, TE/GE employees answered the toll-free calls. Effective October 1, 2006, responsibility for the TE/GE call site shifted to W&I Customer Account Services. *See* TE/GE Call Site Transferred to W&I, *at* http://tege.web.irs.gov/templates/CASHome.asp (last viewed Nov. 25, 2008); TE/GE Call Site Transfers to W&I, *at* http://win.web.irs.gov/cas/tege_welcomed_by_wi.htm (last viewed Nov. 25, 2008).

- Does the centralized structure work seamlessly with the rest of the IRS, including handing off cases, or does it create isolated units?
- Is there a fallback process when the centralized arrangement does not work for a particular taxpayer or type of taxpayer?

Centralized Programs That Have Benefitted Taxpayers

The following are examples of centralized IRS programs that have benefitted taxpayers while creating efficiencies and improving customer service. In each instance, the IRS realized its procedures for dealing with a very complex issue were inadequate. By centralizing, the IRS hoped to benefit from applying its procedures uniformly to taxpayers.

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is a refundable federal income tax credit for low income working individuals and families. It is a complex provision to administer; over 20 different IRS functions handle some portion of the EITC.[9] In July 2002, the IRS took steps to improve administration of the EITC by creating the EITC Program Office in the W&I division.[10] The goal of the EITC Program Office is to strengthen coordination and links among the functions so their interactions are seamless. Here, programmatic centralization of EITC program oversight into one office has brought a more focused approach to EITC marketing efforts and related compliance activities. The EITC Program Office has balanced compliance and outreach while standardizing budget allocations for the diverse EITC population.

Relief from Joint and Several Liability

Following the enactment of RRA 98, the IRS was overwhelmed with applications for relief from joint and several liability, due in part to a change in the law.[11] The inventory of joint and several liability, or "innocent spouse" cases rose from 46,619 in fiscal year (FY) 1999 to 54,402 in FY 2000.[12] To quickly identify new issues as it implemented the law, and to achieve consistency in its relief determinations, the IRS created a centralized unit to process joint and several liability claims. This centralization enabled the IRS to obtain much-needed support from the Office of Chief Counsel, the Appeals function, and TAS in an efficient and effective manner.

9 *See* Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-40-133, *Administration of the Earned Income Tax Credit Program Has Improved, but Challenges Continue*, Appendix V (Aug. 26, 2005).

10 *See* IRS, *EITC Program Effectiveness and Program Management FY 2002 – FY 2003* (Aug. 8, 2003).

11 *See* National Taxpayer Advocate 2005 Annual Report to Congress 326; National Taxpayer Advocate 2003 Annual Report to Congress 170; National Taxpayer Advocate 2002 Annual Report to Congress 150; National Taxpayer Advocate 2001 Annual Report to Congress 128.

12 *See* National Taxpayer Advocate 2001 Annual Report to Congress 128.

Centralized Programs That Have Been Less Than Successful

Some centralized IRS programs have failed to realize the anticipated benefits. One significant drawback of centralized programs is the emphasis on standardized, "cookie-cutter" processes over an individualized, fact-and-circumstances approach. Centralization of the offer in compromise (OIC) program is an example of a flawed centralization initiative.

The OIC program allows for the compromise of tax liabilities based upon "doubt as to liability" or "doubt as to collectability," or in furtherance of "effective tax administration."[13] The goal of the program is to achieve collection of what is reasonably collectible, at the least cost and at the earliest possible time, and to promote future taxpayer compliance.[14]

The National Taxpayer Advocate has repeatedly voiced concerns over the rules and procedures, imposed as a result of centralization, that limit the accessibility and use of the OIC.[15] It appears the IRS no longer uses the program to any significant extent as a viable collection alternative. Between FY 2001 and FY 2008, the number of offers accepted declined by 72 percent.[16]

Centralization Carries Some Drawbacks.

While centralization comes with many benefits, the IRS should not ignore the potential harm to taxpayers when it assesses the costs and benefits of centralizing a program. The National Taxpayer Advocate has raised concerns about the centralization of numerous programs in previous Annual Reports to Congress.[17] The following discussion identifies some of the concerns the IRS needs to address to reduce negative impact on taxpayers when centralizing a process.

Reduced Opportunities for Face-to-Face Contact

In a survey conducted by the IRS Oversight Board, 60 percent of taxpayers stated that it is very important to be able to visit an office where an IRS representative will answer their questions.[18] Since the IRS reorganization, however, taxpayers have had fewer opportunities to meet with employees to resolve their issues – or interact with the IRS in person at all. One significant consequence of centralization is the diminished level of face-to-face service the IRS offers to taxpayers.

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13 *See* Treas. Reg. § 301.7122-1, *et. seq.*; Form 656, *Offer in Compromise.*

14 *See* IRS Policy Statement P-5-100, IRM 1.2.1.5.18 (Jan. 30, 1992).

15 *See* National Taxpayer Advocate 2007 Annual Report to Congress 375; National Taxpayer Advocate 2004 Annual Report to Congress 311; National Taxpayer Advocate 2003 Annual Report to Congress 99; National Taxpayer Advocate 2002 Annual Report to Congress 15; National Taxpayer Advocate 2001 Annual Report to Congress 52; National Taxpayer Advocate 2000 Annual Report to Congress 36; National Taxpayer Advocate 1999 Annual Report to Congress I-35.

16 SB/SE Collection Activity Report No. 5000-108 (FY 2001-FY 2008). In FY 2001, the IRS accepted 38,643 OICs compared to 10,677 in FY 2008.

17 *See* National Taxpayer Advocate 2006 Annual Report to Congress 130; National Taxpayer Advocate 2005 Annual Report to Congress 136; National Taxpayer Advocate 2004 Annual Report to Congress 264, 311; National Taxpayer Advocate 1999 Annual Report to Congress I-27, I-34, I-41, I-42.

18 IRS Oversight Board, *2007 Taxpayer Attitude Survey* (Feb. 2008).

Geographic centralization limits the opportunity for face-to-face interaction and exercise of independent judgment. For example, in an attempt to reduce cycle time and save resources by more efficiently working its "less complex" cases, the Office of Appeals centralized certain work streams at IRS campuses in 2003 and 2004.[19] The National Taxpayer Advocate raised questions about this initiative in both the 2005 and 2006 Annual Reports to Congress and still holds many of the same concerns.[20]

The trend of centralizing Appeals activity at campuses and the subsequent cutbacks in local office staffing reduce opportunities for taxpayers to obtain face-to-face Appeals hearings. While not every taxpayer needs or wants face-to-face meetings with Appeals, the National Taxpayer Advocate remains concerned about the potential impact of this policy, particularly on low income taxpayers. The lessened opportunity for face-to-face contact not only affects taxpayer service, but may also diminish enforcement. If the IRS has no presence in the local community, taxpayers may feel less inclined to keep current on their tax obligations.[21]

Loss of Local Expertise

Many IRS employees and managers possess unique skills and expertise, developed through years of experience in particular subjects. In addition, many have built relationships with state and local tax agencies, other government agencies, professional organizations, industry experts, and grassroots stakeholders. With centralization, the IRS may shift programs away from these experts to employees who (without extensive training) lack the necessary skills and abilities.

For example, the IRS consolidated 33 geographically dispersed lien units into a single centralized case processing lien unit at the Cincinnati Campus in 2005. Until then, each individual lien processing unit provided direct telephone and walk-in service for taxpayers. Lien employees dealt regularly with the appropriate authorities in their local jurisdictions and were familiar with local issues affecting taxpayers. Centralization virtually eliminated taxpayers' ability to walk into an IRS office and obtain an immediate release of a lien.[22]

The IRS experienced a similar loss of local expertise when it centralized oversight of the Taxpayer Assistance Centers (TACs). The IRS decided at the national level which issues were out of scope (*i.e.*, which the TAC employees would not address), leading to one-size-fits-all policies and underuse of local expertise. For example, a farmer in North Dakota may have a few questions about income averaging and depreciation of farm equipment. Before the IRS centralized the management of its TAC operations, the farmer could walk into the

19 See TIGTA, Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* (May 10, 2007).

20 See National Taxpayer Advocate 2006 Annual Report to Congress 130; National Taxpayer Advocate 2005 Annual Report to Congress 136; National Taxpayer Advocate 2004 Annual Report to Congress 264, 311; National Taxpayer Advocate 1999 Annual Report to Congress I-27, I-34, I-41, I-42. IRS Oversight Board, *2007 Taxpayer Attitude Survey* (Feb. 2008).

21 See Marjorie E. Kornhauser, "Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers," National Taxpayer Advocate 2007 Annual Report to Congress Vol. II, 144.

22 See National Taxpayer Advocate 2006 Annual Report to Congress 130.

local IRS office and ask these questions. Now, the IRS deems such farming questions out of scope for TAC employees.[23]

Inadequate Centralized Resources Lead to Increased Inventory and Rework.

When centralization works as intended, an organization can address issues comprehensively and efficiently. However, the IRS must adequately staff its centralized programs and sufficiently train its employees. Insufficient staffing and inadequate training lead to increases in inventory and rework, which waste taxpayer time and agency resources.

In FY 2006 and FY 2007, the IRS consolidated the Combined Annual Wage Reporting (CAWR) and Federal Unemployment Tax Act (FUTA) programs at three campuses, with the Cincinnati Campus handling cases from 27 states. After the consolidation of the CAWR/FUTA program, TAS CAWR/FUTA receipts increased 68.7 percent in FY 2007 over FY 2006.[24]

These examples illustrate a common theme in the problems created by centralization. Rising inventories, inadequate staffing and training, the inability of taxpayers and employees alike to navigate the system and make contacts, the loss of local familiarity, and the lack of face-to-face interactions all have a major impact on both taxpayers and IRS employees. Centralization should not come at the expense of taxpayers or the employees who serve them.

The IRS Should Fully Consider Factors That Impact Taxpayer Service When Deciding Whether to Centralize a Program.

If the IRS decides to centralize a program, the benefits to taxpayers should significantly outweigh any harm to taxpayer service. The IRS should ask and answer each of the following questions when it considers centralizing a program.

What are the expected benefits of centralization?

The IRS should conduct a comprehensive analysis to identify the expected gains in efficiency, cost savings, and other benefits of centralization before deciding to centralize any program. On what data or assumptions are these expectations based? Is there a way to quantify the estimated gains in efficiency? Do calculations of net cost savings include the costs of downstream consequences? Is there a plan to revisit and evaluate the decision to centralize and determine if the IRS has realized the expected benefits?

Is there a need for a strong local presence?

How do taxpayers feel about a faceless and nameless IRS? Does this program involve a subject or a taxpayer population that would benefit from a more localized structure?

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23 *See* Most Serious Problem, *Taxpayer Service: Bringing Service to the Taxpayer, supra.*

24 *See* National Taxpayer Advocate 2007 Annual Report to Congress 651. *See also* Most Serious Problem, *Inefficiencies in the Administration of the Combined Annual Wage Reconciliation (CAWR) Program Impose Substantial Burden on Employers and Waste IRS Resources, infra.*

The trend toward centralization has repercussions through all areas of tax administration. One of the National Taxpayer Advocate's greatest concerns is the loss of a local footprint for the IRS.[25] While one can argue that technology enhances the communication process for taxpayers in some program areas, there is no adequate substitute for face-to-face or local interaction with some taxpayer populations. Some taxpayers may not need a face-to-face opportunity but do need local personnel who understand their particular environment or occupation.

When the IRS centralizes a program or process, it should not necessarily walk away from the local structure. Theoretically, the IRS can organize around the type of taxpayers served by the various operating divisions and functions without abandoning a geographic footprint.

What will be the impact of centralization on compliance?

Taxpayers and their representatives depend on IRS information about tax laws to comply with their tax obligations. A taxpayer's ability to obtain information has a direct bearing on voluntary compliance – *i.e.,* when information is difficult to obtain, voluntary compliance declines.[26] The IRS should consider whether centralization would make it easier or more difficult for taxpayers to obtain information about their tax obligations.

What will be the impact of centralization on taxpayer service?

The IRS needs to maintain fair and consistent treatment of all taxpayers, and must always ask itself whether centralization will harm a certain segment of taxpayers. For example, the IRS should evaluate the impact of centralization on low income taxpayers, the elderly, and those who speak English as a second language, who may be less able to navigate the IRS. Thus, taxpayers should retain their right to request local contact or face-to-face interaction with an IRS employee when appropriate.

Centralization can and should be invisible to taxpayers. Taxpayers have consistently provided their views on the importance of access to the IRS whether by phone, face-to-face, or electronic means. By a wide margin, those who contact the IRS prefer to receive service from a person rather than from automated systems. In a recent study, 61 percent of taxpayers identified calling the IRS as their most preferred way to obtain help in resolving a tax dispute or error, while another 22 percent selected visiting an IRS office as their first choice.[27] A program can achieve the benefits of centralization while preserving personal interaction by providing easily accessible and navigable telephone assistance and appropriate protections for those taxpayers who require face-to-face interactions.

25 Nina Olson, National Taxpayer Advocate, Remarks Before the American Bar Association Section of Taxation (May 9, 2008).

26 *See* Marjorie E. Kornhauser, "Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers," National Taxpayer Advocate 2007 Annual Report to Congress Vol. II, 144.

27 *See* IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey, Special Report* 16 (Nov. 2006).

Are downstream consequences or hidden costs associated with transitioning to a centralized program?

The IRS should do its best to measure the true cost of centralizing a program from the outset. Do calculations of net cost savings include the costs of downstream consequences or costs associated with moving to a centralized program? Failure to adequately measure these costs inflates the projected savings from centralization.

Taxpayers who cannot obtain the information or services they need to comply with federal tax laws, or who cannot resolve their issues on their first attempt, can generate significant downstream costs such as repeat contacts, errors on returns, TAS intervention, revenue loss, and enforcement costs such as audits, audit reconsiderations, collection activity, appeals, and litigation. Hidden costs may include the expenses of training employees and communicating new procedures, as well as the loss of knowledge of local procedures.

Is there a fallback when centralization fails?

The IRS should always have plans in place to assist taxpayers when a centralized unit does not fully address their needs. The IRS needs to develop a strategy for problem solving in situations where centralization does not bring all the projected benefits, or harms taxpayers in ways that the IRS did not anticipate. The taxpayer can always come to TAS for assistance, but the IRS should have its own fallback plan.

In addition, the IRS should continuously analyze the appropriateness of centralization to see if the assumed benefits are actually realized. The IRS should conduct pilot tests that focus on customer feedback before implementing centralization efforts. The IRS should continue to measure the downstream impact on taxpayers after centralization.

Finally, by centralizing a program, the IRS makes itself more vulnerable to a natural disaster or other event that disrupts business activity. This concern is exacerbated if a program is consolidated within one campus. Does the IRS have a business resumption plan that has been tested?

Conclusion

Many large organizations may benefit from centralizing processes. When carried out correctly, centralization can significantly reduce redundancies and increase effectiveness.

However, if centralization is not properly established and implemented, taxpayers may be harmed. When considering whether to centralize a program, the IRS should measure the true cost of centralization, including the impact on taxpayer service and compliance. The IRS must invest the time and effort to properly evaluate the costs and benefits of centralization because the alternative means increased costs and additional compliance barriers for taxpayers.

The IRS should consider taking the following actions to validate that it considers all downstream consequences of centralization. The IRS should substantiate its assumptions about cost savings and taxpayer burden based on lessons learned, feedback mechanisms, and taxpayer trends. It is important for the IRS to base its decisions on research and conduct pilot programs to test the validity of its assumptions. The IRS should also establish a standard project matrix that defines the project, provides background information, sets forth objectives, establishes deliverables, quantifies expected benefits, and identifies necessary resources. The IRS should use this standard project matrix to evaluate programs and determine whether the anticipated benefits of centralization have been realized.

IRS Comments

The IRS agrees with the National Taxpayer Advocate's assessment that centralization of programs can significantly benefit taxpayers, reduce redundancies, increase efficiency and effectiveness, and improve customer services. However, the National Taxpayer Advocate also outlines perceived shortcomings of several IRS centralization efforts, including OIC, Appeals, Lien Processing, TACs, CAWR, and FUTA.

With regard to the OIC program, the National Taxpayer Advocate offers the decline in receipts and accepted offers from FY 2001 to 2007 as evidence of "a flawed centralization initiative." However, new OIC receipts continued to increase from FY 2001 through FY 2003, even after the centralized OIC sites were established in August 2001. The IRS believes the decline in new receipts that began in FY 2004 is not attributable to centralization, but rather is due to changes that began with implementation of the user fee in November 2003.

The user fee was put into effect to help offset the cost of the OIC program and to reduce the number of OICs submitted without merit. The IRS has recently taken steps to minimize the impact of the user fee on taxpayers, most notably by broadening the definition of low-income, so that more taxpayers will qualify for a waiver of the fee. These new guidelines became effective with the publishing of the Form 656, *Offer in Compromise*, in February 2007.

The February 2007 revision of Form 656 also included the new Tax Increase Prevention and Reconciliation Act (TIPRA) OIC guidelines and explanation of the new non-refundable payment terms required by the TIPRA legislation that became effective for all OICs received after July 16, 2006. The IRS recognizes these non-refundable payment terms may cause some taxpayers to be hesitant to submit an OIC; especially those taxpayers whose only means to fund their offers is from gifts or payments from friends or family. Therefore, the IRS is currently working with the Office of Chief Counsel and representatives of TAS to explore reasonable exceptions to this non-refundable payment requirement that are consistent with the statute.

It is also important to understand that the IRS has conducted many outreach efforts over the past few years to help educate taxpayers and their representatives about OICs. We believe these outreach efforts have led to a better understanding of who actually qualifies for an OIC and has contributed to a further reduction in receipts.

The IRS believes the long-term success of the OIC program is best achieved by maximizing the number of cases in which the IRS is able to complete the analysis and make a decision to accept or reject an offer on its merits. Contrary to the National Taxpayer Advocate's assertion that the "IRS no longer uses the program to any significant extent as a viable collection alternative," the IRS's goal is to accept as many OICs as there are taxpayers that qualify for the program. To that end, the IRS has repeatedly revised its procedures to maximize the number of OIC cases that are actually brought to closure, such as the FY 2007 changes to processability criteria that made it easier for taxpayers to file processable offers and the above-mentioned broadening of qualifications for the low income fee waiver.

With regard to centralized campus Appeals workstreams, the National Taxpayer Advocate states this has lessened the opportunity for face-to-face Appeals conferences and, without further explanation, offers a view that this may affect taxpayer service and ultimately diminish compliance. Taxpayers who have cases being considered in Appeals campus operations have a personal point of contact (the Appeals or Settlement Officer assigned to the case). While conferences may be telephonic, these procedures do not decrease a taxpayer's opportunity to be heard on the merits of his or her case, nor are we aware of any adverse impact on effective tax administration. Further, the Office of Appeals considers taxpayer requests for case transfers to permit face-to-face conferences and grants those requests when it is clear that a face-to-face conference will facilitate case resolution.

The National Taxpayer Advocate states that with centralization, the IRS may shift programs away from employees with experience and familiarity in dealing with local issues affecting taxpayers and the authorities in their local jurisdictions, to employees who lack the necessary skills and abilities. Specifically with respect to lien processing, the NTA contends that centralization virtually eliminated taxpayers' ability to walk into an IRS office and obtain an immediate release of a lien.

When the Lien Processing Units were consolidated, local expertise and relationships with state and local agencies transitioned to the centralized site. In addition, although 34 offices had lien operations prior to centralization, the lien operations personnel only occasionally provided assistance to taxpayers in getting liens released. Taxpayer assistance was most often provided by the Collection Advisory, Collection Field, or the Taxpayer Assistance groups that were co-located with these lien units. Those groups remained on-site, so the ability of taxpayers to visit a local office to obtain a lien release was not affected by the centralization of lien processing. In fact, the availability of IRS offices for obtaining a lien release was significantly increased when the IRS extended the authority to provide immediate lien releases to over 400 walk-in TACs.

The IRS believes the centralization of lien operations has had positive effects for taxpayers and other customers, both internal and external. These include significant improvements in payment processing of recording fees,[28] lien filing and recordation accuracy,[29] lien release timeliness,[30] and standardized employee training requirements.[31] In addition, instead of contact points being based on diverse geographical arrangements which may have necessitated taxpayers making several long-distance calls, a single toll-free number was established for use by all taxpayers. While these benefits are significant, the IRS continues to conduct outreach to taxpayers and practitioners to inform them of the options available related to lien releases and other lien-related assistance.

The National Taxpayer Advocate cites centralized management of the TACs and the resulting adoption of national out-of-scope policies as a further example of centralization that underuses local expertise. As a case in point, the National Taxpayer Advocate offers the example of the North Dakota farmer who, due to the centralized management of TAC operations, can no longer walk into a local IRS office and ask questions about income averaging and depreciation of farm equipment.

As noted in the IRS response to this same point raised in the National Taxpayer Advocate's 2007 Annual Report for Congress, just a few years ago the IRS was criticized for the relatively low level of tax law accuracy provided by its TACs. To successfully tackle this concern, the IRS took aggressive, nationally-directed action to increase employee training, to implement enhanced quality measures and employee accountability, and to control the scope of the issues addressed. The latter is specifically intended to allow our training to concentrate on the kinds of issues most often encountered in the TAC environment, as well as to ensure consistency with TAC employees' grade levels and expertise. These nationally managed efforts brought about a significant and sustained improvement in tax law accuracy that benefits all TAC customers.

In this regard, TAC employees are not currently permitted to address Schedule F farm income issues because this is a very complex area of tax law. Farm-related tax issues include such things as accrual accounting, leases and rents, inventory valuation, employee expenses, pensions and profit sharing, depreciation, cooperative distributions, agricultural program payments, crop insurance payments, and other very sophisticated and specialized business issues. However, through the Geographic Coverage Initiative, an evaluation of TAC locations and services, the IRS is exploring adding into scope geographic based tax law topics, such as farming. The IRS expects to accomplish this by training selected subject matter experts and employing a referral system, while carefully evaluating the accuracy of

28 Nearly 100 percent (99.7 percent) of billings paid timely as of September 2008. Beckley Finance Center, *Lien Payment Report.*

29 137,355 potential lost liens in August 2005 compared to 2,431 in November 2008. IRS, *Potential Lost Lien Report.*

30 The untimely lien release rate in 2005 was 22 percent compared to 12 percent in 2008. Government Accountability Office, *GAO Financial Audit,* November 2005 and November 2008.

31 IRM 5.19.12, Training Guides 5737-001 and 5737-002.

these services. As a result of this initiative, two topics have already been added into scope for FY 2009: Non-Resident Alien Issues and Cancellation of Debt (Mortgage Forgiveness).

Finally, the National Taxpayer Advocate asserts that inadequate centralized resources led to an increase in TAS CAWR/FUTA receipts in FY 2007. However, the IRS does not believe there is a correlation between that increase and centralization. Rather the increase in TAS receipts was the direct result of an isolated, one-time inventory management issue that resulted in the erroneous download of additional IRS CAWR cases at one of the sites.

To address these various perceived inadequacies, the National Taxpayer Advocate recommends that the IRS substantiate assumptions about cost savings and taxpayer burden and adopt a standard project matrix to define and evaluate whether anticipated benefits of centralization have been realized. The establishment, assessment, and validation of planning assumptions are a routine and ongoing part of IRS business practices, including for programs that have been centralized. With regard to the use of a standard project matrix, while most IRS business operations and programs are unique and may not lend themselves to a standardized assessment tool, the IRS welcomes and will consider any specific model the National Taxpayer Advocate may have to offer.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate appreciates the examples submitted by the IRS and acknowledges the IRS's continuing efforts to improve the centralization process. The IRS response focuses on the examples we used to illustrate potential problems associated with centralization, and offers explanations for some of the problems associated with the centralized programs we identified. We find some of these explanations unconvincing, especially with respect to the offer in compromise program.[32] We have written in greater detail about these examples in this report or in prior year reports.[33]

32 The IRS centralized its offer in compromise program in 2001. Since then, both the number of offers submitted and the number of offers accepted have declined. Over this period, the IRS introduced many strict procedural requirements, including the imposition of a user fee in 2003, aimed at greater "efficiencies" in processing. It takes a while for the impact of process changes to alter taxpayer behavior (*i.e.*, word about the process changes will spread as the process results in lower acceptance rates and is perceived as a barrier to getting offers accepted). On the other hand, OIC *acceptances* declined *immediately* in FY 2002. The decline in acceptances in FY 2002 and FY 2003 *predate* the imposition of the user fee. Post-2003, OIC submissions have significantly declined as a result of the user fee. The imposition of the user fee also has had a chilling effect on the number of offers accepted, as taxpayers are more reluctant to submit good offers. *See* Most Serious Problem, *The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties.*

33 *See, e.g.*, Most Serious Problem, *The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties, supra*; Most Serious Problem, *Inefficiencies in the Administration of the Combined Annual Wage Reconciliation (CAWR) Program Impose Substantial Burden on Employers and Waste IRS Resources, infra*; National Taxpayer Advocate 2006 Annual Report to Congress 130-40 (Most Serious Problem, *Centralized Lien Procedures*); National Taxpayer Advocate 2005 Annual Report to Congress 326-44 (Most Serious Problem, *Innocent Spouse Claims*).

The National Taxpayer Advocate continues to believe the IRS needs a project matrix to critically evaluate whether anticipated benefits of centralization are realistically achievable. We do not want this larger point to get lost in a discussion of examples. This project matrix is meant to help the IRS focus on when it is appropriate to centralize a program. The framework of questions we have developed should do just that – get the IRS to consider the different aspects of centralization beyond what is just convenient and less costly for itself, without considering the impact on taxpayer service.

The matrix we propose is not formulaic; a well-developed matrix raises questions that can be applied to the facts and circumstances of *any* specific centralization proposal. The questions are sufficiently flexible to be applied to a wide range of programs. It forces the IRS to think about downstream consequences. More importantly, the questions (and answers) allow the IRS the opportunity to evaluate the success of the centralization effort. We have already provided an example of such a matrix in this report. All the IRS has to do is ask and answer these questions for each proposed centralization initiative, and then evaluate the actual implementation against the expected results.

Recommendations

The National Taxpayer Advocate encourages the IRS to adopt the following recommendations to develop a more successful approach to centralization:

1. Establish a standard matrix that defines the project, provides background information, sets forth objectives, establishes tangible products, quantifies expected benefits, and identifies necessary resources.[34]
2. Use this standard project matrix to evaluate programs and determine whether the anticipated benefits of centralization have been realized.

34 TAS has already provided the IRS with a framework for this matrix in the series of questions set forth in this report.

MSP #17 Incorrect Examination Referrals and Prioritization Decisions Cause Substantial Delays in Amended Return Refunds for Individuals

Responsible Officials

Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Art Gonzalez, Chief Information Officer

Definition of Problem

The IRS's handling of amended returns from individual taxpayers needlessly burdens these taxpayers. The processing of amended returns has ranked among the top four Taxpayer Advocate Service (TAS) case receipts every year since 1999.[1] In fiscal year (FY) 2008, problems caused by amended return processing procedures were the number one reason taxpayers came to TAS.[2] In recognition of this continuing problem, the IRS Oversight Board directed the Wage and Investment Division (W&I) and TAS to create a joint task force to study the causes of this rework. W&I and the National Taxpayer Advocate have identified six primary factors that prolong the processing of amended returns and delay taxpayers' refunds:

- No electronic filing option is available for individual taxpayers;
- The IRS does not meet general processing timeframes;
- Unnecessary Examination referrals add to already lengthy processing times;
- Correspondence Examination queue times prior to taxpayer contact add weeks, and sometimes months, to the process – while leaving taxpayers "in the dark" as to the status of their claims;
- The lack of information-sharing among IRS functions causes more unnecessary delays for taxpayers; and
- IRS business decisions on priorities negatively affect amended returns classified as "duplicate filings."

1 *See* National Taxpayer Advocate 1999 Annual Report to Congress VII-3; National Taxpayer Advocate 2000 Annual Report to Congress 135; National Taxpayer Advocate 2001 Annual Report to Congress 230; National Taxpayer Advocate 2002 Annual Report to Congress 389; National Taxpayer Advocate 2003 Annual Report to Congress 436 (reporting processing claims/amended returns as the number two Most Serious Problem for fiscal year (FY) 2003 based on Taxpayer Advocate Management Information System (TAMIS) receipts); National Taxpayer Advocate 2004 Annual Report to Congress 594 (reporting processing amended returns as the number two issue identified for FY 2004 based on TAMIS receipts); National Taxpayer Advocate 2005 Annual Report to Congress 569 (reporting processing amended returns as the number three issue identified for FY 2005 based on TAMIS receipts); National Taxpayer Advocate 2006 Annual Report to Congress 660 (reporting processing amended returns as the number three issue identified for FY 2006 based on TAMIS receipts); and National Taxpayer Advocate 2007 Annual Report to Congress 676 (reporting processing amended returns as the number two issue identified for FY 2007 based on TAMIS receipts).

2 In FY 2008, TAS had 21,963 cases (an increase of 35 percent from FY 2007) in which the primary issue was IRS delays in processing amended returns. *See* TAMIS.

Even if the IRS implements incremental procedural changes aimed at improving efficiency in processing amended returns, significant delays will continue until the IRS gives these returns higher priority.

Analysis of Problem

Background

Millions of individual taxpayers file amended federal tax returns every year.[3] These taxpayers have a variety of reasons for amending their previously filed returns, including:

- Complexity of the tax code;[4]
- Changes in circumstances;
- Late-year tax legislation;[5] and
- Incomplete tax preparation programs.[6]

The processing of original returns and amended returns differ dramatically in processing time and the number of IRS units that the returns generally travel through before the IRS issues the requested refunds. In general, the vast majority of original individual tax returns filed using Forms 1040, *U.S. Individual Income Tax Return,* either are filed and processed electronically or are manually processed within days or weeks of receipt in the IRS campus Submission Processing units.[7]

In contrast, individual amended returns follow a much longer processing path because the IRS's amended return procedures and priorities differ considerably from those for original returns. Individuals cannot electronically file Forms 1040X, *Amended U.S. Individual Income Tax Return,* and only a minority are fully processed by the Submission Processing

3 For the past three fiscal years, the IRS has received approximately three million individual amended returns per year. The IRS received 3,164,872 amended returns/duplicate filings for FY 2005; 3,006,333 for FY 2006; and 3,252,100 for FY 2007. Through August 9, 2008, the IRS has received 3,237,397 amended returns/duplicate filings, an increase of 7.8 percent over the same period in FY 2007. IRS Joint Operations Center, *CAS Accounts Management Paper Inventory Reports, Cumulative Receipts Comparison by Program – Enterprise, FY 2007 and 2008*.

4 *See* National Taxpayer Advocate 2004 Annual Report to Congress 2, (listing the complexity of the tax code as the most serious problem facing taxpayers and the IRS alike). *See also Preparing Your Taxes: How Costly Is It? Hearing Before the Committee on Finance, United States Senate*, 109th Cong. 42 (Apr. 4, 2006) (statement of Michael Brostek, Director, Strategic Issues Team, U.S. Government Accountability Office) (finding that the complexity of the tax code impacts the accuracy of commercial paid tax preparers).

5 *See* National Taxpayer Advocate 2007 Annual Report to Congress 3 (discussing the impact of late-year tax-law changes on taxpayers).

6 Certain software packages and IRS Free File Alliance programs contain limitations on forms, causing taxpayers to overstate tax liabilities. *See, e.g., Preparing Your Taxes: How Costly Is It? Hearing Before the Committee on Finance, United States Senate*, 109th Cong. 10 (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate) (finding that each of the Free File sites had its own capabilities and limitations). *See also Identity Theft: Who's Got Your Number, Hearing Before the Committee on Finance, United States Senate*, 110th Cong. (Apr. 10, 2008) (written statement of Nina E. Olson, National Taxpayer Advocate) (asserting that due to the IRS exerting little control over the content of each Free File program, each of the programs has its own eligibility requirements, capabilities, and limitations, and the complexity is confusing).

7 During 2008, 58 percent of Forms 1040 were filed electronically and were processed electronically. Forty-two percent of individual paper tax returns were manually processed in the Submission Processing units. Submission Processing employees are rated on their measured "production" – a combination of quality and speed in producing completed work. *See IRS Pipeline Status report and The Daily E-File Report* (on file with author).

units, which must either fully process or transfer the amended returns to the Accounts Management (AM) function within 12 days of receipt.[8]

Once transferred into AM, the amended returns may remain unprocessed for months due to competing higher priority items, such as toll-free telephone service, paper Forms 1040, correspondence, and notices. Unlike Submission Processing staff, AM employees are not rated on measured "production" in terms of quality and speed in processing. Instead, AM's primary mission is telephone service.[9] In the 2008 filing season, the economic stimulus payment added yet another higher priority item to the AM inventory by increasing the volume of telephone calls and amended returns received.[10]

Some amended returns may eventually move from AM to the Examination function to be analyzed for audit potential. Examination adds more processing time while determining whether to audit, correspond or close the amended returns, or move them back to AM because they do not meet established examination criteria. All the while, the taxpayer not only fails to receive his or her requested refund but also fails to receive any notification that the IRS ever received the amended return.

Regardless of their reasons for filing an amended return, taxpayers deserve the same filing and processing efficiencies that the IRS generally provides for original returns. To the majority of taxpayers who do not understand the inner workings of the IRS, the differences between the processing of original and amended returns are indistinguishable. Unfortunately, differences in processing and prioritization between original and amended returns cause substantial delay in amended return processing and the release of the associated refunds.

Six Primary Factors Prolong Amended Return Processing and Delay Refunds.

As noted previously, based on a joint study by TAS and W&I, the National Taxpayer Advocate has identified six primary factors in amended return processing that lead to prolonged processing and delayed refunds. Each factor is discussed in greater depth below.

No Electronic Filing Option Is Available for Individual Taxpayers.

In today's electronic era, people have become accustomed to instant or near instant problem resolution and customer service. The IRS, acknowledging this trend, has steadily advanced its electronic filing capabilities over the years. The 2008 tax filing season set records with taxpayers electronically filing more than 86 million returns.[11] Interest in this

8 IRM 3.11.6.1.1(8) (Jan. 1, 2008).

9 Customer Account Services/Accounts Management Kansas City Campus *1040X Amended Return Project Overview.* Processing paper is a secondary mission and the IRS gives higher priority to original returns, correspondence, and notices than it does to amended returns.

10 Because of the unusually high volume of amended returns in 2008, the IRS temporarily modified the normal processing timeframe for Forms 1040X from eight to 12 weeks to 12 to 16 weeks. *See* IRS, Servicewide Electronic Research Program (SERP) Alert AM IMF 080317, Processing Timeframes for Form 1040X, *at* http://serp.enterprise.irs.gov/databases/irm.dr/current/alerts.dr/alert080317.htm (Aug. 6, 2008).

11 *See* IRS News Release, 2008 Tax Return Filing Season Sets E-File Record, IRS Says (May 28, 2008).

year's economic stimulus payments helped fuel a 44 percent increase in visits to the IRS website during the filing season, to almost 206 million visits.[12] Further, to take advantage of faster refunds, approximately 62 million taxpayers (representing almost 70 percent of all refund returns) chose a direct deposit option for their refunds in 2008.[13]

Notwithstanding these strides, the IRS does not allow individual taxpayers to electronically file their amended returns – despite allowing, and even at times requiring, corporations, tax-exempt organizations, and private foundations to do so.[14] Thus, the same individual taxpayers who have come to expect and appreciate the ease and convenience of electronic filing for their original returns are forced to deal with the time-consuming, mistake-prone process of filing an amended return by paper, and its inherent processing delays.[15] These taxpayers cannot reap the benefits of the electronic era, which include faster refunds, reduced chances of error, and an electronic acknowledgment within 48 hours confirming that the IRS has accepted their returns for processing.[16]

The IRS Is Not Meeting General Processing Timeframes.

Amended returns face much longer processing times than original returns. The IRS's own procedures establish that amended return processing takes longer, with original returns requiring six to eight weeks to process (three weeks if filed electronically) versus eight to 12 weeks to process Form 1040X.[17] As mentioned earlier, because of the unusually high volume of amended returns in 2008, the IRS temporarily modified the normal eight to 12 week processing timeframe for Forms 1040X to 12 to 16 weeks.[18]

Data indicates that even prior to the impact associated with the economic stimulus payment, the IRS took much longer than eight to 12 weeks to process some amended returns. A study of a representative sample of TAS amended return case files found that taxpayers waited a mean of 182 days for the IRS to process their amended returns before contacting TAS for help.[19] This equals 26 weeks, or half a year – more than double the highest range

12 *See* IRS News Release, 2008 Tax Return Filing Season Sets E-File Record, IRS Says (May 28, 2008).

13 *See id.* (citing 61,820,000 taxpayers choosing a direct deposit option for their refund in 2008).

14 *See* Treas. Reg. §§ 301.6011-5 and 301.6033-5 (requiring certain corporations, tax-exempt organizations, and private foundations to electronically file their tax returns, including amended and superseding returns). The IRS has been accepting electronically filed corporate amended returns since the 2005 tax year. *See* Amended and Superseding Corporate Returns Tax Years 2005 and 2006, *at* http://www.irs.gov/businesses/corporations/article/0,,id=168161,00.html (Rev. July 26, 2007).

15 In response to a recommendation made by the TAS/IRS Rework Study group to increase the priority of the Form 1040X e-file initiative and thereby allow taxpayers to file Forms 1040X electronically, the IRS stated that it needs to revisit the sequencing strategy for development of e-file returns "in the near future" and that it would certainly put the Form 1040X "on the table" during those discussions. TAS/IRS Rework Study Report, Phase II at 20.

16 IRM 3.42.1.3.1 (Jan. 1, 2008).

17 IRM 21.4.1.3 (Oct. 1, 2006).

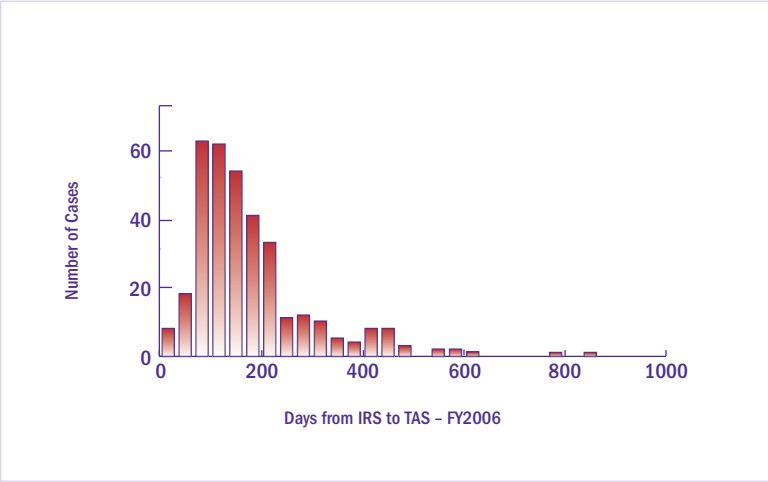
18 SERP Alert AM IMF 080317, *Processing Timeframes for Form 1040X, at* http://serp.enterprise.irs.gov/databases/irm.dr/current/alerts.dr/alert080317.htm (Aug. 6, 2008).

19 The TAS/IRS Rework Study group applied Account Management's Correspondence Imaging System data to a sample of TAS amended return cases. This analysis revealed that the mean number of days that cases were open prior to contacting TAS was 182 + 15 days at the 95 percent confidence level. The median number of days was 143. *See* TAS/IRS Rework Study Report, Phase II at 9.

under the general processing guidelines for amended returns – and ten weeks more than the highest range under the modified timeframes.

Chart 1.17.1 below details the total distribution of the sample of TAS amended return cases analyzed using data from the AM Correspondence Imaging System (CIS).[20] The chart depicts the number of days that the amended return was open in the IRS (based on receipt date) before the taxpayer contacted TAS. This diagram illustrates the lengthy processing timeframes for these amended returns.

CHART 1.17.1, Distribution of TAS Amended Return Cases by Date Received by the IRS to Date Received by TAS



Unnecessary Examination Referrals Add to Already Lengthy Processing Times. The study of TAS amended return cases also shows that unnecessary Examination referrals contribute to prolonged processing times and delayed refunds.[21] Despite the IRS's established referral criteria, approximately three out of four referrals from AM to Examination are never selected for audit.[22] These unnecessary Exam referrals contribute to processing delays by failing to resolve and process the case at the earliest point.

Data from the AM CIS for 2007 supports the notion that amended returns are inappropriately entering the Examination stream. The 2007 data shows that overall, AM referred

20 TAS/IRS Rework Study Report, Phase II at 9. One case with more than 1500 days from the date the case was received in the IRS to the date the taxpayer contacted TAS was removed from the sample as an anomaly.

21 The term "Examination referrals" in this section indicates the process through which an IRS processing function refers an amended return to the Examination function for evaluation as to a potential audit or correspondence examination.

22 *See* CAT-A Reject Rate by Campus Jan-Dec 2007 spreadsheet, email from W&I dated May 28, 2008 (on file with author) (showing that only 25.6 percent of amended return referrals made by AM in 2007 were selected for examination).

approximately 110,000 amended return cases to Examination.[23] Of these, only about 28,000 (or 1.23 percent of the total AM amended return inventory) were selected for examination, bringing the selection rate for referrals to 25.6 percent.[24] The remaining 74.4 percent of referrals were either accepted as filed (47.2 percent), disallowed (3.1 percent), not considered (7.0 percent), did not meet Category A (CAT-A) criteria (8.3 percent), or received another determination (8.8 percent).[25] Tightening up the Examination referral criteria by identifying more of the common characteristics of the amended returns that the Exam function accepts as filed would help expedite case processing, reduce Examination inventory levels, and ultimately lead to faster refunds.

Reducing erroneous referrals would further reduce overall amended return processing time. Based on the data above, erroneous referrals accounted for 15.3 percent of all AM referrals to Examination in 2007 (8.3 percent of referrals that did not meet CAT-A criteria plus seven percent that Examination did not consider).[26] This represents at least 16,700 taxpayers, many of whom are awaiting refunds, whose amended return processing was unnecessarily delayed because their returns, which did not meet Exam criteria or which were otherwise unworkable, were referred to Exam only to wind up, weeks later, back in AM where they started.

Unnecessary Examination referrals have a downstream impact for both the IRS and taxpayers. By overwhelming the Exam function with inappropriate referrals, the IRS is wasting resources that it could otherwise spend analyzing valid referrals. These unnecessary referrals needlessly delay refunds for taxpayers who are waiting for the IRS to process their amended returns. Yet despite the downstream impact and lengthier processing timeframes, AM has no accountability measures to identify or reduce erroneous and needless CAT-A referrals.[27]

23 AM referred 109,593 cases to Examination in 2007. CAT-A Reject Rate by Campus Jan-Dec 2007 spreadsheet, e-mail from W&I dated May 28, 2008 (on file with author).

24 AM referred 109,593 cases to Examination in 2007. CAT-A Reject Rate by Campus Jan-Dec 2007 spreadsheet, e-mail from W&I dated May 28, 2008 (on file with author).

25 *Id.* CAT-A criteria were established based on past examinations that identified characteristics indicating a high degree of noncompliance. Amended returns that meet CAT-A criteria must be referred to Examination.

26 An analysis of CIS information on all AM referrals during FY 2007 showed that the total percentage of erroneous CAT-A referrals varied widely across campuses (from 8.3 percent in the Austin campus to 25.2 percent in the Atlanta campus), with an overall reject rate across all campuses of 15.3 percent. The CIS data analyzed covered planning periods (PPs) 2 and 3 for FY 2007 and PP1 for FY 2008. The reject rates included cases rejected as "not CAT-A" and those categorized as "no consider." Those referrals that did not meet CAT-A criteria, by definition, were erroneous referrals because AM should be forwarding only those cases that meet CAT-A criteria to the Examination function. Amended returns that do not meet CAT-A criteria should be fully processed (including the release of the refund) by the AM function without Examination involvement. Cases that were not considered by Examination ("no consider" cases) may ultimately meet the CAT-A criteria, but they were incomplete/unworkable at the time of the referral (such as a missing form or schedule) and should not have been referred to Examination as CAT-A at this stage.

27 Based on recommendations made by the TAS/IRS Rework Study group, AM has agreed to use test and control groups at the Atlanta campus to measure the effect of accountability measures. Additionally, W&I issued SERP Alerts (internal guidance highlighting areas of concern) to ensure that the new procedures for referring Cat-A cases to Examination are being followed and training is being developed. TAS/IRS Rework Study Report, Phase II at 7.

The downstream impact on taxpayers is reflected in the high volume of TAS cases involving amended returns.[28] While the IRS audits only about one percent of all returns,[29] a sample of TAS cases involving amended returns found that approximately 36 percent had Examination involvement.[30] Rejected CAT-A cases represented 22.8 percent of TAS CAT-A cases and six percent of total TAS amended return cases analyzed.[31] These statistics demonstrate that inappropriate Examination involvement is affecting taxpayers and delaying refunds.

Correspondence Examination Queue Times Prior to Taxpayer Contact Lengthen the Process – While Leaving Taxpayers "In the Dark" As to the Status of Their Claims.

For the 25 percent of CAT-A referrals the IRS ultimately selects for examination, the processing timeframe increases further due to lengthy queue times (delays while the return awaits assignment) for correspondence examinations. Based on a statistically valid sample of the enterprise, average queue times for correspondence examination at IRS campuses (from the date selected for examination to the sending of the initial contact letter) ranged from three weeks to nearly two months (21 to 54 days).[32] The following chart shows the average queue times by campus.

28 In FY 2008, TAS had 21,963 cases in which the primary issue was IRS delays in processing amended returns. *See* TAMIS.

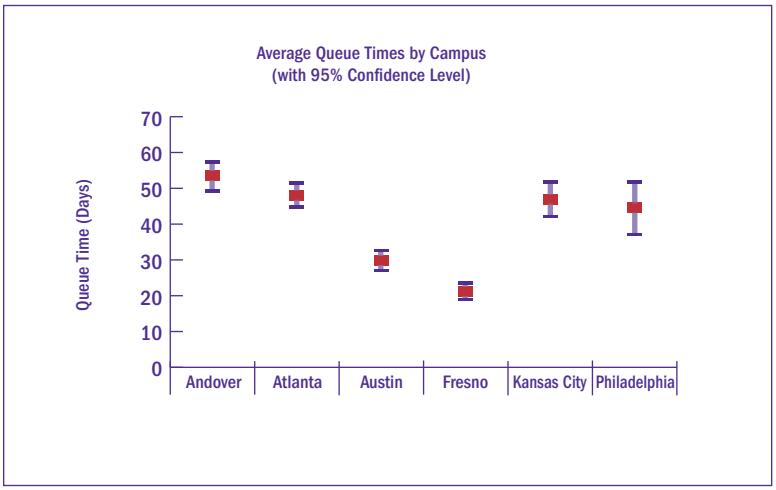
29 Total individual returns audited overall for fiscal year (FY) 2007 increased to 1,384,563 from 1,293,681 in 2006. IRS, *Fiscal Year 2007 Enforcement and Services Results, at* http://www.irs.gov/newsroom/article/0,,id=177701,00.html (last visited Dec. 11, 2008). This represents approximately one percent of all individual returns filed. *See* IRS, *Statistics of Income, 2005: Individual Income Tax Returns Estimated Data Line Counts* (Sept. 2007).

30 *TAS Phase I Report: The PCIC 330 Amended Return Study* 16 (Sept. 25, 2007).

31 TAS/IRS Rework Study Report, Phase II at 5.

32 *Id.* at 2. At a 95 percent confidence level, the average queue times are 21.1 ± 1.9 and 53.5 + 3.8 days, respectively. These figures do not include statistics on the Brookhaven and Memphis campuses, which were removed from the sample to eliminate biases associated with the decrease in operations at these campuses. The average queue time for the Brookhaven campus was 56.8 ± 8.2 days. The average queue time for the Memphis campus was 101.7 ± 9.9 days.

CHART 1.17.2, Correspondence Examination Queue Times



Shortening queue times and notifying taxpayers sooner that their amended returns have been selected for examination not only would ease taxpayers' anxiety, but would reduce unnecessary phone calls and other taxpayer contacts. Under current procedures, until taxpayers receive either their refunds or initial examination letters, they are unaware of the status of their amended return processing. The IRS essentially leaves taxpayers "in the dark" for several weeks while it routes – and as discussed earlier, sometimes reroutes – their amended returns through the processing cycle.[33]

To remedy this problem, the Austin Campus developed a tool, Always Part of the Solution (APOTS), which will automate the opening of the case in Exam on the Audit Information Management System (AIMS) and the issuance of the initial contact letter. This tool provides additional automation through the Examination process for all claims and has reportedly led to excellent improvements to cycle time for these case types. The average cycle time for Exam cases in the Austin Campus using APOTS was 116 days in FY 2007, compared to an average of 153 days for other W&I campuses. Examination is delivering the APOTS tool to the remaining W&I campuses.

The IRS's Lack of Information Sharing Among Functions Is Causing Unnecessary Delays for Taxpayers.

There is no doubt that fully processing amended returns at the earliest possible stage is beneficial for both taxpayers and the IRS. When the IRS closes cases earlier in the process, taxpayers receive refunds faster and inventory levels decline, thus allowing the IRS to process the remaining returns more quickly.

33 *See* TAS/IRS Rework Study Report, Phase II at 4.

The Submission Processing amended return unit processes amended returns within 12 days of receipt under rigid guidelines referred to as adjustment function criteria (AFC). These returns are either fully processed or passed on to the AM function because they meet the AFC. Some cases are AFC because they require the use of the system command code DDBCK, a process by which the Examination function systemically reviews claims for child-related credits and selects those most likely to require further examination.[34] However, the Submission Processing staff has no access to DDBCK, primarily due to workload distribution issues. Allowing the Submission Processing function access to this command code would allow employees to process more amended returns further "upstream" in the process, provide those taxpayers with faster refunds on their child-related credits, and reduce inventory backlogs downstream. Submission Processing and AM concurred with a recommendation in the TAS/IRS Rework Study to shift additional case processing from AM to Submission Processing.[35]

IRS Business Decisions on Prioritization Negatively Impacts Amended Returns Classified as "Duplicate Filings."

A "duplicate filing" in IRS parlance occurs when the same tax form is filed multiple times with the same name and SSN.[36] A duplicate filing can occur for several reasons. For example, taxpayers may attempt to amend a previously filed Form 1040 by filing another Form 1040 rather than a Form 1040X, which is the designated form for an amended return. A duplicate filing condition also occurs when taxpayers' identities are stolen, and the perpetrator files a return under the name and SSN of the victim.[37] It is the job of the AM function to sort out whether the taxpayer was trying to file an amended return or was the victim of identity theft.[38] Making this determination ought to be a priority for the IRS.

34 Command Code DDBCK is used for validating additional children and credits claimed on amended returns. IRM 2.4.58.1(1) (Jan. 1, 2007). When a DDBCK request is entered with the primary taxpayer identification number (usually the Social Security number (SSN)), it displays the dependents and qualifying children from the original return or as last modified. By updating information into DDBCK, the IRS can update existing data to reflect changes from the submitted amended return. IRM 2.4.58.1(2) (Jan. 1, 2007). After the updated amended return information is transmitted, DDBCK validates any new taxpayer identification numbers against, among other databases, the Dependent Database (DDb). IRM 2.4.58.1(3) (Jan. 1, 2007). The DDb is a rule-driven database that identifies non-compliant Earned Income Tax Credit (EITC) and dependent issues using internal and external data elements and provides the ability to freeze refunds. 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. The DDBCK Validation Result Screen instructs the user how to proceed with the case based on the database checks. If the case does not meet Examination criteria, the IRS can process the amended return as usual, but if the case needs to be classified or meets Examination criteria, it should be sent to Examination. IRM 2.4.58.1 (Jan. 1, 2007).

35 W&I's response indicated that this recommendation has been ongoing for a number of years. It is projected that over 500,000 cases will be sent to Submission Processing during FY 2009. Additional work types are being identified and volumes exceed 450,000. Additionally, AM is working with Compliance in an effort to obtain access to the DDBCK Command Code until a request for a related Integrated Data Retrieval System Command Code can be completed through the Unified Work Request process that would require only minor programming to block certain fields on DDBCK. Submission Processing employees could use it to update DUPOL (a command code that lists dependent SSNs claimed by a parent), Child Tax Credit, Additional Child Tax Credit, and earned income tax credit. TAS/IRS Rework Study Report, Phase II at 13.

36 IRM 21.6.7.4.4 (Oct. 1, 2008).

37 Identity thieves file tax returns in this manner either to fraudulently obtain a refund under the account of an innocent taxpayer or as part of accomplishing employment fraud. The National Taxpayer Advocate has again made the IRS's identity theft procedures a Most Serious Problem this year. *See* Most Serious Problem, *IRS Process Improvements to Assist Victims of Identity Theft, supra.*

38 IRM 21.6.7.4.4 (Oct. 1, 2008).

Rather than prioritizing these cases, however, the IRS actually deemphasizes processing duplicate filings.

Prioritization of case processing depends in part on the date a tax return is deemed received. When a duplicate filing occurs, the IRS classifies the return as a duplicate filing and issues an internal notice (CP 36). The IRS then uses the CP 36 notice date rather than the actual date of receipt for the duplicate filing document to set the priority of casework.[39] Therefore, because the IRS changes the original received date on the duplicate filing case, the case receives a later date and hence a lower priority than amended returns that are not designated as duplicate filing cases.

For example, two amended returns arrive at a campus on the same day (June 1) and are both stamped with the IRS received date of June 1, 2008. However, as the returns are processed, the IRS handles one as a duplicate filing and generates a case assignment (control) based on the duplicate filing condition. Commonly, the received date for the generated (automated) control is a minimum of two to three weeks later than the actual received date. For this example, the received date would change to June 21 for the duplicate filing return. Adhering to the IRS's "first in, first out" processing guideline, both cases should be worked alongside others received on approximately June 1. However, the IRS will typically work the duplicate filing later, with other cases received on the 21st. From the taxpayer's viewpoint, his or her amended return is not being processed timely, compared to others received on exactly the same date. The IRS's reported aged inventory percentages do not accurately reflect duplicate filing received dates.[40]

As both amended return processing and IRS identity theft procedures are again Most Serious Problems affecting taxpayers, the IRS needs to stop deemphasizing their processing and begin to prioritize them.

Conclusion

Allowing individual taxpayers to electronically file amended returns would provide them with a myriad of benefits, including acknowledgement of receipt, decreased errors, and faster refunds. The IRS's indefinite date for implementation for accepting electronically filed amended returns needs to be reprioritized and expedited. However, until such an option becomes a reality, the IRS needs to alleviate unnecessary Examination involvement, reduce lengthy Exam queue times, require functions to share information to process

39 IRM 21.6.7.4.4(2) (Oct. 1, 2008).

40 The IRS disagreed with a recommendation by the TAS/IRS Rework Study group to test prioritization of duplicate filing cases. In its response, the IRS stated "[t]he difference in received date of the amended return and the CP 36 received date has been an issue for many years. The automated nature of the DUPF controlling and notice generation would require significant programming changes to recognize the IRS received date of the Transaction Code 976 document (if that can even be accomplished). Prioritization of certain case types without regard to the IRS received date already occurs. However, the significance of the DUPF case volume is too significant to prioritize without creating a major impact on other case types. The number of duplicate filings worked by AM currently exceeds 675,000 per year...." *TAS/IRS Rework Study Report*, Phase II at 12.

amended returns as far upstream as possible, and reconsider prioritization decisions on amended returns classified as duplicate filings.

The IRS should consider taking the following steps to improve amended return processing:

- Reprioritize and expedite the implementation date for accepting Forms 1040X electronically and include TAS representatives in the discussions on revisiting the sequencing strategy for development of e-file returns;
- Reconsider its decision not to provide individuals with a way of transmitting their returns directly with the IRS once Modernized e-file becomes available at the individual level;
- Tighten its Examination referral criteria for amended returns by identifying more of the common characteristics of the amended returns that the Exam function accepts as filed;
- Add accountability measures to reduce the number of CAT-A rejects from AM (based on the results of the study that the IRS has agreed to conduct);
- Implement the Always Part of the Solution (APOTS) tool throughout all remaining W&I campuses to automate the opening on AIMS and the issuance of the Examination initial contact letter for cases that are selected for Examination;
- Continue to identify additional amended return work types that the IRS can shift from AM to Submission Processing, and
- Prioritize duplicate filing conditions by creating a special unit that will only work duplicate filings.

IRS Comments

The IRS continues to be committed to improving the timeliness and quality of customer service to all taxpayers. Each year, millions of taxpayers file amended returns. In FY 2008, Accounts Management and Submission Processing processed 4.9 million amended returns with approximately 60 percent processed by AM and the remaining 40 percent processed by Submission Processing.[41] Of this total volume, less than one half of one percent (21,963) of all amended returns required intervention by TAS caseworkers. Equally important, a statistically valid sample of amended returns conducted by the Program Analysis System (PAS) revealed that 92 to 98 percent of all amended returns received in FY 2005 to FY 2007 were processed within 90 days, which is the processing time cited in the Form 1040X Instructions. In FY 2008, the sample showed that 86 percent of amended returns were processed within the 90-day time frame.[42]

41 IRS, *FY 2008 Work Planning & Cost Control* (WP&C).

42 IRS, National Quality Review System *Time in Inventory Report.*

While amended returns are received throughout the year, it is important to note that approximately 65 percent of the total volume received occurs within a 15 week period that begins in mid-February and extends through the end of May. This peak volume of amended return receipts runs parallel with the peak telephone call demand that occurs from mid-February through April 15. In keeping with historic trends, telephone contacts remain the preferred channel of contact and in FY 2008 unprecedented call volumes were experienced as a result of the economic stimulus payment legislation. Enterprise toll-free CAS Assistor Calls Answered was 40.4 million and was 122.7 percent of plan (32.9 million), and 19.5 percent above the prior year (33.8 million).[43] This unparalleled influx of telephone calls to our toll-free operation regarding these special IRS payments to individuals to stimulate the nation's economy caused AM resources to be diverted almost exclusively to answering these calls. In fact, for a period of time, servicing this unprecedented call demand required the addition of Compliance staff from the Automated Collection System.

In response to these challenges, AM aggressively and strategically made every effort to meet the competing service demands of telephone call volumes and the processing of correspondence and amended returns. In an effort to mitigate the effect of the increased telephone demand, IRS monitored call volumes and the AM campuses were instructed almost instantaneously to move employee resources from telephones to paper whenever possible to maximize the number of tax examiners available to work paper inventories. Additionally, in order to ensure the most productive campuses worked paper inventory, the IRS utilized the Enterprise Management of Inventory, a model that determines which locations are more productively able to handle this workload. Inventory is then shifted to the most productive campus based on performance and resources using the Correspondence Imaging System (CIS). CIS is able to handle electronic shipment of this work so one campus can receive cases from other campuses instantaneously and begin working the cases immediately.

To further mitigate paper inventories, Field Assistance Taxpayer Assistance Center (TAC) employees and AM remote telephone site employees were reassigned correspondence inventory other than amended returns. This reassignment of work increased the number of available resources to work paper and enabled campus employees to concentrate on processing amended returns. SP also worked in collaboration with AM to expand the scope and volume of amended returns that could be processed by SP staff. SP and AM continue to work together to identify additional types of amended returns that can be worked by SP.

Other initiatives implemented this year include utilization of Inventory Control Managers (ICMs), who were installed at each AM campus in order to ensure further prioritization of paper inventory. The ICM is a full-time permanent position and each ICM is given full authority to make inventory decisions, such as ensuring cases are worked on a first-in first-out basis and reviewing old cases to determine why they have not yet been closed. In

43 IRS, Joint Operations *Calls Answered Report*, Fiscal Year Ending Sept. 30, 3008.

addition, the Claim Tool for Form 1040X was developed and deployed to all paper processing campuses in September 2008 to automate many aspects of the processing of amended tax returns. This tool allows the user to adjust accounts accurately and quickly with limited user input. Thus far, this new tool has shown positive impact on the IRS's ability to timely and accurately process amended returns while improving employee satisfaction.

AM also conducted an amended return study to better understand why taxpayers file amended returns. The primary purpose of this study was to gather information on customer needs, identify the most common reasons for filing amended returns, review patterns or trends in taxpayer or preparer behavior, and to identify opportunities to improve processing of these receipts. Data was gathered from 800 amended returns (400 from FY 2007 and 400 from FY 2008) and approximately 300 correspondence cases in the AM inventory. This data is currently being compiled in a database for analysis and will be compared to data from another amended return project that includes a comprehensive analysis of Master File data generated earlier this year. This extract is being paired with notice data and toll-free information. The information gained from these studies will lend insight into developing strategies on inventory planning, targeted training, and inventory assignment to improve the overall efficiency in processing amended returns.

As a result of the combination of the strategies implemented by AM in FY 2008, we have seen a significant improvement in the processing of paper inventory including amended returns. Barring passage of legislation generating the kind of extraordinary telephone demand we experienced earlier this year, we expect further improvements in amended return processing during 2009.

In her report, the National Taxpayer Advocate makes seven specific suggestions to improve amended return processing. We are taking, or have taken, the following actions with respect to these issues.

Modernized e-file (MeF) is designed to accept amended returns for business returns. Currently, the MeF project is working on a revised plan to phase in the Form 1040 and its associated forms and schedules. The current Phase 1 deployment is scheduled for January 2010. The MeF1040 multi-year release strategy will include acceptance of electronic amended returns. The sequencing strategy for MeF was developed to maximize benefits to all taxpayers, not just those filing amended returns. The IRS continues to seek ways to speed the acceptance and processing of amended returns. However, in light of current budgeting and management capacity issues, it will be difficult to significantly modify the current release schedule.

The IRS, working with the National Taxpayer Advocate among others, is producing a comprehensive study on ways to increase electronic filing. Direct filing options will be included in the study, as will a variety of other approaches. While the study will make no recommendations, it will look at how much each option (including direct filing) will likely affect the e-file rate. It will also estimate the costs of providing each option as well as any

other policy considerations. The IRS will wait until that study is complete before determining which options to increase electronic filing it will support.

The Examination function (Compliance) is committed to working with AM to improve the overall CAT-A process. Together, we will review all CAT-A criteria to determine if any changes can be made that would improve the referral process.

Pending implementation of long-term solutions, currently under consideration, the Director of AM has issued a "must improve" directive to reduce the number of erroneous CAT-A referrals. AM campuses are currently reviewing Examination referral data weekly to determine the CAT-A reject percentage. IRM procedures have been added for lead/manager referral reviews to verify the accuracy of CAT-A referrals. In addition, AM will be using test and control groups at the Atlanta campus to measure the effect of establishing an accountability measure with the potential for implementation at the Department level.

APOTS is scheduled to be rolled out to all W&I campuses and through automation should improve the cycle time on selected cases. Currently, this tool is operational now in three campuses and will be added to the remaining W&I campuses in FY 2009.

As noted earlier, SP and AM continue to work together to identify additional types of amended returns that can be worked by SP.

AM will evaluate the suggestion to create specialized units to work duplicate filings. However, due to the complexity of the program and the volume of receipts, resources may not be available to support implementation of this option.

Taxpayer Advocate Service Comments

The IRS notes that only two to eight percent of amended returns filed in FY 2005 to FY 2007 were processed outside the 90-day processing time noted in the Form 1040X instructions. In FY 2008, the percentage of amended returns processed outside this timeframe spiked to 14 percent, an increase the IRS attributes to AM's role in administering the economic stimulus program.

The National Taxpayer Advocate recognizes the impact of the economic stimulus program on AM resources, and commends the IRS for doing a stellar job in administering this program on short notice. However, we note that for many years amended return processing issues have consistently been one of the top problems facing taxpayers who come to TAS for assistance.[44] The difficulties in processing amended returns did not arrive with the stimulus program in 2008.

In its response, the IRS outlines a number of initiatives it has implemented and tools it has developed to improve the processing of amended returns. We are encouraged that the IRS has dedicated resources to this important taxpayer service issue. We are especially pleased that the IRS has conducted a study to better understand why taxpayers file amended returns and identify opportunities to improve processing of these returns. This study should also identify opportunities to educate taxpayers about common errors on original returns, which might reduce the number of amended returns.

Finally, we continue to believe that allowing taxpayers to file amended returns electronically will reduce errors, decrease duplicate filing problems, speed up processing times, and lessen inappropriate examination referrals. Time wasted in handling amended returns inefficiently and ineffectively can be better spent on other taxpayer needs; electronic filing is central to these improvements.

44 See National Taxpayer Advocate 1999 Annual Report to Congress VII-3; National Taxpayer Advocate 2000 Annual Report to Congress 135; National Taxpayer Advocate 2001 Annual Report to Congress 230; National Taxpayer Advocate 2002 Annual Report to Congress 389; National Taxpayer Advocate 2003 Annual Report to Congress 436 (reporting processing claims/amended returns as the number two Most Serious Problem for FY 2003 based on Taxpayer Advocate Management Information System (TAMIS) receipts); National Taxpayer Advocate 2004 Annual Report to Congress 594 (reporting processing amended returns as the number two issue identified for FY 2004 based on TAMIS receipts); National Taxpayer Advocate 2005 Annual Report to Congress 569 (reporting processing amended returns as the number three issue identified for FY 2005 based on TAMIS receipts); National Taxpayer Advocate 2006 Annual Report to Congress 660 (reporting processing amended returns as the number three issue identified for FY 2006 based on TAMIS receipts); National Taxpayer Advocate 2007 Annual Report to Congress 676 (reporting processing amended returns as the number two issue identified for FY 2007 based on TAMIS receipts).

Recommendations

The IRS should consider taking the following steps to improve amended return processing:

1. Allow taxpayers to file Forms 1040X electronically directly with the IRS.
2. Revise its Examination referral criteria for amended returns by identifying more of the common characteristics of the amended returns that the Exam function accepts as filed.
3. Analyze its database of amended returns to identify the reasons for filing those returns and develop an education campaign for taxpayers about avoidable errors on original returns that result in filing an amended return.
4. Prioritize duplicate filing conditions by creating a special unit that will only work duplicate filings.

MSP #18

Inadequate Files Management Burdens Taxpayers

Responsible Officials

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Jim Falcone, Acting Deputy Commissioner, Operations Support

Definition of Problem

The IRS maintains many paper records with IRS Submission Processing Centers (SPC), filing more than 225 million taxpayer documents each year in fiscal year (FY) 2006 and FY 2007.[1] The IRS is required by law to efficiently maintain and manage agency records, including electronic and paper files, as evidence of IRS policies, decisions, and operations.[2] Most importantly, IRS records contain sensitive tax return and other related taxpayer information. Both taxpayers and IRS employees need prompt access to paper documents to resolve tax return issues or verify taxpayer information. In recent years, the IRS failed to follow prescribed administrative procedures and implement necessary safeguards for maintaining and managing paper files and records. This failure contributed to a number of complaints from taxpayers, practitioners, IRS employees, and other government agencies.[3] The National Taxpayer Advocate identified several aspects of the IRS record keeping and paper file management processes that place substantial burden on taxpayers and undermine effective tax administration.[4] These problems include:

- Delays and failures in providing paper records and files to taxpayers, practitioners, and other stakeholders authorized to receive such information;[5]
- A lack of timeframes for retrieval of paper files and follow-up procedures in the Internal Revenue Manual (IRM);
- A lack of adequate safeguards to protect confidential taxpayer information;
- A lack of effective standards to measure the quality of customer service and contractor or IRS performance; and

1 Wage and Investment (W&I) response to TAS information request (June 26, 2008).

2 *See* The Federal Records Act (FRA) of 1950, 44 U.S.C. § 3102.

3 Government Accountability Office (GAO), GAO-07-1160, *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files* 9-10 (Sept. 2007).

4 *See id*. at 12. The report shows that in 420 out of about 900 cases docketed at the U.S. Tax Court (46 percent), the Appeals function did not receive the requested files for over 25 days.

5 The IRS annually refunded more than $3.7 million, or over 40 percent of the fees it collected for photocopies of taxpayers' documents from FY 2005 through FY 2008. W&I response to TAS information request (Dec. 16, 2008).

- An absence of a servicewide record keeping and paper file management strategy and database.

Recently, the IRS resumed in-house performance of the files management function, which was performed by a contractor for most of the past two years.[6] Regardless of which entity operates the files maintenance function, the IRS must substantially improve the file management process.

Analysis of Problem

Background

The Federal Records Act (FRA) governs the IRS's management and use of taxpayer records.[7] The Internal Revenue Code (IRC) requires the IRS to maintain and manage records without jeopardizing the security and confidentiality of the sensitive taxpayer information these records contain.[8] The IRM provides internal control standards to ensure the efficiency of the agency's operations.[9] Taxpayers and IRS employees need prompt access to the paper documents stored in agency records in many situations, including:

- Taxpayers who need copies of prior year documents to accurately complete current year tax returns;
- Taxpayers who have lost all documents in a catastrophic event;
- Taxpayers who are not in compliance with their tax obligations and want to resolve prior issues;
- Parties in tax controversies and administrative hearings; and
- IRS employees who need specific documents to accurately and efficiently serve taxpayers.

The SPCs filed more than 225 million taxpayer documents each year in FYs 2006 and 2007.[10] The documents are stored in seven SPC campuses throughout the country.[11] Until 2006, the IRS managed paper files through local Submission Processing Directors at

6 W&I, *IRS Resumes Management of Campus Files Activity, at* http://irweb.irs.gov/AboutIRS/Nwsctr/OtherNws/10180.aspx (last visited Dec. 12, 2008).

7 United State Code Title 44, Chapter 31, § 3102 *et seq.*

8 *See generally* IRC § 6103.

9 *See generally* IRM 1.15.7 (Jan. 1, 2003).

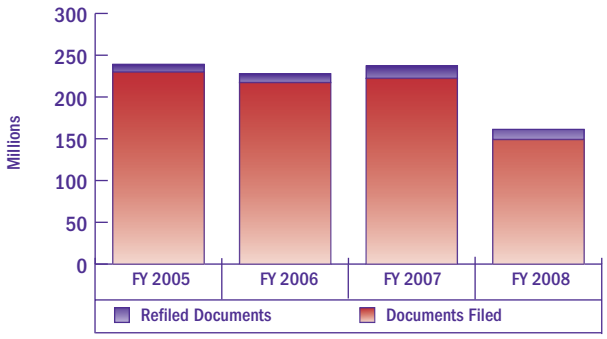
10 W&I response to TAS information request (Dec. 16, 2008). In FY 2006, IRS or vendor employees filed 217,264,116 documents and refiled 10,451,589 documents. In FY 2007, they filed 222,214,957 documents and refiled 14,886,641. In FY 2008, they filed 149,077,410 documents and refiled 12,106,549.

11 Austin, TX; Andover, MA; Kansas City, MO; Ogden, UT; Atlanta, GA; Fresno, CA; and Cincinnati, OH. *See* Submission Processing Directory (May 9, 2008).

each campus.[12] In 2006, the IRS contracted out the operation of the files storage areas.[13] However, on October 1, 2008, control of the files maintenance processes reverted back to the IRS.[14]

The following chart shows the number of paper documents filed and refiled from FY 2005 to FY 2008.

CHART 1.18.1, Documents Filed by Fiscal Year[15]



IRS employees annually request millions of paper documents containing confidential taxpayer information to resolve tax issues or verify tax return information.[16] These requests include the electronic requests that Return and Income Verification Service Unit (RAIVS) employees make on behalf of taxpayers. In FY 2007 and FY 2008 respectively, the files function received approximately 3.3 million and 2.4 million electronic requests for copies of taxpayer documents.[17] The IRS charges a fee for copies of tax returns, but reimburses the money if it cannot fill the taxpayers' requests within the 60 days allowed

12 W&I, Submission Processing Charts for each campus from FY 2002 to FY 2008.

13 In August 2005, the government's Most Efficient Organization proposal won the competition for IRS files. However, on May 31, 2006, after comparison of all proposals, the IRS awarded a five-year contract to IAP World Services, Inc., including a one-year base period and four one-year option periods. IAP World Services, Inc. subcontracted work at three of the seven centers to Catapult Technology. The IRS did not conduct a Reduction in Force, but under Federal Acquisition Regulations governing the Right of First Refusal, employees were eligible for employment under the contract. The contractors did not employ many of the IRS Files employees when the operation assumed contractor management. Instead, the contractor hired new employees who did not have historical files processing operation knowledge and skills. *See* Christopher Lee, *Bush Plan to Contract Federal Jobs Falls Short*, Wash. Post, Apr. 25, 2008, at A01. *See also* Award/Contract to IAP World Services, Inc., Contract No. TIRNO-06-C-00041.

14 W&I, *IRS Resumes Management of Campus Files Activity, at* http://irweb.irs.gov/AboutIRS/Nwsctr/OtherNws/10180.aspx (last visited Dec. 12, 2008).

15 W&I response to TAS information request (Dec. 16, 2008).

16 *See* IRS Command Code Usage Report. Actual document counts are 3,289,901 for FY 2007 and 2,355,860 for FY 2008 (through Sept. 9, 2008) (Martinsburg Computing Center and Tennessee Computing Center counts).

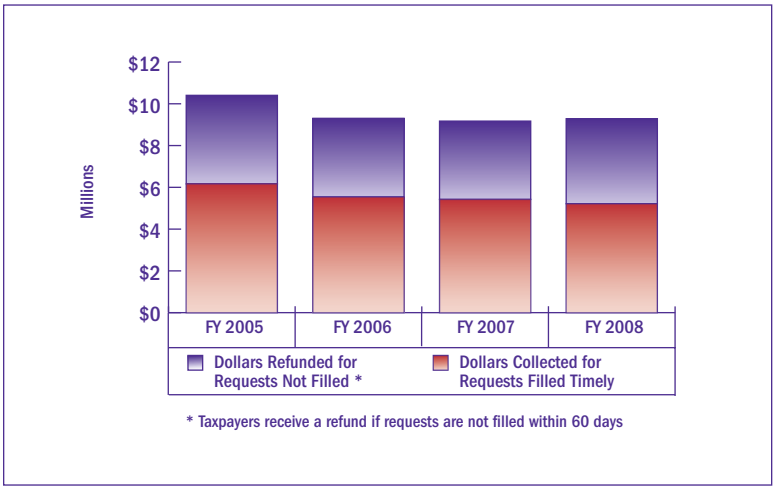
17 *See* IRS Command Code Usage Report. Actual document counts are 3,289,901 for FY 2007 and 2,355,860 for FY 2008 (through Sept. 9, 2008).

by IRS policy.[18] The IRS refunded more than $3.7 million, or over 40 percent of the fees it collected for photocopies of taxpayers' documents from FY 2005 through FY 2008.[19]

The amounts refunded serve as an indicator of the ineffectiveness of the current files operation. Notwithstanding the high level of refunds, the IRS decided to increase the cost of a copy of a tax document from $39.00 to $57.00 beginning on November 1, 2008.[20] The IRS prefers that taxpayers request account transcripts, which it provides free of charge, but are only available for the current and the prior three years.[21]

Chart 1.18.2 below shows the amounts collected from and refunded to taxpayers who requested documents by filing IRS Form 4506, *Request for Copy of Tax Return*, from FY 2005 to FY 2008; however, the IRS does not track the specific reasons for these refunds.[22]

CHART 1.18.2, Dollars Collected and Refunded from/to Taxpayers (Requests (IRS Form 4506) for Documents Sent to RAIVS)[23]



18 *See* Form 4506, *Request for Copy of Tax Return* (Jan. 2008).

19 W&I response to TAS information request (Dec. 16, 2008).

20 W&I response to TAS information request via e-mail with W&I official representative (Aug. 8, 2008).

21 *See* IRM 21.2.3.4.1.2(2) (Oct. 1, 2007). "As stated on Form 4506-T, *Request for Transcript of Tax Return,* Form 1040 series tax return transcripts are only available for the current processing year and the three prior years. Taxpayers should not be told they can order tax return transcripts for earlier years." *Id.*

22 This information was also verified by on-site observation by TAS staff at four contractor files storage facilities: Kansas City (2007), Andover, Austin, and Cincinnati (2008).

23 The IRS refunded $4,238,716, $3,767,113, $3,748,916, and $4,068,317 in photocopy fees to requesters in FY 2005, FY 2006, FY 2007, and FY 2008, respectively. W&I response to TAS information request (Dec. 16, 2008).

Taxpayers and IRS Employees Continue to Experience Substantial Delays in Receiving Paper Records.

The National Taxpayer Advocate and the Treasury Inspector General for Tax Administration (TIGTA) have addressed file management problems on a number of occasions.[24] However, even after the IRS contracted out the paper record keeping system, taxpayers and IRS employees continued to experience delays in receiving records.[25] The National Taxpayer Advocate discussed this issue in her 2001 Annual Report to Congress, yet remaining flaws in the file management process prevent taxpayers and IRS functions from receiving requested records timely.[26]

The IRS has no database to track paper files. Even the Submission Processing RAIVS employees who request copies of taxpayer documents from the paper files operation cannot timely obtain copies of returns.[27] In some cases, the IRS cannot retrieve the requested documents at all.[28] Unfortunately, the IRS does not gather statistics on paper files that it cannot locate.

Affected taxpayers experience substantial hardship when they cannot obtain copies of their tax records.[29] For instance, when taxpayers do not receive copies, they are forced to reconstruct documents to satisfy the institution requesting the information from them. This process requires a significant amount of time and effort.

24 *See* 2002 National Taxpayer Advocate Annual Report to Congress 140; 2001 National Taxpayer Advocate Annual Report to Congress 70. *See also* TIGTA, Ref. No. 2004-10-186, *Better Procedures Are Needed to Locate, Retrieve, and Control Tax Records* 11 (Sept. 2004).

25 *See* GAO, GAO-07-1160, *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files* (Sept. 2007).

26 IRM 3.5.61.5.9 (Jan. 1, 2008) requires expedited processing of TAS document requests within five business days. However, in many cases TAS case advocates experienced extended delays in receiving requested taxpayer documents. For example, TAS case advocates in Rhode Island collected information on all documents they requested between June 23, 2008, and July 21, 2008. Of the 30 documents employees requested, nine were received within two weeks, another ten were received within 30 days, and 11 documents or 37 percent were not received by the end of the study. Additionally, case advocates from Local Taxpayer Advocate (LTA) offices across the United States provided 51 examples of delayed processing of file requests from November 2006 to June 2007 that were documented on the Taxpayer Advocate Management Information System (TAMIS). TAS secured the documents from the Files function in only 36 cases. The average response time was 34 days. TAS did not receive documents or a response from the Files function in 15 cases, or nearly 30 percent. This sample of TAS requests selected using Command Code ESTABDV (Expedited requests for documents) and Form 2275, *Records Request, Charge and Recharge* (Aug. 2006) (paper form requesting a Special Search) methods shows that although the IRM mandates timely processing of TAS requests, such requests were not timely honored. Often, TAS employees made second and third requests, but the Files function indicated the returns were sent per the original request. Sometimes, it took weeks and months to receive the requested documents. Several examples indicate that when the Files function timely extracted documents it failed to mail them for several weeks. Delays prompt TAS case advocates to make multiple requests. These document delays cause taxpayer burden, including delayed refunds, assessed penalties, and interest.

27 In 2007, the National Taxpayer Advocate received a Systemic Advocacy Management System (SAMS) submission from a RAIVS employee regarding the inability to receive returns timely from the Files function. *See* SAMS, Issue P0027183 (submitted on Mar. 20, 2007) on the lack of timely action on document requests. For example, RAIVS employees in Ogden, Utah, and Kansas City submitted a complaint through SAMS regarding a delay in securing requested taxpayer documents. Other SAMS submissions indicated missing documents were requested from the Kansas City campus beginning in December 2006. In one instance, a document request required five additional requests and took over 60 days for the Files function to fulfill. *See* SAMS, Issues P0026815 (submitted on Feb. 8, 2007) and I0027720 (submitted on June 26, 2007).

28 *See* SAMS, Issues No. P0027183, P0026815, and I0027720. *See also* GAO, GAO-07-1160, *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files* 9-10 (Sept. 2007).

29 Although the cost of a copied document increased from $23 to $39, and then to $57 beginning Nov. 1, 2008, taxpayers still do not timely receive the requested tax return information. Despite the number of taxpayer requests decreasing due to the increased availability of account transcripts, the IRS still has problems securing files.

Effective tax administration also suffers when duplicate requests for documents waste labor resources and create additional costs for the IRS.[30] Moreover, in situations involving tax litigation, the inability to timely locate and produce the necessary paper file may cause the IRS to lose the litigation and the revenue at stake.[31]

The Lack of Specific Timeframes for Retrieval of Paper Files and Follow-up Procedures from the IRM Fosters Flaws in the Paper Files Management Process.

The IRM for the Files and Submission Processing functions does not contain any references to specific timeframes for filling requests, and this lack of formal performance requirements contributes to delays.[32] IRS employees do not know when to submit a second request for paper documents. Informal timeframes vary for each Files site and contribute to the overall confusion.[33] The result is a series of constant delays that prompt TAS case advocates and IRS employees to submit multiple document requests, which undermine efficient and effective taxpayer service. The IRS should specifically and clearly define all IRM requirements regarding timeframes for paper files production and make these requirements mandatory for all involved in the process.

The Files Management Process Poses Disclosure Risks.

The law requires the IRS to protect sensitive taxpayer data from inadvertent disclosure.[34] However, in some cases, requesters receive the wrong taxpayer's documents.[35] Taxpayers and IRS employees report that the IRS and the contracted files storage centers mail documents to the wrong government addresses or the wrong taxpayers. In one case, a taxpayer complained to TAS that he received not only the wrong type of document but also documents belonging to several other taxpayers – and never did obtain the document he needed.[36]

Under current procedures, when a taxpayer requests copies of documents, IRS employees do not always compare his or her address of record (the current address on the IRS Master File database) to the address on the request form as long as the Taxpayer Identification

30 IRM 3.5.20.11.1 (Mar. 1, 2008) prescribes procedures for responses to requests for tax return information. When the requested file cannot be located the IRS must refund the taxpayer's money and inform the taxpayer by letter that it cannot locate the document(s).

31 *See* GAO, GAO-07-1160, *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files* 8 (Sept. 2007). The report shows that in 420 out of about 900 cases docketed at the U.S. Tax Court (46 percent), the Appeals function did not receive the requested files for over 25 days.

32 *Cf.* the prior version of IRM 3.30.123.15.1161 (Jan. 1, 2005) *with* IRM 3.30.123 (Jan. 1, 2008). In 2008, the IRS removed references to timeframes from the IRM, explaining that the function formerly known as "Cycle Control" was outsourced and the submission processing function did not establish criteria for monitoring the timeliness.

33 *See* TAS OAR-ESTAB Procedures, *at* http://tasnew.web.irs.gov/index.asp?pid=1487 (last visited July 23, 2008).

34 *See generally* IRC §§ 6103, 7213, 7213A, and 7431.

35 Most recently the Files function sent a local TAS office not only a Form 4251, *Return Charge-Out*, for a document the office requested, but also 50 other Forms 4251 with Social Security numbers (SSN) and taxpayers' Integrated Data Retrieval System (IDRS) name control data, which should have been sent to other centers across the nation. Review of incoming mail in a TAS office indicated that of 51 pieces, only one was requested by that office (Mar. 12, 2008).

36 SAMS, Issue I0027720. A taxpayer sent the contractor Form 4506, *Request for Copy of Tax Return*, requesting a copy of the 2001 tax return. The taxpayer received copies of the Forms W-2 (including names, addresses, and SSNs) of four different taxpayers for tax years 2002 through 2005.

Number (TIN) and name match IRS records.[37] The IRS then mails the requested documents to the address provided by the taxpayer on Form 4506.[38] Because of this flawed verification process, the documents sent to the address on Form 4506 may be inaccurate and received by a different taxpayer.[39] This process also differs considerably from procedures for Customer Service Representatives (CSRs) who receive telephone requests from taxpayers for copies of their transcripts. The CSRs are required (unless the taxpayer correctly answers additional disclosure questions) to mail the transcript to the IRS's address of record to safeguard taxpayer information from disclosure.[40]

At a time when identity theft is increasingly prevalent, the IRS must employ adequate safeguards for taxpayer information.[41] While the Files function was contracted out, the IRM required the Contracting Officer Technical Representative (COTR)[42] to dispatch security personnel to inspect the contractor's facility if the contractor compromised taxpayer information.[43] Although some disclosures are inadvertent, information provided by the IRS indicates that the COTR did not conduct the required inspections.[44] The Files contractor did not track all complaints from taxpayers or IRS employees or document complaints that would trigger an investigation by the COTR. IRS employees could access the Submission Processing *Files Operation Sharing* internal website, where they could obtain the phone number of the manager at a particular contractor site or e-mail a General Program Management Office (GPMO) analyst to complain.[45] However, if a requester complained directly to the contractor, the company did not necessarily provide this information to the COTR. Now that the IRS has resumed in-house files operation as of October 1, 2008, it should adequately track customer complaints and safeguard sensitive taxpayer information.

37 IRM 3.5.20.6.2 (Mar. 1, 2008) requires a Receipt and Control employee or a RAIVS employee to verify two of three items that must be included on the request (address, name, and SSN). However, either the current or the prior address of the taxpayer is determined to be the address of record. IRM 3.5.20.8 (Mar.1, 2008). Currently, IDRS searches taxpayer data based on the maximum of first four letters of the taxpayer's surname or business name. *See* IRM 3.0.273-2 (Jan. 1, 2008).

38 Teleconference with IRS RAIVS analysts (June 3, 2008).

39 *Id.*

40 IRM 21.1.3.9 (Dec. 13, 2007), which is applicable to CSRs, requires that for the IRS to mail documents to a taxpayer's address of record, the taxpayer must answer authentication questions listed in IRM 21.1.3.2.3(4)(d) (Jan. 1, 2008), which include (for individual master file returns) the correct address of record, name, SSN, filing status, and the date of birth. To mail a taxpayer's return to an address other than the address of record, the taxpayer must meet criteria of IRM 21.1.3.2.4 (Oct. 1, 2006), which require verification of two or more of the following items from a taxpayer's return: spouse's date of birth, child's/children's date(s) of birth, amount of income reported on last return or tax due on return, employers shown on taxpayer's Forms W-2, financial institutions from taxpayer's Forms 1099-INT or Forms 1099-DIV, number of exemptions claimed on last return or on return in question, preparer, paid/unpaid, if any expected refund amount (within $100) unless computed by IRS.

41 Identity theft is the number one consumer complaint in the United States, far outpacing all others. In 2007, the Federal Trade Commission received 258,427 complaints of identity theft. *See* Federal Trade Commission Report, *Consumer Fraud and Identity Theft Compliant Data, January–December 2007* (Feb. 2008), *at* http://www.ftc.gov/opa/2008/02/fraud.pdf (last visited Oct. 10, 2008). *See also* Most Serious Problem, *IRS Process Improvements to Assist Victims of Identity Theft, supra.*

42 A technical representative designated by the Contracting Officer (CO) to monitor performance and other contract administration duties associated with the award of a formal contract. *See* IAP/IRS Contract No. TIRNO-06-C-00041, Technical Exhibit 5-004, *Performance Work Statement for the IRS Files Activity.*

43 IRM 11.3.24.4.3 (Jan. 1, 2006).

44 W&I response to TAS information request (June 26, 2008). The IRS performed only Readiness Reviews at each site, which is not an adequate action according to IRM 11.3.24.3.3 (Jan. 1, 2006).

45 W&I, Submission Processing, *Files Operation Sharing* website, *at* http://hqnotes1.hq.irs.gov/SubmissionProcessing/SPWebPage.nsf/7746d2301afe8b468525684b004d8cc0/a9b9007c4362624f852571b7003ad240?OpenDocument (last visited July 18, 2008).

The IRS failed to address existing disclosure related problems before awarding the files management contract. For example, the Integrated Data Retrieval System (IDRS) has a field for the employee requesting documents to enter an address but the address is not a mandatory fill field. If a requester does not enter an address, the IDRS Unit and Unit Security Representative Database (IUUD) system automatically retrieves the security address and contact information of the requester.[46] Sometimes, the retrieved address does not match the address of the requester and the Files function sends the documents to the wrong place.[47] In response to a Government Accountability Office (GAO) audit, the IRS committed to update the system to make the address a required field, but has not yet done so.[48] Nonetheless, TAS commends the IRS effort to address complaints by adding the option of filing a customer complaint as an electronic "Get It" ticket on the IRS intranet. This will allow any internal customers to register complaints immediately and receive a response within a specified time. The IRS has targeted functionality for this system by October 2008,[49] and should keep it operational after resuming direct files management.

Absence of Adequate Standards and Contractor Performance Measurements.

The former contractor's (IAP World Services, Inc.) duties were defined by contract, which included a performance work statement or standards.[50] The IRS's Files Government GPMO reviewed the contractor's performance and communicated the results to the Contracting Officer (CO) or the COTR. The IAP contract measured the actual accomplishment of the task against the performance standard. Each time a contract employee received a request for a document, he or she searched for the document. There was no safeguard in place to determine whether the pulled document actually matched the request, or whether the document was previously sent to the requester.[51] The current IRM neither requires the contractor or the IRS to match documents with the actual request, nor to indicate why the documents are missing.[52] The IRM employs the same measures the IRS had in place prior to the contract.[53]

46 The IUUD system, updated only by security officers, allows IRS employees and managers who use IDRS and have intranet access to obtain contact information about IDRS units, managers, and security personnel. For each IDRS unit, the IUUD enables users to find the Unit Security Representative's (USR) name and phone number, the manager's name, address and phone number, a description of the unit, and additional information. *See* IRS As-Build Architecture, IUUD, *at* http://aba.web.irs.gov/formsandprocesses/rdmpframes.html?/ABARoadMap/APPL134254594.html (last visited May 28, 2008).

47 On-site observations by TAS staff at four contractor Files sites: Kansas City (2007), Andover, Austin, and Cincinnati (2008).

48 GAO, GAO-07-1160, *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files*, Appendix II (Sept. 2007). The IRS indicates that this change to IDRS has not occurred and it could not substantiate any plans for the change. W&I response to TAS information request (June 26, 2008).

49 W&I response to TAS information request (June 26, 2008). However, the IRS has no written plan for marketing the "Get It" ticket method to all operating divisions for tracking customer complaints, which is an important component of this initiative.

50 IAP/IRS Contract, *Performance Work Statement for the IRS Files Activity*, Section C, TIRNO-06-C-00041, at C-48.

51 On-site observation by TAS staff at four contractor Files sites: Kansas City (2007), Andover, Austin, and Cincinnati (2008). *See also* GAO, GAO-07-1160, *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files* 11 (Sept. 2007).

52 In January 2008, the IRS revised the respective IRM eliminating guidelines for IRS operating divisions concerning timeliness of requests. Specifically, former IRM 3.5.61.6.8 (Jan. 1, 2007) provided for expedited service in servicing TAS document requests. With the elimination of this guideline in January 2008, neither the Contractor's Performance Work Statement (PWS) nor the IRM provide for expedited copies of documents to TAS when needed for Operations Assistance Request (OARs). *See* IRM 3.5.61.5.9 (Jan. 1, 2008).

53 *See* W&I response to TAS information request (June 26, 2008); teleconference with the COTR (May 27, 2008).

Quality Assurance Evaluators (QAEs) employed by the IRS performed quality reviews at each campus based on valid customer complaints for general files requests.[54] Based on this data, the CO provided performance feedback to the contractor.[55] The contract required documentation and validation of customer complaints used to evaluate the performance of the contractor.[56] However, in the absence of written criteria regarding what constitutes a valid complaint, the IRS only cited those complaints that the QAEs found valid.[57] In fact, the IRS intranet Submission Processing site suggested sending complaints directly to the contractor site manager.[58] As a result, there were only 28 *valid* complaints in FY 2007 and only three *valid* customer complaints to date in FY 2008.[59] The low number of validated complaints combined with a high dollar volume of refunds indicates that customers may not even know how to properly file a complaint when they receive the money refunded from RAIVS.

The IRS's practice of using customer complaints as a basis for measuring the contractor's performance did not accurately reflect the quality of the services in the absence of adequate standards for determining the validity of complaints and an independent review of complaints by an impartial IRS quality review staff not affiliated with the files management function or the contractor. The absence of adequate standards for the review of customer complaints to determine validity, and for the objective evaluation of the Files function's performance, leaves the IRS unable to control the quality of the operation.[60]

The IRS Still Lacks a Servicewide Paper File Management Strategy and Electronic Database.

A recent study shows that nearly one-third of all taxpayers prefer filing paper returns and will not change their filing method.[61] Moreover, 46 percent of all taxpayers believe that mailing a return is still safer and more reliable than filing electronically.[62] Unfortunately, problems with paper documents are not unique to the Files operation. Other parts of the

54 However, since the IRS does not have a centralized method of receiving customer complaints, Files GPMO representatives decide whether complaints are valid.

55 IAP/IRS Contract No. TIRNO-06-C-00041, Technical Exhibit 5-004, *Performance Work Statement for the IRS Files Activity*. This document reflects the general statements in the contract standards, "The correct returns and documents, including required attachments, are pulled from files, charged out, and routed to the correct recipient as specified on the request. No additional documents or information is inadvertently included." *See id*. According to the contract the PWS provides performance measures of the contract and that the CO provides performance feedback to the contractor. *Id.*

56 IAP/IRS Contract No. TIRNO-06-C-00041, 3.5.2, *Documentation of Customer Complaints*, through 3.5.5, *Analysis of Results*.

57 The QAE works for the Files GPMO and determines whether the complaint is valid. The QAE researches the complaint to determine if the action was caused by the IRS or outside the contractor's control. W&I response to TAS information request (June 26, 2008).

58 Submission Processing Files Information Sharing, *at* http://hqnotes1.hq.irs.gov/SubmissionProcessing/SPWebPage.nsf/7746d2301afe8b468525684b004d8cc0/8f5fef4a3df3f95785257307003ecf72?OpenDocument (last visited May 9, 2008).

59 W&I response to TAS information request (Sept. 15, 2008).

60 GAO, GAO-07-1160, *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files* 13-14 (Sept. 2007).

61 IRS, Russell Research, *2007 Taxpayer Segmentation Study* 33 (Apr. 9, 2007). Thirty-two percent of taxpayers are used to filing paper returns and see no reason to change their filing method.

62 *Id.*

IRS store their own paper files and have experienced numerous problems with timely retrieval of taxpayer records and documentation.[63]

The IRS is attempting to address its files problem, in part, through its modernization efforts. We commend the IRS for its plan to electronically image the paper 1040 family of returns. However, this multi-year project is still in the initial stages.[64] Further, the IRS still lacks a systemic servicewide approach to the management of paper files and records. Even after implementing electronic imaging for all future correspondence, the IRS cannot accomplish its objective of providing effective taxpayer service without an integrated database that can track and retrieve archived historical paper files.

Conclusion

Paper files are a reality and a necessity at the IRS even in this electronic age. Because a certain number of taxpayers are not comfortable filing electronically and will continue to use paper returns, the IRS will continue to receive and store paper documents.[65] The goal of effective and fair tax administration mandated by Congress requires the IRS to make these stored records readily available to the taxpayers and IRS employees when needed, without jeopardizing the security and confidentiality of the sensitive taxpayer information these records contain.

The IRS has taken or is taking specific measures to address many of our concerns. We commend IRS for the effort to create a cross-functional servicewide team (consisting of SB/SE, W&I, and AWSS employees) to improve files practices.[66] We believe the IRS's continued effort to improve the current paper files management operation process should produce tangible and measurable improvements that will benefit taxpayers and the IRS. We also recognize that many of our concerns are more difficult to resolve due to the limitations of IRS computer systems. However, the IRS has not previously been able to implement effective systems that would resolve many of our mutual concerns.

The IRS should consider taking the following actions to address problems in files management: develop a servicewide record keeping and paper file management strategy and database; take steps to convert paper returns to an electronic format; implement procedures in the RAIVS unit where all three items (TIN, address, and name) must be verified with IDRS and if the current address is not the same as the address of record, require a taxpayer to submit Form 8822, *Change of Address*, with the Form 4506; and revise relevant IRM provisions to employ adequate quality control and timeliness measurements for taxpayer

63 For example, the National Taxpayer Advocate received a complaint from an exempt organization that had requested a copy of the IRS Determination Letter on January 30, 2008, from the Tax Exempt & Government Entities (TE/GE) division. Two TE/GE responses received on May 1 and May 15, 2008, erroneously contained determination letters for other exempt organizations but not for the one that requested the document. Letter to the National Taxpayer Advocate (June 9, 2008).

64 W&I response to TAS information request (June 26, 2008).

65 Russell Research, 2007 Taxpayer Segmentation Study, *A Study of The Needs & Drivers of U.S. Taxpayers* 34-35 (Apr. 11, 2007).

66 *See* W&I response to TAS information request (June 26, 2008).

file requests. TAS offers its assistance in implementing these recommendations through participation of TAS representatives in a servicewide cross-functional team.

IRS Comments

As noted by the National Taxpayer Advocate, each year millions of taxpayers continue to file their tax returns on paper. It is the responsibility of the W&I Submission Processing division to manage the day-to-day processes and procedures that involve paper tax return filing and the storage and servicing of those returns.

Tax returns are processed and temporarily stored at the seven Submission Processing Centers throughout the country. Once processed, the returns are transferred to a Federal Records Center (FRC) facility for permanent storage, usually within one year. The amount of time that transpires between SPC processing and FRC storage primarily depends on the availability of space at the SPC. Because the availability of space varies at each of the SPCs, some sites will transfer returns to a FRC facility once a year, while other SPCs will make multiple transfers each year. Consequently, some SPCs are better able to service their document requests in-house without the more time consuming need to access an FRC facility.

As we look at the challenges in managing paper files, it is essential to emphasize the role the FRC facilities, operated by the National Archives and Records Administration, play in this process. The vast majority of requests for copies of tax returns and tax return photocopying for both internal and external customers require a coordinated effort with a FRC facility. There are numerous FRC facility locations and their proximity to the IRS and service levels vary. Also, historically, many of the facilities have had a high volume of re-files (documents previously requested and returned by IRS but waiting to be re-filed by the FRC) which adversely impacts our ability to service subsequent document requests.

The IRS acknowledges the need to improve various aspects of the files management process and has established a servicewide cross-functional team (hereinafter referred to as "the team") to address many of the issues cited here. The central purpose of the team is to conduct a mapping of each of the processes, isolate problems, and then develop strategies to solve those problems. Thus far, the team has developed protocols for expediting requests for special projects, re-vamped the Form 2275, *Manual Request Form for Requesting Documents*, and instituted expedite procedures for FOIA, Ex Parte, and IRC § 6103(d) requests for the Disclosure Office. They have also established a process to address issues that interfere or limit the ability to obtain case files for court cases, Appeals, and other requests that require expeditious service.

Currently, the team is also working with the FRC facilities to improve the processing of requests for returns. In this regard, it has developed a process for the FRC facilities to track paper file requests that cannot be located or serviced timely to better understand the root causes for these delays. The team is also reviewing the feasibility of implementing this same process at the SPCs. In another effort, since many of the SPCs and FRC facilities are

unable to meet the 14-day response time for internal requests for tax returns, more realistic timeframes are being developed and should reduce the need for second and third requests.

It is equally important to note there are other, administrative errors that contribute to the delays or failure to provide paper records to taxpayers, practitioners, and other stakeholders. In this regard, when employees charge out returns and fail to either return the documents or return them timely, it affects the ability to process future document requests. The team also found that many of the complaints about documents that were not received were due to requestors entering incorrect or insufficient information. For example, some requests were made using an incorrect Document Locator Number (DLN). In addition, an SPC is unable to send the requested documents to the employee when he or she fails to provide the correct mailing address information. To deal with these issues, an instructional guide has recently been developed to illustrate the process for requesting documents and will be shared with employees. In addition, employees requesting documents through Command Code ESTAB must now enter their address in a required field prior to submitting the request.

The storage and retrieval of tax and administrative documents is, and always has been, of extreme importance to effective tax administration. Detailed processes and procedures for records management are currently contained in the 1.15 series of the IRM and constitute the Service's recordkeeping and paper file management strategy. In addition, the team will continue to explore opportunities to further improve files management procedures. However, we believe developing a database involving upwards of 12 million returns touched each year by both the SPCs and FRC facilities in order to track the status of document requests would prove labor intensive and prohibitively costly. However, as an alternative solution, the IRS is currently working on a proposal for modernizing the processing of paper returns that would use a scanned document in electronic format as the return of record. This project is part of the Modernized Submission Processing (MsP), a Form 1040 imaging project that will include imaging, auto-data extraction, and image archive for the Form 1040 family of returns. While we have high expectations for the MsP project, it remains in the planning stages and is currently unfunded.

With regard to the recommendations related to verification of address and a new requirement for taxpayers to submit Form 8822, *Change of Address*, with the Forms 4506, we would note that the RAIVS function currently completes a verification of the address of record on all requests. The IRM 3.5.20.8, *Processing Requests for Tax Return/Return Information*, requires verification of both the TIN and address or of the name and address to verify identity. If the address on the Form 4506 does not match current IRS records, RAIVS will conduct additional IDRS research to verify the taxpayer's identity. If unsuccessful, the RAIVS unit will return the Form 4506 and payment to the taxpayer with an explanation. This requirement will be further clarified in the IRM. Because current procedures require address verification, and because we are unaware of any data to support the contention that copies of returns are frequently mailed to unauthorized individuals due

to these procedures, we do not endorse the proposal to require taxpayers to submit Forms 8822 with Forms 4506.

The IRS will again establish the daily High Quality Work review process for filled requests. The team is reviewing this process, including timeframes and whether or not to retain the "Get It" ticket system previously used by the contractor for lodging complaints.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for establishing a servicewide team to address many of the issues raised in this report, and for resuming in-house performance of the files management function. The National Taxpayer Advocate is also pleased that the IRS changed its verification of address procedures to reflect consistency throughout the IRS regarding the provision of taxpayer account information. We appreciate the initiatives to improve file retrieval processes described in the IRS comments, especially the employee instructional guide illustrating the process for requesting documents, and the programming change requiring the requestor's valid address to be entered prior to submitting the request. We hope this change will help the Files function to timely deliver requested documents to the correct addresses.

However, the transition of the Files function back to the IRS has not resolved the majority of the problems experienced by taxpayers, practitioners, and IRS employees with the paper file management process. Since the IRS is required by law to efficiently maintain and manage electronic and paper files, it is responsible for establishing adequate procedures for timely and efficient retrieval of paper files stored at the FRC facilities.[67] The National Taxpayer Advocate is concerned with the IRS's plans to extend the timeframes for document requests beyond the current 14 days because "many of the Submission Processing Centers and FRC facilities are unable to meet the 14-day response time for internal requests for tax returns." While extending this time period may help the IRS meet its deadlines, it will not help the taxpayer who needs the document within two weeks. We encourage the IRS to establish procedures for expedited handling of document requests, including all TAS document requests.[68] Rather than lengthening the timeframes, the IRS should establish effective processes and coordinate requests with FRC facilities, so it can meet the established timeframes. The IRS should also establish adequate IRM quality control and specific timeliness measurements for taxpayer files requests, especially expedited requests.

67 *See* FRA of 1950, 44 U.S.C. § 3102.

68 The National Taxpayer Advocate also encourages prompt IRM changes reflecting specific timeframes for expediting all TAS file requests. Clear and specific IRM requirements regarding expedited processing of these requests will eliminate the significant delays experienced by TAS case advocates and the need to submit multiple document requests, which undermine efficient and effective taxpayer service.

The National Taxpayer Advocate disagrees with the IRS's conclusion that it is prohibitively costly to develop a servicewide record keeping system and paper file management database. Many government agencies that deal with huge volumes of paper documents use bar coding and can track documents at any point of time. Bar coding and imaging of all incoming paper documents may actually save IRS resources in the future, with the costs recouped through the fees charged to requesters.[69] Although we are pleased with the IRS's efforts to implement the Modernized Submission Processing (MsP) project, which includes imaging, auto-data extraction, and image archive for the Form 1040 family of returns, the project will not affect paper file processing unless it receives adequate funding. The National Taxpayer Advocate supports funding for this important project and its expansion to all stored paper files and records.

The National Taxpayer Advocate is extremely concerned about the increase from $39 to $57 in the document retrieval fee in the absence of adequate quality controls and timeliness measurements for files requests. The IRS should reconsider this fee increase, which will place an additional hardship on taxpayers in light of the current economic situation and the increasing need for taxpayers to obtain copies of tax documents.

Recommendations

The National Taxpayer Advocate recommends that the IRS consider taking the following actions to improve the paper file management process:

1. Proactively pursue the Modernized Submission Processing project, allowing imaging, auto-data extraction, and image archive of scanned documents, and expand its application to all stored paper files and records.
2. Reverse the increase in the paper file retrieval fee until such time as the IRS improves the quality of file retrieval.
3. Revise relevant Internal Revenue Manual provisions to employ adequate quality control and specific timeliness measurements for taxpayer file requests, including TAS expedited requests.
4. Include TAS employees on the cross-functional servicewide team created to improve the Files operation.

69 Bar coding paper returns and scanning all paper records would reduce storage space at the SPC and FRC facilities and allow more time to efficiently process and track all remaining paper documents that could not be bar-coded or scanned.

MSP #19 The IRS Miscalculates Interest and Penalties but Fails to Correct These Errors Due to Restrictive Abatement Policies

Responsible Officials

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd, Jr., Commissioner, Wage and Investment Division
Art Gonzalez, Chief Information Officer

Definition of Problem

The Internal Revenue Code (IRC) imposes a failure to pay (FTP) penalty and interest when taxpayers are unable to pay their liabilities in full by the due dates of their returns.[1] Because of system limitations and human error, the IRS miscalculates the FTP penalty and interest in certain situations that negatively affect many taxpayers each year. A TAS study found that computer-generated miscalculations of FTP penalties could potentially impact about two million taxpayer accounts. The IRS has a manual interest accuracy rate of 67.7 percent, which projects to 151,421 potentially incorrect accounts. While the IRS is aware of this problem, it has resorted to temporary work-around procedures to address miscalculations on a case-by-case basis rather than determining the full scope of the problem and instituting permanent solutions.[2]

The consequences of these miscalculations are numerous taxpayer burdens, including:

- Incorrect notices;
- Incorrect account payoff balances;
- Calls and letters from the IRS;
- Defaulted installment agreements; and
- Threats of adverse action through lien or levy.

The National Taxpayer Advocate has also identified policies that make it unnecessarily difficult for taxpayers to receive the statutory "reasonable cause" consideration for abatement of the FTP penalty.[3] These failures by the IRS have contributed to thousands of complaints annually by taxpayers, practitioners, and IRS employees.

1 IRC §§ 6651 and 6601.

2 IRS, Servicewide Electronic Research (SERP) Alert 07077, *IDRS (CC INTST) and Master File Interest Discrepancy* (Dec. 13, 2006, reissued May 1, 2008, Alert 080194). The alert's sample may not be statistically valid to project the accuracy rate to the population. However, the alert, which is based on a zero dollar tolerance, clearly shows that interest and FTP penalty calculation errors likely occurred in almost one out of every three accounts, or an accuracy rate of 67.7 percent, which supports the inference drawn in this report.

3 *See* Treas. Reg. § 301.6651-1(c). For example, the IRS will not abate a FTP penalty for reasonable cause if the taxpayer does not have the ability to pay the tax in full. Internal Revenue Manual (IRM) 20.1.2.1.3(2)(b) (Apr. 25, 2008).

Analysis of Problem

Background

Legal and Procedural Basis for Imposition of the FTP and Interest

The IRS asserts the FTP penalty when taxpayers fail to fully pay their taxes on or before the due dates of their tax returns. Under IRC § 6651(a), the IRS imposes the penalty rate of 0.5 percent per month, up to a maximum of 25 percent in the following instances:[4]

- Failure to pay tax shown on a return, which is calculated from the original due date of the return;[5] and
- Failure to pay any tax required to be reported on a return that was not reported on the return, and for which the IRS has issued a notice and demand. This penalty does not apply if the amount shown in the notice and demand is paid within 21 calendar days from the date of the notice and demand (or within ten business days if the total balance due is $100,000 or more). The IRS calculates this penalty from the date that is 21 calendar days, or ten business days, if applicable, after the notice and demand for payment was issued.[6]

  Example: A taxpayer who has a tax liability of $5,000 tax on April 15 and pays $4,000 timely would be subject to the FTP penalty on the unpaid portion of $1,000. Under IRC § 6651(a), the maximum penalty would be 25 percent of $1,000, or $250.

The FTP penalty is reduced every month by payments made before the day on which the penalty is imposed, and by any credits that are applied against the tax.[7] Taxpayers who timely filed their returns (taking into account authorized extensions for the time to file) and enter into installment agreements are subject to a decreased FTP penalty rate – 0.25 percent – for any month the agreement is in effect.[8] After the IRS determines the collection of tax is in jeopardy and issues a notice and demand for immediate payment, or ten days after the IRS issues a notice of intent to levy, it will increase the taxpayer's FTP penalty to one percent per month, double the original rate of 0.5 percent.[9] However, the IRS will reduce the taxpayer's FTP penalty down to 0.25 percent per month beginning the month after the taxpayer enters an installment agreement following a levy or jeopardy notice.[10]

4 IRC § 6651(a)(2) and (3).

5 IRC § 6651(a)(2).

6 IRC § 6651(a)(3); IRM 20.1.2.5.1(1)(a) (Apr. 25, 2008).

7 IRC § 6651(b).

8 IRC § 6651(h).

9 IRC § 6651(d) and IRM 20.1.2.6.1 (June 17, 2008).

10 IRM 20.1.2.6.1(6) (Apr. 25, 2008).

Miscalculation of the FTP Penalty by the IRS

FTP penalty calculation errors are widespread, whether the IRS computes the amount manually or systemically.[11] A 2004 Treasury Inspector General for Tax Administration (TIGTA) report found a 24 percent error rate on manually calculated FTP penalties.[12] In 2008, TAS conducted research to determine the current potential scope of systemically computed penalty and interest miscalculations on taxpayer accounts.[13] Table 1.19.1 below illustrates the systemic IRS error rate found in a statistically representative sample of taxpayer accounts, in which the IRS has assessed the FTP penalty.

TABLE 1.19.1, FTP Penalty Computation Errors Found In Current Taxpayer Accounts

2007 Total Population Taxpayer Accounts	Miscalculation Rate Observed in Sample	Potentially Miscalculated Taxpayer Accounts
23,886,760	8.3%	1,982,601

TAS observed a systemic FTP penalty and interest error rate of 8.3 percent in the statistically representative test population of 23,886,760 current Individual Master File (IMF) and Business Master File (BMF) taxpayer accounts.[14] A projection of this sample to the total volume of automated IRS accounts shows that these errors would potentially affect about 1,982,601 taxpayer accounts.[15]

In the study, TAS found taxpayers who were systemically charged FTP penalties exceeding the maximum rate of 25 percent in direct violation of IRC § 6651, and taxpayers who were not charged the reduced FTP penalty rate due to an installment agreement (0.25 percent).[16] These errors continue to plague taxpayers despite attempts by the IRS to correct programming problems.

Taxpayers face further burden when they must contact the IRS to resolve the erroneous accounts. Inaccurate computations from the program used by the IRS to calculate the FTP and interest accruals can lead the IRS to provide erroneous payoff amounts to taxpayers.[17] When taxpayers are on installment agreements, miscalculated computations can cause defaulted agreements, which lead to additional user fees and the loss of the reduced

11 "Systemically" refers to the IRS's computer-generated computations. The IRS programs its computers to calculate the FTP penalty from rates determined by IRC § 6651 and procedures explained in the IRM. *See generally* IRM 20.1.2 (Apr. 25, 2008).

12 TIGTA, Ref. No. 2004-30-184, *Errors in Failure to Pay Penalty Accounts Occur When the Penalty Is Computed Manually* (Sept. 27, 2004). This report presented the results of the TIGTA review of manually computed FTP penalty amounts.

13 FTP penalty population obtained from IRS data in the Compliance Data Warehouse. The statistical sample size observed was 373 with an error count of 31. This sample has a 95% confidence interval ± 2.8 percent.

14 Margin of error is 2.8 percent at the 95 percent level. Five of the 31 defects occurred on accounts containing a past or present timely filed return with an installment agreement.

15 This would potentially affect 1,982,601 miscalculated taxpayer accounts when projected across 23,886,760 automated IRS calculations.

16 IRC § 6651(h).

17 INTST is the primary program used by customer service representatives, TAS, and the ACS to calculate FTP penalty and interest. The Small Business/Self-Employed Office of Servicewide Interest supports INTST.

FTP penalty rate of 0.25 percent. The rate then doubles (0.5 percent) or quadruples (one percent), depending on the status of the taxpayer's account. The taxpayer may also receive erroneous notices. An example of this occurs when taxpayers who live or work abroad (including military personnel) should receive an automatic 60-day extension of time to file and pay but are sometimes erroneously charged an FTP penalty.[18]

Miscalculation of Restricted Interest

The IRS charges interest on a tax deficiency under IRC § 6601 for the time the taxpayer has use of the government's money. Conversely, the IRS pays interest to the taxpayer on an overassessment or overpayment under IRC § 6611 for the time the government has the taxpayer's money. In many instances, the period for which the IRS charges or pays interest to the taxpayer begins on the due date of the return. The interest accrual period is suspended, or "restricted" if certain deductions, credits, or items of income are present.[19]

The IRS's Integrated Data Retrieval System (IDRS) cannot identify all conditions involved in a restricted interest account, which means the IRS must manually compute *all* restricted interest.[20] IRS procedures require manual interest (restricted interest) calculations in numerous situations, including those where the taxpayer:

- Is located in a designated combat zone;
- Is located in a designated disaster area; or
- Has submitted an offer in compromise that reduces the liability.[21]

Significant Problems Exist Because IRS Computers Cannot Systemically Accrue Restricted Interest on Many Taxpayers' Accounts.

When account penalties and interest do not update automatically, IRS personnel must perform a series of complicated manual transactions that routinely give rise to errors. The IRM lists reasons for restricting interest on a taxpayer's account, but due to the complex and changing nature of interest, the list is not all-inclusive. Thus, the IRM offers only a partial reference for employees seeking to resolve account concerns.[22]

18 *See* Treas. Reg. § 1.6081-5. U.S. citizens or residents living outside the U.S. and Puerto Rico (including military personnel) are granted an automatic two-month extension of time for filing and paying tax on a return if they attach a statement showing they are entitled to the extension.

19 IRM 20.2.8.6 (Aug. 1, 2006) lists the deductions, credits, or items of income and the IRC provisions that "restrict interest." Some of the reasons for restricting interest on a tax module are as follows: Forms 2285, *Combination Adjustments*; tax motivated transactions; net rate interest netting; Rev.-Rul. 99-40 (interest on deficiency after overpayment); multiple Form 870 waiver dates; error or delay in ministerial or managerial acts; ascertained date under IRC § 6502; non master file assessments; Forms 8697, *Look Back Method*; estate tax returns; combat zones; offers in compromise; large corporate underpayments; disaster areas; tax modules reinstated from retention; and reversals of gas tax credits.

20 IRM 20.2.8.1(2) (July 31, 2001).

21 IRM 20.2.8.6 (Aug. 1, 2006).

22 IRM 20.2.8.6 (Aug. 1, 2006).

The IRM requires qualified IRS personnel to review all manual interest computations of more than $50,000 in order to verify the accuracy.[23] Given that the restricted interest IRM is complex and the systemic tools for computing interest presents additional challenges, the IRS should reevaluate its current practices so that *all* taxpayers receive accurate interest charges. That is, all taxpayers with manually calculated interest should receive the same accuracy reviews as taxpayers who owe greater than $50,000 in interest.

TAS researched IRS's databases and found that, as of July 2008, there were 468,795 restricted interest accounts.[24] An IRS Office of Servicewide Interest review of previously posted manual interest computations found the accuracy of these calculations to be only 67.7 percent.[25] This figure indicates that 32.3 percent of manual interest computations – almost one in three – are incorrect.

By the very nature of the scenarios surrounding restricted interest tax modules and the circumstances that cause these accounts to be restricted, taxpayers should not be subjected to additional burden when the IRS miscalculates manual interest. Based on the current number of restricted interest accounts, a 67.7 percent accuracy rate would project to 151,421 current potentially incorrect manual interest accounts.

Significant Taxpayer Burden Situations Occur When the IRS Miscalculates Penalties and Interest.

The IRS is aware of but has failed to correct many systemic problems that cause penalty and interest miscalculations.[26] These incorrect calculations lead numerous taxpayers to believe they have fully paid what the IRS says they owe, only to receive subsequent bills for accruals of interest, penalties, or both. If a taxpayer was planning to refinance his or her home or borrow from a bank or retirement savings under the mistaken belief that the IRS provided a correct final payoff amount, the taxpayer may be unable to raise the additional funds needed to resolve the remaining debt. This could lead to lien or levy action *after the IRS's own calculations led the taxpayer to believe the tax was fully paid.* The IRS could minimize this problem by systemically posting FTP and interest accruals on balance due accounts at least every three months.

The complexity of penalty and interest calculations makes it difficult for the ordinary taxpayer to identify errors in IRS notices and payoff statements. Taxpayers sometimes overpay penalty and interest without ever knowing the IRS made a mistake. Inaccurate penalty and interest calculations also cost the IRS because it must devote resources to refund excess payments or attempt to collect erroneous refunds.

23 IRM 20.2.8.1(3) (Aug. 1, 2006).

24 Compliance Data Warehouse IMF database. Data compiled from the Individual Master File; transaction code 340 dates between Oct. 1, 2007, and July 31, 2008.

25 *See* IRS, Office of Servicewide Interest, reviews of previously posted manual interest computations for October 2007 through March 2008; *see also* Linda Stiff, Deputy Commissioner for Services and Enforcement, Memorandum to Division Commissioners (July 10, 2008).

26 IRM 5.12.6.1.2 (Mar. 15, 2005).

Another example of problematic rework occurs each year during the period known as the "Dead Cycles," the time from mid-December through the first week of January, when the IRS updates its IDRS computer system.[27] During this time, the IRS Masterfile does not allow accruals to taxpayers' accounts on IDRS. As a result, systemic releases and account accruals do not occur until the "Dead Cycles" updates are complete. Work performed on taxpayers' accounts during this time may require manual computations that are vulnerable to human error.

Inadequate IRS Training and Software Programming Contribute Significantly to Taxpayer Burden.

Many IRS business units utilize unique tax and interest computation software, containing programming variations for the calculation of the FTP penalty and interest. These differences are exacerbated when IRS employees possess varying degrees of skill and training in these areas.

Until the IRS completes a comprehensive review to verify computer programs that impact penalty and interest assessments are designed and functioning in accordance with law and policy, it will continue to use programs that may not work as intended. The IRS's continued reliance upon inadequate programming could cause inequitable treatment of taxpayers and over-collection or lost revenue.

FTP Penalty Calculation Errors Can Be Compounded by the IRS's Restrictive Reasonable Cause Penalty Abatement Policy.

A taxpayer can reduce or eliminate the FTP penalty by showing the failure to pay is due to reasonable cause and not willful neglect.[28] Under Treasury Regulation § 301.6651-1(c) (1), an FTP penalty abatement will be considered due to reasonable cause if the taxpayer shows he exercised "ordinary business care and prudence in providing for payment of his tax liability" and, nonetheless, was either unable to pay the tax, or would suffer an undue hardship if he paid on the due date.[29] However, the IRS has taken the position that a taxpayer must pay the tax due before it will abate the FTP penalty for reasonable cause.

The IRM provides that, "Generally, the taxpayer must pay the tax due before the Service will abate a FTP penalty for reasonable cause. The penalty and interest continue to accrue until the tax is paid."[30] While IRC subsections 6651(a)(2) and (3) and the accompanying

27 IRM 5.12.6.1.2 (Mar. 15, 2005).

28 IRC § 6651(a)(2) and (3).

29 "Undue hardship" is defined in Treas. Reg. § 1.6161-1(b).

30 IRM 20.1.2.1.3(2)(b) (Apr. 25, 2008). The term "generally" in this IRM section suggests that there might be some situations in which the IRS would agree to consider reasonable cause for the FTP penalty without requiring that the taxpayer first pay the underlying liability. However, the IRS has made clear that in practice it does not make any exception to its "pay first" policy. TAS receives complaints from taxpayers who desire to assert reasonable cause to abate the FTP pay penalty but were denied that opportunity by the IRS because the tax had not yet been paid. In these cases, the crisis that gave rise to the taxpayer's failure to pay the tax, such as a severe health condition that kept the taxpayer from earning wages, is the same crisis which the taxpayer desires to serve as the basis for the reasonable cause abatement. In April 2007, TAS proposed that the IRS change IRM 20.1.2.1.3(2) to allow reasonable cause to be raised in certain limited situations when the taxpayer's inability to pay the tax was at issue; however, the IRS refused to do so.

Treasury Regulation § 301.6651-1(c)(1) do not list full payment of the underlying liability as a prerequisite for reasonable cause abatement of the FTP penalty, the IRS enforces such a requirement.[31] Given this policy, the IRS would not consider the reasonable cause claim of a taxpayer who has a severe health condition preventing him or her from earning income and paying the tax unless the tax is paid in full – which the taxpayer could not do.[32] The IRM provides, "There is no statutory requirement that the tax has to be paid in full before a FTP abatement request can be considered or can in fact be made," but asserts that "there is no statutory requirement that the Service has to consider a FTP penalty abatement before the tax is fully paid."[33] The IRM states the IRS has decided on the full-pay policy "per administrative discretion in the interests of the taxpayer and the Service."[34] The IRM further asserts that: "These type scenarios do not provide quality taxpayer relations and only serve to multiply confusion."[35] However, the IRM does not explain how refusing to hear the taxpayer's explanation of reasonable cause, for not being able to pay the tax until the taxpayer pays the tax, encourages voluntary compliance. As this report was being developed, the IRS agreed to change its "pay first" policy. The National Taxpayer Advocate applauds the IRS for this change and looks forward to reviewing the revised policy.

The IRS may feel the abatement policy is in the best interest of tax administration in some cases; however, it is clear that taxpayers with no ability to pay the underlying tax in the foreseeable future are harmed when they are not granted the right to have their reasonable cause abatement claims heard.

Conclusion

It is important that the IRS protects the integrity of taxpayer accounts by accurately calculating the FTP penalty and interest. Too often, its systems fail to accurately calculate these additions to tax. While the IRS's *intent* to administer the tax law fairly is not in question, the IRS must reduce miscalculations of penalties and interest, and further eliminate frustrating penalty abatement requirements. By reducing these barriers, the IRS will enhance voluntary compliance and taxpayer confidence in the IRS.

The IRS should consider taking the following actions to improve the process of calculating the FTP penalty and interest: include TAS as a partner on any existing teams or working groups concerning any instances in which programs are not functioning in accordance with the intent of the IRM; allocate adequate resources towards planning and programming for its Customer Account Data Engine, IDRS, Financial Management Information System, IMF, and BMF to resolve common penalty and interest computation issues allowing for systemic updates every three months; revise pertinent IRM sections so *all* taxpayers

31 IRM 20.1.2.1.3(2)(b) (Apr. 25, 2008).

32 An example taken from a closed TAS case. Taxpayer Advocate Management Information System (TAMIS) Primary Core Issue Code (PCIC) 520.

33 IRM 20.1.2.1.3(2)(b) (Apr. 25, 2008).

34 *Id.*

35 *Id.*

are entitled to accuracy reviews of interest and penalty calculations; re-evaluate the overly complex restricted interest procedure in the IRM to make certain all taxpayers receive accurate interest charges; and allow taxpayers who have demonstrated the inability to pay the underlying tax the ability to be heard on their claims for reasonable cause abatement of the FTP penalty before the tax is paid.

IRS Comments

The IRS recognizes the need for continual scrutiny of our penalty and interest computations to ensure taxpayers are being treated fairly and assessments are accurate. The Servicewide Penalty and Servicewide Interest policy groups, embedded in the Small Business/Self-Employed Division were formed to uniformly address penalty and interest issues on an agency-wide basis.

The IRS has done much to correct systemic errors that cause penalty and interest miscalculations. All identified systemic conditions resulting in inaccurate calculations are reported to the Servicewide Penalty and Interest groups who meet with Master File and Integrated Data Retrieval System (IDRS) personnel to resolve and correct each reported condition. A cross-functional working group led by Servicewide Penalty and Interest, which includes members from functional areas, Modernization & Information Technology Services, and the Chief Financial Officer, was formed and meets weekly to address identified systemic problems within the penalty and interest programs. Members of this working group conducted a review of Master File programming, including a general random sample of open modules, as well as a sample of modules impacted by the recent implementation of programming changes. The review methodology was designed to confirm that recently implemented programming changes were performing as required under the law and to identify any programming that was not in compliance. The IRS will continue to perform periodic reviews and implement corrective programming to address identified issues.

Solutions to identified systemic differences between Master File and IDRS penalty and interest computations that cannot be fixed under the current processing system are being addressed by modernization efforts, through the use of the Common Services Penalty and Interest Computation Module. Use of a common module for systemic calculations will eliminate computational differences that can arise when more than one program is used to determine overpayment and underpayment interest and penalty amounts.

The IRS agrees that more work can be done to improve the accuracy of manual interest calculations; however, since we have not yet implemented a statistically valid review process, our actual accuracy rate is not known because our sample cannot be projected to the entire population. We are working with Research and Statistics to develop a statistically valid random sampling methodology that is planned for implementation in fiscal year (FY) 2009. We are also working with a vendor to improve a software product used by our employees which assists them with manual interest computations. Several significant en-

hancements of this software are scheduled for implementation this fiscal year. In addition, manual interest training has been updated and will be provided to interest computation functions servicewide. The priority to fully train interest computation personnel, and the availability of on-site assistance from the Servicewide Interest group, was communicated to all functions by the Commissioner in a memorandum dated July 10, 2008.

The IRS has a mandatory review in place of all manual interest computations greater than $50,000.[36] The $50,000 criterion was set to provide review of large dollar adjustments and to address sizable interest accuracy issues. In addition to this review requirement, all interest calculations, regardless of dollar amount, are subject to a random post review by interest reviewers located in the Servicewide Interest group. Feedback on errors and corrective actions are implemented as a result of these reviews.

There are restricted interest conditions which Master File and IDRS programming can systemically handle. For instance, generally, Master File and IDRS can systemically handle restricted conditions of modules with combat zone, disaster relief, and carryback adjustments stemming from net operating losses. To ensure accuracy, the IRM provides specific instructions for those special situations that require the manual computation and restriction of interest.[37]

To alleviate any issues that may occur during IDRS "Dead Cycles", we have included in the IRM instructions on how to handle the processing of adjustments in anticipation of the Dead Cycle timeframe.[38] "Dead Cycles" are necessary to provide Master File and IDRS systems the needed time to update computer programming. Processing of interest on underpayments input prior to the Dead Cycles does not in itself require or mandate the manual computation and restriction of interest. However, for overpayments that will complete processing during dead cycles, instructions provide for the issuance of manual refunds to limit the unnecessary accrual of credit interest that would occur by not being able to process refunds during this time period.

In her report, the National Taxpayer Advocate makes five specific suggestions to improve the process of calculating the FTP penalty and interest. The IRS is taking or has taken the following actions with respect to these issues:

We work in conjunction with the TAS Office of Systemic Advocacy to uncover systemic computational errors in our systems or gaps in our procedures. The IRS agrees that, where appropriate, we should include TAS as a partner on teams. We will provide periodic updates to TAS to ensure they are kept abreast of current activities where their active involvement on teams is not warranted.

36 IRM 20.2.8.1 (July 31, 2001).

37 IRM 20.2.8 (Aug. 1, 2006).

38 IRM 21.2.4.3.15 (Jan. 11, 2008).

The IRS agrees to continue devoting resources toward planning and programming for its systems to resolve penalty and interest computation issues. Given the magnitude of this task, we must determine the correct balance of resource usage between updating this infrastructure and conducting day-to-day business. However, we do not have plans to allow for systemic updates every three months. A notice needs to be sent to the taxpayer for penalty and interest accruals to be posted to the taxpayer's account. Currently, the print sites are sending notices annually and can not handle the additional volume that would result from these additional accruals. We do not have the personnel or equipment resources to issue these additional notices.

The IRS threshold for mandatory review of manual interest computations was set at amounts greater than $50,000.[39] The $50,000 criterion was set to provide review of large dollar adjustments and to address sizable interest accuracy issues. Those not meeting this threshold are subject to our sample review process. Reviewing all manual interest computations is not the best use of our limited resources.

Complex restricted interest procedures are due in great part to the complexity of the IRC and the limitations of our systemic interest capabilities. The IRS will review IRM procedures and simplify restricted interest procedures where appropriate.[40]

The IRS will change its policy of generally requiring the tax be paid before considering reasonable cause abatements. To establish reasonable cause, a taxpayer must make a satisfactory showing that he or she exercised ordinary business care and prudence in providing for payment of his or her tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if they paid on the due date.[41] If the taxpayer meets this reasonable cause criteria for not paying the tax when it was due (including any extension of time to pay), the FTP penalty will be abated. IRM 20.1.2 is being updated to reflect this position.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS agrees with the need for continual scrutiny of penalty and interest computations to guarantee taxpayers are treated fairly and assessments are accurate. The IRS response demonstrates that it is trying to be vigilant in its efforts to maintain taxpayers' confidence in the IRS and enhance voluntary compliance.

The National Taxpayer Advocate acknowledges the IRS's proactive efforts to correct systemic errors that cause penalty and interest miscalculations through periodic reviews and

39 IRM 20.2.8.1 (July 31, 2001).

40 IRM 20.2.8 (Aug. 1, 2006).

41 Treas. Reg. § 301.6651-1(c)(1).

corrective programming. The National Taxpayer Advocate applauds the IRS's modernization efforts and looks forward to seeing the impact of the Common Services Penalty and Interest Computation Module on inaccurate penalty and interest computations.

When the IRS makes assessments and provides notices to taxpayers annually rather than at least quarterly, FTP penalty and interest accruals may not post properly to taxpayers' accounts.[42] Upon request for a payoff amount, an IRS employee must force a posting of the penalty and interest accrual which updates the account.[43] If an IRS employee does not monitor the account and the accruals do not post before payment, the IRS may erroneously refund the difference between the balance when the payment is posted and the balance when the proper accruals finally post; which, in turn, could create unnecessary work for the IRS and a tremendous burden for the taxpayer.

For example, the IRS's erroneous refund procedures require sending the taxpayer a notice requesting repayment of the erroneous refund. The taxpayer, who assumed the refund was correct, is then subject to interest charges. This creates unnecessary confusion. Taxpayers would rather pay the correct balance due (as advised by the IRS) rather than receive an erroneous refund notice in the future. While the IRS is reluctant to find the resources to systemically notify taxpayers of accruals every three months, the National Taxpayer Advocate believes these resources are a small cost to protect taxpayers' rights and prevent taxpayer confusion and unnecessary burden.

The National Taxpayer Advocate is pleased that the IRS agrees with the need to improve accuracy of manual interest calculations. We commend the IRS for working with Research and Statistics to develop a statistically valid random sampling methodology to review these calculations.

The IRS states it has a mandatory review in place for all manual interest computations greater than $50,000.[44] However, the IRS recently informed its Division Commissioners that the manual interest computation accuracy rate for the first half of FY 2008 was 67.7 percent.[45] The National Taxpayer Advocate is troubled by this statistic and believes all taxpayers are entitled to the same level of quality reviews for accuracy, regardless of dollar amount. Moreover, it seems the IRS assumes that $50,000 is the threshold amount to have

42 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-30-052, *Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue* (Mar. 18, 2005). IRC § 6303(a) provides that the IRS shall as soon as practicable after making an assessment give notice to each person liable for the unpaid tax. IRC § 6601(e)(2)(A) requires the IRS to assess and issue notice and demand for the FTP penalty before interest is accrued on the penalty. The IRS generally makes this assessment annually. However, for restricted interest and manually calculated penalties, the IRS may assess the penalty and interest more than annually thereby causing disparity between taxpayers whose interest and penalty charges are assessed annually and taxpayers whose interest and penalty charges are assessed manually. The report presented that the IRS would generate more revenue if it assessed penalty and interest and issued notices and demand for payment quarterly rather than annually.

43 Servicewide Electronic Research and Policy (SERP) Alert 07077 (issued Dec 13, 2006).

44 IRM 20.2.8.1 (July 31, 2001).

45 *See* IRS, Office of Servicewide Interest, reviews of previously posted manual interest computations for October 2007 through March 2008; *see also* Linda Stiff, Deputy Commissioner for Services and Enforcement, Memorandum to Division Commissioners (July 10, 2008).

a great impact on a taxpayer's financial well-being. However, for a low income taxpayer, $100 or $1,000 can have the same relative economic impact as $50,000 has for a more affluent taxpayer. If the IRS is trying to consider the taxpayer's perspective, it should impose a mandatory review of *all* manual interest computations.[46]

The National Taxpayer Advocate does not dispute the necessity of "Dead Cycles." However, "Dead Cycles" lead to human error when computing interest and FTP penalties. Because these errors persist, it would be prudent for the IRS to offer clear guidance to customer service employees handling account payoff balances during the "Dead Cycles."[47]

The National Taxpayer Advocate is pleased the IRS will include TAS as a partner on teams, and anticipates updates of current activities where TAS's active involvement on teams is not warranted.

The National Taxpayer Advocate applauds the IRS for agreeing to change its "pay first" policy, as it now allows a reasonable cause abatement to occur before the tax is paid. If the taxpayer meets reasonable cause criteria for not paying the tax when it was due (including any extension of time to pay), the FTP penalty will be abated. The IRS states it is updating IRM 20.1.2 to reflect this position. TAS looks forward to reviewing the revised policy. By reducing many of these barriers, the IRS will enhance voluntary compliance and taxpayer confidence.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following actions to improve penalty and interest administration:

1. Allocate adequate resources toward planning and programming for the Common Services Penalty and Interest Computation Module, Customer Account Data Engine, IDRS, Financial Management Information System, IMF, and BMF.
2. Resolve common penalty and interest computation and notice issues by allowing for assessments and systemic updates every three months in order to provide current account balance information to taxpayers.
3. Revise pertinent IRM sections to simplify restricted interest procedures and provide for accuracy reviews of interest and penalty calculations to *all* taxpayers.

46 This review would provide the additional benefit of helping the IRS to identify all of the problem areas relating to restricted interest.

47 In its response, the IRS claims that it has "included in the IRM instructions on how to handle adjustments in anticipation of the Dead Cycle . . .," but the IRM cited in the footnote only discusses how to process a manual refund to avoid interest charges to the IRS. The IRM cited does not discuss how to abate a penalty or adjust an account so that a taxpayer may avoid erroneous interest or penalties during the Dead Cycle.

MSP #20 Inefficiencies in the Administration of the Combined Annual Wage Reporting (CAWR) Program Impose Substantial Burden on Employers and Waste IRS Resources

Responsible Official

Chris Wagner, Commissioner, Small Business/Self-Employed Division

Definition of Problem

The Combined Annual Wage Reporting (CAWR) program ensures that employers accurately report annual wage data to the IRS and the Social Security Administration (SSA). If the IRS discovers a discrepancy in the wage and tax data reported by an employer, it issues a notice to the employer and requests that the employer provide the information necessary to resolve that discrepancy.[1] Employers often experience significant problems when they attempt to reconcile wage and tax discrepancies, including:

- Delays in case resolution;
- Unclear notices and letters that do not help employers reply timely or comply with reporting requirements; and
- Improper assessment of penalties.

These problems lead to downstream consequences that produce rework for the IRS and impose a burden on employers. An increasing number of employers seek assistance from TAS to resolve their CAWR issues. TAS cases increased by 264 percent between fiscal year (FY) 2005 and FY 2008.[2] In FY 2008, CAWR ranked as the number one issue in cases closed within TAS for large and midsize businesses, tax exempt organizations, and government entities.[3]

1 Internal Revenue Manual (IRM) 4.19.4.3.1 (Feb. 1, 2008).

2 TAS receipts for CAWR increased from 1,663 cases in FY 2005 to 2,867 cases in FY 2006 to 4,563 cases in FY 2007 to 6,059 cases in FY 2008. This is an increase of 264 percent from FY 2005 to FY 2008. *See* TAS Technical Analysis and Guidance response to research request (Nov. 10, 2008).

3 In FY 2008, CAWR ranked as the number one issue for cases closed for large and midsize businesses, tax exempt organizations, and government entities seeking assistance from TAS. CAWR is the fourth most common issue driving small business employers to TAS. The relief rates in CAWR cases are 82.5 percent for the Large and Mid-Size Business division (LMSB), 88.7 percent for the Tax Exempt and Government Entities division (TE/GE), and 86.5 percent for the Small Business/Self-Employed division (SB/SE). *See* TAS Technical Analysis and Guidance response to research request (Nov. 10, 2008); TAS, *Business Performance Review 4th Quarter FY 2008.*

Analysis of Problem

Background

The IRS and the SSA jointly administer the CAWR program, which compares Forms W-2, *Wage and Tax Statement*, and W-3, *Transmittal of Wage and Tax Statements*,[4] to the Forms 94x series[5] of employment tax returns. Generally, the purpose of the CAWR program is to ensure employers pay and report the correct amount of Social Security and Medicare taxes, federal income tax withheld, and Advanced Earned Income Tax Credit, and file Forms W-2 with SSA.[6] An employer's failure to file Forms W-2 accurately and timely can adversely affect employees' individual SSA benefits.

When the IRS discovers a discrepancy between information reported on an employer's employment tax return and the information submitted to the SSA, it researches the issue before contacting the employer. If it cannot resolve the discrepancy internally, the IRS issues a notice advising the employer of the discrepancy and of the potential tax assessment or penalty for intentionally disregarding filing requirements for information returns.[7]

Delays in Case Resolution Due to Lack of Proper Inventory Management Controls

In 2006, the IRS began to consolidate the CAWR program in three campuses – Cincinnati, Memphis, and Philadelphia. Presumably, one goal of consolidation was to improve efficiency by developing and concentrating CAWR expertise. However, as shown in Table 1.20.1, the IRS has experienced a significant backlog of CAWR cases at these campuses in recent years.

TABLE 1.20.1, Percent of Overage CAWR Cases by Campus, FY 2006 - 2008[8]

Campus	FY 2006	FY 2007	FY 2008
Cincinnati	71.9%	65.5%	23.9%
Memphis	6.2%	71.7%	34.5%
Philadelphia	19.7%	13.4%	51.3%

TAS case advocates, employers, and practitioners report delays of six to 11 months in resolving cases.[9] These delays leave employers in limbo about the status of their cases and

4 Forms W-2 and W-3 are the most common forms employers use to report wages paid to employees. Employers file these statements with the SSA. Other statements, including Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA, Insurance Contracts*, and Form W-2G, *Certain Gambling Winnings*, are filed with the IRS.

5 The Forms 94x series includes Forms 941(*Employer's Quarterly Federal Tax Return*), 943 (*Employer's Annual Tax Return for Agricultural Employees*), 944 (*Employer's Annual Federal Tax Return*), and 945 (*Annual Return of Withheld Federal Income Tax*). Taxpayers file Schedules H (*Household Employment Taxes*) with Forms 1040 (*U.S. Individual Income Tax Return)* or 1041 *(U.S. Income Tax Return for Estates and Trusts*).

6 IRM 4.19.4.1 (Feb. 1, 2008).

7 IRM 4.19.4.3.1 (Feb. 1, 2008).

8 SB/SE response to TAS research request (Oct. 23, 2008).

9 The TAS Office of Systemic Advocacy received several advocacy issues concerning lengthy delays in case resolution. *See* Systemic Advocacy Management System (SAMS).

may expose them to inappropriate collection action.[10] The IRS should develop internal management controls and adequately staff the program to prevent such backlogs of CAWR cases.

We are encouraged that the IRS recognizes the problem in the current procedures for working CAWR cases. TAS and the Small Business/Self-Employed division (SB/SE) established a team to study the effect of the CAWR program on TAS case receipts. The team will review CAWR processes, identify systemic problems, and discuss potential solutions.

IRS CAWR Notices Are Unclear and Do Not Necessarily Help Employers Comply

Screening is one of the most important aspects of CAWR case processing. The IRS conducts extensive research up front, working to resolve the discrepancy and avoid unnecessary contact with the taxpayer.[11] When the IRS does contact the taxpayer, however, the CAWR notices and letters are unclear and often leave employers unable to identify the cause of the discrepancy. For example, suppose an employer reports both wage and nonwage information returns. The employer files Forms W-2, Forms 1099-R, and Forms 941 for a tax year. The IRS issues a notice of a discrepancy and asks the employer to provide the information necessary to resolve that discrepancy.[12] The notice lists the total amounts reported on all forms (W-2, W-2G, 1099-R, and 1099-G) and includes a breakdown of the amounts of Social Security wages, Medicare wages, and income tax withheld, but does not specifically identify the discrepant data. This lack of specificity forces the employer to review all of its records, which can be time-consuming and costly. When employers have to spend a significant amount of time researching past years' tax information, they may not be able to respond timely. The employer has 45 days to respond to the CAWR notices.[13]

When the IRS issues unclear notices, it increases the chance that taxpayers will not respond timely. Table 1.20.2 below indicates a significant number of employers respond late or not at all to CAWR notices.

10 Under IRM 21.7.1.4.6.4 (Jan. 1, 2005), the IRS can take payments from one affiliated taxpayer account or tax period to satisfy an unpaid balance on another affiliated taxpayer account or tax period. It also allows offset to past due federal agency debts in some situations. This practice can lead to much work "unwinding" unnecessary credit transfers that could have been avoided if the IRS had promptly resolved the original problem.

11 IRM 4.19.4.2 (Feb. 1, 2008).

12 IRM 4.19.4.3.1 (Feb. 1, 2008).

13 IRM 4.19.4.3.1(3) (Feb. 1, 2008).

TABLE 1.20.2, Response to CAWR Notices[14]

Fiscal Year	Notices Issued	Replies	Late Replies[15]	No Replies	Undeliverable Notices
2006	272,105	70,586	107,415	92,708	8,468
2007	275,472	88,103	118,196	128,389	17,146
2008	358,162	76,712	162,232	121,957	14,056

The low taxpayer response rate clearly indicates the IRS has an opportunity to improve notices sent to employers. For example, the CAWR notices do not provide employers an option to speak to employees in the CAWR units (who have done the screening, conducted extensive research, and issued the notice), but instead provide a toll-free number answered by an automated system. While the employer may reach a live assistor, the assistor is not able to provide additional guidance but simply advises the employer to respond to the notice immediately.[16] Moreover, the live assistor does not have access to the CAWR Automated Program system[17] and in many cases must refer the matter to the CAWR Unit.[18] Further, the IRS does not send copies of these discrepancy notices to employers' representatives (including reporting agents). Due to a systemic limitation, the representatives do not get the pre-assessment notices.[19]

Improper Assessment of Penalties Leads to Subsequent Abatement

Employers are required to file complete and accurate information returns in a timely manner.[20] Internal Revenue Code (IRC) § 6721(a) provides for a penalty for failure to file correct information returns. The penalty is imposed for a failure to file an information return on or before the due date, or a failure to include all of the information required on the return or the inclusion of incorrect information. Generally, the penalty imposed under IRC § 6721(a) is $50 for each return with respect to which a failure occurs, to a maximum of $250,000 per filer per year.[21] There are exceptions to the imposition of the penalty and to the maximum amount of the penalty in cases where the filer corrects the failure within

14 *See* SB/SE response to TAS research request (Oct. 23, 2008). The table includes data about the notices IRS sends in IRS-CAWR and SSA-CAWR cases. An IRS-CAWR case involves underpayment of taxes or excess withholding of Federal Income Tax or Advance Earned Income Credit. An SSA-CAWR case is generated when an employer does not file proper wage and tax statements (Forms W-2) which adversely affect individuals' retirement benefits.

15 Late replies are cases in which the employer's response is received by the IRS after the initial case is closed on the CAWR Automated Program (CAP system). Late replies consist of current tax years and prior tax years. *See* IRM 4.19.4.6 (Feb. 1, 2008).

16 IRM 4.19.4.11.1 (Feb. 1, 2008).

17 The CAWR cases identified by IRS and SSA are stored on the CAWR Automated Program (CAP) system. The CAP system acts as an audit trail of all actions taken on the cases worked by IRS. *See* http://www.irs.gov/privacy/article/0,,id=139361,00.html (last visited Nov. 21, 2008).

18 IRM 4.19.4.11.1-2 (Feb. 1, 2008).

19 However, employers' representatives receive copies of the notice of penalty assessment (the CP 215 notice). *See* SB/SE Issue Management Resolution System, Issue No. 06-0000130.

20 IRC § 6724(d)(1)(A)(vii) defines the term information return as any statement of the amount of payments to another person required by IRC § 6051(d) (relating to information returns with respect to income tax withheld). IRC § 6051(d) provides that a Wage and Tax Statement (Form W-2) constitutes an information return.

21 IRC § 6721(d) provides lesser penalty amounts for taxpayers (*i.e.*, small businesses) with gross receipts of $5 million or less.

a specified time, the failure to include information is *de minimis*, or the filer's gross receipts do not exceed certain amounts.[22]

IRC § 6721(e) provides for a higher penalty in the case of failures due to intentional disregard of filing requirements for information returns. "Intentional disregard" is defined as "knowing or willful."[23] Whether a person knowingly or willfully fails to file timely or fails to include correct information is determined on the basis of all the facts and circumstances in the particular case.[24] The penalty is the greater of $100 per form required to be filed or ten percent of the total amount required to be reported on the information returns.[25] There is no set maximum amount for this penalty.[26]

SB/SE recently updated its guidance on CAWR case procedures and the application of late filing penalties under IRC § 6721.[27] This update has led to inconsistent application of penalties, including multiple penalty assessments for single infractions. TAS case advocates are reporting increasing number of cases involving inconsistent treatment of employers.[28] Cases with similar fact patterns and proof of timely filing are sent to various campuses, with very different results.

Table 1.20.3 shows the total assessments and abatements of the IRC § 6721(e) intentional disregard penalty for FY 2003 to FY 2008.[29] On average, 81 percent of the penalty dollar amounts and 39 percent of the number of penalties assessed are later resolved, reduced, or abated.

22 IRC §§ 6721(b) - (d).

23 Treas. Reg. § 301.6721-1(f)(2).

24 Treas. Reg. § 301.6721-1(f)(2)(ii).

25 IRC § 6721(e)(2)(A) and Treas. Reg. § 301-6721-1(f)(4).

26 Treas. Reg. § 301.6721-1(f)(4) and (5) sets forth the rules and regulations for determining the amount of the penalty, the applicable statutory percentages and, how to compute the penalty.

27 IRM 4.19.4, CAWR Reconciliation Balancing, was updated in February 2008.

28 Since the change in policy, the TAS Office of Systemic Advocacy has received several advocacy issues regarding the application of the penalty, including issues concerning the inconsistent treatment of employers at the campuses. *See* SAMS.

29 The National Taxpayer Advocate's 2003 Annual Report to Congress included penalty data from 1998 to 2002.

TABLE 1.20.3, Analysis of Assessment and Abatement of IRC § 6721(e)[30]

Fiscal Year	Number of Assessments	Penalty Assessments	Number of Abatements	Abatement Amounts	Percent of Assessments Abated	Percent of Dollars Abated
2008	90,400	$1,673,461,062	16,313	$843,154,686	18.05%	50.38%
2007	145,508	$2,544,823,429	57,019	$2,044,439,852	39.19%	80.34%
2006	76,111	$3,512,608,088	32,448	$3,258,809,072	42.63%	92.77%
2005	104,994	$2,843,505,108	44,321	$2,522,471,493	42.21%	88.71%
2004	95,345	$2,157,423,272	42,592	$1,905,064,051	44.67%	88.30%
2003	117,096	$1,872,673,195	55,357	$1,615,361,239	47.27%	86.26%

The frequent abatement of penalty assessments under IRC § 6721(e)(2)(A), for intentional disregard of the filing requirements for information returns, indicates a serious problem with the administration of this penalty. In the 2003 Annual Report to Congress, the National Taxpayer Advocate expressed concern about premature CAWR assessments of tax and penalty, and subsequent abatements.[31] The IRS has also recognized that CAWR assessments and subsequent abatements are a serious problem. In March 2007, the Large and Mid-Sized Business division (LMSB) analyzed CAWR cases involving its taxpayers that included assessment of tax and penalties,[32] and found the IRS ultimately abated or significantly adjusted 90 percent of the penalties.[33] The assessment and subsequent abatement of penalties causes substantial rework for the IRS. It affects business results and customer satisfaction because securing the abatements requires substantial resources. Not only does the improper assessment of CAWR penalties cause a serious drain on IRS resources, it also imposes an unnecessary burden on employers.

Downstream Consequences Lead to Increased Rework for the IRS

Significant downstream consequences can emerge when the IRS does not timely resolve tax issues. Potential consequences may include repeat contacts on the same issue, the need for TAS assistance, revenue loss, and possible costs of enforcement such as collection activity and appeals.[34]

Delayed resolution of wage and tax discrepancies negatively affects a variety of corrective actions to an employer's account. Correspondence delays generate additional follow-up contacts from employers, including multiple submissions of information and requests for

30 IRS Enforcement Revenue Information System (ERIS), *IRC § 6721 Penalty Data on Intentional Disregard Penalty* (Sept. 30, 2008). ERIS captures data on civil monetary penalties.

31 *See* 2003 National Taxpayer Advocate Report to Congress 220-226.

32 LMSB CAWR Briefing (Mar. 2, 2007).

33 *Id.*

34 IRS, *Taxpayer Assistance Blueprint, Phase II*, at 53.

abatements, calls to the toll-free lines, and referrals to TAS – all of which mean re-work for the IRS.

The downstream impact on employers is reflected in the increasing volume of TAS cases involving wage reconciliation. Although SB/SE worked aggressively to reduce the open CAWR inventory and close overage cases by the end of 2007,[35] TAS continues to see growth in CAWR cases. TAS has experienced a 264 percent increase in cases received on CAWR issues from FY 2005 through FY 2008.[36] In FY 2007 and 2008, the number of related SAMS submissions increased considerably compared to FY 2005 and FY 2006.[37] These increases clearly indicate that many taxpayers are unable to resolve their problems and issues through normal IRS channels. The prolonged process of reconciling wage and tax returns adversely affects employers. The delays in case processing discussed above are an undue burden facing employers when they try to resolve wage reporting discrepancies.

Conclusion

IRS Commissioner Douglas Shulman frequently compares the service the IRS provides with that of other financial institutions. When interacting with a bank or brokerage firm, customers want to spend the least amount of time conducting their transactions. Likewise, the Commissioner stated, "the IRS should do everything possible to make it easy for taxpayers who are trying to navigate the organization, get answers to questions, pay their taxes, and get on their way."[38] To achieve this goal in the CAWR program, the IRS should consider providing specific information about the wage reporting discrepancy on notices and letters to enable employers to more quickly respond to CAWR correspondence; including the phone number to the CAWR unit on notices and letters so that employers may contact a live assistor; and continuously training employees on when it is appropriate to assess CAWR penalties, thereby minimizing the need for penalty abatements.

IRS Comments

The IRS has taken significant steps to improve the overall effectiveness of the CAWR program. A one-time inventory backlog has been eliminated, the volume of overage cases has declined considerably, abatement rates continue to trend downward, and the quality of case actions continues to improve. The IRS is dedicated to building upon these successes and will continue to explore opportunities to improve the CAWR program.

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35 *See* SB/SE Business Performance Review 35 (Aug. 13, 2007).

36 TAS case receipts for CAWR increased from 1,663 cases in FY 2005 to 2,867 cases in FY 2006 to 4,563 cases in FY 2007 to 6,059 cases in FY 2008. This is an increase of 264 percent from FY 2005 to FY 2008. *See* TAS Technical Analysis and Guidance response to research request (Nov. 10, 2008).

37 TAS Office of Systemic Advocacy received 14 advocacy issues regarding CAWR in FY 2007 and 14 more issues in FY 2008, a significant increase over the six issues received in FY 2005 and the five in FY 2006. The advocacy issues describe the problems as backlogs of CAWR casework and taxpayer correspondence, premature collection and enforcement actions, and inconsistent application and treatment of CAWR civil penalty cases at the campuses. *See* SAMS.

38 Remarks of IRS Commissioner Douglas Shulman Before the American Bar Association, *at* http://www.irs.gov/irs/article/0,,id+18280,00.html (last visited Oct. 24, 2008).

Recent actions taken by the IRS have produced notable improvements. To address an inventory backlog and alleviate taxpayer burden, the IRS implemented programming changes to prevent erroneous workload downloads. The IRS worked one-on-one with Reporting Agents affected by the backlog and provided expeditious handling of their clients' cases. The IRS established performance improvement milestones for the impacted campus and continuously monitors progress. As a result of these efforts, inventory backlogs in the CAWR program have been eliminated and overage casework has trended downward consistently over the past several months as shown in the chart below.[39]

TABLE 1.20.4, CAWR Overages FY 2007-2008

Month Ending	FY 07 Overage	FY 08 Overage	FY 08 vs. FY 07
March	35,291	29,115	-17.5%
April	30,309	23,669	-21.9%
May	24,696	16,808	-31.9%
June	65,959	11,741	-82.2%
July	58,614	11,346	-80.6%
August	59,219	14,859	-74.9%
September	45,588	28,343	-37.8%

The IRS has taken steps to improve CAWR correspondence and has identified a number of system enhancements that focus specifically on improvements to CAWR notices. During FY 2010, copies of CAWR notices will automatically be sent to taxpayers' authorized representatives, interim letters to acknowledge the receipt of taxpayer correspondence will be systemically generated, and notice content and clarity will be improved through the use of case specific notice paragraphs. The IRS has also established a Taxpayer Correspondence Team (TaCT). Participants represent agency wide program areas, including CAWR/FUTA. The objective of the team is to further improve understandability and clarity of IRS notices and correspondence.

The IRS has bolstered outreach efforts to educate taxpayers on the importance of responding timely to CAWR Notices. Information was added to www.irs.gov on responding to SSA-CAWR Notices.[40] An article was included in the fall 2008 edition of the SSA/IRS Reporter linking the reader to the www.irs.gov for tips on responding to CAWR notices. Finally, the IRS developed and distributed background information about the CAWR program as well as a guide for responding to SSA-CAWR notices to the Reporting Agent community including the National Payroll Reporting Consortium, Independent Payroll Providers Association, and the American Payroll Association.

39 Source: Compliance Inventory Reports (CIR).

40 IRS, *Combined Annual Wage Reporting Missing Form W-2 Inquiries, at* http://www.irs.gov/businesses/small/article/0,,id=182835,00.html.

From 2003 through 2007, the percentage of penalty abatements decreased from 47 percent to 31.8 percent.[41] In 2008, the abatement rate fell to 18.05 percent.[42] The downward abatement trend is expected to continue as a result of outreach efforts and clarified case processing guidance.[43] The downward trend is also attributable to the collaborative efforts between SB/SE and LMSB to develop and implement an improved referral process between CAWR and the Large Corporation Technical Units (LCTUs). The refined process allows CAWR to resolve more large corporate case discrepancies prior to issuing a notice.

The IRS acknowledges that the download of unplanned inventory by campus operations did influence a one-time increase to CAWR-related TAS casework. As noted earlier, this backlog has now been eliminated. However, the IRS has concerns with the accuracy of the CAWR TAS case volumes and percentage increases noted in the National Taxpayer Advocate's report. In March 2008, IRS headquarters began collaborative efforts with TAS to address the increase in CAWR and FUTA related TAS cases. During related discussions, the IRS found that TAS case volumes attributed to the CAWR program on the Taxpayer Advocate Management Information System (TAMIS) included non-CAWR casework from at least four other IRS programs. The IRS also reviewed a sampling of 25 cases that TAS provided as CAWR/FUTA cases and found that 32 percent were unrelated to either CAWR or FUTA.

In her report, the National Taxpayer Advocate makes three specific suggestions to improve the CAWR program. The IRS has taken or is taking the following actions with respect to these suggestions:

As noted in the National Taxpayer Advocate's report, CAWR notices include several pieces of information. The notices provide information on discrepancies between the amounts reported to the IRS on employment tax returns and the corresponding amounts submitted on Forms W-2, W-2G, 1099-R, and 1099-G for each of the following fields:

- Social Security Wages;
- Social Security Tips;
- Medicare Wages;
- Federal Income Tax (FIT) Withheld; and
- Advanced Earned Income Credit (EIC) Payments.

These items are reported as overall totals on the employment tax returns. When the sum total of the corresponding amounts the taxpayer reports to the IRS on Forms W-2, W-2G, 1099-R, and 1099-G do not match the employment tax return, a notice is issued. Due to the aggregate reporting on the employment tax returns, the IRS is unable to determine the

41 See Table 1.20.3, *supra*.

42 IRS ERIS, *IRC § 6721, Penalty Data on Intentional Disregard Penalty* (Sept. 30, 2008).

43 IRM 4.19.4.6.1(6) – Late Replies Addressing SSA-CAWR Penalties.

specific information return(s) that may be the source of the mismatch. The IRS also does not know whether the mismatch was due to misreporting on the employment tax returns or the information return(s). Therefore, additional specificity to identify the discrepant data as suggested by the National Taxpayer Advocate is not possible.

The IRS has been exploring the feasibility of establishing a unique toll-free telephone number for use in the CAWR program. While this is being pursued, taxpayers who call the current business toll-free customer service number can speak to a customer service representative (CSR). Through the Integrated Data Retrieval System, CSRs have access to the same information that is available to CAWR program employees on the CAWR Automated Program (CAP) System. In addition, the CAWR handbook, IRM 4.19.4, includes an entire section that provides CSRs with guidance needed to respond to CAWR related inquiries.[44] Finally, until a CAWR program toll-free telephone number is available, the IRS will continue to use the current business toll-free customer service number on CAWR notices.

Clarifications regarding the late filing/intentional disregard penalties were finalized and included in the February 2008 CAWR handbook revision.[45] Related training materials were similarly updated to correspond with the clarified IRM guidance. The IRS did discover isolated instances where examiners, in one campus, had misinterpreted the updated instructions and were inappropriately attempting to apply multiple penalty assessment for single infractions. Upon discovery, IRS took immediate action to ensure the guidelines were being applied appropriately. We believe these efforts have sufficiently resolved the previous training issues.

Taxpayer Advocate Service Comments

The IRS should make it easier for employers to report wage and tax data and reconcile discrepancies. The National Taxpayer Advocate commends the IRS for its efforts to eliminate the backlog of inventory, reduce overage cases, and drive down penalty assessment and subsequent abatement rates. These are important steps to improving the efficiency of the CAWR program.

The IRS suggests that the increase in CAWR-related TAS casework was a one-time event attributable to the download of unplanned inventory by campus operations. The National Taxpayer Advocate does not agree with the IRS's perception that the rise in CAWR cases was due to a one-time event. An analysis of TAS case issues and feedback from taxpayers and practitioners suggests other factors contributed to the increase in TAS casework. As noted above, TAS case receipts involving CAWR issues went up 264 percent between

44 IRM 4.19.4.11, IRS-CAWR/SSA-CAWR – CSR Information.

45 IRM 4.19.4.

FY 2005 and FY 2008. During this period, TAS case advocates, employers, and practitioners complained about delays in case processing and repeated requests for documentation. In March 2008, SB/SE identified the lack of adequate clerical procedures and inventory management controls as reasons for the backlog.[46] TAS analysis of recent CAWR cases identifies the administration of penalties imposed under IRC § 6721(a) and (e) as a common issue. In our view, the problems with the CAWR program cannot be attributed solely to a one-time event.

The IRS noted that it worked one-on-one with reporting agents affected by the backlog to expedite the handling of their clients' cases. We commend the IRS for conducting this outreach, but what about the employers who were not represented by reporting agents? When significant delays occur in case processing, the IRS must communicate with all affected taxpayers – represented or otherwise.

The IRS states penalty abatements fell to 18.05 percent in FY 2008. We note that this figure refers to the percentage of assessments abated; the percentage of dollars abated in FY 2008 was still over 50 percent (50.38 percent).[47] We further note that both assessments and dollars abated will almost certainly increase over time. For example, the FY 2008 number for assessments abated was 10.7 percent and the percent of dollars abated was 17.8 percent as of March 2008.[48] By September 2008, the number of cases with penalty abatements had risen 7.35 percent while dollars abated increased 32.58 percent.

The IRS expressed concerns about the accuracy of the volume of TAS case receipts and the percentage of increases noted above, pointing to a review of 25 TAS cases that found 32 percent (eight cases) were unrelated to CAWR or FUTA. TAS provided the IRS with this sample of 25 cases for the TAS-IRS CAWR and FUTA Rework Study. The purpose of this small sample was to help TAS and the IRS develop a data capture instrument for the study. Further review of the eight cases shows the cases did involve a CAWR, FUTA, or civil penalty issue in at least one tax period. Most of these cases involved multiple tax periods and multiple issues.

The National Taxpayer Advocate commends the IRS on its efforts to improve the clarity and the content of CAWR notices and letters. However, the IRS can and must do more to communicate clearly about the CAWR program and the applicable penalties. The notices should include information that will help employers understand how to reply and provide documentation to resolve discrepancies.

46 To remedy this problem, SB/SE created an IRM for clerical operations and program control guide. *See* IRM 4.19.22 (Apr. 2, 2008); FY 2008 CAWR Control Directions.

47 *See* Table 1.20.3, Analysis of Assessment and Abatement of IRC § 6721(e), *supra.*

48 IRS ERIS, *IRC § 6721 Penalty Data on Intentional Disregard Penalty* (Mar. 31, 2008).

Recommendations

The National Taxpayer Advocate recommends the IRS take the following actions to improve the CAWR program:

1. Redesign CAWR notices and letters to include specific information about the wage reporting discrepancy to enable employers to respond more quickly, or provide employers with more time to respond.
2. Include a toll-free telephone number for the CAWR unit on notices and letters so employers can contact a live IRS employee.
3. Provide regular refresher training for employees on when it is appropriate to assess CAWR penalties, incorporating examples culled from inventory showing when it is and is not appropriate to impose the penalty.

Status Update: The IRS's Private Debt Collection Initiative is Failing in Most Respects

Responsible Official

Chris Wagner, Commissioner, Small Business/Self-Employed Division

Definition of Problem

In congressional testimony this past year, the National Taxpayer Advocate reiterated her call for repeal of the IRS's authority to use private collection agencies (PCAs) to collect delinquent taxes, citing numerous deficiencies and concerns with the initiative.[1] Most of the deficiencies still exist and several new concerns have arisen:

- Data analysis shows that PCAs are less efficient than the IRS at resolving taxpayers' cases;
- Taxpayers would be better served if the IRS Collection function intervened quickly – before liabilities balloon because of accumulating interest charges to the point where more taxpayers cannot afford to pay them – rather than sending cases to PCAs, where cases seem to languish;
- After working with the PCAs for several years, the IRS has not identified any "best practices" from the agencies that it finds worthy of adoption; and
- Long-term risks to taxpayer rights and taxpayer privacy remain.

Because PCAs do not have the authority to determine or negotiate the amount of a taxpayer's liabilities, the only cases PCAs can resolve are those in which there is no dispute about the liability amount. Cases that fit the criteria for PCA referral are quite limited. Thus, while the IRS collected *$2.7 trillion* in fiscal year (FY) 2007 overall,[2] the IRS has been devoting significant time, energy, and dollars toward maintaining a program that brought in only *$37 million* on a gross basis (before subtracting the operating costs of the program, the commissions of up to 25 percent paid to the PCAs, and indirect payments) in FY 2008.[3] Taking into account the opportunity costs of spending appropriated funds on the private debt collection (PDC) program instead of spending those funds on more productive IRS Collection activities, the PDC program is probably causing a net reduction in federal revenue, which obviously defeats the purpose of the program. IRS data now show that the IRS's Collection function outperforms the PCAs in almost every way.

1 *Internal Revenue Service FY 2009 Budget Request: Hearing Before the Senate Subcomm. on Financial Services and General Government Committee on Appropriations*, 110th Cong. (Apr. 16, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

2 IRS, *FY 2007 Data Book*, Table 1.

3 IRS, *Filing and Payment Compliance Advisory Council* (Oct. 20, 2008).

Analysis of Problem

Background

Since the inception of the PDC program in 2002, the National Taxpayer Advocate has expressed concerns about the initiative and has identified it as a serious problem in her last three Annual Reports to Congress.[4] In these reports and in prior testimony, the National Taxpayer Advocate raised questions about cost effectiveness, transparency, inventory issues, training, privacy, and taxpayer rights.[5] The IRS has attempted to address several of these issues by including TAS in the development of training materials and posting the PCA Policy and Procedures Guide on IRS.gov.[6] However, despite the IRS's best efforts to make the initiative a success, its own Collection function can resolve taxpayer cases more efficiently and can better protect taxpayer rights.

The IRS Collection Function Is More Efficient at Resolving Taxpayer Cases.

Data analysis now shows that the IRS Collection function performs much better than the PCAs. The Automated Collection System (ACS), which is responsible for locating taxpayers by correspondence and phone and attempting to collect unpaid tax liabilities, is similar to the PCAs in design and purpose. TAS used data from the IRS's Cost Effectiveness Study, which has not yet been finalized and is still under IRS review, and compared PCA inventory to ACS cases that are very similar to cases worked by the PCAs, such as those involving relatively low dollar amounts or those in which the taxpayer cannot be contacted.[7] The results were striking: ACS performed substantially better, collecting *three times* as much as the PCAs (*i.e.*, ACS collected 13 percent of the balance due while PCAs collected four percent of the balance due).[8]

Moreover, ACS performed better at working "PCA-like" inventory than at working its so-called "next best case" inventory.[9] Totally apart from the PDC program, this finding could and probably should have a dramatic impact on the way the IRS prioritizes its collection cases. The IRS has repeatedly stated that if given additional funding for collection activities, it would not choose to work the types of cases it assigns to the PCAs. Instead, the IRS

4 See National Taxpayer Advocate 2007 Annual Report to Congress 411; National Taxpayer Advocate 2006 Annual Report to Congress 34; National Taxpayer Advocate 2005 Annual Report to Congress 76. For a discussion of the National Taxpayer Advocate's initial position on the Private Debt Collection initiative, see *IRS Use of Private Debt Collection Agencies by the IRS: Hearing Before the Subcomm. on Oversight of the H. Comm. Ways and Means*, 108th Cong. (May 23, 2003) (statement of Nina E. Olson, National Taxpayer Advocate).

5 See National Taxpayer Advocate 2007 Annual Report to Congress 411; National Taxpayer Advocate 2006 Annual Report to Congress 34; National Taxpayer Advocate 2005 Annual Report to Congress 76; *Internal Revenue Service Operations and FY 2009 Budget: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 110th Cong. (Mar. 13, 2008) (statement of Nina E. Olson, National Taxpayer Advocate), and *Internal Revenue Service FY 2009 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations*, 110th Cong. (Apr. 16, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

6 IRS, *Private Collection Agency (PCA) Policy and Procedures Guide, at* http://www.irs.gov/pub/irs-pdf/p4708.pdf (July 1, 2008).

7 IRS response to TAS research request (Nov. 10, 2008). ACS worked cases similar to the types handled by PCAs, which are: shelved, low priority, or unable to locate or contact delinquency cases with balances due less than $100,000.

8 IRS response to TAS research request (Dec. 19, 2008).

9 The next best cases are cases that the IRS has prioritized and usually involve high dollar balances due of less than $100,000 for the Wage and Investment (W&I) Division and less than $100,000 for the Small Business/Self-Employed (SB/SE) Division.

has maintained it has a large category of cases that it currently lacks the resources to work, but that it believes would generate a higher return on investment than the cases being assigned to the PCAs. In general, the IRS has used the dollar amount of the balance due as a primary factor when prioritizing cases. However, data suggests the IRS business rules for determining the "next best cases" are far off the mark. While ACS collected 13 percent of the balance due when working "PCA-like" inventory, it brought in just two percent of the balance due for Wage and Investment (W&I) Division inventory and four percent for Small Business/Self-Employed (SB/SE) Division inventory when working what the IRS has heretofore considered its "next best case" inventory.[10] This finding suggests that waiting until liabilities become large is not only bad for taxpayers but bad for revenue collection as well. It suggests that working the current inventory, even where the liabilities involve lower dollar amounts, may be more productive than waiting until interest charges accrue to the point where it is more difficult for the taxpayer to satisfy the tax debt.[11]

IRS Early Intervention Is More Beneficial to Taxpayers than Having Their Cases Sit in the PCAs' Inventory.

As the above statistics illustrate, the IRS is very successful when it takes action on smaller liabilities, which also enables the taxpayer to resolve his or her liability before penalties and interest accumulate. Having the IRS work these cases upfront, rather than waiting for the penalties and interest to balloon high enough for the IRS to deem them a priority, is better for the taxpayer and is consistent with the IRS's Strategic Plan.[12] The National Taxpayer Advocate believes that prioritizing cases according to the greatest balance due amount, rather than intervening early, harms taxpayers and impacts voluntary compliance. Therefore, we believe the IRS should rethink this approach to prioritizing cases as a first step toward meeting the goals established in its Strategic Plan to "expedite and improve issue resolution" and to deliver "improved service to make voluntary compliance easier."[13]

While the IRS resolved PCA-like cases efficiently in the cost effectiveness test, the PCAs are permitting cases to linger unresolved. Of the 181,210 modules placed with the PCAs through March 2008, only 36,000 (about 20 percent) have been resolved. This suggests that over 145,000 modules have remained unresolved in PCA inventory for at least six months, in addition to another 107,000 modules assigned during the last half of FY 2008.[14] Since 62 percent of collections typically occur within the first six months, the most lucra-

10 IRS response to TAS research request (Dec. 19, 2008). In addition to collecting a higher percentage of the balance due on the "PCA-like" inventory, ACS also collected over eight times as many actual dollars from the "PCA-like" inventory than from W&I or SB/SE next best case inventory.

11 *See* National Taxpayer Advocate 2006 Annual Report to Congress 68-69. As noted in the 2006 report, IRS data provides ample evidence to suggest the IRS may not be working its optimal inventory, and collecting newer, lower dollar inventory is more effective than working older, higher dollar inventory.

12 IRS, *Strategic Plan 2009-2013: Overview.*

13 *Id.*

14 PCA inventory at the end of FY 2007 = 107,544 + 73,666 PCA receipts through March FY 2008 = 181,210 cases available for PCAs to work through March FY 2008. FY 2008 dispositions include 25,808 full pay cases, 6,547 installment agreements (IAs), 1,800 cases reported as currently not collectible, and 1,630 closed because the taxpayer was deceased or in bankruptcy for total FY 2008 dispositions of 35,785 or 19.7 percent (35,785 / 181,210) of FY 2008 cases assigned to the PCAs for at least six months. IRS, *Private Debt Monthly Snapshot* (Oct. 4, 2007); IRS, *Filing and Payment Compliance Modernization Briefing Private Debt Collection* (Apr. 14, 2008), IRS, *Filing and Payment Compliance Advisory Council* (Oct. 20, 2008).

tive time for collection has passed.[15] With more than 62 percent of PCA revenue collected within the first six months of placement, it appears unnecessary and risky to leave personal tax information with the PCAs for much longer than six months while the agencies take little productive action on their cases. The PCAs have held many cases in inventory for well over a year and they are just now being recalled.

Instead of putting these cases back into its pile of low priority cases, the IRS should evaluate what type of cases are coming back from the PCAs to prevent similar cases from going to the agencies in the first place and sitting in inventory. In our view, the IRS should work these cases itself once this analysis has been completed. Once the IRS selects a case for collection action, IRS Collection policy has generally been to work the case to completion. If the IRS did not work cases to completion, more taxpayers would choose to ignore IRS Collection attempts, hoping that the IRS would eventually give up. The impression that collection cases will be worked to completion will be undermined if the IRS assigns a case to a PCA and then shelves the case if the PCA is unsuccessful in collecting the debt, potentially contributing to a perception that ignoring tax collection may be a successful strategy.

After Working with PCAs for Several Years, the IRS Cannot Identify Any Best Practices to Adopt from the PCAs.

One of the theoretical benefits of contracting with private industry was that the IRS could learn techniques to improve its own efficiency and efficacy. However, in attempting to identify best practices based on the PCAs' work, the IRS PDC Program Office found that "the IRS is a high performing organization using many of the same practices used in private industry," and has not yet been able to adopt any practices.[16] To the contrary, the IRS identified areas needing improvement in the PCAs' collection practices, such as the agencies' contacting and authentication rate.[17] It is significant that the IRS has turned out to be more efficient at resolving taxpayers' cases than the PCAs and is now assisting the PCAs on improving their collection practices.

Long-Term Risks to Taxpayer Rights and Taxpayer Privacy

The National Taxpayer Advocate recognizes that the IRS has established and enforced safeguards that have protected against significant violations of taxpayer rights and taxpayer privacy.[18] However, we remain concerned that the use of PCAs poses long-term risks in these areas, and even the strictest safeguards will only mitigate the inherent risks of this initiative. While the mission of the federal government is to serve its citizens, the mission of private companies like PCAs is to maximize profits. The PCAs' compensation is heavily tied to the amount of debt they collect, which may lead some collection agencies to take shortcuts or violate the rights or privacy of the debtors whose accounts they are trying to

15 Data based on cases assigned since PDC program inception through cycle 200739, meaning each module was assigned to the PCAs for at least one year.

16 IRS, *Filing and Payment Compliance Advisory Council* (Sept. 26, 2007); IRS response to TAS research request (Nov. 10, 2008).

17 IRS, *Filing and Payment Compliance Advisory Council* (May 5, 2008).

18 IRS, *Tax Collection Services Statement of Work*, TIRNO-08-K-00164, 8, 10, 23, 24 (§ 1.13-15 and ¶J.3.2.1-5) (Mar. 8, 2008).

collect. Largely because of this incentive, the Federal Trade Commission reports that it receives more consumer complaints about PCAs each year than about any other industry.[19]

Additionally, PCA employees do not face the same consequences as IRS employees for violating taxpayer rights or privacy. An IRS employee who violates taxpayer rights or privacy may be subject to termination or another serious penalty. By contrast, the IRS does not require PCAs to take any action in such cases other than to remove the employee from work on IRS debts. For example, a PCA employee who violates the Taxpayer Bill of Rights, Taxpayer Bill of Rights 2, Fair Debt Collection Practices Act, Privacy Act, Disclosure statutes, or other applicable laws would only have to be taken off the IRS contract, not terminated like an IRS employee in the same circumstances.[20]

We want to emphasize that to the best of our knowledge, no significant violations of this nature have occurred and the IRS has implemented procedures to minimize the risks. But we also believe that the incentives are such that violations eventually are likely to occur if the program is continued for the long term and particularly if it is expanded.

Conclusion

The National Taxpayer Advocate remains concerned that there is an inherently greater risk to taxpayer rights and taxpayer privacy when tax collection is outsourced to private, for-profit businesses. Further, data shows that the IRS is far superior to the PCAs in resolving taxpayer cases.[21] Not only does the IRS outperform the PCAs in collecting revenue, but it also resolves more cases earlier, which benefits taxpayers by preventing interest and penalties from growing. Given the risk to taxpayer rights and the failure of the PDC initiative to produce revenue that exceeds expenses to date, the National Taxpayer Advocate continues to believe that the program should be discontinued.[22] Moreover, the analysis of the IRS-PDC Cost Effectiveness Study suggests that if the IRS redesigned its own method of selecting priority cases, it would collect greater revenue, earlier in the process, at less cost and burden to taxpayers.

19 Federal Trade Commission, *Annual Report 2008: Fair Debt Collection Practices Act* 12.

20 IRS, *Tax Collection Services Statement of Work*, TIRNO-08-K-00164, 8, 10, 23, 24 (§ 1.13-15 and ¶J.3.2.1-5) (Mar. 8, 2008). PCA employees are subject to a number of criminal and civil penalties if they make unauthorized disclosures. However, beyond these penalties the IRS itself has no authority to terminate employment, but only to remove that employee from the contract. This means the employee may still be employed with the PCA, where as IRS employees would be terminated in addition to civil and criminal penalties.

21 The PCAs disposed of 18 percent of their FY 2008 inventory by receiving full pay or establishing an installment agreement. Calculation based on PCA FY 2007 ending inventory, PCA receipts through March 2008 and PCA full pay and IA dispositions through all of FY 2008 (PDC Monthly Snapshot Reports for Sept. 2007, Mar. 2008, and Sept. 2008). ACS closed 41 percent of its FY 2008 inventory by full pay or the establishment of an IA. Calculation based on ACS FY 2007 IMF ending inventory, ACS IMF receipts through March 2008 and ACS IMF dispositions through all of FY 2008 (Collection Activity Report 5000-2 for Sept. 2007, Mar. 2008, and Sept. 2008).

22 IRS, Filing and Payment Compliance Advisory Council, 15 (May 1, 2007); e-mail from Director, PDC Program Office, to TAS Attorney Advisor (Feb. 29, 2008). The IRS incurred $71 million in start-up cost for the PDC initiative. Since that point, the initiative has incurred annual costs of about $7.65 million. This results in a total cost for the PDC initiative of $78 million. However, the initiative's projected cumulative for actual dollars collected is $73 million. This means the initiative's costs still exceed its revenue by $5 million. IRS, Filing and Payment Compliance Advisory Council (Nov. 17, 2008).

IRS Comments

Over the past year, the IRS and the National Taxpayer Advocate have collaborated on efforts to improve the PDC program, maintain a high level of work quality and performance, and enforce the safeguards established to protect taxpayer rights and taxpayer privacy. The IRS improved the transparency of PCA operations, added opt-out language to the IRS.gov web page for taxpayers who have had their accounts placed with the PCAs, and delivered refresher training to PCA employees. The IRS is committed to continuing to improve program performance, and we look forward to working with the National Taxpayer Advocate in addressing some of the key points outlined in her report.

The PDC program has been successful when measured against the goals established for it at inception. The program has generated revenue which would have gone uncollected in the absence of the program and allowed for the earlier resolution of taxpayer accounts than would have otherwise occurred. Specific accomplishments include:

- Coverage: Through October 25, 2008, the program has placed 178,460 taxpayer entities.[23]
- Dollars collected: $72.7 million in gross revenue has been collected.[24]
- High taxpayer satisfaction: Taxpayer satisfaction has averaged nearly 96 percent since program inception.[25]
- High quality: Regulatory, procedural, and customer accuracy metrics have averaged 99 percent since program inception.[26]

It is important to evaluate the PDC program in the context of its original design and purpose.[27] Given limited IRS collection resources, PCAs provide an alternative method for taxpayers with unpaid tax liabilities to resolve their tax obligations. Cases selected for PCA assignment are from inventories that IRS employees would not otherwise work. As the IRS stated in the National Taxpayer Advocate's 2007 Annual Report to Congress, "The issue is not whether the PCAs or IRS can do a better job collecting this revenue. The issue is whether the revenue collected by PCAs goes uncollected."[28] The two organizations are inherently different, and will never have identical processes, people, or technology.

The IRS agrees with the National Taxpayer Advocate that early intervention in delinquent taxpayer cases is beneficial for both the taxpayer and the IRS. The IRS currently makes

23 IRS, *Filing and Payment Compliance Modernization Briefing* 3 (Nov. 17, 2008).

24 *Id.* at 4.

25 *Id.* at 3.

26 *Id.* at 4.

27 The National Taxpayer Advocate used data in her report from an unfinished IRS Private Debt Collection Cost Effectiveness Study to compare PCA performance with the performance of IRS collection functions. Draft report findings have not been validated nor shared outside the PDC program. IRS leadership will review and approve the final report prior to its release.

28 National Taxpayer Advocate 2007 Annual Report to Congress 422.

several attempts through the notice process to resolve a taxpayer's delinquency prior to the case being assigned to the ACS, Field Collection, or a PCA.

The IRS concurs with the National Taxpayer Advocate position that cases being returned from the PCAs should be evaluated to help improve both IRS and program performance. The IRS has initiated a comprehensive plan to recall cases assigned to PCAs for more than 26 months in which no payments have been received within the past 60 days. Cases returned under the recall process will be analyzed to identify improvement opportunities for inventory selection and case processing procedures.

A potential benefit from the PDC program is the identification of best practices in use by private sector collection agencies which could be adopted by the IRS. Dissimilarities between IRS and PCA operations have made the identification of best practices more challenging. While we have not yet formally adopted PCA best practices within the IRS, we continue to investigate opportunities to apply lessons learned from the PDC program to IRS operations.

The IRS appreciates the National Taxpayer Advocate's acknowledgement that we have established and enforced safeguards for the PDC program that have protected taxpayer rights and taxpayer privacy. Protection of taxpayer rights and privacy has been an overriding consideration in program administration since its inception, and will continue to be so going forward. To date, there are no reported instances of taxpayer information being misused or protected taxpayer information being intentionally disclosed. The IRS will continue its aggressive oversight of the program to ensure the PCAs maintain the highest level of compliance with all statutory requirements.

The PDC program is just one component of the IRS' overall collection strategy. The program has reduced potentially collectible delinquent tax receivables by providing taxpayers with the opportunity to resolve their tax liabilities sooner. Aggressive oversight and effective management have ensured PCA adherence to contract.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate acknowledges the steps the IRS has taken to improve the PDC program and appreciates its collaboration with TAS throughout the program. Additionally, the National Taxpayer Advocate is encouraged to learn that the IRS will carefully analyze the cases it recalls from the PCAs. However, the National Taxpayer Advocate still holds numerous concerns about the protection of taxpayer rights and the overall success of the program. It makes little sense for the IRS to continue to devote significant time, energy, and dollars toward maintaining a program that brought in only *$37 million*

in FY 2008[29] and $72.7 million overall[30] on a gross basis (before subtracting the operating costs of the program, the commissions of up to 25 percent paid to the PCAs, and indirect payments), especially when these figures are compared to the $2.7 trillion the IRS collected in FY 2007.[31]

The IRS argues the PDC program has brought in revenue that would have gone uncollected and has resulted in earlier intervention in cases, but this is true only if the IRS did not take any action on these cases. The choice does not come down to either failing to work cases or hiring PCAs. In fact, the National Taxpayer Advocate has long suggested that PCA-type cases may be productive inventory for the IRS to work, and now there is data to support this claim.[32] For instance, the results of a study conducted by the IRS shows that ACS performed substantially better, collecting *three times* as much as the PCAs (collecting 13 percent of the balance due while PCAs collected four percent) when working "PCA-like" inventory.[33] The data demonstrates how superior the IRS is at resolving these cases and how keeping tax collection inside the IRS benefits the IRS and taxpayers alike. Not only did the study show the IRS's ability to resolve cases more efficiently than the PCAs, but it also demonstrated that ACS performed better at working "PCA-like" inventory than at working its so-called "next-best case" inventory. This finding was totally apart from the PDC program, but nonetheless, it should have a significant impact on the way the IRS prioritizes its collection cases.[34]

The National Taxpayer Advocate understands that the IRS attempts to resolve taxpayers' cases through its notice process, but once this process has run its course, cases are placed on a "shelf" until interest charges accrue to the point where it is more difficult for the taxpayer to satisfy the debt.[35] Now, instead of sitting on the IRS's shelf, it appears many of these cases are languishing in PCA inventory.[36] The IRS's own policy now permits cases to stay with PCAs for 26 months before being recalled. In light of the recent data cited in this report and the IRS's commitment to early intervention, it seems the IRS needs to reprioritize its case inventory, so it works these smaller cases up front, rather than waiting for the penalties and interest to mushroom enough for the IRS to deem them a priority.[37]

29 IRS, *Filing and Payment Compliance Advisory Council* (Oct. 20, 2008).

30 IRS, *Filing and Payment Compliance Advisory Council* (Nov. 17, 2008). This figure includes dollars for the first month of FY 2009.

31 IRS, *FY 2007 Data Book*, Table 1.

32 *See* National Taxpayer Advocate 2006 Annual Report to Congress 68-69.

33 IRS response to TAS research request (Nov. 10, 2008).

34 IRS response to TAS research request (Dec. 19, 2008). This data was collected by the IRS's own Cost Effectiveness Study, which has not yet been released.

35 *See* National Taxpayer Advocate 2006 Annual Report to Congress 68-69. As noted in the 2006 report, IRS data provides ample evidence to suggest the IRS may not be working its optimal inventory, and collecting newer, lower dollar inventory is more effective than working older, higher dollar inventory.

36 Of the 181,210 modules placed with the PCAs through March 2008, only 36,000 (about 20 percent) have been resolved. This suggests that over 145,000 modules have remained unresolved in PCA inventory for at least six months, in addition to another 107,000 modules assigned during the last half of FY 2008.

37 IRS, *Strategic Plan 2009-2013: Overview.*

In its response, the IRS states that the PDC program should be evaluated "in the context of its original design and purpose." Under that analysis, the program is a failure. It was originally projected to bring in between $1.5 and $2.2 billion over ten years,[38] and $46 million in FY 2007 and $88 million in FY 2008.[39] Instead, the program has raised only $32 million cumulative in FY 2007 and $37 million through FY 2008 in gross revenue (this is before subtracting the operating costs of the program, the commissions of up to 25 percent paid to the PCAs, and indirect payments collected through offsets).[40] The IRS no longer publishes these ten-year projections and has not yet revised these long-term projections. Moreover, although the original "design" stated that PCAs would only work "simple" cases that taxpayers either agreed to or made three or more voluntary payments toward, since FY 2007 IRS has considered (and is) referring more complicated cases to the PCAs as the inventory of "simple" cases proves nonexistent.[41]

Most disturbing, the IRS misses the fundamental lesson is should draw from this initiative: that the IRS needs to develop processes – beyond the important notice stream – for actively interviewing and contacting taxpayers early in the collection life cycle. The IRS's cost effectiveness study shows how successful the IRS can be when it approaches cases in this manner. It is true that the National Taxpayer Advocate elsewhere in this report identifies aspects of the IRS's collection program that need improvement.[42] Nevertheless, the cost effectiveness data, combined with the IRS's mission of helping taxpayers become compliant (as contrasted to the PCA mission of maximizing profits for its shareholders), makes the case that federal tax collection should remain in the hands of the federal employees charged to collect federal revenue.

38 IRS, *Filing and Payment Compliance Advisory Council* (May 1, 2007) at 14.

39 *Id.*

40 *Id.* at 2. The PDC program collected $32 million in gross revenue for FY 2007. *IRS, Filing and Payment Compliance Advisory Council* (Oct. 20, 2008) at 4. The PDC program collected $37 million in gross revenue for FY 2008.

41 IRS, *Filing and Payment Compliance Advisory Council* at 7 (Jan. 14, 2008). The taxpayers have not agreed to the additional tax assessed in these cases. It seems it would be more efficient for the IRS worked these cases itself, rather than sending them to the PCAs, since taxpayers have not agreed with the assessment and may dispute the addition to tax.

42 See Most Serious Problem, *The IRS Needs to Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulty, supra.*

Introduction

Section 7803(c)(2)(B)(ii)(VIII) of the Internal Revenue Code (IRC) 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 immediately following this Introduction summarizes congressional action on legislative recommendations the National Taxpayer Advocate proposed in her 2001 through 2007 Annual Reports to Congress.[1] The Office of the Taxpayer Advocate places a high priority on working with the tax-writing committees and other interested parties 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 hearings on the problems faced by taxpayers to ensure that a taxpayer perspective receives due congressional consideration. The following discussion details recent legislation incorporating the National Taxpayer Advocate's proposals.

On October 3, 2008, the President signed into law the Energy Improvement and Extension Act of 2008. The Act contains a significant proposal initially recommended by the National Taxpayer Advocate in her 2005 Annual Report to Congress. To assist taxpayers who sell stocks or mutual funds in correctly reporting gain or loss on their returns, the Act will require brokers to keep track of the investor's adjusted basis, to transfer adjusted basis information to a successor broker, and to report adjusted basis information to the taxpayer and the IRS (along with the amount of proceeds generated by the sale and whether the resulting gain or loss is long-term or short-term).[2] This provision will address the challenge facing taxpayers who hold stocks or mutual funds for many years and lose track of their original or adjusted basis. It will also enable to the IRS to identify situations in which taxpayers deliberately overstate their basis to reduce or avoid tax.

The legislation also addressed some of the National Taxpayer Advocate's short-term concerns regarding the expanding application of the Alternative Minimum Tax (AMT). Specifically, the bill increases the AMT exemption amounts and allows personal credits to be used against the AMT.[3] In addition, the legislation included relief for taxpayers facing outstanding AMT liabilities from exercising incentive stock options (ISOs). The National Taxpayer Advocate has previously urged Congress to pass legislation to repeal or limit the scope of the AMT.[4]

1 An electronic version of the chart is available on the Taxpayer Advocate Service website at http://www.irs.gov/advocate.

2 Pub. L. No. 110-343, § 403, 122 Stat. 3765, 3854-60 (2008); National Taxpayer Advocate 2005 Annual Report to Congress 433-41.

3 Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343, §§ 101-103, 122 Stat. 3861, 3863 (2008).

4 National Taxpayer Advocate 2004 Annual Report to Congress 383-85; National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate FY 2009 Objectives Report to Congress xxxiii-xxxix.

A number of legislative proposals made by the National Taxpayer Advocate in previous annual reports were included in H.R. 5716, the Taxpayer Bill of Rights Act of 2008, which was referred to the House Committee on Ways and Means in April 2008.[5] Specifically, H.R. 5716 included the following recommendations:

- **Taxpayer Bill of Rights.** Section 2 of the bill would require the Secretary of the Treasury to publish a summary statement of taxpayer rights and obligations. The National Taxpayer Advocate made a substantially similar proposal in her 2007 Annual Report.[6]
- **Grant Program for Return Preparation.** Based on a 2002 proposal of the National Taxpayer Advocate, § 3 of the bill would authorize the Secretary of the Treasury to make grants to provide matching funds for the development, expansion, or continuation of qualified return preparation clinics.[7]
- **Regulation of Return Preparers.** Section 4 of the bill would authorize the Secretary of the Treasury to promulgate regulations establishing a system to regulate compensated unenrolled return preparers. Preparers would be required to take an initial exam and renew eligibility every three years, at which point they would be required to demonstrate completion of continuing education requirements. This bill was modeled on a proposal initially recommended in the National Taxpayer Advocate's 2002 Annual Report to Congress.[8]
- **Increased Preparer Penalties.** Section 6 of the bill would increase preparer penalties in IRC § 6695 (a) through (c) from $50 to $1,000. The National Taxpayer Advocate recommended to raise these penalties as well as others.[9]

A separate bill, H.R. 5719, the Taxpayer Assistance and Simplification Act of 2008, passed the House and was referred to the Senate Committee on Finance.[10] The bill included the following recommendations of the National Taxpayer Advocate:

- **Home-Based Service Workers.** Section 5 of the bill is based on recommendations by the Taxpayer Advocate. In both the 2001 and 2007 Annual Reports, the National Taxpayer Advocate proposed that Congress clarify that home-based workers are employees rather than independent contractors.[11]

5 H.R. 5716, 110th Cong. (2008).

6 National Taxpayer Advocate 2007 Annual Report to Congress 478-89.

7 National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.

8 National Taxpayer Advocate 2002 Annual Report to Congress 216-30; *see also* National Taxpayer Advocate 2006 Annual Report to Congress 197-221; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

9 National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

10 H.R. 5719, 110th Cong. (2008).

11 National Taxpayer Advocate 2001 Annual Report to Congress 195-201; National Taxpayer Advocate 2007 Annual Report to Congress 556-57.

- **Referrals to Low Income Taxpayer Clinics (LITCs).** Section 6 of the bill is based on the National Taxpayer Advocate's 2007 recommendation to amend IRC § 7526(c) to permit IRS employees to refer taxpayers to specific LITCs.[12]
- **Return of Levy or Sale Proceeds.** Section 11 of the bill would extend the period of time within which a third party can request a return of levied funds or proceeds from the sale of levied property under IRC § 6343. It also would extend the time to return levied funds or sale proceeds. The National Taxpayer Advocate made a similar proposal in 2001.[13]
- **Reinstatement of Retirement Accounts.** Section 12 of the bill is based on a 2001 recommendation of the National Taxpayer Advocate.[14] The bill would amend the IRC to allow contributions to individual retirement accounts and other qualified plans from the funds returned to the taxpayer or third parties under IRC § 6343.
- **Private Debt Collection.** The National Taxpayer Advocate recommended in her 2006 Annual Report to Congress that Congress repeal the IRS's authority to enter into private debt collection (PDC) contracts.[15] Section 14 of H.R. 5719 would repeal that authority.

Finally, S. 2861, a bill introduced in the Senate and referred to the Committee on Finance, would prohibit any person from charging a fee for the electronic filing of federal tax returns. This provision is based on a recommendation made by the National Taxpayer Advocate in 2004.[16]

We continue to advocate for the proposals we have made previously. In this report, we present 17 Legislative Recommendations, the first ten of which are designed to simplify the tax laws.

Legislative Recommendations

Repeal the AMT for individuals. Few people think of having children or living in a high-tax state as a tax-avoidance maneuver, but under the unique logic of the AMT, that is essentially how those actions are treated. The AMT effectively requires taxpayers to compute their taxes twice – once under the regular rules and again under the AMT rules – and then to pay the higher of the two amounts. The regular tax rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing "double taxation" at the federal and state levels), but the AMT rules disallow those deductions. It is estimated that 77 percent of all additional income subject to tax under the AMT is attributable to the

12 National Taxpayer Advocate 2007 Annual Report to Congress 551-53.

13 National Taxpayer Advocate 2001 Annual Report to Congress 202-14.

14 *Id.*

15 National Taxpayer Advocate 2006 Annual Report to Congress 458-62.

16 National Taxpayer Advocate 2004 Annual Report to Congress 471-77; S. 2861, 110th Cong. (2008).

disallowance of deductions for dependents and state and local tax payments. The AMT computations are also extremely burdensome. The National Taxpayer Advocate recommends that Congress repeal the AMT for individuals in the context of fundamental tax reform.

Simplify the Family Status Provisions. Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004, the IRC family status provisions continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction. These provisions include filing status, personal and dependency exemptions, the child tax credit, the earned income tax credit, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b). Many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting audits into taxpayers' personal and private lives. The National Taxpayer Advocate recommends that, as part of a comprehensive reform of the tax treatment of families, Congress consolidate the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Worker Credit would provide an incentive and subsidy for low income individuals to work.

Simplify and Streamline Education Savings Tax Incentives. The IRC contains at least 11 separate incentives to encourage taxpayers to save for and spend on education. The eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. But taxpayers will only respond to incentives if they know they exist and understand them. Few if any taxpayers are both aware of each of the education tax incentives and familiar enough with the particulars to make wise choices. The National Taxpayer Advocate recommends that Congress consolidate existing incentives and harmonize definitions and other terms to the extent possible.

Simplify and Streamline Retirement Savings Tax Incentives. The IRC contains at least 16 separate incentives to encourage taxpayers to save for retirement. These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. As with education incentives, the large number of options and lack of common definitions and terms can preclude taxpayers from making wise choices or understanding how each incentive works. The National Taxpayer Advocate recommends that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.

Worker Classification. The complexity and ambiguities in the existing worker classification rules create uncertainty and lead to noncompliance. In general, businesses are only required to pay employment tax, withhold income tax, and provide benefits with respect to employees. As a consequence, businesses often classify workers as independent contractors to reduce their costs. Some employees seeking to avoid their tax obligations may also prefer to be classified as independent contractors if the employer does withhold taxes or report the payments to the IRS. Depending on the terms of the relationship between a business and a worker, however, many workers should be classified as independent contractors. The National Taxpayer Advocate recommends that Congress (1) replace Section 530 of the Revenue Act of 1978 with a provision applicable to both employment and income taxes and require the Secretary of the Treasury to issue associated guidance, including guidance with specific industry focus, (2) direct the IRS to develop an electronic tool to determinate worker classifications that employers would be entitled to use and rely upon, absent misrepresentation; (3) allow both employers and employees to request classification determinations and seek recourse in the United States Tax Court; and (4) direct the IRS to conduct public outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.

Simplify the Tax Treatment of Cancellation of Debt Income. Most financially distressed individuals who lose their homes to foreclosure or cannot pay off their car loans, credit card balances, student loans, or medical bills probably do not realize that their delinquency may increase their tax liabilities, but it often does. The IRC generally treats canceled debts as taxable income. Congress has carved out a number of exclusions, including a recently enacted exclusion to help homeowners whose mortgage debts are canceled when their houses are foreclosed upon and sold, but taxpayers do not receive the benefit of these exclusions automatically. Moreover, the rules are complex, and a taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to claim an exclusion. Very few taxpayers or preparers are familiar with this intricate form. The National Taxpayer Advocate is concerned that tens of thousands and possibly hundreds of thousands of taxpayers who qualify to exclude canceled debts from gross income may not be filing Form 982. Instead, some of these taxpayers unnecessarily include the amount of the canceled debt in gross income (based on their receipt of a Form 1099-C, *Cancellation of Debt*), and other taxpayers who fail to include it unnecessarily face IRS examinations and tax assessments. The National Taxpayer Advocate recommends that Congress enact one of several proposed alternatives to remove taxpayers with modest amounts of debt cancellation from the cancellation of debt income regime.

Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets. The IRC contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when there is significant uncertainty about whether Congress will extend a provision that is set to expire.

The complexity and uncertainty caused by sunsets makes it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicates tax administration for the IRS, reduces the effectiveness of tax incentives, and may even reduce tax compliance. The National Taxpayer Advocate recommends that Congress consider several options to reduce or eliminate the procedural incentives to enact temporary tax provisions.

Eliminate (or Simplify) Phase-Outs. More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer's income increases. Like tax sunsets, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. However, phase-outs are burdensome for taxpayers, reduce the effectiveness of tax incentives, and make it more difficult for taxpayers to estimate their tax liabilities and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance. Phase-outs also create marginal "rate bubbles" – income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer. Because Congress could achieve a similar distribution of the tax burden based on income level by adjusting marginal rates, phase-outs introduce unnecessary complexity to the Code. The National Taxpayer Advocate recommends repealing phase-outs or at least taking another look at phase-outs to ensure that they are really necessary to accomplish their intended objective.

Reforming the Penalty Regime. The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today. The last comprehensive reform of the IRC's penalty provisions was enacted in 1989, after careful study by Congress, the IRS, and others. Since then, legislative and administrative changes to the penalty regime have proceeded piecemeal, but without the kind of careful analysis conducted in 1989. The National Taxpayer Advocate's primary recommendation is that Congress direct the IRS to (1) collect and analyze more detailed penalty data on a regular basis and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. Congress should appropriate additional funds for this research, as necessary. In the meantime, based on penalty reform principles identified in 1989, the National Taxpayer Advocate recommends 11 common-sense reforms, which are described in *A Framework for Reforming the Penalty Regime* in volume 2 of this report.

Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact. Section 6707A of the IRC imposes a penalty of $100,000 per individual per year and $200,000 per entity per year for failure to make special disclosures of a "listed transaction." Enacted in 2004 to help combat tax shelters, this penalty is having an unconscionable and possibly unconstitutional impact on taxpayers who have done nothing wrong. The penalty *must* be imposed where a taxpayer fails to make the special disclosures – even if the taxpayer had no knowledge that the transaction was listed or even questionable, even if the taxpayer derived no tax savings from the transaction, and even if the transaction is not "listed" until years after the taxpayer entered into it and filed a return on which

the transaction was reflected. A taxpayer who does business through a wholly owned S corporation is subject to a penalty of $300,000 ($200,000 at the entity level and $100,000 at the individual level) for each year in which the transaction is reflected on a return. The requirement that this penalty be imposed without regard to culpability may have the effect of bankrupting middle class families who had no intention of entering into a tax shelter. The National Taxpayer Advocate recommends that Congress quickly amend Section 6707A so that the amount of the penalty bears a proportional relationship to the amount of any tax savings realized.

The Time Has Come to Regulate Federal Tax Return Preparers. Tax return preparers are an essential component of taxpayer rights and tax compliance. Despite the vital role return preparers play in effective tax administration, anyone can prepare a tax return for a fee — with no training, no licensing, and no oversight required. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities and are subject to censure, suspension, or disbarment from practice before the IRS in the event of wrongdoing. Yet there is virtually no federal oversight over "unenrolled" preparers, who constitute the majority of tax return preparers today. The National Taxpayer Advocate recommends that Congress enact a registration, examination, certification, and enforcement program for unenrolled tax return preparers. In addition, Congress should direct the Department of the Treasury and the IRS to conduct a public awareness campaign to inform the public about the registration requirements.

Refund Delivery Options. Particularly in light of the current downturn in the economy, federal tax refunds are an important source of funds for many individual taxpayers. As a result, the Department of the Treasury and the IRS need to provide all taxpayers with the ability to receive refunds as quickly as possible and at minimal cost. The National Taxpayer Advocate recommends that Congress direct the Department of the Treasury and the IRS to (1) minimize refund turnaround times; (2) implement a Revenue Protection Indicator; (3) develop a program to enable unbanked taxpayers to receive refunds on stored value cards (SVCs); and (4) conduct a public awareness campaign to disseminate accurate information about refund delivery options.

Crediting an Overpayment Against an Unassessed, Outstanding Tax Liability. In August of 2007, the IRS issued Revenue Ruling 2007-51, permitting the IRS to (1) reduce refunds pursuant to IRC § 6402(a) to satisfy unassessed tax liabilities or (2) credit a decrease in tax resulting in a carryback adjustment against an unassessed liability. Permitting the IRS to reduce a refund to satisfy an unassessed liability inappropriately allows collection prior to assessment. The examples described in the revenue ruling were limited to corporations, and the Office of Chief Counsel has advised Congress that it is only applying the ruling to corporations. However, Revenue Ruling 2007-51 undermines taxpayers' right under IRC § 6212 to challenge a proposed deficiency before assessment and payment of the tax. Absent compelling public policy, taxpayers, particularly low income taxpayers who rely on refunds to help pay for basic living expenses, should be protected from this type of

premature collection. If Congress shares the IRS's concern that large refunds or credits are being issued when corporations have significant unassessed liabilities, the National Taxpayer Advocate recommends that Congress carve out a specific exception in the Code for these circumstances.

Waiver of Levy Prohibition Under Internal Revenue Code Section 6331(k). IRC § 6331(k) generally provides that the IRS cannot levy on a taxpayer's assets while an offer in compromise (OIC) is pending or an installment agreement (IA) is pending or in effect. This prohibition does not apply, however, if the taxpayer files a written notice with the IRS waiving the levy restriction. The National Taxpayer Advocate has witnessed occasions when the IRS has attempted to require a waiver in exchange for agreeing to an IA. The IRS may make such a waiver a necessary condition to obtain an IA or OIC. To protect taxpayers from IRS overreaching, the National Taxpayer Advocate recommends that Congress amend IRC § 6331(k)(3)(A) to clarify that the IRS is prohibited from conditioning approval of an IA or OIC on the taxpayer's execution of a waiver of the levy prohibition.

Mailing Duplicate Notices to Credible Alternate Addresses. IRS notices often trigger the legal rights and obligations of taxpayers to take critical actions, such as contest a liability, challenge a notice of deficiency, or contest a lien filing, and most require the taxpayer to take the action within a specified number of days. The IRS mails these notices to the taxpayer's last known address. However, with a population that is mobile and transitory, the last known address contained in the IRS's Master File may not reflect the taxpayer's current residence. As a result, taxpayers who are between return filing seasons and have not updated their addresses with the IRS or the U.S. Postal Service may not receive critical notices from the IRS. The National Taxpayer Advocate recommends that Congress direct the Secretary of the Treasury to develop procedures for checking third party databases for credible alternate addresses prior to sending notices that establish legal rights and obligations and, when there is a credible alternate address, require the IRS to mail the notice simultaneously to the last known address and to the credible alternate address.

Health Insurance Deductions for Self-Employed Individuals. Many wage-earners participate in benefit plans that allow them to exclude the amount of their health insurance premiums from gross income, thereby avoiding Social Security and Medicare taxes. Unlike their wage-earning counterparts, self-employed individuals cannot deduct health insurance costs when determining net earnings for self-employment tax purposes. The National Taxpayer Advocate recommends that Congress repeal IRC § 162(l)(4) to place self-employed taxpayers on an equal footing with their wage-earning counterparts.

Mileage Deduction for Charitable Activities. IRC § 162(a) generally allows a trade or business to take a deduction for trade or business expenses associated with operating a passenger automobile. The IRS adjusts the standard mileage rate for business expenses annually, adjusting for inflation. Unlike the standard mileage deduction for business expenses, however, the deduction for charitable activities is specified in the IRC, which denies the

IRS the discretion to adjust the amount from year to year. The National Taxpayer Advocate recommends that Congress amend IRC § 170(i) to allow the Secretary of the Treasury to determine the standard mileage rate for charitable activities.

National Taxpayer Advocate Legislative Recommendations with Congressional Action

Alternative Minimum Tax (AMT)				
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 110th Congress	S 55	Baucus	1/4/2007	Referred to the Finance Committee
	S 14	Kyl	4/17/2007	Referred to the Finance Committee
	S 1040	Shelby	3/29/2007	Referred to the Finance Committee
	HR 1365	English	3/7/2007	Referred to the Ways & Means Committee
	HR 1942	Garrett	4/19/2007	Referred to the Ways & Means Committee
	HR 3970	Rangel	10/25/2007	Referred to the Ways & Means Committee
	S 2293	Lott	11/1/2007	Placed on Senate Legislative Calendar under General Orders. Calendar No. 464
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 AMT is not possible, it should be indexed for inflation.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	HR 1942	Garrett	4/19/2007	Referred to the Ways & Means Committee
Legislative Activity 109th Congress	HR 703	Garrett	2/9/2005	Referred to the Ways & Means Committee
	HR 4096	Reynolds	10/20/2005	12/7/2005–Passed House; 12/13/2005–Placed on Senate Legislative Calendar
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 AMT purposes.			

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	S 102	Kerry	1/4/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	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
Private Debt Collection (PDC)				
Repeal PDC Provisions National Taxpayer Advocate 2006 Annual Report to Congress 458-462.	Repeal IRC § 6306, thereby terminating the PDC initiative.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	S 335	Dorgan	1/18/2007	Referred to the Finance Committee
	HR 695	Van Hollen	1/24/2007	Referred to the Ways & Means Committee
	HR 3056	Rangel	7/17/2007	10/15/2007–Referred to Senate Committee
Tax Preparation and Low Income Taxpayer Clinics (LITC)				
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 LITC grant program. The program should be designed to avoid competition with VITA and should support the IRS's goal (and need) to have returns electronically filed.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	**Pub. L. No. 110-161, Div. D, Title I, 121 Stat. 1975, 1976 (2007).**			
	HR 5716	Becerra	4/8/2008	Referred to the Ways & Means Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
	S 1967	Clinton	8/2/2007	Referred to the Finance Committee
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 S. Rep. 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	5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	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	4/18/2002–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 check-box 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 110th Congress	HR 5716	Bercerra	4/8/2008	Referred to the Ways & Means Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
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	5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee

Referrals to LITCs

National Taxpayer Advocate 2007 Annual Report to Congress 551-553.

Amend IRC § 7526(c) to add a special rule stating that notwithstanding any other provision of law, IRS employees may refer taxpayers to LITCs receiving funding under this section. This change will allow IRS employees to refer a taxpayer to a specific clinic for assistance.

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance 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 110th Congress	HR 5716	Bercerra	4/8/2008	Referred to the Ways & Means Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
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 S. Rep. 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	5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	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 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 4318	Crowley/ Ramstad	12/6/2007	Referred to the Ways & Means Committee
	S 2851	Bunning	4/14/2008	Referred to the Finance Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
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	5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Taxpayer Bill of Rights National Taxpayer Advocate 2007 Annual Report to Congress 481-482, 486-489.	Enact a Taxpayer Bill of Rights setting forth the fundamental rights and obligations of U.S. taxpayers.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	HR 5716	Bercerra	4/8/2008	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 110th Congress	S 2239	Bingaman	10/25/2007	Referred to the Finance Committee
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.			
Legislative Activity 110th Congress	**Pub.L. No. 110-28, Title VIII, § 8215, 121 Stat. 193, 194 (2007).**			
Legislative Activity 109th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	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	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	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 2001 Annual 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	**Pub. L. No. 108-357, § 314, 118 Stat. 1468, 1469 (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.			
Legislative Activity 109th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	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.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	S 1773	Snowe	7/12/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	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.

Pub. L. No. 110-343, § 403, 121 Stat. 3854, 3855 (2008).

Legislative Activity 110th Congress

Bill Number	Sponsor	Date	Status
HR 878	Emanuel	2/7/2007	Referred to the Ways & Means Committee
S 601	Bayh	2/14/2007	Referred to the Finance Committee
S 1111	Wyden	4/16/2007	Referred to the Finance Committee
HR 2147	Emanuel	5/3/2007	Referred to the Ways & Means Committee
HR 3996 PCS	Rangel	10/30/2007	11/14/2007–Placed on Senate Calendar; became Pub. L. No. 110-166 (2007) without this provision

Legislative Activity 109th Congress

Bill Number	Sponsor	Date	Status
S 2414	Bayh	3/14/2006	Referred to the Finance Committee
HR 5176	Emanual	4/25/2006	Referred to the Ways & Means Committee
HR 5367	Emanual	5/11/2006	Referred to the Ways & Means Committee

IRS Promote Estimated Tax Payments Through the Electronic Federal Tax Payment System (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 1321RS	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 1321RS	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

Joint and Several Liability

Tax Court Review of Request for Equitable Innocent Spouse Relief

National Taxpayer Advocate 2001 Annual Report to Congress 128-165.

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.

Legislative Activity 109th Congress

Pub. L. No. 109-432, § 408, 120 Stat. 3061, 3062 (2006).

Collection Issues

Return of Levy or Sale Proceeds

National Taxpayer Advocate 2001 Annual Report to Congress 202-214.

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.

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 1677	Rangel	3/26/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1321 RS	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
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 3991	Houghton	3/19/2002	Defeated in House
	HR 586	Lewis	2/13/2001	4/18/02–Passed the House w/ an amendment–referred to Senate

Reinstatement of Retirement Accounts

National Taxpayer Advocate 2001 Annual Report to Congress 202-214.

Amend the following IRC 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, and SEP-Individual Retirement Account
- § 408A – Roth Individual Retirement Account

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 1677	Rangel	3/26/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1321RS	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
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated in H.R. 1528 an amendment and HR 1528 passed in lieu of S 882
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/2002–Passed the House w/ an amendment–referred to Senate
	HR 3991	Houghton	3/19/2002	Defeated in House

Consolidation of Appeals of Collection Due Process (CDP) Determinations

National Taxpayer Advocate 2004 Annual Report to Congress 451-470.

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.

Legislative Activity 109th Congress	**Pub. L. No. 109-280, § 855, 120 Stat. 1019 (2006).**			
Partial Payment Installment Agreements National Taxpayer Advocate 2001 Annual Report to Congress 210-214.	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.			
Legislative Activity 108th Congress	**Pub. L. No. 108-357, § 833, 118 Stat. 1589-1592 (2004).**			
Penalties and Interest				
Interest Rate and Failure to Pay Penalty National Taxpayer Advocate 2001 Annual Report to Congress 179-182.	Repeal the failure to pay penalty provisions of IRC § 6651 while revising IRC § 6621 to allow for a higher underpayment interest rate.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Interest Abatement on Erroneous Refunds National Taxpayer Advocate 2001 Annual Report to Congress 183-187.	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.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 109th Congress	HR 726	Sanchez	2/9/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
First Time Penalty Waiver National Taxpayer Advocate 2001 Annual Report to Congress 188-192.	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.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 3991	Houghton	3/19/2002	Defeated in House
Federal Tax Deposit (FTD) Avoidance Penalty National Taxpayer Advocate 2001 Annual Report to Congress 222.	Reduce the maximum FTD penalty rate from ten to two percent for taxpayers who make deposits on time but not in the manner prescribed in the IRC.			
	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 1321RS	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 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/2002–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: **Pub. L. No. 108-311, § 201, 118 Stat. 1169-1175 (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 1321RS	Santorum	6/28/2005	9/15/2006–Referred to 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

Free Electronic Filing For All Taxpayers

National Taxpayer Advocate 2004 Annual Report to Congress 471-477.

Revise IRC § 6011(f) to provide that the Secretary shall make electronic return preparation and electronic filing available without charge to all individual taxpayers.

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	S 2861	Schumer	4/15/2008	Referred to the Finance Committee

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 IRC, Local Taxpayer Advocates have the discretion to withhold from the IRS the fact that a taxpayer contacted the 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	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	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 2001 Annual 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	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated in HR 1528 an amendment and HR 1528 passed in lieu of S 882
	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: **Pub. L. No. 108-357, § 703, 118 Stat. 1546-1548 (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	7/21/2004–Passed House; 7/22/2004–Received in the Senate

Home-Based Service Workers (HBSW)

National Taxpayer Advocate 2001 Annual Report to Congress 193-201.

Amend IRC § 3121(d) to clarify that HBSWs are employees rather than independent contractors.

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
Legislative Activity 107th Congress	S 2129	Bingaman	4/15/2002	Referred to the Finance Committee

LR #1

Repeal the Alternative Minimum Tax for Individuals

Problem

The AMT Imposes Undue Burden on Taxpayers

The individual alternative minimum tax (AMT) is a parallel and complex tax structure that is imposed on top of the regular tax structure.[1] The AMT concept, originally enacted in response to a report that 155 high-income taxpayers had paid no tax for the 1966 tax year,[2] now effectively requires taxpayers to compute their taxes twice – once under the regular rules and again under the AMT regime. The taxpayer is then generally required to pay the higher of the two amounts.[3]

Few people think of having children or living in a high-tax state as a tax avoidance maneuver, but under the unique logic of the AMT, that is essentially how these actions are treated. While the AMT was originally conceived to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed. For tax year 2006, it is estimated that 77 percent of the additional income subject to tax under the AMT was attributable not to any such loopholes, but simply to family size or residing in a high-tax state.[4]

Those factors give rise to AMT tax liability because the regular tax rules allow taxpayers to claim a tax deduction for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing "double taxation" at the federal and state levels), but the AMT rules disallow those deductions. Common sense suggests that Congress did not, in fact, view the act of having children or living in a high-tax state as a significant tax-avoidance technique. To the chagrin of most observers, it has merely evolved that way.

1 The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony. *See* National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-85 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-77 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); *see also Alternative Minimum Tax: Hearing Before the Subcomm. On Select Revenue Measures of the House Comm. On Ways & Means* (Mar. 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *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* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

2 *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 forerunner of the AMT was an "add-on" minimum tax enacted in 1969.

3 The AMT rules are contained in IRC §§ 55-59.

4 *See* Tax Policy Center, Tax Facts: AMT Preference Items 2002, 2004-2006 (citing unpublished tabulations from the Office of Tax Analysis, Department of the Treasury), *available at* http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt_preference.pdf.

Yet government has become so dependent on AMT revenue that Congress to date has been unwilling to make permanent changes in law to curtail the AMT. It is estimated that the cost of repealing the AMT outright over the 2008-2018 period would be $966 billion if the tax cuts enacted under President Bush are extended and $1.944 trillion if the tax cuts enacted under President Bush are allowed to expire.[5] Another perspective: One projection shows that by 2009 it would cost more to repeal the AMT than it would cost to repeal the regular tax system and leave the AMT in place.[6]

The AMT is ensnaring an increasing 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 $177,000 today.[7] Instead, the exemption amount, after a temporary increase that will expire after 2008, is $45,000 for married taxpayers and $33,750 for most other taxpayers.[8] As a result, it is now projected that in 2010, just one year from now, 33 million individual taxpayers – or 35 percent of individual filers who pay income tax – will be subject to the AMT.[9] Among the categories of taxpayers hardest hit, 87 percent of married couples with adjusted gross incomes (AGI) between $75,000 and $100,000 with two or more children will owe AMT.[10] Significantly, a congressional decision to reduce tax rates by itself will do nothing to assist taxpayers with AMT liabilities, because any tax reduction provided under the regular tax rules will be offset by a corresponding increase in tax liability under the AMT regime.

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that the average AMT taxpayer will owe an *additional* $7,600 in tax in 2008.[11] In terms of complexity and time, taxpayers often must complete a 14-line worksheet,[12] read 12 pages of

5 *See* Tax Policy Center, *Aggregate AMT Projections, 2008-2018*, Table T08-0248 (Nov. 4, 2008), *available at* http://www.taxpolicycenter.org/numbers/Content/PDF/T08-0248.pdf.

6 *Id.*

7 Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Dec. 12, 2008). 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 more than sextupled since 1966, so the kinds of taxpayers who caught Congress' attention at that time would be making over $1.3 million today. *See* Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Dec. 12, 2008). Yet the AMT today is not primarily affecting taxpayers with incomes over $1.3 million. By 2010, it has been estimated that 80 percent of all taxpayers affected by the AMT will have incomes under $200,000 – and 31 percent will have incomes under $100,000. *See* Tax Policy Center, *Distribution of AMT and Regular Income Tax by Cash Income, Current Law*, Table T08-0252 (Nov. 4, 2008), *available at* http://www.taxpolicycenter.org/numbers/Content/PDF/T08-0252.pdf.

8 IRC § 55(d).

9 Tax Policy Center, *Aggregate AMT Projections, 2008-2018*, Table T08-0248 (Nov. 4, 2008), *available at* http://www.taxpolicycenter.org/numbers/Content/PDF/T08-0248.pdf. This projection is based on current law. Most observers believe that Congress, at a minimum, will pass another "patch" that limits the growth in the AMT by increasing the AMT exemption amounts.

10 *Id.*

11 *Id.*

12 IRS Form 1040 Instructions, at 39 (2008).

instructions,[13] and complete a 55-line form[14] 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.[15]

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 subjects these taxpayers to penalties.

Thus, while the concept of a minimum tax is not unreasonable, the AMT as currently structured has evolved into something that was never intended: The AMT hits taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it primarily penalizes taxpayers for such nontax-driven behavior as having children or choosing to live in a state that happens to impose high taxes; it takes large numbers of taxpayers by surprise – and subjects them to penalties to boot; it imposes onerous compliance burdens; it alters the distribution of the tax burden that exists under the regular tax system; it changes the tax incentives built into that system; and it neutralizes the effects of changes to tax rates imposed under the regular tax rules.

How the AMT Is Computed

After a taxpayer computes his tax liability under the regular tax rules, he must re-compute it under the AMT rules. The taxpayer generally pays the higher of the tax computed under the regular tax rules and the tax computed under the AMT rules.

More specifically, a taxpayer must take the following eight steps to determine his AMT liability, if any:

1. ***The taxpayer must calculate his regular tax liability.*** The regular income tax rules provide preferred treatment for certain types of income and allow taxpayers to claim certain exemptions, deductions, exclusions, and credits.
2. ***The taxpayer must determine whether he is subject to additional tax under the AMT regime.*** The IRS provides a 14-line worksheet (*Worksheet To See if You Should Fill in Form 6251 – Line 45*)[16] to help taxpayers determine whether they may be subject to the AMT. If the worksheet indicates that a taxpayer is potentially subject to the AMT, the taxpayer must complete Form 6251, *Alternative Minimum Tax – Individuals*, which

13 IRS Form 6251 Instructions (2008).

14 IRS Form 6251, *Alternative Minimum Tax – Individuals* (2008).

15 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

16 IRS Form 1040 Instructions, at 39 (2008).

contains 55 lines. Many taxpayers are required to complete Form 6251 – only to find that they do not have an AMT liability.

3. ***The taxpayer must compute his alternative minimum taxable income (AMTI) on Form 6251.*** This computation generally requires the taxpayer to give up the benefit of tax preference items to which he is entitled under the regular tax rules (*e.g.*, personal exemptions, the standard deduction and itemized deductions for state and local taxes, employee business expenses, and legal fees).[17]
4. ***The taxpayer must determine an "exemption amount" to which he is entitled based on filing status.*** In 2008, the AMT exemption amounts were $69,950 for married taxpayers filing jointly and $46,200 for singles.[18] The exemption amounts are phased out for married taxpayers with AMTI exceeding $150,000 and non-married taxpayers with AMTI exceeding $112,500.[19]
5. ***The taxpayer must compute his "taxable excess."*** The taxable excess is computed by subtracting the exemption amount from AMTI.
6. ***A taxpayer with a positive taxable excess must compute his "tentative minimum tax."*** A taxable excess of $175,000 or less is taxed at a flat 26 percent rate, and any additional taxable excess is taxed at a flat 28 percent rate (excluding the effects of the phase-out described in step 4 above). The sum of the two amounts, minus the AMT foreign tax credit, is the tentative minimum tax.[20]
7. ***The taxpayer must compute his "alternative minimum tax" or "AMT."*** The AMT is equal to the excess of the taxpayer's tentative minimum tax, if any, over his regular tax liability (reduced by any tax from Form 4972, *Tax on Lump Sum Distributions*, and any foreign tax credit from Form 1040). If the net result is a negative number or zero, the taxpayer does not owe AMT.
8. ***If the taxpayer owes AMT, he computes his total tax liability by adding his regular tax liability and his AMT liability.***[21]

17 Required adjustments listed on Form 6251 include adjustments for medical and dental expenses, state and local taxes, certain non-allowable home mortgage interest, miscellaneous itemized deductions, tax refunds, investment interest, depletion, certain net operating losses, interest from specified private activity bonds, qualified small business stock, the exercise of incentive stock options, estates and trusts, electing large partnerships, property dispositions, depreciation on certain assets, passive activities, loss limitations, circulation costs, long-term contracts, mining costs, research and experimental costs, income from pre-1987 installment sales, intangible drilling costs, certain other adjustments and alternative tax net operating loss deductions. *See* IRC §§ 56 and 57; IRS Form 6251, *Alternative Minimum Tax – Individuals*, Part I.

18 IRC § 55(d). In the absence of an AMT "patch" for 2009, the exemption amounts will revert to their 1993 levels – $45,000 for married taxpayers filing jointly and $33,750 for singles. *Id.* Where married taxpayers file separate returns, the exemption amount for each spouse is 50 percent of the exemption amount allowed for married taxpayers filing joint returns (*i.e.*, $22,500 per spouse under permanent law and $34,975 per spouse under the AMT patch in effect for 2008).

19 IRC § 55(d)(3). Although the maximum stated AMT tax rate is 28 percent, a taxpayer's marginal AMT tax rate may reach 35 percent due to the phase-out of the AMT exemption amount. For a detailed discussion of the tax administration concerns that phase-outs raise, see Legislative Recommendation: *Eliminate (or Simplify) Phase-Outs, infra*.

20 IRC § 55(b)(1)(A). The AMT rate threshold is not indexed for inflation.

21 In many cases, the taxpayer's final tax liability is the greater of his regular tax liability or his tentative minimum tax liability. But because the Code requires adjustments for credits and other taxes, steps 7 and 8 are required to ensure that taxpayers with these tax items obtain the correct result.

Then the taxpayer applies any applicable tax credits. Except for years in which Congress has enacted an AMT "patch," often retroactively, a taxpayer can use nonrefundable tax credits to offset regular tax liability, but not to offset the AMT.[22]

A taxpayer's AMT liability may generate an AMT credit that generally can be used in future years to offset his regular tax liability if, and to the extent that, his regular tax liability exceeds his tentative minimum tax.[23] However, a taxpayer who owes AMT generates an AMT credit only to the extent that the AMT is attributable to "deferral" items and not to "exclusion" items.[24] Deferral items are tax benefits that are allowed under both the regular and AMT systems but are accounted for in different tax years under the two systems. For example, both the regular and AMT rules allow deductions for depreciation, but the AMT in some instances requires taxpayers to depreciate property over a longer period of time. By contrast, exclusion items are tax benefits allowed under the regular tax system but permanently disallowed under the AMT (*e.g.*, the standard deduction, personal exemptions, and certain itemized deductions). Thus, many individual taxpayers who pay AMT do not receive AMT credits.

Examples

Example 1: AMT Penalty for Having Children

Mr. and Mrs. Brady live in California in a rented home with their six children, ages 5-16. They filed a joint return and claimed the $10,700 standard deduction in 2007. Mr. Brady, an architect, made $73,160. Mrs. Brady worked part-time as a teacher and earned $28,000. The Bradys owed $2,709 in taxes under the regular tax system, but their tax bill rose to $3,077 with the AMT because the tax benefits of the personal exemptions for their children were phased out under the AMT.

Example 2: AMT Marriage Penalty

Assume the same facts as in the prior example except that Mr. and Mrs. Brady did not marry. If each used the "Head of Household" filing status and claimed three of the children, the AMT would not have applied to either of them and their combined tax bill would have been lower. Mrs. Brady would have paid no tax and received $4,397 in refundable credits (*i.e.*, a $2,055 earned income tax credit and a $2,342 child tax credit (CTC)), and Mr. Brady would have paid tax of $5,106. Their combined tax liability would have been $709 (*i.e.*, $5,106 minus $4,397) – or $2,368 less than if they were married. Part of the difference in

22 Nonrefundable business credits such as the alternative motor vehicle credit or the alternative fuel vehicle refueling credit are generally not allowed against the AMT. *See, e.g.*, IRC § 30(b)(3); IRC § 30(b)(g)(2)(B). In the absence of an extension of the AMT patch, as noted above, nonrefundable personal credits such as the dependent care credit or the credit for the elderly and disabled also cannot be applied to reduce the AMT. IRC § 26(a).

23 In general, an AMT credit may be used in the future only when the taxpayer's regular tax liability, reduced by other nonrefundable credits, exceeds the taxpayer's tentative minimum tax for the year. IRC § 53. In certain circumstances, however, AMT credits that cannot be used for a substantial period of time may qualify as refundable credits which the taxpayer may use even in years in which he is subject to AMT liability. IRC § 53(e).

24 IRC § 53(d)(1)(B)(ii).

tax in these two examples is attributable to a "marriage penalty," but a significant portion is caused by the AMT.

Example 3: AMT Penalty for High State and Local Taxes

A married couple filed a joint return claiming two dependent children for 2007. The taxpayers had an AGI of $190,000 and paid state income and property taxes totaling $28,000. In an attempt to comply with the estimated tax payment requirements, the taxpayers had 90 percent of their regular tax liability withheld from their paychecks. When the taxpayers prepared their return, they discovered they had an additional liability of $4,042 due to the AMT, and because of the additional liability, they also owed a $184 penalty for failure to pay estimated tax.

Example 4: AMT Penalty Due to Combination of Having Children and Using "Married Filing Separately" Filing Status

A mother of five earned $57,500 in 2007. She is seeking a legal separation from her husband and lived apart from him during the final months of the year. Thus, she claimed "married filing separately" filing status. Because she was entitled to claim the children as her dependents and to claim the CTC, she had no tax liability under the regular tax rules and therefore had no tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of $1,488 due to the AMT. Because of the AMT tax liability, she also owed a penalty of $68 for failure to pay estimated tax.

Recommendation

The National Taxpayer Advocate recommends that Congress repeal the provisions of the Internal Revenue Code that pertain to the AMT for individuals in the context of fundamental tax reform.[25]

The obvious challenge in repealing the AMT (or even permanently indexing the AMT exemption amounts) is that the AMT's increasing revenue stream has been built into revenue estimates, so if the AMT is repealed, either Congress will have to raise tax receipts in other ways or budget deficits will balloon. To provide taxpayers with partial short-term relief from the AMT, Congress has enacted a series of "patches" since 2001 that have temporarily increased the AMT exemption amounts to prevent the AMT from affecting a larger number of taxpayers.[26]

25 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.

26 *See* Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, § 701, 115 Stat. 38 (2001); Job Creation and Worker Assistance Act, Pub. L. No. 107-147, § 601, 116 Stat. 21 (2002); Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27, § 106(a)(1), 117 Stat. 752 (2003); Working Families Tax Relief Act, Pub. L. No. 108–311, § 103, 118 Stat. 1168 (2004); Tax Increase Prevention and Reconciliation Act, Pub. L. No. 109-222, § 301(a)(1), 120 Stat. 345 (2006); Tax Increase Prevention Act, Pub. L. No. 110-166, § 2, 121 Stat. 2461 (2007); Tax Extenders and Alternative Minimum Tax Relief Act, Pub. L. No. 110-343, § 102, 122 Stat. 3, 765 (2008). For additional discussion of problems associated with temporary tax provisions, see Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*, *infra.*

While short-term relief from the AMT is better than no relief at all, the use of annual patches is not a desirable long-term solution for several reasons. First, patches still leave large numbers of taxpayers potentially exposed to the AMT. Second, the absence of a permanent rule makes it more difficult for taxpayers to estimate their tax liabilities for the year and to save and pay estimated tax accordingly. This uncertainty increases the risk that taxpayers will not save enough to pay their full tax liabilities or will be subject to penalties for failure to pay sufficient estimated tax, thereby causing taxpayer frustration and loss of confidence in the fairness of the tax system. Third, the uncertainty imposes significant burdens on the IRS as the tax administrator. Each year, the IRS must program its computer systems with millions of lines of code to process tax returns. When Congress enacts annual patches, especially if it does so late in the year, the IRS must perform substantial reprogramming. In 2008, the late enactment of an AMT patch at the end of the prior year delayed the start of the filing season for 13.5 million taxpayers (which, in turn, delayed many refunds) and required the IRS to shelve or postpone other priority programming work.[27]

Because AMT revenue projections for future years are made on the basis of current law (*i.e.,* the low permanent AMT exemption amounts), the long-term costs of repealing the AMT outright increase substantially each year. For reasons discussed elsewhere in this report, the National Taxpayer Advocate urges Congress to pass fundamental tax simplification, and she recommends that Congress repeal the AMT in that context.[28]

27 *See* IRS Fact Sheet, *Highlights of 2007 Tax Changes: Law Raises AMT Exemption, Filers of Five Forms Must Wait Until Feb. 11*, FS-2008-1 (Jan. 2008). For a detailed discussion of the impact of late-year tax-law changes, see National Taxpayer Advocate 2007 Annual Report to Congress 3-12 (Most Serious Problem: *The Impact of Late-Year Tax-Law Changes on Taxpayers*).

28 *See* Most Serious Problem: *The Complexity of the Tax Code, supra.*

LR #2

Simplify the Family Status Provisions

Problem

A taxpayer's "family status" is central to the way the taxpayer is taxed in relation to at least six of the most basic provisions in the Internal Revenue Code (IRC):

- Filing status (*i.e.*, single, married filing jointly, married filing separately, and head of household);[1]
- Personal and dependency exemptions;[2]
- Child Tax Credit (CTC);[3]
- Earned Income Tax Credit (EITC);[4]
- Child and Dependent Care Credit (CDCC);[5] and
- Separated spouse rules.[6]

Each of these provisions affects the amount of tax a taxpayer pays or the amount of refund he or she receives. These provisions, directly or indirectly, confer tax benefits on taxpayers if they meet certain eligibility requirements, and at least one of these six provisions impacts every individual income tax return in the United States.

Prior to 2005, each of these provisions defined "child" in a different manner. In 2001, the National Taxpayer Advocate recommended that Congress adopt a uniform definition of a child for purposes of the Code, in order to eliminate some of the confusion and inconsistencies generated by these numerous definitions.[7] Congress adopted a Uniform Definition of a Child (UDOC) in the Working Families Tax Relief Act of 2004, effective for tax years

1 IRC §§ 1 and 2.

2 IRC §§ 151 and 152.

3 IRC § 24.

4 IRC § 32.

5 IRC §§ 21 and 129.

6 IRC § 7703.

7 National Taxpayer Advocate 2001 Annual Report to Congress 82-100. UDOC was supported by the Bush Administration, the Joint Committee on Taxation, and many tax professional groups (including the American Bar Association, the American Institute of Certified Public Accountants, and Tax Executives Institute). *See, e.g.*, Department of the Treasury, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002); 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); Tax Executives Institute, *Letter Regarding Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002); and American Bar Association Section of Taxation, *Letter Regarding Pending Tax Legislation* (June 30, 2004).

beginning after December 31, 2004.[8] The new definitions of "qualifying child" and "qualifying relative" apply to the EITC, CTC, CDCC, dependency exemption, and head of household filing status. For most taxpayers today, determining whether a child qualifies as a "child" for purposes of the Code's family status provisions involves an inquiry into whether the child has the appropriate relationship to the taxpayer, has the same principal place of abode as the taxpayer for more than half the year, and is the appropriate age.

Notwithstanding the improvements brought about by the enactment of UDOC, the tax code's family status provisions continue to ensnare taxpayers and make tax administration difficult because of the number of provisions and their structural interaction.[9] Moreover, many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting audits into taxpayers' personal and private lives. And despite the IRS's best efforts, some of the provisions – especially those involving refundable credits such as the EITC – offer opportunities for some to attempt to defraud the federal government and its taxpayers.

In 2002, the IRS and the Department of the Treasury established a joint task force to identify ways to improve administration of the EITC, including minimizing fraud and inadvertent errors and reducing taxpayer compliance burdens.[10] Among other things, the task force recommended that the IRS explore requiring certain taxpayers to precertify their eligibility for the EITC. As a consequence, the IRS conducted several research studies involving representative samples of the EITC population to test different methods of verifying eligibility and to enhance its understanding of the EITC taxpayer base.[11] As a result of the research conducted for the task force as well as separate EITC certification studies, we learned that the IRS is able to systemically verify the relationship between the taxpayer and child in 80 percent of the tax returns claiming EITC.[12] We have also learned that where the IRS cannot systemically verify the claim, taxpayers may not be opposed to providing documentation in advance of filing.[13] In addition, the IRS has sought out and tested government databases that could enhance its ability to verify a taxpayer's eligibility systemically, without the need to contact (or audit) the taxpayer.

8 Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004). Congress made further revisions to the uniform definition of a child in Pub. L. No. 109-135, § 404(a), 119 Stat. 2577, 2632 (2005), and Pub. L. No. 110-351, § 501, 122 Stat. 3949, 3979 (2008).

9 For a discussion of some of these lingering complexities, see National Taxpayer Advocate 2006 Annual Report to Congress 463–69, and American Bar Association Section of Taxation, *Report Regarding the Uniform Definition of Qualifying Child* 8-9 (July 24, 2006).

10 Department of Treasury Press Release, PO-1059, *Treasury, IRS Announce Task Force On Improving The Administration Of The Earned Income Tax Credit*, Feb. 28, 2002.

11 IRS Earned Income Tax Credit (EITC) Initiative, *Final Report to Congress* (Oct. 2005).

12 For example, the 2002 joint Treasury-IRS EITC Task Force found that the IRS was able to systemically verify relationships between taxpayer and child in 80 percent of the tax returns claiming EITC. Moreover, the IRS was able to be reasonably confident, based on its own and other studies, that where the child was claimed by the mother or on a married-filing-jointly return, the child actually did reside with the claimant for more than one-half the year. This population accounted for 80 percent of EITC tax returns.

13 About 72 percent of the test group and about 63 percent of the control group of taxpayers believed that they should show that they meet the EITC requirements before they receive the EITC. IRS, *Earned Income Tax Credit Initiative* (Jan. 2007). IRS Earned Income Tax Credit (EITC) Initiative, *Final Report to Congress* (Oct. 2005).

The easiest and least burdensome provisions – from both the taxpayers' and the IRS's perspectives – are those with eligibility requirements that can be validated systemically by reference to a reliable data source. Today, with respect to the family status provisions, the IRS can relatively easily verify:

- The existence and age of the person associated with a Social Security number (SSN);
- The mother and often the father of the person associated with a SSN;
- The consistency of current year return data with prior year returns (including filing status); and
- The earnings and other income of the taxpayer as reported by a third party (including on Form W-2, *Wage and Tax Statement*, and other information returns).

Moreover, by utilizing data from other government agency programs where eligibility is often verified before granting benefits (*e.g.*, Medicaid and food stamps), the IRS can be reasonably confident that where the child was claimed by the mother or on a married-filing-jointly return, the child actually did reside with the claimant for more than half the year. As noted, this population accounts for about 80 percent of EITC tax returns.[14] Thus, the IRS can now systemically verify (or identify a reasonable proxy for) the relationship, age, income, and even residence of a taxpayer's family unit. The National Taxpayer Advocate recommends that Congress utilize these factors as the building blocks for reform of the Code's complicated family status provisions.

Between 2004 and 2005, the National Taxpayer Advocate also conducted a review of the approach to taxation of the family unit taken in other countries, including the United Kingdom, Canada, Australia, and New Zealand. This research led the National Taxpayer Advocate to recommend in her 2005 Annual Report to Congress that Congress restructure the Code's family status provisions to better reflect the living situations of families today, incorporate greater flexibility into their design, and improve horizontal and vertical equity as well as administrability.

We particularly have sought to identify and refine the rationale for so many family status provisions, which introduce enormous complexity for taxpayers – particularly for low income taxpayers who are more likely to have difficulty in understanding and applying these rules – and increase the risk of fraud and the burden on the IRS in administering these multiple provisions. In essence, we concluded that all of these tax benefits, at their core, provide reductions in tax for two purposes. One purpose is to give taxpayers tax relief that reflects the costs of maintaining a household and raising a family (*i.e.*, filing status, dependency exemption, CTC, the portion of the EITC that varies based on the number of qualifying children, and CDCC). The second purpose is to provide tax relief and a subsidy as an incentive for low income individuals to work (*i.e.*, the portion of the EITC that does

14 Department of Treasury Press Release, PO-1059, *Treasury, IRS Announce Task Force On Improving The Administration Of The Earned Income Tax Credit*, Feb. 28, 2002.

not vary based on the number of qualifying children). In light of this analysis, we have focused on consolidating the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. Revenue estimators could compute the total amount of tax expenditures associated with each of the existing family status provisions and Congress could then reallocate the same dollar amount (or a different dollar amount if it chooses) between the Family Credit and the Worker Credit, as more fully described below.

Since 2005, the National Taxpayer Advocate has continued to study this issue and engage in discussions with U.S. and international tax professionals, economists, academics, and tax administrators. We have revised our 2005 recommendations to reflect some of the concerns raised in these discussions. While the 2004 Uniform Definition of a Child increased consistency, as the example below demonstrates, problems remain. There are still inconsistent tests among the family status provisions, particularly with respect to "qualifying relatives." Our current proposals build upon UDOC and take one more step toward consistency by eliminating head of household filing status and rolling all family status provisions into one credit, subject to UDOC.

Example

Taxpayer, an employed adult, provides a home and support for her 12-year-old cousin for the entire year. To claim the child as a "qualifying" child, Taxpayer must show (1) that the child has the requisite relationship to Taxpayer, (2) that the child had the same principal place of abode for more than half of the year, (3) that the child meets the age requirements, and (4) that the child did not provide more than half of his or her own support. Although Taxpayer is the only *individual* providing support for her cousin, Taxpayer receives food stamps and housing assistance from federal and state agencies for the benefit of the child in excess of half of the child's support. Therefore, although the child meets the relationship, age, and residency requirements, Taxpayer cannot claim the child as a dependent on her tax return, and is ineligible for the Child Tax Credit and the Child and Dependent Care Credit, because the federal benefits received by Taxpayer are deemed to be contributed by the child for his or her own support. Since the amounts of federal and state assistance to the household exceed half of the cost of maintaining the home, Taxpayer also cannot claim head of household filing status. Moreover, Taxpayer has been estranged from her spouse for over ten years, but does not qualify as "not married" under IRC 7703(b) because (1) she cannot claim the child as a dependent and (2) she cannot show that she provides over one-half of the cost of maintaining the household. Thus, Taxpayer must file as "married filing separately" and is ineligible for the EITC.

Recommendations

The National Taxpayer Advocate makes the following recommendations:

1. Consolidate the numerous family status provisions into two. One provision (the Family Credit) would reflect the costs of maintaining a household and raising a family. It would incorporate all current family status provisions that are based on the specific make-up of the family unit and its corresponding ability to pay taxes. The second provision (which could be called the "Worker Credit" or could continue to be called the EITC) would provide an incentive and subsidy for low income individuals to work.[15]
2. The refundable Family Credit, which would replace the personal and dependency exemptions, Child Tax Credit, Head of Household filing status, and the family-size differential of the EITC, would be available to all taxpayers regardless of income.[16] The Family Credit would consist of two components – one would apply to each taxpayer and a second aspect would be available to any taxpayer who claims a "qualifying child" under IRC § 152(c) or a "qualifying relative" under IRC § 152(d).[17] There would be no cap on the number of qualifying children the taxpayer could claim.
3. 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 any other taxpayer for any taxable year in the calendar year in which such taxable year begins."
4. Amend IRC § 152(f) to provide a definition of "support" that excludes any means-tested federal, state, or local benefits paid on behalf of or for the qualifying child or qualifying relative.[18]

15 The President's Advisory Panel on Federal Tax Reform proposed replacing the standard deduction, personal exemptions, CTC, and head of household filing status with a family credit, and replacing the EITC and the refundable Child Tax Credit with a working credit. President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005). *See also* Adam Carasso, Jeffrey Rohaly & C. Eugene Steuerle, *A Unified Children's Tax Credit*, National Tax Association Proceedings (May 15, 2005); and Max B. Sawicky, Robert Cherry, & Robert Denk, *The Next Tax Reform: Advancing Benefits for Children*, Economic Policy Institute (2002).

16 The National Taxpayer Advocate has never seen the logic of denying an affluent or wealthy family the recognition that it takes a certain base amount of funds to raise a child. The recommendation to make the Family Credit a refundable tax credit (instead of an exemption or deduction) available to all taxpayers addresses vertical equity concerns. Moreover, provisions involving phase-outs unnecessarily complicate the Code and reduce transparency, which can increase noncompliance. *See* Legislative Recommendation, *Eliminate (or Simplify) Phase-outs, infra*; National Taxpayer Advocate 2006 Annual Report to Congress 470-82 (Key Legislative Recommendation, *Eliminate (or Simplify) Phase-outs*). *See also* Lawrence Zelenak, *Redesigning the Earned Income Tax Credit as a Family-Sized Adjustment to the Minimum Wage*, 57 Tax Law Rev. 301 (Spring 2004). To the extent that Congress believes high income families should pay more tax, it can achieve the same result more simply and transparently by adjusting marginal tax rates.

17 In the National Taxpayer Advocate's 2005 proposal, we suggested that the Family Credit be made available to the taxpayer who is the "main caregiver" of the child. The concept of a "main caregiver" was designed to introduce more flexibility into the family status provisions. While based on the current UDOC definition, the main caregiver would receive the credit so long as the child met age requirements and the main caregiver (a) had a primary relationship, (b) maintained the principal residence for the child, or (c) was the principal financial supporter of the child. As under current law, a tie-breaker rule would reconcile competing claims. *See* IRC § 152(c)(4). On reflection, we believe that the requisite flexibility can be achieved by maintaining a slightly revised version of UDOC, instead of introducing a new concept such as the "main caregiver." This approach provides continuity with current law and also will yield better compliance results. We note that many competing claims will disappear by enacting the "noncustodial parent" add-on credit and eliminating the child-related EITC differential, described in Recommendations (6) and (7) herein.

18 IRC § 152(c)(1)(D) requires that a qualifying child must not provide more than one-half of his or her own support. IRC § 152(d)(1)(C) requires the taxpayer who is claiming a qualifying relative must provide more than one-half of the support of that relative.

5. Once family status is determined under the rules of the Family Credit, the taxpayer could qualify for certain add-on credits. For example, if the child qualified as a qualifying child of the taxpayer, the taxpayer could receive an add-on for child care. Congress also could enact an add-on credit for disabled taxpayers or dependents or for taxpayers who provide primary care for members of their extended families inside or outside of their homes. As under current law, add-on credits may have supplemental eligibility requirements geared to the specific purpose of the credit, but the foundational eligibility requirements should be the same – those for the Family Credit.[19] This approach guards against inconsistencies and "complexity creep."
6. Enact a refundable "add-on" credit for noncustodial parents of qualifying children who pay substantially all child support legally due for that tax year.[20] This add-on would recognize that noncustodial parents who pay child support have a reduced ability to pay federal income tax and would improve compliance by reducing unnecessary tax disputes arising from dueling tax claims by the custodial and noncustodial parent.[21] Moreover, the credit may eliminate the need to retain the complex special rules (and the resulting disputes) for divorced or separated parents regarding waiving the dependency exemption under IRC § 152(e).
7. Replace the current EITC with a modified EITC that is a refundable credit based solely on a taxpayer's individual earned income and available to low income wage earners, age 18 or older, who are not qualified children or qualified relatives of another taxpayer.[22] The objective is to eliminate the variation in EITC amounts based on the number of qualifying children the taxpayer claims, if any, since tax relief based on family size would be reflected in the Family Credit discussed above. The adjusted gross income limitation of IRC § 32(a)(2)(B) and the investment income rule of IRC § 32(i) would be retained, thereby ensuring the refundable credit would go to low income taxpayers who do not have significant investment or other income.

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19 Congress can enact these "add-on" credits as refundable credits, where appropriate. Where compelling public policy considerations require a narrow targeting of the add-on credits, Congress could adopt different age and even income requirements, since these variations are fairly easy for the IRS to systemically verify. However, in the interests of reducing complexity in the IRC, income phase-outs should be kept to a minimum. *See* Legislative Recommendation, *Eliminate (or Simplify) Phase-outs, infra*; National Taxpayer Advocate 2006 Annual Report to Congress 470-82 (Key Legislative Recommendation, *Eliminate (or Simplify) Phase-outs*).

20 President-elect Obama offered a similar proposal during the recent presidential campaign. *See Factsheet: Barack Obama's Comprehensive Tax Plan*, at 2, *at* http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf (last visited on Dec. 26, 2008) ("Obama will ... increase the benefits available to noncustodial parents who fulfill their child support obligations").

21 We recognize that this provision presents administrability challenges, since the IRS has not yet identified a comprehensive and reliable third party data source to systemically verify payment of child support. It is worth exploring whether the IRS could achieve a satisfactory level of compliance by verifying claims against the child support enforcement database and otherwise requiring an affidavit from the payee parent. The National Taxpayer Advocate also recognizes that this provision does not provide any relief to noncustodial parents who have significant visitation with their children and provide support pursuant to an informal agreement. She believes that the credit should be extended to this population too, but has yet to come up with a way to systemically verify these claims, except to suggest that taxpayers submit a copy of any divorce decree or separation agreement that sets forth custody arrangements showing significant visitation.

22 This recommendation is consistent with the "Making Work Pay" proposal that President-elect Obama made during the recent presidential campaign. *See Factsheet: Barack Obama's Comprehensive Tax Plan*, at 2, *at* http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf (last visited Dec. 26, 2008) ("For 95 percent of workers and their families – 150 million workers overall – the "Making Work Pay" credit will provide a refundable tax cut of $500 for workers or $1,000 for working families. This credit will benefit over 15 million self employed workers and for 10 million low income Americans, will completely eliminate their federal income taxes.").

8. Repeal the head of household filing status under IRC §§ 1(b) and 2(b). Allocate the tax savings provided by repeal to the Family Credit.
9. Amend IRC § 7703(b) to permit taxpayers who have a legally binding separation agreement and who live apart on the last day of the tax year to be considered "not married" for purposes of filing status.

LR #3

Simplify and Streamline Education Tax Incentives

Problem

In the 2004 Annual Report to Congress, the National Taxpayer Advocate recommended that Congress simplify the education provisions of the Internal Revenue Code (IRC).[1] The existing provisions are difficult to navigate and extremely complex.[2] Taxpayers face difficulties in merely understanding the eligibility requirements for these incentives, not to mention the burdens involved in calculating the tax incentives. Aside from the sheer number of education provisions, taxpayers face complexities and inconsistencies regarding:

- Student qualification standards;
- Types of eligible educational expenses;
- Income level requirements;
- Phase-out calculations;
- Inflationary or cost-of-living adjustments; and
- Expiration dates.[3]

The complexities involved in the education provisions of the Code impose a significant burden on taxpayers. Faced with too many complicated choices, taxpayers may not take full advantage of the benefits to which they are entitled. The complexity exposes taxpayers without skilled tax preparers to a higher risk of errors on their returns. Further, taxpayers who are planning for future education expenses, or simply trying to calculate their current quarterly estimated tax payments, face the daunting task of determining how the wide array of education incentives will affect their tax liabilities.

1 For a more detailed discussion of the applicable education provisions and recommendations for simplification, see National Taxpayer Advocate 2004 Annual Report to Congress 403-422.

2 Tax benefits for past educational expenses include the deduction for interest on education loans in IRC § 221 and an income exclusion for the cancellation of student loan debt in IRC § 108(f). Tax incentives for current expenses include the Hope and Lifetime Learning Credits in IRC § 25A, the above-the-line deduction for qualified tuition and related deductions in IRC § 222, the income exclusion for qualified scholarships in IRC § 117, and the income exclusion for employer education assistance programs in IRC § 127. Tax incentives for future education expenses include the exclusion of interest income from U.S. Savings Bonds used to pay education tuition and fees in IRC § 135, the income exclusion for early distributions to pay qualified higher education expenses from Roth IRAs in IRC § 408A, Qualified Tuition Programs in IRC § 529, and Coverdell Education Savings Accounts in IRC § 530.

3 For a complete discussion of the various education incentives, their inherent complexities, and recommended solutions to simplify the provisions, see National Taxpayer Advocate, *2004 Annual Report to Congress* 403-422; Joint Committee on Taxation, Present Law and Analysis Relating to Tax Benefits for Higher Education: Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on May 1, 2008, JCX-35-08 (April 29, 2008).

Example

During the 2008 tax year, a married couple contributed $10,000 to each of their two children's college-related expenses. Both spouses are college educated, work full-time, and have a total household adjusted gross income (AGI) of $100,000. They are adamant about not paying for tax return preparation and attempt to prepare their own 2008 joint return. To ascertain which tax credit or deduction is most beneficial, the couple must determine the eligibility requirements for each provision. To find out which incentives apply to their particular facts and circumstances, they navigate through the 80-page IRS Publication 970, *Tax Benefits for Education*. They learn the Hope Scholarship Credit (HSC) and Lifetime Learning Credit (LLC) of IRC § 25A will be partially phased out due to their income level.[4] However, their AGI does not exceed the phase-out threshold for the IRC § 222 Deduction for Qualified Tuition and Related Expenses.[5] In addition, the HSC is not available for expenses related to the oldest student because she is not in the first two years of school.[6] Once the couple determines which provisions apply, they must then calculate which ones produce the greatest tax benefit.[7] The couple fills out several worksheets in the IRS publication to compute each available incentive.

Recommendation

The National Taxpayer Advocate recommends that Congress simplify the education provisions in the IRC through the following measures:

- Consolidate the provisions to the extent possible and clearly state how the remaining incentives interact. For example, Congress should consolidate the Hope Scholarship and Lifetime Learning Credits and make clear whether taxpayers can take advantage of several incentives in the same tax year.[8]
- Provide consistent standards regarding student eligibility, such as the relationship of the student to the taxpayer, the age of the student, and the type of enrollment.
- Provide a uniform definition of "qualifying higher education expenses" and "eligible education institution."
- Provide consistent income-level thresholds, phase-out calculations, and inflationary adjustments, unless inconsistency is justified by compelling policy reasons.

4 The credits begin to phase out once the couple's modified adjusted gross income exceeds $80,000, as adjusted for inflation after 2001. IRC §§ 25A (d) and (h). In 2007, the AGI threshold equaled $94,000. IRS Pub 970, *Tax Benefits for Education* 2.

5 The deduction for qualified tuition and related expenses is fully available if their AGI does not exceed $130,000, without any provision for inflationary adjustments. IRC § 222(b)(2)(B).

6 IRC § 25A(b)(2)(C); IRS Pub 970, *Tax Benefits for Education* 12.

7 Both IRC § 25A credits and the IRC § 222 deduction cover only tuition and required enrollment fees.

8 Congress should consider, as part of the simplification, whether any consolidated provisions should be an above-the-line deduction, credit, or refundable credit. While an above-the-line deduction is available to all taxpayers, tax credits prove more beneficial the lower the income (based on marginal tax rates). However, many tax provisions hinge on the AGI amount. For example, taking a deduction as opposed to a credit can impact Earned Income Tax Credit (EITC) eligibility. IRC § 32.

- After initially using sunset provisions to test the education incentives and any associated simplification amendments, Congress should make all education incentives permanent.[9]

[9] For a discussion of previous recommendations to simplify the education provisions in the Code, see Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education: Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on May 1, 2008*, JCX-35-08 (April 29, 2008) 40-42.

LR #4

Simplify and Streamline Retirement Savings Tax Incentives

Problem

The Internal Revenue Code contains numerous tax incentives for participants of certain retirement accounts. More than a dozen different tax-advantaged[1] retirement planning vehicles are available to the workforce today.[2] While these arrangements have a singular goal of helping taxpayers save for retirement, they are subject to different sets of rules regulating eligibility, contribution limits, tax treatment of contributions and distributions, withdrawals, availability of loans, and portability. Retirement plan administrators and participants alike may find themselves at a loss in trying to sort through the unnecessarily complex and often conflicting provisions of the various types of plans.[3]

Example

Taxpayer A opened a Roth IRA account three years ago and has contributed the maximum each year. The taxpayer's current balance is $12,000. Taxpayer A currently works part-time for Employers B and C. Employer B is a for-profit company that maintains a 401(k) plan for its employees. The present value of Taxpayer A's 401(k) account is $60,000. Taxpayer A also participates in the 457(b) plan maintained by Employer C, a state agency. The present value of Taxpayer A's 457(b) plan is $18,000.

Taxpayer A is faced with a medical emergency that will require surgery and force him to miss six months of work. Because his health insurance will cover only 70 percent of his estimated $50,000 medical expenses, Taxpayer A will have out-of-pocket costs of $15,000 for his surgery. Moreover, Taxpayer A estimates he will need an additional $20,000 to cover living expenses for his family during the next six months, while he is on unpaid leave.

Taxpayer A recalls that some coworkers from Employer B could make "hardship" withdrawals from their retirement plans for occasions such as a home purchase. Taxpayer A would like to know whether he can make an early withdrawal or take a plan loan from his IRA or two employer-based plans to help pay his medical and living expenses for the

1 The term "tax-advantaged" includes the ability to defer the taxation of income by making an elective deferral, the tax-deferred growth of account assets, or the tax-free withdrawals available to plan participants.

2 We limit our discussion to retirement plans where plan participants make contributions to their account, including, but not limited to, traditional IRAs, nondeductible IRAs, nonworking spousal IRAs, Roth IRAs, rollover IRAs, SIMPLE IRAs, 401(k) and other defined contribution plans for private employers, Simplified Employee Pensions and SIMPLE 401(k) plans for small employers, 403(b) tax-sheltered annuity plans for 501(c)(3) organizations and public schools, and 457(b) deferred compensation plans for state and local governments. We exclude employer-funded defined benefit pension plans from our discussion.

3 For further discussion of the need for retirement plan simplification and a detailed recommendation, see National Taxpayer Advocate 2004 Annual Report to Congress 423-32.

next six months. After spending two weeks reading through plan documents and talking with friends, colleagues, and plan administrators, Taxpayer A comes to the following conclusions:

(1.) His Roth IRA plan does not allow for either plan loans or hardship withdrawals.

(2.) His 401(k) plan with Employer B allows plan loans up to 50 percent of account balance as well as hardship withdrawals of his elective deferrals in instances of "immediate and heavy financial need." Medical expenses, but not living expenses for the period he is unable to work, fall under the safe harbor definition of immediate and heavy financial need. Hardship distributions are included in taxable income, subject to the ten percent additional tax for early withdrawal.

(3.) His 457(b) plan with Employer C allows plan loans up to 50 percent of account balance and allows hardship withdrawals for "unforeseeable emergencies." Severe financial hardship resulting from an illness or accident is considered an instance of unforeseeable emergency. The ten percent additional tax does not apply to a hardship withdrawal from a 457(b) plan.

Recommendation

The National Taxpayer Advocate urges Congress to take a fresh look at the significant complexity of the retirement plan system. Congress should consolidate retirement plans where the differences in plan attributes are trivial. Such consolidation would reduce confusion and may lead to increased participation, or at least to fewer inadvertent errors. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one tailored for small businesses, and one suitable for large businesses (eliminating plans that are limited to governmental entities).

With or without consolidation of retirement plans, the National Taxpayer Advocate recommends that Congress establish uniform rules regarding hardship withdrawals, plan loans, and portability. Creating a uniform set of rules should (1) eliminate inadvertent errors, (2) enable greater portability among plans, and (3) increase participation by employers.

LR #5

Worker Classification

Problem

Misclassification of workers can have serious consequences for the workers, the recipients of the services they provide, and tax administration in general. Whether a worker is classified as an employee or independent contractor affects the application of labor laws as well as tax treatment for both the worker and the service recipient. Worker classification rules are complicated and confusing, in part because the rules are not the same for federal income taxes and employment taxes.

In addition to their complexity, existing worker classification rules do not serve the best interests of tax administration. Whether inadvertent or deliberate, the misclassification of employees as independent contractors has a significant revenue impact due to the difference in, and in many cases the absence of, information reporting and tax withholding requirements for independent contractors. Further, the IRS is prohibited from issuing guidance on worker classification for employment tax purposes despite its responsibility to enforce the associated laws.

Example

Worker provides services to Company A, which attempts to comply with the tax laws. Company A follows the lead of other businesses in the industry, which treat similar workers as independent contractors and file Forms 1099-MISC, *Miscellaneous Income*. After Worker has spent five years on the job, Company A is subjected to an IRS employment tax examination. The IRS reclassifies Worker as an employee and Company A decides not to petition the United States Tax Court to review the determination. Worker actually preferred independent contractor status because it allowed him to deduct work-related expenses, but has no standing to appeal the determination. In addition, Worker files a claim for refund of the excess Social Security and Medicare taxes paid (as Self-Employment Contributions Act taxes) during the period of misclassification, but the statute of limitations for refunds has expired for one of the five years of employment. Finally, when Worker is subsequently terminated in a cost-cutting measure, he learns he does not qualify as an employee for state unemployment benefits.

Recommendation

To reduce complexity and confusion, promote compliance, and improve tax administration, the National Taxpayer Advocate recommends that Congress take the following legislative actions:

- Require the Department of Treasury and the IRS to publish guidance on classification for both income and employment taxes.
- Direct the IRS to develop a program similar to the Employment Status Indicator of the United Kingdom.
- Repeal § 530 of the Revenue Act of 1978[1] and replace it with an Internal Revenue Code (IRC) provision providing a safe harbor applicable to both federal income and employment taxes, which allows the taxpayer to establish a reasonable basis for the classification. In making the classification determination, the IRS should be authorized to consider industry practices.
- Amend Internal Revenue Code (IRC) § 7436 to permit workers to petition the United States Tax Court to review the IRS's classification determinations.
- Require service recipients to issue Forms 1099-MISC to incorporated service providers and increase the penalties for failure to comply with the information reporting requirements of IRC § 6041A.
- Amend IRC § 3402(p)(3) to authorize the IRS to agree not to challenge the classification of workers who are party to a voluntary income tax withholding agreement.
- Amend IRC § 3406 to require backup withholding for substantially noncompliant Schedule C filers. Congress should also authorize the Secretary to exempt service recipients from back-up withholding responsibilities on payments to Schedule C filers who present valid Compliance Certificates.
- Direct Treasury and the Joint Committee on Taxation to report on the operation of the revised worker classification rules and provide recommendations to increase compliance.
- Require the IRS and the Department of Labor to conduct targeted public awareness campaigns to inform workers of the comparative rights afforded to employees and independent contractors, the tax consequences associated with each classification, and the opportunity to enter into voluntary income tax withholding agreements.

Present Law

Common Law Test

The worker classification determination is generally made under a facts and circumstances test. A common law test, developed over the years by courts identifying various factors of relevance, determines whether an employee-employer relationship exists for both income and employment tax purposes.

[1] Pub. L. No. 95-600, 92 Stat. 2763, 2885-86.

In Revenue Ruling 87-41,[2] the IRS developed a list of 20 factors, based on cases and rulings decided over the years, to determine whether an employer-employee relationship exists. Pursuant to Rev. Rul. 87-41, the degree of importance for each factor varies depending on the occupation and the context in which the services are performed.

In an effort to clarify the analysis of worker classification, the IRS in 1996 developed training materials focused on the concept of "right to control." These materials identified three categories of evidence in determining whether the requisite control exists under the common-law test:

1. Behavioral control;
2. Financial control; and
3. Relationship of the parties.

The training materials also noted:

- Factors in addition to the 20 factors may be relevant;
- Weight of the factors varies based on circumstances; and
- Relevant factors may change over time.[3]

The common law test is also incorporated into the Internal Revenue Code and Treasury Regulations. For example, IRC § 3121(d)(2) defines "employee" by referring to the common law test.[4] Similarly, Treas. Reg. § 31.3401(c) provides that:

> [g]enerally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

In addition, certain Code provisions prescribe treatment for a specific category of worker. For example, IRC § 3508 provides that certain real estate agents and direct sellers are treated as independent contractors for all tax purposes.

Employment Taxes

The common law test discussed above also applies for employment tax purposes. However, § 530 of the Revenue Act of 1978 was crafted to address the increased enforcement of

2 Rev. Rul. 87-41, 1987-1 C.B. 296.

3 IRS, *Independent Contractor or Employee? Training Materials*, Training 3320-102, TPDS 84238I, at 2-7 (Oct. 1996) available *at* http://www.irs.gov/pub/irs-utl/emporind.pdf.

4 In defining "employee" for purposes of Chapter 21 (FICA), § 3121(d)(2) includes as one of the four provisions "any individual who, under the common law rules applicable in determining the employer-employee relationship, has the status of employee."

employment tax laws in the late 1960s.[5] Controversies developed between the IRS and taxpayers regarding the classification of certain workers as self-employed rather than as employees. It is clear that the provision was intended to curb aggressive enforcement of classification issues by the IRS. In fact, the legislative history states that § 530 should be "construed liberally in favor of taxpayers."[6]

Section 530 provides a safe harbor rule allowing service recipients to treat workers as independent contractors, regardless of their actual status under the common law test, if there is reasonable basis for treating the worker as an independent contractor and certain other requirements are met. Pursuant to § 530, a reasonable basis for treating a worker as an independent contractor exists if the taxpayer reasonably relies on:

1. Past IRS audit practice with respect to the taxpayer;
2. Published rulings or judicial precedent; or
3. Longstanding recognized practice in the taxpayer's industry.[7]

If the taxpayer cannot satisfy one of the above three "safe harbors," it may still qualify for relief if it had any "other reasonable basis" for treating a worker as an independent contractor.

To receive § 530 relief, the taxpayer must also:

1. Report payments made to independent contractors on Forms 1099-MISC;
2. Not have treated the worker as an employee for any period; and
3. Not have treated any worker holding a substantially similar position as an employee for employment tax purposes (the "substantive consistency requirement").

The § 530 safe harbor, however, does not apply in whole or in part to certain professions. For example, the safe harbor is entirely inapplicable to a worker who, pursuant to an arrangement between the taxpayer and another person, provides services as an engineer,

5 Pub. L. No. 95-600, 92 Stat. 2763, 2885-86; Joint Committee on Taxation, *Description and Analysis of Proposals Relating to the Deduction for Health Insurance Expenses of Self-Employees Individuals, Worker Classification, Taxation of Home Office Expenses, and Electronic Filing Scheduled for Public Hearing Before the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance on June 5, 1997*, JCX-19-97 (June 4, 1997) (Text accompanying fn. 8).

6 H.R. Conf. Rep. 104-737, 104th Cong, 2d Sess. § 1122 (Aug. 1, 1996); Joint Committee on Taxation, *Description and Analysis of Proposals Relating to the Deduction for Health Insurance Expenses of Self-Employees Individuals, Worker Classification, Taxation of Home Office Expenses, and Electronic Filing Scheduled for Public Hearing Before the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance on June 5, 1997*, JCX-19-97 (June 4, 1997).

7 The term "longstanding" was clarified so as not to be construed as requiring the practice to continue for more than ten years. The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1112(a), 110 Stat. 1759.

designer, drafter, computer programmer, systems analyst, or similarly skilled worker engaged in a similar line of work.[8]

Finally, § 530 prohibits Treasury and the IRS from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes.[9] However, a taxpayer (a business or a worker) may obtain a written determination from the IRS on the status of a particular worker for purposes of employment taxes and income tax withholding.[10]

Right to Contest IRS's Determination

IRC § 7436 allows an employer that has been audited regarding employment taxes to petition the United States Tax Court to litigate the issue of whether a worker is an independent contractor or employee, or whether the employer is entitled to relief from any misclassification under § 530 of the Revenue Act of 1978. The collection of any underpayment of employment taxes is barred while the action is pending.[11] It is important to note that this provision does not authorize the *worker* to petition the Tax Court.

Information Reporting

IRC § 6041A requires service recipients who pay independent contractors $600 or more during the taxable year to file information returns with the IRS. The recipients must file Form 1099-MISC with the IRS and provide a copy to the contractor by January 31 of the following year. The penalty for failing to issue a required Form 1099-MISC is $50 per return.[12]

The information reporting requirements have several exceptions. For example, the dollar threshold is set higher at $5,000 for direct sales,[13] and there is an exemption from filing if the service provider (*i.e.*, worker) is incorporated.[14] However, the incorporation exemption does not apply if the service recipient is a federal executive agency, which is also subject to separate reporting requirements for contracts over $25,000.[15]

8 Section 530(d) of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978). Another example of the complexity is illustrated by the special rules applicable to test proctors and room supervisors. The similar worker consistency requirement does not apply to services performed after December 31, 2006 by test proctors or room supervisors assisting in the administration of college entrance or placement examinations. However, the exception only applies to proctors if the service recipient is a § 501(c) organization and the worker is not otherwise treated as an employee for employment tax purposes. Section 864, Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (Aug. 17, 2006).

9 Section 530(b) of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978).

10 Rev. Rul. 87-41; IRS Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*; Rev. Proc. 2007-3, 2007-1 I.R.B. 108.

11 Employers also have the option to pay some or all of those disputed taxes and proceed (after denial of their refund claims) to bring suit in their local U.S. district court or the United States Court of Federal Claims.

12 IRC § 6721(a).

13 IRC § 6041A(b).

14 Treas. Reg. § 1.6041-3(p)(1).

15 IRC §§ 6041A(d)(3)(A), 6050M; Treas. Reg. § 1.6050M-1(c)(1)(i); Rev. Rul. 2003-66, 2003-26 I.R.B. 1115, 2003-1 C.B. 1115 (June 30, 2003).

Voluntary Withholding Agreements

IRC § 3402(p)(3) authorizes the Secretary to promulgate regulations to provide for withholding from any type of payment that does not constitute wages if the Secretary finds withholding would be appropriate and the payor and recipient of the payment agree to such withholding. However, the provision specifically states that the Secretary must find the withholding would be appropriate "under the provisions of [IRC chapter 24, Collection of Taxes at the Source]." IRC chapter 24 deals with collection of taxes at the source with respect to employees (*e.g.*, wage withholding). Thus, it is unclear whether the IRC § 3402(p)(3) authorizes the Secretary to draft regulations addressing non-wage withholding arrangements.[16]

Reasons For Change

Revenue Impact of Misclassification

Income earned by independent contractors is not subject to withholding requirements. Research has shown that approximately 99 percent of income subject to withholding (*i.e.*, wages) is reported on tax returns.[17] When income is reported and taxes are withheld at the source, taxpayers have fewer opportunities to be noncompliant.[18]

The exact impact worker classification has on the tax gap is unclear.[19] However, in 1984, the IRS examined 3,331 employers and found:

- Nearly 15 percent misclassified employees as independent contractors;
- Section 530 protected nine percent of misclassified employees from reclassification;
- Nearly half of returns using § 530 safe harbor protections relied on the prior audit provision;
- When service recipients classified workers as employees, the employees reported more than 99 percent of income;
- Only 77 percent of gross income was reported when a Form 1099 was filed;
- Only 29 percent of gross income was reported when no Form 1099 was filed; and

16 For a more detailed discussion of the National Taxpayer Advocate's voluntary withholding agreement proposal and the legal impediments to achieve by regulation, *see* National Taxpayer Advocate 2005 Annual Report to Congress 392-394.

17 IRS Research, Individual Income Tax Underreporting Gap Estimates, Tax Year 2001 (Feb. 2007), available *at* http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf (last visited September 26, 2008) (The net misreporting percentage for wages and salaries is 1.2 percent for items subject to substantial information reporting and withholding).

18 *The Causes of and Solutions to the Federal Tax Gap: Hearing Before the Senate Comm. on the Budget* 3 (Feb. 15, 2006) (Written Statement of Nina E. Olson, National Taxpayer Advocate).

19 The IRS Tax Gap Map for Tax Year 2001 provides $54 billion in underreporting employment taxes out of an estimated $345 billion tax gap. It is unclear how much is attributable to worker misclassification. IRS Research, Tax Gap Map for Tax Year 2001 (in $ Billions) (Feb. 2007), available *at* http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf (last visited September 26, 2008).

- Projecting the findings to the general population would result in misclassification of 3.4 million workers as independent contractors with an estimated tax loss of $1.6 billion in 1984.[20]

Results from the IRS's Employment Tax Examination Program further illustrate the revenue impact of misclassifications. The IRS performed 11,380 audits from FY 1988 through FY 1994 to determine the employment status of personnel not classified as employees. The General Accounting Office (GAO, now the Government Accountability Office) studied the audits and found the IRS reclassified 483,000 workers and the audits led to proposed tax assessments of $751 million.[21]

Reasons for Misclassification

Inadvertent Misclassification due to Complexity

The rules surrounding classification are confusing. The 20-factor test to determine proper classification is complex, subjective, and does not always produce clear answers. The potential for errors and abuse is high in those gray areas where not all factors yield the same result, particularly because there are no weighting rules.

The National Federation of Independent Businesses (NFIB) has deemed worker classification as a top priority and is calling for a better definition of "independent contractor." According to the NFIB, the 20-factor test is an extremely tough challenge that handcuffs small businesses due to its vagueness and lack of clarity.[22]

In addition, the IRS's Small Business / Self-Employed Operating Division (SB/SE) conducted focus groups during the 2007 IRS Nationwide Tax Forums on the topic of employment tax compliance. The participants indicated the worker classification issue is very confusing because it involves numerous substantive tests that are different at the state and federal levels. They also felt that the worker classification determination by the IRS is arbitrary. To address the confusion surrounding these rules, the participants recommended a simple set of classification rules and an IRS publication with detailed examples.[23]

20 Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2009*, JCX-26-07 (May 7, 2007); United States Government Accountability Office, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-07-859T (May 8, 2008) (GAO adjusted the 1984 tax loss of $1.6 billion for inflation and estimated the tax loss to be $2.72 billion in 2006 dollars).

21 Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007); Government Accountability Office, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-07-859T (May 8, 2008).

22 National Federation of Independent Businesses, IRS *Rules Blur Lines Between Employees, Independent Contractors*, available at http://www.nfib.com/page/independentContractor?_templateId=315 (last visited on July 1, 2008).

23 SB/SE Research, 2007 Nationwide Tax Forums: Employment Tax Compliance – Are your Clients at Risk? NCH0088 (May 2008).

Deliberate Misclassification

Whether a worker is classified as an independent contractor produces significant tax consequences for both the worker and the service recipient. Some consequences favor employees while others favor independent contractors. Such consequences include:

- Income tax withholding requirements;[24]
- Employment tax requirements;
- Ability to exclude certain types of income or take deductions for certain types of expenses;[25] and
- Satisfaction of coverage requirements applicable to qualified retirement plans.[26]

The nontax consequences of worker classification may also drive the determination. Classifying workers as independent contractors excludes them from coverage under laws designed to protect them. Thus, it may be in the service recipient's interest to deliberately misclassify a worker as a contractor to avoid the burden associated with these protective laws. Such protections include the Fair Labor Standards Act (FSLA), which provides minimum wage, overtime pay, and child labor protections. Additional laws designed to protect employees include the Family Medical Leave Act, Occupational Safety and Health Act, and the National Labor Relations Act. Misclassified workers may also lose access to employer-provided benefits such as health insurance coverage and pensions.[27]

Section 530 Safe Harbor Rule Creates Confusion

The safe harbor rule of § 530 adds confusion to an already complicated set of classification rules. Apparently, § 530 was enacted "to alleviate what was perceived as an overly zealous pursuit and assessment of taxes and penalties against employers who had, in good faith, misclassified their employees as independent contractors."[28]

While § 530 was intended to reduce disputes between the IRS and taxpayers, interpretation of the provisions has become an additional source of disputes and confusion for the following reasons:

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24 Pursuant to IRC § 3402, every employer making payment of wages must deduct and withhold a tax on such wages pursuant to tables and computations prescribed in the Regulations. If the employer fails to deduct and withhold taxes, the employer is liable for penalties or additions to the applicable tax in case of a failure to deduct and withhold. The employer will not be relieved of his liability for payment of the tax required to be withheld unless he can show that the tax has been paid by the employee. IRC § 3402(d); Treas. Reg. § 31.3402(d)(-1; Treas. Reg. § 31.3403-1.

25 For example, an employee may exclude employer-provided benefits such as pension, health, and group-term life insurance. Independent contractors can establish pension plans and deduct contributions to the plan. Independent contractors can also deduct work-related expenses. For a more detailed discussion of the tax treatment of both classifications, *see* Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

26 IRC § 410(b).

27 *See* Government Accountability Office, Employee Misclassification: *Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-07-859T (May 8, 2007); Subcomm. on Income Security and Family Support, Comm. On Ways and Means, Advisory ISFS-6 (May 1, 2007).

28 *Boles Trucking, Inc. v. U.S.*, 77 F.3d 236, 239 (8th Cir. 1996).

- The provision is difficult to find because it is not part of the Internal Revenue Code;
- Certain provisions rely on facts and circumstances;
- The provisions only apply to the service recipients and not the worker; and
- The provisions apply to employment tax, which is statutorily defined to include income tax withholding.[29]

Further, judicial decisions have made clear that there is no *de minimis* exception to the substantive consistency requirement of § 530, which looks as far back as 1978.[30] Thus, a service recipient could disqualify from the safe harbor by treating one individual as an employee for one hour of service by reporting that hour on a Form W-2 twenty years ago.

Consequences of Reclassification by IRS

Whether misclassification is inadvertent or deliberate, significant tax consequences result if the IRS subsequently reclassifies the worker after an audit. For example, the service recipient may have a liability for employment taxes for a number of years,[31] interest, penalties, and potential disqualification of employee benefit plans. The worker may have to pay self-employment taxes and lose the ability to take certain business-related deductions. In addition, if the worker is classified as an employee, he or she may be barred from claiming a refund of self-employment taxes because the statutory period for claiming a refund expired while the IRS was dealing with the employer's classification issue. Further, the worker has no right to petition the classification determination to the Tax Court under IRC § 7436.

Lack of Published Guidance

Because the Revenue Act of 1978 prohibits Treasury and the IRS from publishing regulations and revenue rulings on worker classification for employment taxes, there is no current guidance. Given that overtime and general working conditions have changed significantly over the last three decades, such a prohibition is contrary to sound tax administration and likely increases the potential for both deliberate and inadvertent misclassification. Although the IRS has published training materials on this issue, they do not carry the force of law.

29 The Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, § 530(c)(1) (Nov. 6, 1978)("The term 'employment tax' means any tax imposed by subtitle C of the Internal Revenue Code of 1986.").

30 *See Institute for Resource Management, Inc. v. U.S.*, 90-2 U.S.T.C. Par. 50,586 (Cl. Ct. 1990).

31 Where an employer fails to deduct and withhold income taxes due to treating the worker as a nonemployee, the resulting liability may be determined under IRC § 3509. To the extent § 3509 applies, the employer's liability for income tax withholding is determined as if the amount required to be deducted and withheld was equal to 1.5 percent (three percent where the employer disregards certain reporting requirements) of the wages paid to the individual erroneously treated as a nonemployee. The employer is also liable for 20 percent of the social security taxes (40 percent if the employer disregards reporting requirements). Section 3509 does not apply where the employer intentionally disregarded the deduction and withholding requirements. IRC § 3509(c).

Recent Industry and Congressional Proposals

Congress and industry have made several proposals to address the worker misclassification problem. The Office of the Taxpayer Advocate reviewed these proposals, which are summarized below, and the legislative recommendation made herein incorporates what we deem to be the most effective and administrable provisions of the various proposals.

Increase Information Reporting Requirements

The Coalition to Preserve Independent Contractor Status supports the existing § 530 safe harbor. However, the organization has stated that a better approach to increase compliance is to redirect the focus away from worker classification, and instead enhance Form 1099 information reporting requirements for independent contractors. The rationale behind the proposal is the significantly higher rate of compliance among independent contractors subject to information reporting requirements.[32]

Check-the-Box Approach

The "check-the-box" proposal allows the worker and service recipient to agree by contract to classification for all federal tax purposes. If the IRS agrees not to challenge the agreed upon status, this method would eliminate controversies regarding classification. However, this method would likely create a trap for the unwary worker who is unfamiliar with the tax consequences of each classification. Thus, this approach is most certainly going to lead to more favorable tax results for the party with the greater bargaining power, which is generally the service recipient.[33]

Limiting the Relevant Factors

To eliminate the uncertainty surrounding the 20-factor test, several proposals have attempted to limit the number of relevant factors. This approach would reduce but not eliminate complexity due to the inevitable evaluation of facts and circumstance.[34]

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32 Coalition to Preserve Independent Contractor Status, *Coalition Submits Statement for the Record: Hearing Before the U.S. House of Representatives, Committee on Ways and Means* (May 8, 2007), available *at* http://www.iccoalition.org/Display-Article.asp?cat=Latest%20News&subcat=Federal&a=208 ("Rather than pursuing a broad campaign aimed at reclassifying independent contractors to employees, the Coalition submits that a better approach would be to increase the level of Form 1099 information reporting among independent contractors."). It is unclear exactly how the Coalition would enhance the reporting requirements. The National Taxpayer Advocate believes that because the IRC § 6041A filing thresholds have not been adjusted for inflation, they have already been effectively lowered over the years.

33 Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

34 For example, some proposals focus on whether the worker has substantial investment in training or education. Others would focus on whether the worker has a substantial investment in work facilities or substantial unreimbursed business expenses. Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

Amend Section 530 Safe Harbor

Several congressional bills have attempted to amend or repeal and replace the provisions of the § 530 safe harbor provision in an effort to increase compliance and improve tax administration.

The Independent Contractor Proper Classification Act of 2007[35] amends § 530 as follows:

- Allows the IRS to issue guidance on classification issues;
- Eliminates the service recipient's ability to rely on industry classification practices;
- Requires the IRS to develop a process for workers to petition for a determination of status;
- Guards against employee retaliation;
- Requires the IRS and Department of Labor to share information about misclassification practices;
- Requires employers to notify independent contractors of their rights and federal tax obligations; and
- Requires service recipients to retain a list of the names of independent contractors for three years.

The Taxpayer Responsibility, Accountability, and Consistency Act of 2008[36] is similar to S. 2044 above. The bill would replace § 530 with a new safe harbor provision to be incorporated into the Code under a new IRC § 3511. The bill provides the following:

- The proposed safe harbor does not ban Treasury and the IRS from issuing guidance;
- The safe harbor only protects the taxpayer from reclassification if the taxpayer did not receive a written IRS determination that the covered workers are employees;
- The taxpayer must consistently treat the worker as an independent contractor for employment tax purposes (since 1978);
- Compensation to the worker must be reported on Form 1099; and
- The taxpayer must have a reasonable basis to treat the worker as an independent contractor. The taxpayer can establish reasonable basis in two ways:
  1. A written IRS determination issued within the past seven years addressing the worker in question or another individual with a substantially similar position with the taxpayer;[37] or

35 S. 2044, 110th Cong, 1st Sess. (Sept. 12, 2007).

36 H.R. 5804, 110th Cong. (April 15, 2008).

37 The bill also requires Treasury to develop a new procedure for workers to petition for an IRS determination of their status for employment tax purposes. Workers would have appeal rights following a determination of independent contractor.

2. A concluded IRS examination (for employment tax purposes) of whether the worker or individual with substantially similar position should be treated as an employee.[38]

Like S. 2044, H.R. 5804 contains anti-retaliation provisions prohibiting a taxpayer from discriminating against an individual for filing a petition seeking a determination of worker status.

Penalties for Misclassification

The Employee Misclassification Act of 2008[39] allows successful plaintiffs claiming misclassification as independent contractors and denial of overtime and/or minimum wages under the Fair Labor Standards Act (FSLA) to recover triple damages. In addition, the bill would subject service recipients to new recordkeeping requirements, which include the names of independent contractors, their remuneration, and hours of service. The service recipient must also provide all employees and contractors with information on the workers, status, legal rights, and Department of Labor contact information. Further, employers that have repeatedly or willfully misclassified workers as independent contractors would be subject to a civil penalty of up to $10,000 per misclassified worker.

While the bill addresses the FLSA, adverse decisions may lead to inquiries by the IRS as well as state agencies. This approach also appears to severely penalize both inadvertent and deliberate misclassifications. Thus, if the IRS were to adopt a similar rule, it should require repetitive offenses as well as requisite intent.

Explanation of Recommendation

The National Taxpayer Advocate believes the complexity of the existing worker classification rules creates confusion and uncertainty, and encourages noncompliance. Accordingly, the National Taxpayer Advocate has reviewed various proposals to improve the worker classification rules and makes specific recommendations to minimize worker misclassification. Specifically, we recommend that Congress replace § 530 with a provision in the Code applicable to both employment and income taxes and require the Secretary to issue associated guidance, including some with specific industry focus. In addition, employers should be able to use and rely upon an electronic tool developed by the IRS to determine worker classification. Further, both employers and employees should be able to request classification determinations and seek recourse in Tax Court. The IRS should conduct public outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification. Finally, we also recommend several measures we have previously proposed to improve compliance with employment tax obligations. We believe our proposals, adopted in their entirety, appropriately balance the needs of workers, service

38 H.R. 5804, 110th Cong. (April 15, 2008).

39 H.R. 6111, 110th Cong. (May 22, 2008).

recipients, and the IRS. In addition, the proposals address fairness as well as the need to encourage compliance in this area.

Administrative Guidance on Worker Classification

The repeal of the existing § 530 safe harbor provisions will lift the prohibition on Treasury and the IRS from issuing administrative guidance on worker classification for employment tax purposes. Without the prohibition, the IRS should issue straightforward guidance to clarify the application of the common law to different facts and circumstances. In addition, the guidance should provide consistent rules for both income and employment taxes.

Self-Help Tool to Determine Classification

In conjunction with the additional guidance issued by Treasury and the IRS, the IRS should develop a program similar to that of the United Kingdom. Her Majesty's Revenue and Customs (HMRC) provides taxpayers with a free, web-based service called the Employment Status Indicator (ESI), which asks service recipients a series of questions and, based on the answers given, supplies an "indication of employment status." ESI specifically provides that the determination is not a binding opinion. The IRS can develop a similar program to use as a factor in establishing reasonable basis for the safe harbor.[40] Employers should be able to rely upon the classification generated from the online tool, unless they misrepresent the information input into the system while answering questions or circumstances have materially changed.

Repeal Section 530 of the Revenue Act of 1978

The National Taxpayer Advocate recommends the repeal of § 530. The safe harbor was enacted to protect service recipients and their workers from aggressive IRS enforcement initiatives. However, the current provision creates unnecessary confusion due to its location outside of the IRC. In addition, the rule introduces a new set of facts and circumstances tests, which only lead to more disputes. Finally, it is not in the best interest of tax administration to prohibit the tax administrator from issuing guidance on laws it must enforce.

Section 530 should be replaced with a Code provision to eliminate any unnecessary confusion. In addition, the new safe harbor rule should:

1. Clearly state that it applies to both income taxes and employment taxes;
2. Require the taxpayer to have a reasonable basis to treat the worker as an independent contractor. However, in establishing reasonable basis, the taxpayer can only rely on an IRS determination or completed examination. Rather than permitting the taxpayer to rely on industry practices to establish reasonable basis, the IRS should look to industry

40 For more information on the ESI, see http://www.hmrc.gov.uk/calcs/esi.htm (last visited on Sept. 17, 2008).

practices in reaching its decision, either in a written determination or examination. Finally, the provision would have anti-retaliation protections; and

3. Retain a substantive consistency requirement, but with a *de minimis* exception. Thus, a service recipient would still qualify for the safe harbor if it treated an individual as an employee for a brief time before changing the classification to independent contractor.

Right to Contest IRS's Determination

Congress should amend IRC § 7436 to permit service providers to petition the United States Tax Court to litigate the classification issue or whether the worker is entitled to relief from any misclassification. Currently, IRC § 7436 only permits a service recipient that has been audited regarding employment taxes to file a petition in the Tax Court to litigate the issue. However, the service provider also incurs potentially detrimental tax consequences upon the IRS's classification determination and should have the right to petition the Tax Court to review the IRS's determination.

In addition, Congress should direct the Department of Treasury and the IRS to create procedures allowing the worker to initiate an administrative review of worker classification. The worker should also have the right to appeal any IRS classification determination.

Information Reporting for Independent Contractors

Increasing Form 1099-MISC reporting requirements would increase compliance among independent contractors. The National Taxpayer Advocate recommends that Congress amend information reporting requirements for independent contractors in the following manner:[41]

- Increase the IRC § 6721(a) penalty for failing to issue Form 1099-MISC;[42] and
- Require service recipients to issue Form 1099-MISCs to incorporated service providers.[43]

Voluntary Withholding Agreements

To reduce both underreporting by independent contractors and the controversy associated with worker classification, Congress should amend IRC § 3402(p)(3) to authorize the IRS to agree not to challenge the classification of a worker who is party to a voluntary withholding agreement. Under this arrangement, an independent contractor and a service recipient agree the service recipient will withhold taxes at a specified rate. As discussed previously, it is questionable whether the existing statutory language provides authority for Treasury to

41 *See The IRS and the Tax Gap: Hearing Before the House Comm. On the Budget* 5 (Feb 16, 2007) (Statement of Nina E. Olson, National Taxpayer Advocate); *Hearing Before the Subcomm. On Federal Financial Management, Government Information, and International Security, Comm. On Homeland Security and Government Affairs* 21 (Oct. 26, 2005) (Statement of Nina E. Olson, National Taxpayer Advocate).

42 The current penalty is $50 for each return per return with a maximum of $250,000 per calendar year. IRC § 6721(a)(1).

43 See National Taxpayer Advocate 2007 Annual Report to Congress 494-496; National Taxpayer Advocate 2005 Annual Report to Congress 381, 394; National Taxpayer Advocate 2004 Annual Report to Congress 478, 483.

draft regulations addressing withholding agreements for non-wage compensation between service recipients and independent contractors. Thus, additional legislative action may be warranted to authorize the IRS to agree not to challenge the worker classification based on these agreements.[44]

Backup Withholding on Substantially Noncompliant Schedule C Filers

Because income-reporting compliance is nearly 100 percent when payments are subject to withholding,[45] the National Taxpayer Advocate recommends that Congress amend IRC § 3406 to require a form of "back-up withholding" by the payor in cases where a Schedule C filer has a demonstrated history of substantial noncompliance with the laws. In conjunction with the back-up withholding program, Congress should authorize the Secretary to exempt payors from back-up withholding on payments to Schedule C filers who present payors with a valid IRS "Compliance Certificate." A taxpayer would be eligible for the certificate if the taxpayer has been in compliance with prior filings and payment obligations. Noncompliant taxpayers could "redeem themselves" and reestablish eligibility for the certificates by demonstrating "substantial compliance," which entails the satisfaction of past obligations (or arrangements to satisfy them, such as an installment agreement) and scheduling a year's worth of estimated tax payments through the Electronic Funds Transfer Payment System (EFTPS).[46] The United Kingdom has had success with a similar certificate program for independent contractors in the construction industry.[47]

An inherent benefit of the Compliance Certificate proposal is that market forces would act to oblige independent contractors to operate among the ranks of the tax compliant. Payors could avoid the burdens associated with backup withholding if they only hire contractors that present a valid Compliance Certificate. Thus, tax compliance would become a condition of conducting business.

Comprehensive Report on Rules

Congress should direct Treasury and the Joint Committee on Taxation (JCT) to issue a report within six months of enactment of the aforementioned new safe harbor rule. The report should review the current rules for worker classification and make recommendations that are fair to both parties while improving tax compliance. In preparing the report, Treasury and JCT should consult with employer and employee representatives in roundtable discussions as well as other forms of communication.

44 For a detailed discussion of this proposal as well as legal impediments to authorizing such agreements by regulation, *see* National Taxpayer Advocate 2005 Annual Report to Congress 392-394.

45 IRS National Headquarters Office of Research, Tax Gap Map for Year 2001 (June 7, 2005).

46 For a more detailed discussion of this proposal, *see* National Taxpayer Advocate 2005 Annual Report to Congress 381-396.

47 For more information on the Construction Industry Scheme of Her Royal Majesty Revenue and Customs (HMRC), *see* http://www.hmrc.gov.uk/cis/ (last visited September 22, 2008).

Public Awareness Campaign

Congress should require the IRS to collaborate with the Department of Labor to conduct targeted public awareness campaigns on worker classification. The campaigns should inform workers of the comparative rights afforded to employees and independent contractors as well as the tax consequences associated with each classification. By educating workers about their rights and benefits under each classification, the government will leave them better prepared to analyze their particular facts and circumstances, determine which classification is appropriate, and negotiate more effectively for their best interest.

LR #6

Simplify the Tax Treatment of Cancellation of Debt Income

Problem

At a time when the government is taking extraordinary steps to assist individuals who stand to lose their homes to foreclosure, there is surprisingly little recognition that many of these individuals will face federal income tax consequences as a result. The same is true for individuals who default on consumer debt.[1] Many taxpayers will be required to include the amount of any debts written off by the lender in gross income and pay the associated tax. Some taxpayers will be entitled to exclude the amount of canceled debt from gross income, but they will have to navigate extremely challenging tax reporting requirements to do it.

When a borrower becomes unable to repay a debt and the lender cancels some or all of it, the Internal Revenue Code (IRC) generally provides that the amount of debt cancellation must be included in the gross income of the borrower.[2] This amount is referred to as "cancellation of debt income" (CODI). The Code also provides that in certain situations, a taxpayer may exclude CODI from gross income, including where a taxpayer is "insolvent," (meaning that the taxpayer's total liabilities exceed the taxpayer's total assets)[3] or where "qualified" debt (also known as "qualified principal residence indebtedness") is canceled in the course of a mortgage foreclosure.[4] However, the rules for claiming one of these exclusions are so complex that many and probably most taxpayers who qualify to exclude CODI from gross income do not do so. As a result, some taxpayers unnecessarily include CODI in gross income. Other taxpayers fail to report CODI and fail to claim a corresponding exclusion because they do not realize that debt forgiveness is a taxable event. These taxpayers may unnecessarily face IRS examination and tax assessment.[5]

The following is a list of some of the obstacles that prevent taxpayers from claiming exclusions to which they are entitled:

1 According to an article in the *New York Times*, lenders wrote off an estimated $21 billion in bad credit card loans during the first half of 2008. Eric Dash, *Consumers Feel the Next Crisis: It's Credit Cards*, New York Times, Oct. 29, 2008, at A1.

2 IRC § 61(a)(12).

3 IRC § 108(a)(1)(B).

4 IRC § 108(a)(1)(E). The exclusion applies to the extent that the principal balance of the loan does not exceed $2 million and the home is the taxpayer's principal residence.

5 The IRS receives Forms 1099-C, *Cancellation of Debt*, from lenders reporting the amount of each canceled debt. The IRS document-matching program compares each Form 1099-C it receives against the tax return of the taxpayer with the same taxpayer identification number. If a canceled debt is reported to the IRS on Form 1099-C and the amount is not reported on the taxpayer's return, the discrepancy will be flagged and the taxpayer may face IRS examination and tax assessment.

1. ***Requirement to File Form 982.*** A taxpayer who qualifies for an exclusion does not receive it automatically. To claim an exclusion, the taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness* (and *Section 1082 Basis Adjustment*). Form 982 is not simple. The IRS estimates that it takes business taxpayers ten hours and 43 minutes to complete it.[6] Moreover, many taxpayers and practitioners have never even encountered the form, which is not included in many tax software packages available to taxpayers.
2. ***Requirement to Adjust Tax Attributes.*** The main reason for the complexity of Form 982 is that taxpayers generally are required to reduce "tax attributes," in a specified sequence, by the amount of CODI they are entitled to exclude. Among the tax attributes listed on the form are net operating losses, general business credit carryovers, minimum tax credits, net capital losses, nondepreciable and depreciable property, passive activity loss and credit carryovers, and foreign tax credit carryovers. These terms are baffling to most taxpayers. Non-business taxpayers who do not have most of these tax attributes are generally required to reduce their basis in personal property like furniture, jewelry, and clothing, and keep track of it prospectively.[7] Taxpayers often have no idea what this means or how practically to do it.[8]
3. ***Qualified Principal Residence Indebtedness Exclusion.*** In December 2007, Congress added the "qualified principal residence indebtedness" exclusion that generally allows homeowners whose mortgage debts are canceled in the course of a foreclosure or loan restructuring to exclude the resulting CODI from gross income.[9] In practice, however, many homeowners whose debts are canceled in the course of a foreclosure or loan restructuring will *not* qualify to exclude CODI from gross income. That is because the exclusion only applies with respect to funds used to *acquire or improve* a principal residence.[10] It appears that a significant percentage of homeowners with subprime mortgages – probably a majority – used a portion of the loan proceeds for non-qualified purposes like paying off car loans, medical bills, student loans, or credit card balances.[11] In these cases, the taxpayer must reduce the amount of CODI eligible for exclusion by the amount of mortgage debt used for such non-qualified purposes. Thus,

6 The IRS does not provide a separate estimate of the amount of time individual taxpayers spend completing Form 982.

7 However, no basis adjustment is required upon cancellation of qualified principal residence indebtedness where a taxpayer loses his home in a foreclosure. *See* IRS Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* 13, *Example 2 – Mortgage loan foreclosure* (2007). Where a taxpayer retains his residence and excludes CODI solely under the qualified principal residence indebtedness exclusion, the taxpayer is required to reduce the basis in his residence by the amount of the canceled debt. IRC § 108(h)(1); IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* 7 (2007).

8 The reduction in the basis of these items of personal property is designed to increase any gain upon their disposition.

9 Mortgage Forgiveness Debt Relief Act, Pub. L. No. 110-142, § 2(b) (2007).

10 IRC § 108(h)(4) (providing that if only a portion of a mortgage loan constitutes "qualified principal residence indebtedness," the qualified principal residence indebtedness exclusion applies only to the extent that the amount of debt canceled exceeds the portion of the loan that does not constitute qualified principal residence indebtedness).

11 According to a federal government report issued in 2000: "The primary purpose of over 50 percent of first lien subprime mortgages and up to 75 percent of second lien subprime mortgages is debt consolidation and/or general consumer credit, not home purchase, home improvement or refinancing the rates and terms of a mortgage." Department of Housing and Urban Development and Department of the Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending* 26 (2000). We have not located more recent government data on this point.

despite last year's legislation, tens of thousands of taxpayers who lose their homes to foreclosure are still required to pay tax on some or all of the canceled debt unless another exclusion applies.

4. ***Insolvency Exclusion.*** The insolvency exclusion is generally designed to allow financially distressed taxpayers to exclude CODI from gross income. However, many taxpayers who qualify for the insolvency exclusion fail to claim it because they do not know it exists, do not understand the meaning of the word "insolvency," or do not know how to claim it. In general, a taxpayer is considered insolvent if the sum of all of his liabilities exceeds the sum of all of his assets (including the value of such items as furniture, jewelry, and clothing). To claim the insolvency exclusion, it is not sufficient simply that the taxpayer know he is insolvent. Rather, the taxpayer is only entitled to claim an exclusion up to the amount of insolvency, so the taxpayer must compute the insolvent amount exactly. For example, if a taxpayer's liabilities are $60,000 and his assets are worth $56,500, the taxpayer is entitled to exclude up to $3,500 in CODI from gross income; if the taxpayer has $10,000 of CODI, he is taxable on the remaining $6,500.
5. ***Combining Exclusions.*** In the case of a home foreclosure where a portion of the mortgage proceeds was used for nonqualified purposes, a taxpayer may be eligible to exclude some CODI under the qualified principal residence indebtedness exclusion and other CODI under the insolvency exclusion. For example, if a taxpayer takes out a mortgage for $200,000 and uses $25,000 to pay off medical bills and student debt, he may exclude CODI under the qualified principal residence indebtedness exclusion only to the extent that the amount of CODI exceeds $25,000. If the taxpayer is also insolvent, he is generally entitled to exclude additional amounts up to the amount of the insolvency. Yet another provision entitles taxpayers to exclude canceled debts which would, if paid, have been deductible; for example, a taxpayer generally may exclude canceled medical bills from gross income to the extent they exceed 7.5 percent of adjusted gross income.[12] It is asking a lot to expect taxpayers to be cognizant of all these rules and the interaction among them.
6. ***Variation in Federal Tax Consequences Based on Taxpayer's Place of Residence.*** The federal tax treatment of CODI varies depending on the state in which the taxpayer resides. In most states, a borrower is personally liable for his debts, which means that the lender is entitled to pursue the borrower's other assets if the borrower defaults. This type of debt is referred to as "recourse" debt. In other states, including California, the lender's only remedy in case of default is generally to repossess the property that secures the debt.[13] This type of debt is referred to as "nonrecourse" debt. Because the lender has no right to pursue the borrower's other assets in the case of nonrecourse

12 IRC § 108(e)(2).

13 This result is achieved through anti-deficiency statutes. *See, e.g.*, Cal. Civ. Proc. § 580(b); Ariz. Rev. Stat. Ann. § 33-729(A); N.C. Gen. Stat. § 45-21.38; S.D. Codified Laws Ann. § 44-8-25. In some states with anti-deficiency statutes, a lender may be able to collect additional amounts if the matter is pursued through judicial proceedings.

debt, the lender is not considered to cancel any unpaid balance and the borrower has no CODI. Most taxpayers do not understand the differences between recourse and nonrecourse debt or the fact that the tax consequences of a debt default may differ depending on where they live.

The result of having to navigate this CODI minefield is that hundreds of thousands of taxpayers have cancellation of debt income each year, but very few claim exclusions. Overall, lenders send about two million Forms 1099-C, *Cancellation of Debt*, to the IRS each year reporting CODI.[14] Yet it appears that *less than one percent* of taxpayers with CODI may be filing Form 982 to claim the exclusion.[15] Taxpayers who default on their debts are generally experiencing significant financial problems, and almost by definition, their liabilities are high relative to their assets. The National Taxpayer Advocate believes that a significant percentage of taxpayers who qualify for exclusions, particularly the insolvency exclusion, do not make claims.[16]

Example

Taxpayers purchased a house for their family in 2003 for $200,000 and took out a 30 year, fixed-rate mortgage for $160,000 (*i.e.*, 80 percent of the purchase price). In 2005, at a time when the taxpayers had other debts of $50,000, including student loans and two car loan balances, a representative of a subprime lending company contacted them and urged them to refinance their mortgage so they could consolidate all of their debt at a lower interest rate. The subprime lender offered a mortgage product that required interest-only payments for three years. Because real estate values were then rising, the subprime lender offered them a mortgage for $210,000. The taxpayers refinanced and used $50,000 to pay off their student loans and car loans.

In 2008, the monthly mortgage payment increased to include payments on principal. At that time, the principal balance of the mortgage was still $210,000, but the value of the house had fallen to $170,000. The taxpayers could not make the higher payments, so the lender foreclosed and sold the house. The mortgage was considered recourse debt, and the lender canceled the remaining $40,000 balance. The borrowers received a Form 1099-C from the lender reporting $40,000 of CODI. Although Congress passed legislation generally

14 IRS Document 6961, Table 2 (showing that the IRS expects to receive about 1.9 million Forms 1099-C in 2008 and about 2.1 million Forms 1099-C in 2009).

15 For tax year 2005, the IRS received 495,495 electronically filed returns from taxpayers who had cancellation of debt income reported on a Form 1099-C. IRS Compliance Data Warehouse, Information Returns Master File and Individual Returns Transaction File (Tax Year 2005). By comparison, the IRS received only 4,571 electronically filed Forms 982 for that time period. IRS E-File Reports (Processing Year 2006). Note that the number of electronically filed returns actually was greater than 495,495 because our data search only reflects Forms 1099-C issued to taxpayers listed with the primary taxpayer identification number (TIN) on a tax return. It does not reflect cases where a spouse or a person whose TIN was listed as other than the primary TIN received a Form 1099-C. Note, too, that the data excludes returns filed on paper, which represented slightly less than half of all individual income tax returns filed. We could not determine how many Forms 982 were submitted with paper-filed returns.

16 For a more detailed description of the complexity of the CODI rules and the tax administration problems arising from that complexity, see Most Serious Problem: *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income, supra. See also* National Taxpayer Advocate 2007 Annual Report to Congress 13-34 (Most Serious Problem: *Tax Consequences of Cancellation of Debt Income*).

allowing taxpayers to exclude CODI arising from foreclosures, the exclusion provides that only CODI in excess of amounts borrowed for non-qualified purposes may be excluded. Since these taxpayers borrowed $50,000 for non-qualified purposes, they are not entitled to exclude any portion of the CODI under the qualified principal residence indebtedness exclusion.

The taxpayers may be able to exclude some or all of the CODI under the insolvency exclusion. To make that determination, the taxpayers must compute the value of all their assets and all their liabilities. The fair market value of many assets, including cars, furniture, and clothing, is not clear-cut, requiring them to make judgments and develop substantiation in case they are later audited. If they wish to claim an exclusion, they must file Form 982 and make adjustments to their tax attributes. This is a particularly challenging exercise if one of the taxpayers is engaged in a trade or business.

If the taxpayers do not realize they have CODI or are not familiar with the CODI rules (perhaps, for example, because they lost their home and the Form 1099-C never reached them), they may fail to report the income or claim the exclusion. In that case, the IRS's document-matching system will generally flag the CODI amount as unreported income, and the IRS may issue a notice proposing additional tax. Once this notice is issued, the taxpayers at best will have to spend time understanding and responding to the notice to avoid a tax assessment. At worst, the taxpayers will not respond or will not respond adequately, and the IRS will assess tax that the taxpayers may not owe.

Recommendation

The National Taxpayer Advocate recommends that Congress pass legislation to make it easier for financially distressed taxpayers to exclude CODI from gross income. As discussed above, Congress established a general rule that CODI is includible in gross income but also created certain exclusions that generally are geared toward providing relief for taxpayers who are experiencing financial difficulties.

We suggest three options for consideration:

1. ***Provide that CODI is not includable in gross income unless the total amount of CODI attributable to the taxpayer from all sources exceeds a certain threshold for the taxable year.*** This would be the simplest option for taxpayers, because they would be relieved of the burden of learning about and filing Form 982 to claim an exclusion. The IRS could automatically program its computers to ignore CODI if the sum of CODI reported on Forms 1099-C with respect to the taxpayer falls below the threshold. The threshold should be set at a level high enough to provide relief to a majority of the financially distressed taxpayers whom the proposal is designed to assist and low enough to prevent widespread abuses that could undermine the general rule that CODI is taxable.

2. ***Provide that taxpayers with CODI below a certain threshold do not need to make adjustments to their tax attributes.*** This option is less attractive in that taxpayers would still have to file Form 982, would still have to distinguish between "qualified" and "non-qualified" indebtedness for purposes of the qualified principal residence indebtedness exclusion, and would still have to compute insolvency.[17] But it would create a more limited exception to the general rule that CODI is taxable than would be the case under option 1, while alleviating some taxpayer burden and reducing record-keeping requirements.
3. ***Amend the definition of "qualified principal residence indebtedness" to provide that the full amount of canceled mortgage debt qualifies for exclusion, even if a portion of the proceeds was used to pay off non-residential debt like car loans, medical bills, student loans, or credit card balances.***[18] This option would provide complete relief from CODI tax liability attributable to mortgage debt cancellation for most homeowners or persons who have lost their homes. However, it would not relieve taxpayers of the burden of filing Form 982 to claim the exclusion or provide any relief to taxpayers who have CODI from canceled debts (*e.g.*, car loans, medical bills, student loans, or other consumer debt) that are not rolled into a mortgage.[19]

17 If taxpayers are not required to adjust tax attributes, the National Taxpayer Advocate recommends that the IRS create a simplified Form 982-EZ for their use. The National Taxpayer Advocate also recommends that the IRS develop and provide a worksheet that taxpayers may use for purposes of computing whether and to what extent they are insolvent. For additional detail, see Most Serious Problem: *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income, supra*.

18 This could be accomplished by redefining "qualified principal residence indebtedness" in IRC § 108(h)(2) as acquisition indebtedness under IRC § 163(h)(3)(B)(i) *or* home equity indebtedness under IRC § 163(h)(3)(C)(i). Interest on amounts borrowed under home equity lines of credit is currently deductible, so this change would align the tax treatment of interest on the debt with the tax treatment of cancellation of the debt.

19 Our understanding is that the majority of canceled debts are not mortgage-related, so it may be desirable to combine this option with option (1).

LR #7

Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets

Problem

Tax law changes are increasingly subject to sunsets, *i.e.*, they are more often set to expire. The Joint Committee on Taxation (JCT) and Congressional Budget Office (CBO) recently identified more than 100 temporary tax provisions, up from about 21 in 1992.[1] According to government estimates, the cost of extending provisions that expired in 2008 (called "extenders") into 2009 is about $100 billion and the ten year cost of extending provisions expiring before 2018 is nearly four trillion dollars.[2] Sunsets burden both taxpayers and the IRS, often for no compelling reason. According to the President's bipartisan Advisory Panel on Federal Tax Reform:

> Frequent changes in the tax code, which often add to or undo previous policies, as well as the enactment of temporary provisions, result in uncertainty for businesses and families. This volatility is harmful to the economy and creates additional compliance costs.[3]

Similarly Peter Orszag, Director of the CBO and President-Elect Obama's announced nominee to serve as Director of the Office of Management and Budget, co-authored an article on tax sunsets in 2003 with William Gale, co-director of the Tax Policy Center, which observed:

> Recent [tax] sunsets have been motivated by the desire to manipulate budget rules and hide the likely cost of new tax cuts... leave policymakers in the future with less flexibility than they would otherwise have... [and have] create[ed] needless uncertainty over the future structure of the tax code.[4]

More specifically, tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when significant questions exist about whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets

1 *Compare* William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003) (describing 21 tax provisions set to expire over a five-year period as of January 1992) *with* Joint Committee on Taxation, JCX-1-08, *List of Expiring Federal Tax Provisions, 2007-2020* (Jan. 11, 2008) (listing 123 expiring provisions, but not separately listing each provision of the Economic Growth and Tax Relief Reconciliation Act of 2001, which are all scheduled to sunset at the end of 2010) *and* Congressional Budget Office, *Updated Estimates for Table 4-9, Effects of Extending Tax Provisions Scheduled to Expire Before 2018*, The Budget and Economic Outlook: Fiscal Years 2008 to 2018, 101-106 (Jan. 2008) (hereinafter, "CBO Estimate") (listing 102 expiring provisions).

2 Joint Committee on Taxation, JCX-78-08, *Estimated Budget Effects of the Tax Provisions Contained in an Amendment in the Nature of A Substitute to H.R. 1424*, 7-13 (Oct. 1, 2008) (estimating the cost of extenders for 2009 as $79 billion for extension of the AMT patch, $6 billion for extensions affecting individuals, $14 billion for extensions affecting businesses, and about 3 billion for temporary disaster relief); CBO Estimate (estimating the total cost as $3.9 trillion).

3 Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, xiii (Nov. 2005).

4 William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003).

reduce the effectiveness of tax incentives, make it harder for taxpayers to estimate their tax liabilities and pay the correct amount of estimated taxes, make it more difficult for the IRS to administer the law, and likely reduce tax compliance.[5]

While any tax law change is burdensome and any change that is set to expire is more so, some changes are scheduled to expire for valid tax policy reasons that justify the burden. For example, these changes may be temporary to address a temporary problem or to allow time to evaluate the effectiveness of a new tax incentive before committing significant resources to it. According to some observers, however, policymakers generally do not review the unique strengths and weaknesses of specific expiring (or expired) provisions before extending them.[6] Moreover, some tax sunsets are adopted solely to reduce the apparent cost to the federal government of providing popular tax benefits by granting the benefit for only a limited period or to avoid some of Congress' procedural rules. These sunsets (which we call "budget-driven" sunsets) cannot be justified based on substantive policy considerations.[7] Procedural rules, such as the Pay-As-You-Go (PAYGO) rules, "section 302 spending allocation" limits, budget scoring rules, and the "Byrd" rule, described below, provide incentives for lawmakers to enact sunsets. However, sunsets may be more costly than lawmakers realize if they increase noncompliance and raise tax administration costs and burdens for both the government and taxpayers.

Examples

The following examples illustrate how sunsets can make tax planning difficult, confuse taxpayers, and complicate tax administration.

Example 1: Sunsets increase complexity.

Congress has repeatedly enacted temporary "patches" to keep the alternative minimum tax (AMT), which is not indexed for inflation, from affecting a growing number of taxpayers.[8] The AMT requires taxpayers to compute their (tentative) tax liability twice – once under the regular tax rules and once under special AMT rules. It generally requires taxpayers to modify their computation of regular taxable income by taking into account the addition or subtraction of certain items (called adjustments and preferences), and then applying a basic exemption and special marginal rates to compute the "tentative minimum tax."[9] The taxpayer then compares this "tentative minimum tax" liability to his or her regular tax

5 As described below, sunsets may reduce compliance by confusing taxpayers, making it more difficult for them to pay sufficient estimated tax payments.

6 *See* Pamela J. Jackson and Jennifer Teefy, Congressional Research Service, RL 32367, *Certain Temporary Tax Provisions ('Extenders') Expired in 2007* (Oct. 8, 2008), *reprinted as, CRS Updates Report on Temporary Tax Provisions*, 2008 TNT 203-84, 2 (Oct. 20, 2008) (noting the extension of expiring provisions are generally lumped together as an "extenders" package).

7 One commentator has argued that sunsets may be justified on the basis that permanent provisions often have unexpected costs that cannot be included in budget estimates, such as costs that extend beyond the applicable budget window. *See* George Yin, *Temporary-Effect Legislation and Fiscal Responsibility*, Colloquium on Tax Policy and Public Finance (Spring 2007).

8 For a discussion of the problems created by the AMT, see, *e.g.*, Legislative Recommendation, *Repeal the Alternative Minimum Tax for Individuals, supra/infra,* National Taxpayer Advocate 2001 Annual Report to Congress 166.

9 *See generally*, IRC §§ 55, 56, 57, 58, 59.

liability and generally pays the greater of the two. This complexity makes it difficult for many taxpayers to predict how much they will owe.

Tax sunsets exacerbate these difficulties. In 2001, Congress increased the AMT exemption level to partially adjust it for inflation and prevent the AMT from affecting a larger number of taxpayers.[10] However, this so-called AMT "patch" was set to expire for tax years beginning after 2004.[11] On October 4, 2004, Congress extended the patch to tax years beginning in 2005.[12] On May 17, 2006, after the patch expired, Congress retroactively extended it to tax years beginning in 2006.[13] On December 26, 2007, Congress again retroactively extended the patch to tax years beginning in 2007.[14] After this patch expired, Congress retroactively extended it for another one-year period.[15]

The continuing state of uncertainty surrounding the already-complex AMT makes it more difficult for taxpayers to predict and plan to meet their tax obligations. Not only does such uncertainty reduce taxpayers' ability to plan long-term expenditures, such as where they can afford to live or send their children to school,[16] but the uncertainty also makes it more difficult for taxpayers to comply with existing estimated tax payment requirements.[17] Retroactive AMT patches enacted late in the year further exacerbate these difficulties.

Example 2: Sunsets promote costly retroactive and late-year tax law changes.

On December 20, 2006, Congress retroactively extended a number of expiring (and expired) tax provisions, including the research tax credit, the state and local sales tax deduction,

10 The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38 § 701 (2001) (codified, as amended, at IRC § 55(d)(1)).

11 EGTRRA increased the exemption amount from $45,000 to $49,000 for married individuals filing joint returns and from $33,750 to $35,750 for singles. *Id.* The Job Creation and Worker Assistance Act of 2002 (JCWAA), Pub. L. No. 107-147, 116 Stat. 21 § 601 (2002) extended other temporary provisions that allowed individuals to use personal tax credits against their AMT liability through December 31, 2003. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRA), Pub. L. No. 108-27, 117 Stat. 752 § 106(a)(1) (2003) increased the AMT exemption level from $49,000 to $58,000 for married individuals filing joint returns and from $35,750 to $40,250 for singles for tax years beginning in 2003 and 2004.

12 Working Families Tax Relief Act of 2004 (WFTRA), Pub. L. No. 108–311, 118 Stat. 1168 § 103 (2004). WFTRA § 312 also retroactively extended the provision allowing personal tax credits to offset AMT liability for tax years 2004 and 2005. On October 22, 2004, the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, 118 Stat. 1418 § 314(a) (2004) provided AMT relief to farmers and fisherman so that their use of income averaging rules would not subject them to the AMT.

13 Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Pub. L. No. 109-222, 120 Stat. 345 § 301(a)(1) (2006). TIPRA retroactively increased the exemption amount from $58,000 to $62,550 for married individuals filing joint returns and from $40,250 to $42,500 for singles for tax years beginning in 2006. *Id.*

14 Tax Increase Prevention Act of 2007 (TIPA), Pub. L. No. 110-166, 121 Stat. 2461 (2007). TIPA retroactively increased the exemption amount from $62,550 to $66,250 for married individuals filing joint returns and from $42,500 to $44,350 for singles for tax years beginning in 2007.

15 IRC § 55(d), *as amended by* Pub. L. No. 110-343, 122 Stat. 3,765, Division C, § 102 (2008) (retroactively increasing the 2008 AMT exemption amount from $66,250 to $69,950 for married individuals filing joint returns and from $44,350 to $46,200 for singles for tax years beginning in 2008).

16 *See* Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. Rev. 656, 675-679 (May 2007) (describing how sunsets reduce a taxpayer's ability to make economically efficient decisions).

17 Taxpayers are generally required to make annual estimated tax payment of the lesser of 90 percent of the individual's current year tax liability or 100 percent of the individual's tax for the prior year. *See* IRC § 6654(d).

the higher education deduction, and the educator's classroom expense deduction.[18] These sunsets resulted in late-year tax law changes, as lawmakers worked to extend expiring provisions before the end of the year – too late for the IRS to revise its tax forms, for tax software companies to update their shrink-wrapped software packages, for taxpayers to adjust their withholding, or for taxpayers to adjust their behavior to take advantage of the extended tax incentives. Probably as a result of late-year extenders, taxpayers ultimately claimed these deductions about 1.4 million fewer times in tax year 2006 than in 2005, when the deductions were included in the Form 1040, *U.S. Individual Income Tax Return*, instructions and built into tax software.[19]

Example 3: Sunsets increase the cost of tax planning.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually increases the estate tax exemption amount, gradually reduces rates, and then eliminates the estate tax in 2010.[20] However, since EGTRRA expires in 2010, the estate tax, including 2001 rates and exemption amounts, is set to return in 2011.[21] Because of the uncertainty created by this sunset, many taxpayers will be advised to set up more complicated and costly estate plans than they would otherwise need.[22]

Recommendation

The National Taxpayer Advocate recommends that Congress consider ways to ensure that procedural rules, such as PAYGO rules, "section 302 spending allocation" limits, budget scoring rules, and the "Byrd" rule, do not provide an inappropriate incentive for legislators to enact tax laws with sunset provisions.

18 Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, 120 Stat. 2,922 (2006). The research credit (codified at IRC § 41), enacted in 1981 as a temporary provision, has been extended 11 times between 1981 and 2004. *See* Gary Guenther, Congressional Research Service, RL31181, *Research Tax Credit: Current Status, Legislative Proposals in the 109th Congress, and Policy Issues* 10, 18 (Sept. 22, 2006). Section 501 of the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, 118 Stat. 1,418 (2004) first enacted the sales tax deduction (codified at IRC § 164) for tax years beginning after December 31, 2003, and before January 1, 2006. Section 431(a) of EGTRRA first enacted the qualified higher education expense deduction (codified at IRC § 222) for payments made after December 31, 2001, for tax years beginning on or before December 31, 2005. Section 406(a) of JCWAA first enacted the educator's classroom expense deduction (codified at IRC § 62(a)(2)(D)) for tax years beginning during 2002 or 2003. On October 4, 2004, § 307(a) of WFTRA retroactively extended the educator's deduction for tax years 2004 and 2005.

19 *See* National Taxpayer Advocate 2007 Annual Report to Congress 3, 6-7 (Most Serious Problem: *The Impact of Late-Year Tax-Law Changes on Taxpayers*).

20 Pub. L. No. 107-16, 115 Stat. 38 §§ 501, 511, 521 (2001).

21 Pub. L. No. 107-16, 115 Stat. 38 (2001). For a description of related problems, see National Taxpayer Advocate 2005 Annual Report to Congress 442 (Key Legislative Recommendation: *Tracking Cost Basis as a Result of Estate Tax Repeal*).

22 *See, e.g.*, Testimony of Conrad Teitell, Principal, Cummings & Lockwood, LLC before the United States Senate Committee on Finance, *Federal Estate Tax – Uncertainty in Planning Under Current Law* (Nov. 14, 2007).

Present Law

"Pay As You Go" (PAYGO) Rules

Tax legislation may be subject to procedural rules commonly known as "Pay-As-You-Go" (PAYGO).[23] PAYGO generally allows a member of Congress to raise a "point of order" with respect to a provision that would result in a net increase in mandatory spending or revenue reductions (*e.g.*, tax cuts) over various multi-year periods – the current fiscal year plus five years and the current fiscal year plus ten years. If a PAYGO point of order is sustained, the provision is eliminated from the bill unless the Rules Committee in the House or three-fifths of the Senate (whichever is applicable) waives the point of order or exempts the bill from PAYGO.[24] A member of Congress can use a sunset to reduce the apparent cost of a tax cut so that another member cannot challenge it by raising a PAYGO point of order.[25]

Section 302 Spending Allocations

Tax legislation included in a reconciliation bill – a bill subject to special streamlined procedural rules – may also be subject to "section 302 spending allocation" limits which provide similar incentives for legislators to enact temporary tax provisions. The Congressional Budget Act of 1974 streamlined the process for passing certain legislation.[26] Pursuant to the act, Congress first passes a budget resolution, which sets out Congress' goals for each category of revenue and spending for at least five fiscal years by assigning "section 302 spending allocations" that limit spending for each category.[27] If tax-writing committees want to include tax cuts in excess of the section 302 allocation, they must also include

23 Statutory PAYGO rules enacted as part of the Budget Enforcement Act of 1990 (Title XIII of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1,388) were effective from fiscal year (FY) 1986 through FY 2002. Under these rules, a PAYGO violation could result in sequestration – across the board cuts in nonexempt direct spending programs – if the Office of Management and Budget determined that revenue and direct spending legislation enacted for the immediate fiscal year yielded a net cost. *See, e.g.*, Robert Keith, Congressional Research Service, RL34300, *Pay-As-You-Go Procedures for Budget Enforcement* (Dec. 31, 2007). Today the operative PAYGO rules do not automatically result in across the board cuts. Rather, the House and Senate have adopted non-statutory PAYGO rules that are enforced when individual members raise a PAYGO point of order. *Id*; S. Con. Res. 21, 110th Cong. (2007); H. Res. 6, 110th Cong. (2007).

24 *See, e.g.*, Robert Keith, *Congressional Research Service*, RL33850, *The House's "Pay-As-You-Go" (PAYGO) Rule in the 110th Congress: A Brief Overview*, 5 (Jan. 31, 2007). Three-fifths of the Senate is 60 votes if no seats are vacant. A simple majority is generally all that is required to waive the PAYGO rules in the House. *Id.*

25 There are a number of similar procedural rules. For example, section 321 of the Conference Report to the Concurrent Resolution on the Budget for Fiscal Year 2008 described a provision that would subject certain tax cuts to a point of order in the House unless they were contingent on a later determination that the government will actually receive revenues projected to offset the tax cuts with surpluses through 2012. H. Conf. Rep. 110-153 (explained on page 121). Another provides for a point of order against increasing the long-term deficit, *i.e.*, increasing the deficit in any of four ten-year periods. *See* S. Con. Res. 21, 110th Cong. 1st Sess. § 201 (2007); H. Conf. Rep. 110-659, 130 (2008) (describing various budget-related points of order that remain in effect for 2009).

26 Titles I-IX of the Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 (1974) (as amended and codified at 2 U.S.C. §§ 621-692) are cited as the "Congressional Budget Act of 1974."

27 *See, e.g.*, 2 U.S.C §§ 631 (providing a timetable), 632 (describing the content of the concurrent resolution on the budget), 633 (describing spending allocations to committees), 633 (requiring the spending allocations to cover at least five years), 636 (describing procedural limits applicable to concurrent resolutions), 641(a) (describing the reconciliation directives to be included in the concurrent resolution); Robert Keith, Congressional Research Service, RL33850, *The House's "Pay-As-You-Go" (PAYGO) Rule in the 110th Congress: A Brief Overview* 4 (Jan. 31, 2007) (noting that budget resolutions sometimes cover up to ten years, plus the current year). The FY 2008 Senate Budget Resolution prohibits consideration of reconciliation legislation that would increase a deficit or reduce a surplus for the sum of years 1-6 (2007-2012) or the sum of years 1-11 (2007-2017). S. Con. Res. 21, 110th Cong. 1st Sess. (2007). The FY 2009 concurrent budget resolutions did not change the PAYGO rules. *See* S. Con. Res. 70, 110th Cong. (2008); H. Con. Res. 312, 110th Cong. (2008). These resolutions are sometimes called "nonbinding" because they are not signed by the President and do not have the force of law.

additional revenue-raising measures so the legislation meets the allocation limits on a net basis. Then the Budget Committee generally incorporates provisions drafted by each committee with jurisdiction over the matters covered by the budget resolution into an omnibus budget reconciliation bill. The reconciliation bill is subject to special procedural rules that limit the opportunity for debate (or filibuster) and the opportunity for members to offer amendments that are not "germane" or are "extraneous."[28]

As with a PAYGO violation, a member can generally raise a "point of order" with respect to any provision in a reconciliation bill that increases spending above or reduces revenue below the section 302 spending allocation levels established by the concurrent budget resolution for years covered by the resolution.[29] Thus, like the PAYGO rules, the section 302 spending allocation limits encourage legislators to use sunsets to reduce the apparent cost of a tax cut over the multi-year budget-scoring period.[30]

The Byrd Rule

The Byrd Rule virtually requires any tax cut in a reconciliation bill to sunset. It is a statutory rule that generally prevents special-interest provisions, such as those unrelated to the budget, from receiving the benefit of the streamlined reconciliation process in the Senate.[31] The rule allows a senator to raise a point of order against any "extraneous" provision in a reconciliation bill or resolution.[32] However, Congress was also concerned about the use of provisions that increased revenue or reduced spending during the period covered by a reconciliation bill, but had the opposite effect afterwards.[33] In 1987, Congress expanded the definition of "extraneous" to include a provision that "increases... net outlays, or ...decreases... revenues during a fiscal year after the fiscal years covered by such reconciliation bill..."[34] Thus, the Byrd Rule now discourages legislators from accelerating revenue that would otherwise be received outside of the fiscal years covered by the reconciliation bill to meet the section 302 spending allocation limits. However, when tax cut provisions are included in a reconciliation bill, the rule encourages legislators to make them temporary.[35] Because tax cuts that do not sunset decrease revenues "during a fiscal year after the fiscal

28 *See, e.g.*, 2 U.S.C. §§ 641(d) (describing procedural limits applicable to reconciliation bills) and 641(e) (same). For further discussion of these processes, see, *e.g.*, Robert Keith and Bill Heniff Jr., RL33030, Congressional Research Service, *The Budget Reconciliation Process: House and Senate Procedures* (Aug. 10, 2005); Robert Keith, RL30862, Congressional Research Service, *The Budget Reconciliation Process: The Senate's "Byrd Rule"* (Apr. 7, 2005); Michael W. Evans, *The Budget Process and the "Sunset" Provisions of the 2001 Tax Law*, 99 Tax Notes 405 (Apr. 21, 2003).

29 *See, e.g.*, 2 U.S.C. § 642(a).

30 *See, e.g.*, George Yin, *Temporary-Effect Legislation and Fiscal Responsibility,* Colloquium on Tax Policy and Public Finance (Spring 2007) (noting: "Due to the very gradual phase-in of the repeal and the sunset of the repeal [of certain tax cuts enacted in 2001] as of December 31, 2010, the provision was estimated to cost about $138 billion over the budget window, or roughly one-fifth of the estimated cost had the repeal been in effect throughout the period.").

31 *See* 2 U.S.C. § 644(a).

32 *See id.*

33 Michael W. Evans, *The Budget Process and the "Sunset" Provisions of the 2001 Tax Law*, 99 Tax Notes 405 n. 38 (Apr. 21, 2003) (quoting 1999 statements by the former chair of the Senate Finance Committee, Senator Roth, explaining concerns that prompted the 1987 change to the Byrd rule).

34 Pub. L. No. 100-119, Title II, § 205 (1987) (codified, as amended, at 2 U.S.C. § 644(b)(1)(E)).

35 Use of the reconciliation process to enact tax cuts (rather than to raise revenue) was somewhat controversial. *See, e.g.*, Michael W. Evans, *The Budget Process and the "Sunset" Provisions of the 2001 Tax Law*, 99 Tax Notes 405 (Apr. 21, 2003).

years covered by such reconciliation bill," they are considered extraneous. Thus, a member can raise a Byrd Rule point of order to strike tax cuts from a reconciliation bill unless the tax cuts expire during the fiscal years covered by the bill.[36]

Budget Scoring Rules

Under the PAYGO rules, the House and Senate budget committees determine the budget effect of a provision by using baseline estimates computed in a manner consistent with § 257 of the Balanced Budget and Emergency Deficit Control Act of 1985 (codified at 2 U.S.C. § 907).[37] Similarly, in assessing compliance of a provision with a section 302 spending allocation provided under a budget resolution, the budget committees rely on CBO and JCT estimates, which continue to use the principles of section 257 of the Balanced Budget and Emergency Control Act of 1985 for scoring purposes, even though they are not statutorily required to do so.[38] Pursuant to section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985, these estimates ignore sunsets applicable to programs with estimated current-year outlays greater than $50 million.[39] However, budget estimates do not ignore sunsets applicable to tax cuts, even if current-year outlays for the tax cut are estimated to represent more than $50 million. Thus, the scoring methodology does not provide an incentive for legislators to use sunsets to reduce the apparent cost of significant spending programs, but does provide an incentive for them to use sunsets to reduce the apparent cost of significant tax cuts.

Reasons for Change

Tax law changes are increasingly subject to sunsets. In January 1992, the tax code included 21 provisions that were set to expire.[40] In contrast, the JCT and the CBO recently published lists of more than 100 temporary tax provisions.[41]

36 As an example, in 1999, H.R. 2488, a reconciliation bill, included tax cuts and two provisions that were crafted in anticipation of a Byrd Rule challenge: (1) section 1501 sunset the tax cuts at the end of 2009, thereby complying with the Byrd Rule; and (2) section 1502 would have reversed the sunset by reinstating all of the tax cuts on the first day of 2010. After a senator raised a Byrd Rule point of order, section 1502 was deleted. *See* Michael W. Evans, *The Budget Process and the "Sunset" Provisions of the 2001 Tax Law*, 99 Tax Notes 405 (Apr. 21, 2003).

37 *See* Section 405 of Title IV of H. Res. 6, 110th Cong. (2007), *reprinted at*, 153 Cong. Rec. H19, H22 (daily ed. Jan. 4, 2007), *adopted at*, 153 Cong. Rec. H82-H83 (daily ed. Jan. 5, 2007) (adopted as new Clause 10 of House Rule XXI); S. Con. Res. 21, 110th Cong. § 201 (2007). In the House, the estimates prepared by the Budget Committee must be "relative to" the most recent baseline estimates supplied by the CBO. Although section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985 expired on September 30, 2006, CBO will continue to follow its procedures. Pub. L. No. 105-33, 111 Stat. 251 § 10212 (1997) (codified at 2 U.S.C. § 900 (note)); Robert Keith, Congressional Research Service, RL33850, *The House's "Pay-As-You-Go" (PAYGO) Rule in the 110th Congress: A Brief Overview*, 5 (Jan. 31, 2007). In adopting and revising section 257, in reconciliation legislation in 1990 and 1997, respectively, the conferees included scorekeeping rules in the joint explanatory statements accompanying the conference reports on those measures. These rules are incorporated into Appendix A of Office of Management and Budget Circular A-11 (July 2007).

38 *See* 2 U.S.C. §§ 639, 653, 658b (scoring and other reporting requirements); 2 U.S.C. § 642 (budget resolution limitations).

39 *See* 2 U.S.C. § 907(b)(2)(A) (sunset rule).

40 William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003) (describing tax provisions set to expire over a five-year period as of January 1992).

41 *See* Joint Committee on Taxation, JCX-1-08, *List of Expiring Federal Tax Provisions, 2007-2020* (Jan. 11, 2008) (listing 123 expiring provisions, but not separately listing each provision of the Economic Growth and Tax Relief Reconciliation Act of 2001, which are all scheduled to sunset at the end of 2010); CBO Estimate (listing 102 expiring provisions).

While any tax law change is burdensome and any change that is set to expire is more so, some sunsets, such as those applicable to temporary disaster relief or one-time economic stimulus initiatives, expire for obvious policy reasons. Since they apply to one-time events, they do not even need to expire to be temporary.[42] Others may expire because Congress would like to see the effect of a provision on taxpayer behavior before making it permanent, a reasonable policy justification. According to some observers, however:

> [p]olicymakers have for the most part, considered the extenders [provisions further extending temporary tax provisions] as a group during the enactment process, and have not reviewed the unique strengths and weaknesses of specific provisions.[43]

Moreover, budget-driven tax sunset provisions cannot be justified on the basis of compelling non-procedural tax policy considerations. For example, the EGTRRA reduced tax rates, created a ten percent tax bracket, increased the child tax credit, phased out the estate tax, and provided relief from the AMT and the marriage penalty.[44] All of these changes were set to expire after 2010 or earlier.[45] Some believe there is no good policy justification for allowing these basic tax rule changes to expire.[46]

Legislators reportedly included these sunset provisions in EGTRRA so they could pass tax cuts using the reconciliation process while avoiding a Byrd Rule point of order in the Senate, rather than because the sunsets necessarily made sense from a policy perspective.[47]

Sunsets promote burdensome retroactive and late-year tax law changes.

When legislators enact tax cuts and make them temporary for procedural reasons, they leave future Congresses scrambling to extend the cuts, often late in the year and sometimes after the provisions have expired. Taxpayers and IRS employees need to relearn the law

42 For example, Section 403 of the Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2,016 (2005), amended IRC § 7508A, allowing the IRS to provide relief to taxpayers determined to be in a disaster area affected by Hurricane Katrina. This provision did not need to expire because it was limited by the fact that it only allowed relief with respect to a single event.

43 Pamela J. Jackson and Jennifer Teefy, Congressional Research Service, RL 32367, *Certain Temporary Tax Provisions ('Extenders') Expired in 2007* (Oct. 8, 2008), *reprinted as, CRS Updates Report on Temporary Tax Provisions*, 2008 TNT 203-84, 2 (Oct. 20, 2008).

44 Pub. L. No. 107-16, 115 Stat. 38 (2001).

45 Pub. L. No. 107-16, 115 Stat. 38 § 901 (2001) (codified in a note under IRC § 1).

46 *See, e.g.*, William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003). *See also* Elizabeth Garrett, *Accounting For The Federal Budget And Its Reform*, 41 Harv J. Legis. 187, 196 (Winter 2004) (noting that although "there is no legal commitment that requires Congress to extend these provisions... there is a political commitment." Thus, sunsets allow lawmakers "to mask the long-term cost of tax reduction bills"); Rebecca M. Kysar, *The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code*, 40 Ga. L. Rev. 335 (Winter 2006) (same); Cheryl D. Block, *Pathologies at the Intersection of the Budget and Tax Legislative Processes*, 43 B.C. L. Rev. 863, 912 (July 2002) (quoting Gene Steuerle as stating that "[A]s a matter of tax policy, ... the rules have not worked well, and the tax code is again being made more complex and more unfair with the passage of each new act."). *But see*, George Yin, *Temporary-Effect Legislation and Fiscal Responsibility*, Colloquium on Tax Policy and Public Finance (Spring 2007) (arguing that temporary provisions help ameliorate the budget deficit, in part, because permanent provisions sometimes have significant and unexpected costs that are not included in budget estimates). For a description of many of these provisions and recent legislative efforts to extend the provisions, see Maxim Shvedov, Congressional Research Service, *Expiration and Extension of the Individual Income Tax Cuts Enacted in 2001 Through 2007* (Mar. 26, 2008), *reprinted as*, Maxim Shvedov, *CRS Reviews History of 2001 Tax Cuts, Extensions*, 2008 TNT 62-61 (Mar. 31, 2008).

47 *See, e.g.*, Maxim Shvedov, *CRS Reviews History of 2001 Tax Cuts, Extensions*, 2008 TNT 62-61 (Mar. 31, 2008). For additional discussion of the history of the Byrd Rule, see Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. Rev. 656, 664-668 (May 2007).

any time it changes. However, late-year tax law changes are even more burdensome for both taxpayers and the IRS. As illustrated above, these changes sometimes come too late for the IRS to revise its tax forms, for tax software companies to update their shrink-wrapped software packages, and for taxpayers to adjust their estimated tax payments or take advantage of tax incentives. Because late-year changes degrade the IRS's ability to communicate current rules to taxpayers, many taxpayers remain confused or uninformed about the changes and do not receive the tax benefits that Congress intended.[48] Late-year changes can also degrade the IRS's ability to timely process returns. A delay in processing returns means a delay in issuing refunds to taxpayers, some of whom need the refunds to pay essential bills.[49]

Sunsets increase complexity, potentially reducing tax compliance.

Sunsets may prompt some taxpayers to make mistakes on their returns by inadvertently claiming expired tax benefits when a provision is not renewed. Tax benefits that are allowed to sunset during the year also make it more difficult for taxpayers to estimate their liability ahead of time, potentially leading to estimated tax penalties and noncompliance. According to one study, taxpayers who owe a balance upon filing their returns are more likely than others to understate their liabilities, and more than 20 percent of such taxpayers failed to pay in full with the return.[50] Thus, to the extent that sunsets make it more difficult for taxpayers to estimate their current year tax liability ahead of time, they may reduce tax compliance.

Sunsets increase the need for costly tax advice, which may reduce tax compliance.

For taxpayers who can estimate how sunsets will affect them, sunsets provide planning opportunities. These taxpayers can shift income and deductions from one year to another to avoid sunsets. For example, concern about the extension of the AMT "patch" over the last few years led some tax advisors to recommend bunching expenditures for items that are deductible for regular tax purposes but not for the AMT into a year in which they will be allowed (*e.g.*, a year in which they are sure an AMT patch will apply).[51] As noted above, taxpayers may also feel the need to engage in estate tax planning to take advantage of the ways in which the estate tax law will shift over time. Not only is such planning costly, but taxpayers who choose not to pay a professional to help them plan for sunsets are likely to

48 As noted above, late year tax law changes may be responsible for taxpayers claiming 1.4 million fewer deductions in tax year 2006 than in 2005. *See* National Taxpayer Advocate 2007 Annual Report to Congress 3, 6-7.

49 According to the IRS, due to late year tax law changes, as many as 13.5 million taxpayers who needed to file certain AMT forms had to wait until February 11, 2008 to begin filing them. IR-2007-209 (Dec. 27, 2007).

50 *See* 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), *citing* District Office of Research & Analysis, Connecticut-Rhode Island and Southwest Districts, Project No. 13.0, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments* 44 (June 21, 2000); Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance* 1-2 (July 14, 1995). For the 2006 tax year, 15 percent of all taxpayers who owed a balance upon filing their return failed to pay it in full. Compliance Data Warehouse, Individual Returns Transaction File (IRTF) (Oct. 2008).

51 *See, e.g.*, Jeff Schnepper, MSN Money, *The Basics: 8 ways to escape the AMT tax sting* (2008), *at* http://moneycentral.msn.com/articles/tax/basics/6647.asp?Printer.

feel they are paying more in taxes than other similarly situated taxpayers. This perception of unequal treatment likely reduces the perceived fairness of the tax system, which may in turn reduce tax compliance at the margins.

Sunsets dilute tax incentives and potentially increase recordkeeping burdens.

Sunsets sometimes prompt lawmakers to allow tax incentives to expire and then retroactively extend them, diluting the effect of incentives for activities that require advance planning. A business is less likely to make a long-term investment in response to a tax incentive such as the research credit if the credit is set to expire.[52] For example, in early 2006 a business might have had difficulty obtaining financing to conduct research based on the potential of obtaining the research and experimentation credit, since the credit expired on December 31, 2005, even though on December 27, 2006, Congress retroactively extended it to apply from January 1, 2006 to December 31, 2007.[53] As a result, Congress is likely getting less for its money – generating less research activity than it otherwise could for the same tax credit dollars.

In addition, if lawmakers routinely allow a temporary tax incentive to expire, as they did with the research credit, businesses that might be eligible for the incentive may feel they should keep records that they hope will be sufficient to qualify them for the credit based on the possibility that it will be extended on a retroactive basis.[54] Such recordkeeping is a waste of resources if lawmakers do not retroactively extend the provision. Other taxpayers may not keep sufficient records to claim the benefit. If it is retroactively extended, they may be tempted to take the credit even though they do not have adequate records of their activities. Burdensome recordkeeping requirements have long been thought to decrease voluntary compliance in this manner.[55]

Sunsets increase tax uncertainty and possibly stock market volatility.

Sunset provisions generate so much uncertainty about the cost of doing business that, pursuant to securities laws,[56] some publicly traded corporations feel the need to warn potential investors that the expiration of certain tax provisions presents a material risk to their businesses. For example, the General Electric Company's annual report warns, in the "risk factors" section:

> [A beneficial tax provision] is scheduled to expire at the end of 2008, has been scheduled to expire on four previous occasions, and each time it has been extended

52 Joint Economic Committee, *The Effects of the Duration of Federal Tax Reductions: Examining the Empirical Evidence* (Feb. 2002) (finding that people respond more strongly to permanent tax incentives than to temporary ones).

53 Pub. L. No. 109-432, 120 Stat. 2922 § 104(a)(1) (2006) (codified at IRC § 41(h)(1)(B)).

54 *See, e.g.*, Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. Rev. 656, 678 (May 2007).

55 *See, e.g.*, Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals,* 45 Tax L. Rev. 121, 166–67 (1989).

56 *See, e.g.*, 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; 15 U.S.C. § 77q(a)(2); 15 U.S.C. § 78r.

by Congress. If this provision is not extended, the current U.S. tax imposed on active financial services income earned outside the United States would increase, making it more difficult for U.S. financial services companies to compete in global markets.[57]

Such uncertainty could potentially increase the volatility of the U.S. stock market, as stock prices fall in anticipation that favorable tax provisions will expire and then recover if Congress later extends them.

Explanation of Recommendation

It is generally beyond the scope of the National Taxpayer Advocate's authority and institutional competence to recommend specific changes to Congress' procedural rules. Above and in our 2007 report, however, we outlined the significant impact to taxpayers of late-year tax law changes – the cause of which was the routine sunsetting of tax provisions.[58] As noted earlier, the number of sunset provisions is increasing. Thus, in looking at the root cause of these and other problems facing taxpayers, the National Taxpayer Advocate believes that a change in these rules would benefit taxpayers.

Ideally, the true costs of sunset provisions, including burden to taxpayers, the tax system, and the IRS, should be taken into account as Congress evaluates them. Because many of these costs cannot be quantified and taken into account as part of the budget scoring process, however, it may be appropriate for Congress to consider ways to reduce or eliminate the incentive for lawmakers to use tax sunsets to circumvent the procedural rules.

Congress should prevent its procedural rules from providing an incentive to enact tax sunsets for which there is no substantive policy justification (*i.e.*, "budget-driven" sunsets). A budget-driven tax sunset could be defined as a tax provision that expires only for procedural reasons. A sunset would not be "budget-driven" if proponents could provide a non-procedural justification for it. For example, a non-procedural justification might include the need to address uniquely challenging economic conditions or natural disasters on a temporary basis. It might also include the need to test a new tax incentive to determine its effectiveness. The same justification could not be used renew the provision repeatedly, however.[59] As a starting point for discussions, Congress could consider the options listed below.

57 General Electric Company, Form 10-K, *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934* (Dec. 31, 2007), *at* http://www.sec.gov/Archives/edgar/data/40545/000004054508000011/frm10k.htm#item1a (last visited Dec. 4, 2008).

58 *See* National Taxpayer Advocate 2007 Annual Report to Congress 3, 6-7.

59 We note that many of the sunset provisions in EGTRRA could probably have been justified on non-procedural grounds. However, it would be more difficult to justify temporarily renewing those provisions on the same basis. According to one review, of the tax provisions that expired in 2005 and were retroactively extended in 2006-2007, one provision was 20 years old, another was ten years old, and nine other provisions had been in existence for five years or more. Pamela J. Jackson and Jennifer Teefy, Congressional Research Service, RL 32367, *Certain Temporary Tax Provisions ('Extenders') Expired in 2007* (Oct. 8, 2008), *reprinted as, CRS Updates Report on Temporary Tax Provisions*, 2008 TNT 203-84, 6 (Oct. 20, 2008).

1. **Consider modifying the Byrd Rule to (a) allow a senator to raise a point of order if a reconciliation bill includes "budget-driven" tax sunset, or (b) allow a reconciliation bill to include tax cuts that extend beyond the fiscal years covered by the bill.**[60]

Either of these changes would eliminate the incentive, created by the current Byrd Rule, to enact temporary tax cuts using a reconciliation bill. If Congress modified the rule to allow a senator to raise a point of order if a reconciliation bill includes a tax sunset provision that could not be explained on any basis other than procedural considerations, the strategy of making tax cuts temporary simply to avoid a Byrd Rule point of order would no longer be effective. As a result, any budget-driven temporary tax cut included in a reconciliation bill would require the support of three-fifths of the Senate (60 votes, if no seats are vacant) to survive a Byrd Rule point of order.

If, instead, Congress modified the Byrd Rule to allow a reconciliation bill to include tax cuts that extend beyond the fiscal years covered by the bill, the strategy of making tax cuts temporary simply to avoid a Byrd Rule point of order would no longer be necessary. Neither of these options would affect the PAYGO or budget scoring rules. Nonetheless, if Congress adopts either of them, any temporary tax cut that lawmakers include in a reconciliation bill will be more likely to be based on policy (or fiscal considerations) rather procedural maneuvering prompted by the Byrd Rule.

Option 1(b), however, would allow lawmakers to enact permanent tax cuts using the reconciliation process. Some have argued that because the reconciliation process circumvents normal Senate rules, which allow for debate (including potential filibuster) and amendment, it should not be used to pass tax cuts of any kind.[61] While that point is debatable, either option could help reduce the incentive to enact tax sunsets. Especially if Congress does not adopt option 1(a) or 1(b), it may wish to consider option 2.

2. **Consider modifying the Byrd Rule to allow a senator to raise a point of order if a reconciliation bill includes a provision that would extend a previously enacted temporary tax cut that was originally included in a reconciliation bill, provided the extension is budget-driven (as defined above).**

Unlike the first option, this one would not reduce the incentive created by the Byrd Rule to include budget-driven temporary tax cuts in reconciliation bills. It would, however, eliminate the procedural incentive to use the reconciliation process to renew them. As a result, unless proponents could justify another temporary extension of a provision on non-procedural grounds, lawmakers would be more likely to let it expire on schedule. Thus,

60 For ease of discussion, we use the term "bill" to encompass a bill, amendment, conference report, or resolution. Similarly, we use the term "tax cut" to include not just tax rate reductions, but also any deduction, exemption, credit, adjustment, or other provision that reduces federal tax revenue.

61 *See, e.g.*, Michael W. Evans, *The Budget Process and the "Sunset" Provisions of the 2001 Tax Law*, 99 Tax Notes 405 (Apr. 21, 2003) (discussing the argument that the reconciliation process should not be used to enact tax cuts).

this option would reduce the incentive for lawmakers to continually extend temporary tax cuts using reconciliation bills rather than making them permanent or letting them expire. However, it would still allow lawmakers to use the reconciliation process to enact temporary tax cuts without getting the support of three-fifths of the Senate needed to allow the provision to survive a Byrd Rule point of order.

3. Consider revising applicable revenue scoring rules so that any tax cut provision is scored, for purposes of PAYGO and similar rules, as if the provision would remain in effect for the duration of the applicable budget window, at least if its expiration is budget-driven.[62]

This option would remove the budget-driven incentive created by PAYGO, section 302 spending allocation limitations, and similar rules that encourage legislators to repeatedly extend temporary tax cuts, which are scored as being less expensive than permanent ones. Such a change would be consistent with how section 257 of the Balanced Budget and Emergency Control Act of 1985 treats sunsets applicable to spending for programs with estimated current-year outlays greater than $50 million.[63] As noted above, such spending sunsets are ignored for scoring purposes under section 257, so budget-driven tax cut sunsets could be ignored as well. Moreover, since taxpayers and legislators often expect temporary tax cuts to be extended, especially if they have been extended in the past, this change would probably make budget estimates more realistic.[64]

62 Congress could revise the applicable budget scoring rules either by amending section 257 of the Balanced Budget and Emergency Control Act of 1985 or by congressional resolution.

63 *See* 2 U.S.C. § 907(b)(2)(A) (sunset rule).

64 Some commentators, including Peter Orszag, the Director of the CBO, have suggested that the CBO should at least provide, as an alternative baseline, estimates which assume that temporary tax provisions continue. *See, e.g.*, William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003) (noting that "[S]ince the assumption that all temporary provisions will expire is unrealistic, the official projections are increasingly biased as a guide to the underlying policy stance").

LR #8

Eliminate (or Simplify) Phase-Outs

Problem

The Internal Revenue Code (IRC) contains many tax benefits that are phased out at various levels of income.[1] Over 70 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]

Because we could reach a similar result by adjusting marginal rates, phase-outs introduce unnecessary complexity. Phase-outs make it more difficult for taxpayers to determine if they are eligible for a given tax benefit or even to compute their marginal tax rate. Phase-outs use different measures of income to determine whether and how to reduce a given tax benefit as income increases. 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, requiring taxpayers to fill out additional "quasi-returns" (*i.e.*, forms, schedules, and worksheets) to recompute their "income" for purposes of the phase-out.[4] The effect of marital and filing status on the phase-out range also varies from phase-out to phase-out.[5] 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.[6]

Such complexity is burdensome for taxpayers, reduces the effectiveness of tax incentives, and makes it more difficult for taxpayers to estimate their tax liability and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance.[7] Phase-outs

1 *See* National Taxpayer Advocate 2006 Annual Report to Congress 470, 473. For purposes of this discussion, we use the term "phase-out" to include phase-downs, which reduce (but do not eliminate) tax benefits as income increases.

2 This data is compiled from the Individual Return Transaction File (IRTF) for Tax Year (TY) 2006 from the Compliance Data Warehouse (CDW).

3 IRC § 21(a)(2).

4 For example, the dependent care tax credit phase-out is based on AGI. IRC § 21(a). The earned income tax credit (EITC) phase-out is based on the greater of earned income or AGI. IRC § 32. The Hope credit phase-out is based on a modified computation of AGI, which starts with AGI and then adds amounts excluded from AGI under IRC §§ 911, 931, or 933. IRC § 25A(d).

5 *See* National Taxpayer Advocate 2006 Annual Report to Congress 470, 473.

6 *See id.* For example, the phase-out range for the Dependent care tax credit is not indexed for inflation, but the phase-out range for the Hope credit is. IRC §§ 21(a) and 25A(h).

7 According to one research study, taxpayers who owe a balance upon filing their return are more likely than others to understate their liabilities, and more than 20 percent of such taxpayers with a balance due failed to pay it in full. *See* 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), *citing* District Office of Research & Analysis, Connecticut-Rhode Island and Southwest Districts, Project No. 13.0, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments* 44 (June 21, 2000). *See also* Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance* 1-2 (July 14, 1995) (finding: "On average, understated tax on balance due returns is ten times as large as understated tax on other returns."). For the 2006 tax year, 15 percent of all taxpayers who owed a balance upon filing their return failed to pay it in full. Compliance Data Warehouse, Individual Returns Transaction File (IRTF) (Oct. 2008).

may also reduce tax compliance by creating the perception that the tax code is unfair. Unlike an increase in marginal rates, 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.[8] Since such marginal rate "bubbles" produce unexpected deviations from our otherwise progressive rate structure, some taxpayers probably feel that phase-outs are unfair. Studies have found that the perception that the code is unfair may reduce voluntary compliance.[9] 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.

Example

A 63-year-old retiree with $15,000 in Social Security benefits, $15,000 in wage income, $20,000 in taxable pension income, and two children in college received a $500 bonus in 2007. He has an effective marginal income tax rate of about 70 percent with respect to the bonus as a result of just two phase-outs.[10] Because the nontaxable portion of his Social Security benefits is phased out as his income increases, the $500 bonus increases his taxable income by $925.[11] Since he is in the 15 percent tax bracket, the additional income would increase his federal income tax by $143 (approximately 15 percent x $925).[12] Because the bonus pushes the taxpayer into the phase-out range for the Hope credit for educational expenses, it would reduce his Hope credit by about $214 (from $3,300 to about $3,086).[13] 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 $357 ($143 + $214) so he would only get to keep the remaining $143 (or approximately 29 percent).[14] In contrast, if the $500 bonus were paid to someone in the highest 35 percent income tax bracket, he or she would typically get to keep $325 ($500 – ($500 x 35

8 We have no position regarding whether marginal rates should be higher or lower for all taxpayers or for any particular group of taxpayers. Our concern is with tax administration.

9 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress vol. II, 138, 149-150 (Marjorie E. Kornhauser, Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers); Kim M. Bloomquist, *Income Inequality and Tax Evasion: A Synthesis*, Second Edition of the OECD Jan Francke Tax Research Award (Mar. 20, 2003) (citing studies suggesting that growing dissatisfaction with the tax system, perception of unfair treatment, and perception with the value received is less than taxes paid may be causes of noncompliance).

10 This analysis assumes that before computing the Hope credit phase-out, each child would qualify for the full 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.

11 The phase-out range for the Social Security benefit exclusion begins when modified adjusted gross income plus one-half of the Social Security benefits exceed $32,000 for joint filers and $25,000 for single and head of household filers. IRC § 86(b), (c).

12 *See* Instructions to Form 1040, *U.S. Individual Income Tax Return* (2007) (tax tables). The amount is not exactly 15 percent of $925 because the figure comes from the tax tables.

13 The phase-out range for the Hope credit begins at $94,000 for joint filers and $47,000 for single or head of household filers for TY 2007. *See* IRC § 25A(h); Form 8863, *Education Credits (Hope and Lifetime Learning Credits)* (2007).

14 The taxpayer would have to fill out the Social Security Benefits Worksheet in Form 1040, the worksheet in Publication 915, *Social Security Benefits and Equivalent Railroad Retirement Benefits*, or the worksheets in Publication 590, *Individual Retirement Arrangements (IRAs)*, to determine how the bonus would affect the tax treatment of his Social Security benefits. He would also need to fill out Form 8863, *Education Credits*, to determine the amount of his Hope credit.

percent)) – more than twice as much. Moreover, if the taxpayer did not anticipate the effect of these phase-outs on his tax liability, he could be unexpectedly under-withheld.

Recommendation(s)

The National Taxpayer Advocate recommended in her 2006 annual report that Congress eliminate or at least simplify phase-outs, and reiterates those recommendations again this year as Congress considers tax reform options.[15] Although in most instances outright repeal would improve tax administration, the National Taxpayer Advocate recommends policymakers consider the questions below with respect to each phase-out. Congress should analyze these issues as well as the effect of phase-outs on marginal rates.[16]

1. Can we identify a tax policy reason (other than revenue scoring) for 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

15 National Taxpayer Advocate 2006 Annual Report to Congress 470.

16 Commentators have recently recommended that the JCT and Treasury's Office of Tax Analysis provide a detailed analysis of effective marginal tax rates for both current law and all major tax proposals. *See* Alan D. Viard and Alex Brill, *Effective Marginal Tax Rates, Part 2: Reality,* 121 Tax Notes 327 (Oct. 20, 2008). For example, the Urban-Brookings Tax Policy Center analyzed the implications of the McCain and Obama tax proposals on marginal rates. *See* Katherine Lim and Jeffrey Rohaly, *The Impact of the Presidential Candidates' Tax Proposals on Effective Marginal Tax Rates* (Sept. 30, 2008), *at* http://www.taxpolicycenter.org/UploadedPDF/411759_candidates_tax_proposals.pdf (last visited Dec. 4, 2008).

create planning opportunities for taxpayers who are able to shift income from one year to the next or to related individuals or entities. They also increase the perception of the tax law as unfair and arbitrary, which may reduce voluntary compliance.[17] However, phase-outs with wider phase-out ranges generally affect more taxpayers directly.

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.[18] Uniform ranges might also enable the IRS to reduce the number of forms, worksheets, and schedules required to administer phase-outs.

17 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress vol. II 138, 149-150 (Marjorie E. Kornhauser, Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers); Kim M. Bloomquist, *Income Inequality and Tax Evasion: A Synthesis*, Second Edition of the OECD Jan Francke Tax Research Award (Mar. 20, 2003) (citing studies suggesting that growing dissatisfaction with the tax system, perception of unfair treatment, and perception with the value received is less than taxes paid may be causes of noncompliance).

18 *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), *at* https://www.abanet.org/tax/pubpolicy/2002/020913lt-atb.pdf (last visited Dec. 4, 2008) (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).

LR #9

Reforming the Penalty Regime[1]

The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today.[2] The last comprehensive penalty reform was enacted in 1989, after careful study by an IRS task force, Congress, and others.[3] Since then, legislative and administrative changes to the penalty regime have continued piecemeal with a focus on deterring tax cheating, but without the kind of careful analysis the government conducted in 1989.[4]

Penalties are important because of their potential to increase voluntary tax compliance and reduce the $345 billion annual tax gap.[5] If structured improperly, however, penalties can *reduce* voluntary compliance, potentially endangering collection of the 84 percent of all taxes due that come in timely and voluntarily each year without any direct effort on the part of the government.[6] Perhaps for this reason, in 1989 both Congress and the IRS reached the conclusion that the purpose of civil tax penalties should be to enhance voluntary compliance.[7]

The IRS task force rejected other purposes, such as raising revenue, punishing noncompliant behavior, and reimbursing the government for the cost of compliance programs, because policies designed to fulfill other purposes may conflict with the goal of enhancing voluntary compliance.[8] Penalties may deter noncompliance for some taxpayers by imposing costs on it. However, if such deterrence were the only consideration, penalty reform

1 For a more detailed discussion of this topic and the recommendations, see *A Framework for Reforming the Penalty Regime*, vol. II, *infra.*

2 *See* IRM 20.1.1.1.1 (Feb. 22, 2008). For a list of current law penalties, see *A Framework for Reforming the Penalty Regime*, vol. II, Appendix A, Table 4, The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section, *infra*. We use the term "penalty" to refer to civil monetary penalties and "additions to tax," exclusive of interest charges and loss of tax benefits, for violating federal tax rules. For purposes of this report, a penalty does not include an increase in tax liabilities resulting from the failure to satisfy substantive requirements to obtain a tax benefit. For example, it excludes the so-called penalties for premature distributions from annuity contracts or individual retirement accounts. *See, e.g.*, IRC §§ 72(q), (t).

3 *See* Omnibus Budget Reconciliation Act of 1989 (OBRA), Pub. Law No. 101-239 §§ 7701-7743 (Dec. 19, 1989). OBRA incorporated penalty reform legislation entitled the "Improved Penalty Administration and Compliance Tax Act" (IMPACT). *See* H.R. Conf. Rep. No. 101-386 at 647-665 (1989).

4 *See* Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft), *reprinted in* 111 DTR L-1 1988 (June 9, 1988) (hereinafter "IRS Task Force Report I"); Executive Task Force for the Commissioner's Penalty Study, *Report on Civil Tax Penalties* (Working Draft of Chapters 1-4 and 8), *reprinted in* 237 DTR L-10 (Dec. 9, 1988) (hereinafter "IRS Task Force Report II"); Executive Task Force for the Commissioner's Penalty Study, *Report on Civil Tax Penalties, reprinted in* 89 TNT 45-36 (Feb. 27, 1989) (hereinafter "IRS Task Force Report III"). *See also* Joint Committee on Taxation, JCS-9-88, *Description of Tax Penalties* (Mar. 24, 1988).

5 *See* Internal Revenue Service U.S. Department of the Treasury, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance*, 10 (Aug. 2, 2007), *at* http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf (last visited Dec. 4, 2008). The $345 billion figure represents the "gross" tax gap, before accounting for late payments and enforced collections. *Id.*

6 When the IRS last measured compliance, it found that taxpayers voluntarily and timely pay about 84 percent of all federal taxes due each year – about $1.767 trillion out of $2.112 trillion in 2001 – without any action by the government. See Internal Revenue Service U.S. Department of the Treasury, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance*, 10 (Aug. 2, 2007), *at* http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf (last visited Dec. 4, 2008). Only about one percent are collected via enforcement (*i.e.*, $24.3 billion). *Id.*

7 *See, e.g.,* IRS Task Force Report I 8-9; H.R. Conf. Rep. No. 101-386 at 661 (1989) (stating in connection with significant civil tax penalty reform: "[T]he IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance.").

8 *See* IRS Task Force Report I at 9-10.

would be easy – we could simply increase the severity of all civil tax penalties and work to impose them in every instance of noncompliance. But, severe civil and criminal penalties already apply to intentional tax evasion.[9] Even very high penalties may not improve compliance if the likelihood that the IRS will detect noncompliance and impose the penalty is small.

Moreover, severe penalties that are not well designed could reduce compliance if they provide a disincentive for noncompliant taxpayers to step forward, are so disproportionate or arbitrarily imposed that taxpayers feel they are unjust, or result in protracted disputes that leave the IRS with few resources to impose them.[10] Even seemingly moderate penalties may be seen as disproportionately severe and arbitrary if they apply (or the IRS proposes them) in situations where taxpayers reasonably believe they have done nothing wrong or have done their best to comply. Therefore, any legislative changes to the penalty regime need to be based on research, rather than a reflexive reaction to the abuse of the day.

The Need for Better Data

Before we begin serious penalty reform, we need better data about whether and how penalties promote voluntary compliance. As early as 1989, Congress recommended that the IRS "develop better information concerning the administration and effects of penalties."[11] In addition, the IRS's official policy is to collect information

> to determine the effectiveness of penalties in promoting voluntary compliance... [and recommend] changes when the Internal Revenue Code or penalty administration does not effectively promote voluntary compliance...[12]

However, the government still has no significant quantitative data to show how penalties affect voluntary compliance.[13] The IRS either does not assess or does not track assessments of many current law penalties, much less study them in a comprehensive manner.[14] As a result, policymakers lack the information they need to structure and administer tax

9 *See, e.g.*, IRC § 6651(f) (fraudulent failure to file); IRC § 6663 (fraudulent underpayment); IRC § 7201 (criminal sanction for willful tax evasion); IRC § 7203 (criminal sanction for willful failure to file, report, or pay).

10 One survey found that the strongest factors influencing compliance was personal integrity. *See* Roper ASW, *IRS Oversight Board 2005 Taxpayer Attitude Survey* 7 (Feb. 21, 2006), *at* http://www.ustreas.gov/irsob/releases/2006/02212006.pdf (last visited Dec. 4, 2008) (finding that for 95 percent of the respondents personal integrity was somewhat of an influence or a great deal of influence on their compliance decision). *Accord* Marjorie E. Kornhauser, *Tax Compliance and the Education of John (and Jane) Q. Taxpayer*, 121 Tax Notes 737 (Nov. 10, 2008) (suggesting personal integrity and tax morale drive voluntary compliance). When a taxpayer feels the government (or the tax system) has become unjust, this sense of personal integrity may no longer require tax compliance – he or she may feel justified in evading the tax rules.

11 H.R. Conf. Rep. No. 101-386, 101st Cong., 1st Sess. 661 (1989).

12 Policy Statement 20-1 (June 29, 2004).

13 *See* Treasury Inspector General for Tax Administration, Ref. No. 2001-40-069, *Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity* 9 (Apr. 2001) (stating "[T]he IRS does not know if the individual taxpayer penalty program is achieving its objective of encouraging voluntary compliance;" and finding that the IRS lacked systems to assess whether it was assessing and abating penalties consistently or following up on recommended improvements).

14 *See A Framework for Reforming the Penalty Regime*, vol. II, Appendix A, Table 4, The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section, *infra* (showing many penalties for which the IRS either has no specific assessment data or did not assess in FY 2007).

penalties to maximize voluntary compliance or even to accurately estimate the budget effect of changes to the penalty rules.[15]

Analytical Framework

In the absence of better data, any penalty reform should consider the following principles, which the IRS penalty task force first identified in 1989 after extensive dialogue with stakeholders:[16]

- *Perceptions of Fairness.* Fairness has at least three components, as follows:
  - Horizontal equity – "treating similarly situated taxpayers similarly." A horizontally equitable penalty applies only to similarly situated taxpayers – those who fail to comply and also fail to put forth the expected level of effort to comply (*i.e.,* the taxpayer has no reasonable cause for the failure).
  - Proportionality – "the punishment should fit the crime." A proportionate penalty bears some relation to the culpability of the taxpayer and the harm caused by the infraction.
  - Procedural fairness – don't "shoot first and ask questions later." Procedural fairness requires the government to avoid asserting penalties against taxpayers that have not violated the rule.[17] It may also require the IRS to provide taxpayers with an effective process for administratively appealing penalty assessments.[18]
- *Comprehensibility.* Penalties cannot promote voluntary compliance if taxpayers do not understand them.
- *Effectiveness.* To be effective, a penalty must be severe enough to eliminate noncompliance without being so severe as to be difficult to enforce or perceived as disproportionate or unfair. A penalty may be more effective in encouraging remedial action if it is graduated (or reduced) based on the taxpayer's efforts to correct any initial noncompliance, provided such graduations do not produce excessive complexity.

15 Revenue generated directly from new penalties can be taken into account in connection with the federal budget "scoring" process, but any resulting effect on voluntary compliance can probably not be taken into account given the lack of quantitative research in this area. Because the scoring process takes the IRS's tendency not to enforce an unduly harsh penalty into account, a focus on budget scoring may provide an incentive for legislators to enact penalties that cannot be waived by the IRS even if such penalties might ultimately reduce voluntary compliance and tax revenues in ways that are difficult to measure. *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* (Feb. 2, 2005) (stating: "the effectiveness of the applicable penalty regime and the IRS enforcement posture (*i.e.*, whether the IRS routinely waives penalties for a particular issue and how frequently they audit an issue) that would be associated with a proposal are also taken into account."). However, as one commentator has observed: "[t]he best penalties are those that don't raise any revenue [directly] because they encourage the conduct that the penalty is designed to encourage." Jeremiah Coder, *Tax Shelter Penalties Are Unclear and Weakly Enforced, Panelists Say*, 2008 TNT 145-3 (July 28, 2008) (quoting N. Jerold Cohen).

16 The discussion in this section is drawn, in large part, from the IRS Task Force Reports.

17 *See* IRS Task Force Report II at L-18 (noting "the Task Force believes that, at the fringes, penalizing those who should not be penalized creates more negative attitudes and more problems than providing a slight tilt toward allowing some taxpayers who have violated a standard of behavior to avoid penalties").

18 *See* Task Force Report II at L-19 and L-20; Task Force Report III at 13-15. According to the Supreme Court, "taxes are the lifeblood of government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection... [therefore] the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified." *Bull v. U.S.*, 295 U.S. 247, 259-260 (1935).

- *Ease of administration.* A penalty is administrable if it is easy for the IRS to determine when it should be imposed while still allowing the IRS to exercise discretion in determining whether to waive the penalty. IRS employees may find reasons not to enforce penalties perceived to be unfairly harsh. Such penalties are also difficult to administer, in part, because they lead to controversy, which drains IRS resources, limiting the number of taxpayers the IRS will be able to impose the penalty against.

These four principles – fairness, comprehensibility, effectiveness, and ease of administration – are not always consistent with one another. Nonetheless, in the absence of quantitative data on the characteristics of penalties that best promote voluntary compliance, these considerations represent a sensible starting point for evaluating potential penalty reforms.

Recommendations[19]

Our primary recommendation is for Congress to have the IRS (1) collect and analyze more detailed penalty data on a regular basis, and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. This quantitative research should also identify changes to penalty laws and penalty administration that would improve voluntary compliance. Congress should appropriate additional funds for this research, as necessary.

Without such research, any penalty analysis will be somewhat subjective and superficial. Nonetheless, the limited data and analysis that are available, as discussed in greater detail in volume II of this report,[20] suggest the following changes to the major penalty provisions would promote voluntary compliance based on the principles described above:

1. Prevent IRS systems from automatically assessing accuracy-related penalties without considering all of the facts and circumstances;
2. Consider the feasibility of clarifying the definition of a "tax shelter" for purposes of the substantial understatement penalty;
3. Restructure the penalty for failure to file a "reportable transaction" information disclosure;
4. Improve the proportionality and effectiveness of the failure to file penalty for those who are more than six months late;
5. Reduce the penalty for late filers who timely pay within a period of extension;
6. Reduce the number of failure to pay penalty rates and eliminate interaction with the failure to file penalty;
7. Simplify the prior year estimated tax payment safe harbor and encourage taxpayers to use it;

19 For a more detailed discussion of this topic and each of the recommendations, see *A Framework for Reforming the Penalty Regime*, vol. II, *infra.*

20 *Id.*

8. Simplify the estimated tax penalty computation and provide an automatic waiver of *de minimis* estimated tax penalties;
9. Allow the IRS to abate estimated tax penalties for first-time estimated tax payers who have reasonable cause;
10. Make the trust fund recovery penalty more effective by clarifying that it covers third party payers; and
11. Reduce the penalty for failure to make tax deposits in the prescribed manner.

LR #10

Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact

Problem

Section 6707A of the Internal Revenue Code imposes a penalty of $100,000 per individual and $200,000 per entity for each failure to make special disclosures with respect to a transaction that the Treasury Department characterizes as a "listed transaction" or "substantially similar" to a listed transaction.[1] Consider the following:

- The penalty imposes strict liability – it applies without regard to whether the taxpayer has knowledge that the transaction has been listed and without regard to whether the transaction is reported correctly on the taxpayer's return.[2]
- The penalty applies even if the taxpayer derived no tax savings from the transaction.[3]
- The penalty must be imposed by the IRS and cannot be rescinded under any circumstances.[4]
- The penalty may not be appealed in court.[5]
- The taxpayer's disclosure must initially be made twice – once with the IRS Office of Tax Shelter Analysis and again with the tax return for the year in which the transaction is first required to be disclosed.[6] A disclosure included with the taxpayer's filed return, no matter how detailed, will not suffice by itself to avoid the penalty. After the first year in which the transaction must be disclosed, the taxpayer must continue to make disclosures with each filed return that reflects the transaction.
- A taxpayer that discloses a transaction may be subject to the penalty if the IRS deems the disclosure to be incomplete.[7]
- If a transaction is not "listed" at the time the taxpayer files a return but it becomes listed years later, the taxpayer becomes responsible for filing a disclosure statement and will be liable for this penalty for failing to do so. This is true even if the taxpayer has no knowledge that the transaction has been listed.[8]

1 IRC § 6707A. For the definition of a "listed transaction," see Treas. Reg. § 1.6011-4(b)(2).

2 IRC § 6707A; Joint Explanatory Statement of the Committee of Conference accompanying H.R. 4520, 108th Cong. at 373 (2004).

3 *Id.*

4 IRC § 6707A(a) & (d)(1). Section 6707A(a) provides that "[a]ny person who fails to [make the required disclosures] *shall* pay [the] penalty" (emphasis added). This language seems absolute, and the IRS to date has interpreted the provision as requiring it to impose the penalty in all circumstances described in the statute. There is a minority view that the Commissioner has broad authority in determining whether to impose penalties and that the Commissioner could refrain from imposing penalties in cases where he believes that doing so promotes effective tax administration.

5 IRC § 6707A(d)(2).

6 Treas. Reg. § 1.6011-4(a) & (e).

7 Treas. Reg. § 1.6011-4(d).

8 Treas. Reg. § 1.6011-4(e)(2). The requirement will cease to apply after the period of limitations for the final return reflecting the transaction has expired.

- The penalty applies to each tax return the taxpayer files.[9]
- The usual three-year statute of limitations does not apply.[10]

Thus, an individual who does business through a wholly owned S corporation may enter into a ten-year transaction that he does not believe is improper and that produces little or no tax savings – only to end up owing a penalty of $3 million (*i.e.*, a penalty of $200,000 on the S corporation and a penalty of $100,000 on the individual taxpayer for each of the ten years).[11]

A taxpayer who has entered into a transaction that is a "reportable transaction other than a listed transaction" fares only slightly better.[12] The penalty amount is $10,000 per individual and $50,000 per entity.[13] The penalty may be rescinded by the Commissioner of Internal Revenue, but only if a finding is made that rescinding the penalty would "promote compliance with the requirements of this title and effective tax administration."[14] This means the IRS must first assess the penalty and the taxpayer must then prepare a rescission request. The taxpayer may not seek judicial review of the final IRS determination.[15]

Section 6707A was added to the Code in 2004 in an effort to combat tax shelters.[16] The tax-writing committees were concerned that the IRS in some cases did not learn of the existence of tax shelters until it conducted audits after the fact, and in other cases, the IRS probably did not learn about the shelters at all. The purpose of imposing a harsh

9 IRC § 6707A; Treas. Reg. § 1.6011-4(e)(1); Joint Explanatory Statement of the Committee of Conference accompanying H.R. 4520, 108th Cong. at 373 (2004).

10 IRC § 6501(c)(10) (providing that the statute of limitations will remain open with respect to an undisclosed listed transaction until at least one year after the earlier of (i) the date on which the taxpayer provides the required disclosure or (ii) the date on which a material advisor provides the name of the taxpayer to the Treasury Department in response to a request made under IRC § 6112(b).).

11 As a general matter, the National Taxpayer Advocate believes that the IRS has broad authority to provide relief in cases where the application of a law to a taxpayer's circumstances produces egregious results. Section 7122 of the Code gives the IRS broad authority to compromise tax liabilities. Prior to 1998, the IRS considered offers in compromise only if they were based on doubt as to the taxpayer's liability or doubt as to collectibility. In 1998, Congress amended IRC § 7122, directing the Secretary to prescribe guidelines for IRS employees to use in determining whether an offer-in-compromise is adequate and should be accepted to resolve a dispute. *See* Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 3462 (1998); IRC § 7122(c). The conference report accompanying the legislation stated:

> [T]he conferees expect that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (*i.e.*, factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, the conferees anticipate that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration.

H.R. Rep. No. 105-599, at 289 (1998) (Conf. Rep.). We believe that imposing enormous penalties on taxpayers who either had no awareness of the Section 6707A disclosure requirements or who realized little or no tax savings is inequitable, imposes undue hardship, and contravenes public policy by undermining public respect for the fairness of the tax system. In the case of the Section 6707A penalty, however, it appears that Congress may have intended to override the Commissioner's general authority to compromise tax liabilities. Section 6707A(d) specifically limits to reportable transactions that are not listed transactions the Commissioner's authority to take into account "effective tax administration" considerations. Thus, the statute arguably excludes listed transactions from compromise. For additional perspective on "effective tax administration" offers in compromise, see National Taxpayer Advocate 2004 Annual Report to Congress 433-450 (Legislative Recommendation, *Offers in Compromise: Effective Tax Administration*).

12 For the definition of a "reportable transaction," see Treas. Reg. § 1.6011-4(b)(1).

13 IRC § 6707A(b)(1).

14 IRC § 6707A(d)(1).

15 IRC § 6707A(d)(2).

16 American Jobs Creation Act, Pub. L. No. 108-357, 118 Stat. 1418 § 811(a) (2004); H.R. Rep. No. 108-548, pt. 1, at 261 (2004).

penalty on taxpayers who fail to provide information was to increase the likelihood that the IRS could analyze questionable transactions and challenge transactions it thought were improper. Section 6707A also requires publicly traded companies to report the penalty to the Securities and Exchange Commission, which was also thought to serve as a deterrent to abusive transactions.[17]

Notwithstanding the underlying congressional intent in enacting Section 6707A, the statute as written can impose unconscionable hardship on taxpayers. Even the penalty for proven cases of civil fraud is capped at 75 percent of the tax underpayment.[18] Yet this statute allows penalties of up to $300,000 per year to be imposed on taxpayers with no underpayment of tax and no knowledge that they entered into transactions that the IRS has "listed." It is rare that a tax provision is found to violate the United States Constitution, but we believe the imposition of such a large penalty on a taxpayer who entered into a transaction that produced little or even no tax savings and without regard to the taxpayer's knowledge or intent raises significant constitutional concerns, including possible violation of the Eighth Amendment's prohibition against excessive government fines and due process protections.

In practice, the requirement that this penalty be imposed without regard to culpability may have the effect of bankrupting middle class families who had no intention of entering into a tax shelter – an outcome that has dismayed even hardened IRS enforcement personnel. For example, an Appeals Officer seeking advice from the IRS Office of Chief Counsel on whether he had any grounds to remove a Section 6707A penalty wrote:

> All the IRS employees involved in this case agree that the taxpayer (and the taxpayer's CPA) had no knowledge or reason to suspect that the transaction violated IRC 6011 and was a listed transaction requiring disclosure.... I am both an attorney and CPA and in my 29 years with the IRS I have never [before] worked a case or issue that left me questioning whether in good conscience I could uphold the government's position even though it is supported by the language of the law.[19]

TAS currently has about 40 cases in its inventory involving taxpayers who are facing this penalty,[20] and we understand that the IRS is considering the penalty in hundreds of additional cases.

17 IRC § 6707A(e); H.R. Rep. No. 108-548, pt. 1, at 261 (2004). The House committee report stated: "[T]he Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions."

18 IRC § 6663(a).

19 E-mail from Appeals Officer to a senior attorney in the IRS Office of Chief Counsel (Dec. 17, 2008).

20 Taxpayer Advocate Service, Taxpayer Advocate Management Information System (keyword and history search performed in December 2008).

Example

In 2004, an individual doing business through a wholly owned S corporation purchased a life insurance policy. Like many insurance policies, this one was touted as having certain tax benefits, which were worth about $45,000 over three years. Although the taxpayer was reasonably diligent in evaluating the transaction, he was unaware that it was substantially similar to a listed transaction and subject to special reporting requirements. On audit, the IRS was persuaded that neither the taxpayer nor his advisors knew the transaction was a listed transaction. Because the transaction was listed and was not disclosed, however, the IRS imposed a $900,000 penalty, consisting of three $200,000 penalties at the entity level and three $100,000 penalties at the individual level. The IRS cannot rescind the penalty, and the taxpayer is prohibited from challenging it in court.

Recommendation

The National Taxpayer Advocate recommends that the amount of the penalty imposed by Section 6707A be revised so that it bears a proportional relationship to the amount of tax savings. We understand that the purpose of the penalty is to promote disclosure, but the benefits of disclosure must be balanced against the burdens the penalty imposes on taxpayers. A transaction, even if tax-motivated, does not present significant compliance concerns if a taxpayer receives little or no tax savings. To the contrary, compliance concerns generally increase in direct proportion to the amount of the claimed tax savings. We recommend that the penalty be restructured to reflect this proposition.

The National Taxpayer Advocate is also concerned about the absence of a "reasonable cause" exception, the "stacking" of multiple Section 6707A penalties, and the potential imposition of the Section 6707A penalty on taxpayers who derived no tax benefit whatsoever. If the IRS concludes, for example, that neither the taxpayer nor his advisors had any knowledge that a transaction was questionable, we believe the IRS should have the authority to waive the penalty. For a discussion of these concerns and related penalty issues, see *A Framework for Reforming the Penalty Regime*, volume 2, *infra*, and Legislative Recommendation, *Reforming the Penalty Regime, supra.*

LR #11

The Time Has Come to Regulate Federal Tax Return Preparers

Problem

For most Americans, the annual ritual of preparing and filing tax returns represents their most significant contact with the U.S. government. Thus, the importance of making the return preparation process run smoothly cannot be overstated. More than 60 percent of individual taxpayers and most business taxpayers pay practitioners to prepare and file their returns.[1] In addition, in fiscal year 2006, nearly 73 percent of taxpayers who claimed the Earned Income Tax Credit (EITC) used preparers.[2] Accordingly, tax return preparers are an essential component of taxpayer rights and tax compliance. The IRS relies on preparers to educate taxpayers about tax laws, facilitate efficient electronic filing, and reduce the stress and anxiety often associated with the tax filing season.[3] Despite the vital role return preparers play in effective tax administration, anyone can prepare a tax return for a fee — with no training, licensing, or oversight required. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities, and are subject to censure, suspension, or disbarment from practice before the IRS in the event of wrongdoing.[4] Yet there is virtually no federal oversight over "unenrolled" preparers, who constitute the majority of tax return preparers today.

A 2006 study by the Government Accountability Office (GAO) underscores the significant problems in the tax return preparation industry. GAO auditors posing as taxpayers made 19 visits to several national tax preparation chains in a large metropolitan area. Using two carefully designed fact patterns, they sought assistance in preparing tax returns. The tax preparation chains made errors on all 19 returns. In 17 instances, the preparers computed the wrong refund amounts, with variations of several thousand dollars. In five of ten applicable cases, preparers failed to ask relevant probing questions, and as a result, they prepared returns claiming ineligible children for the EITC. Perhaps the most troubling finding was that preparers failed to report business income in ten of the 19 cases. Several preparers even advised the GAO "taxpayers" that reporting certain income was unnecessary because the IRS would have no way of knowing about it.[5]

1 IRS, Tax Year 2006 Taxpayer Usage Study, Report No. 16 (Returns received from Jan. 1, 2007 to Oct. 26, 2007).

2 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax year 2006).

3 *See* Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*, *infra*; National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

4 Circular 230, 31 C.F.R. § 10.50.

5 Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 2 (Apr. 4, 2006) (Statement of Michael Brostek, Director Strategic Issues, before the Committee on Finance, U.S. Senate).

The Treasury Inspector General for Tax Administration (TIGTA) conducted a similar study in 2008 and also found troubling results. TIGTA auditors posing as taxpayers visited 12 commercial chains and 16 small, independently owned tax return preparation offices in a large metropolitan area. All of the preparers visited were unlicensed and unenrolled. Of the 28 returns prepared, 17 (61 percent) were prepared incorrectly. Sixty-five percent of the inaccurate returns contained mistakes or omissions deemed to be caused by human error and/or misinterpretation of the tax laws. However, 35 percent of the inaccurate returns contained misstatements or omissions that TIGTA deemed willful or reckless. Finally, all of the business returns were prepared inaccurately.[6]

Since 2002, the National Taxpayer Advocate has proposed a plan for the IRS to register, test, and certify unenrolled federal income tax preparers. Given the role that preparers play in guiding taxpayers through our complex tax laws, it is incumbent on the IRS to register and identify unenrolled preparers and administer a basic examination to ensure at least a minimal level of competency among paid preparers. Moreover, an ongoing continuing professional education (CPE) requirement would keep preparers current on tax law changes and help them learn from the most common mistakes.[7]

Several states have experience in regulating return preparers. Oregon and California have requirements that preparers must meet before preparing tax returns in those states.[8] The GAO evaluated the two programs and determined the program in Oregon seemed to increase the accuracy of returns prepared in that state as compared to the rest of the country. Oregon has a two-tiered licensing program, with the first tier requiring qualifying education, an examination, and continuing education, and the second tier requiring work experience and a second examination. California's program requires qualifying education and the completion of continuing education.[9] However, the GAO review found the returns filed in California were *less* likely to be accurate than those filed elsewhere in the country.

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6 Treasury Inspector General for Tax Administration, Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (Sept. 3, 2008).

7 *See* National Taxpayer Advocate 2006 Annual Report to Congress 197-221; National Taxpayer Advocate 2005 Annual Report to Congress 223-37; 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 216-30; *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate). In her 2003 Annual Report to Congress, the National Taxpayer Advocate further encouraged Congress to enact a more stringent compliance and penalty regime to deter reckless disregard of the rules and/or negligence by paid preparers. National Taxpayer Advocate 2003 Annual Report to Congress 270-301. Based on continual discussions with internal and external stakeholders, the National Taxpayer Advocate's recommendation has evolved since originally proposed. The initial proposal required an initial exam and annual refresher exams. After discussing the issue with various stakeholder groups, we still firmly believe that an initial examination is essential to an effective program. However, rather than require annual refresher exams, we believe preparers should be required to periodically prove, upon renewing registration, the completion of either a continuing education or an examination requirement. Thus, preparers would be able to choice between an examination and CPE.

8 Maryland recently enacted legislation to regulate paid preparers. The Maryland Individual Tax Preparers Act establishes an eight-person Board of Income Preparers, and, effective June 2010, requires all preparers not specifically exempted to register, pay a fee, and take an examination modeled after the Special Enrollment Examination prepared by the IRS. The preparer must renew the registration every two years, at which time the preparer must pay a renewal fee and provide evidence of completion of continuing education requirements. Maryland Individual Tax Preparers Act, Senate Bill 817, Md. Code Business Regulation and Occupations, chap. 623 (May 22, 2008).

9 GAO, GAO-08-781, *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation* (Aug. 2008).

Thus, GAO's findings appear to support the need to require preparers to pass an initial examination in addition to continuing education.

Based on many discussions with a wide variety of external stakeholders, including commercial tax preparation chains and national professional trade associations, we believe there is general agreement that such legislation is necessary to protect the best interests of taxpayers. At a House subcommittee hearing held in 2005, the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the National Society of Accountants, and the National Association of Tax Professionals all testified in favor of the proposal in principle.[10] While there are remaining logistical issues to be addressed, the overriding goal must be to advance the long-term best interests of taxpayers and tax administration.

In the 110th Congress, proposals to regulate return preparers were included in two separate bills – S.1219, the Taxpayer Protection and Assistance Act of 2007, and H.R. 5716, the Taxpayer Bill of Rights Act of 2008.[11] Both bills include provisions to ensure unenrolled preparers are equipped with the necessary knowledge and skills to accurately prepare tax returns.

Recommendation

The National Taxpayer Advocate recommends that Congress enact a registration, examination, certification, and enforcement program for unenrolled tax return preparers. This program should consist of the following components:

- Any tax return preparer as defined in IRC § 7701(a)(36) other than an attorney, certified public accountant, or enrolled agent must register with the IRS, and Congress should authorize the IRS to impose a per-return penalty for failure to register, absent reasonable cause.
- All registered preparers must pass an initial examination designed by the Secretary to test the technical knowledge and competency of unenrolled return preparers to prepare federal tax returns. The exam can be administered in two separate parts. The first part would address the technical knowledge required to prepare relatively less complex Form 1040-series returns. The second part would test the technical knowledge required to prepare business returns, including complex sole proprietorship schedules.
- All registered preparers must complete CPE requirements as specified by the Secretary. The Secretary should have the authority to permit preparers to satisfy such requirements by instead passing a specified examination.

10 *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 109th Cong. (2005)

11 S.1219, § 4, 110th Cong. (2007); H.R. 5716, § 4, 110th Cong. (2008).

- All registered preparers must renew their registration every three years, at which point they must show evidence of completion of CPE requirements.
- The Secretary should be authorized and directed to conduct a public awareness campaign to inform the public about the registration requirements and offer guidelines about what taxpayers should look for in choosing a qualified tax return preparer.

LR #12

Refund Delivery Options

Problem

With the current downturn in the economy, federal tax refunds are an important source of funds for many individual taxpayers. As a result, the Department of Treasury and the IRS need to provide all taxpayers with the ability to receive refunds as quickly as possible and at minimal cost. The following measures would serve the best interests of taxpayers as well as tax administration:

- *Minimizing Refund Turnaround Time.* A significant number of taxpayers purchase commercial refund delivery products, such as refund anticipation loans (RALs), to receive their refunds quickly. Refunds for returns processed through the IRS Customer Account Data Engine (CADE) are released in five to seven days, while those processed through the Individual Master File (IMF) require nine to 15 days. The IRS should convert to CADE as quickly as possible and should evaluate all refund processes with the ultimate goal of minimizing the time it takes to release refunds.[1]
- *Revenue Protection Indicator.* The IRS e-file program is not designed to provide taxpayers with the reasonably accessible information necessary to make informed decisions about purchasing commercial refund delivery products. The IRS acknowledgement file, which is sent to taxpayers who e-file, includes the Debt Indicator but does not inform taxpayers whether compliance screens will delay the release of or reduce the amount of refunds. The IRS runs these compliance screens after it releases the acknowledgement file, and after taxpayers purchase RALs and potentially spend the loan proceeds. Thus, by including a Revenue Protection Indicator (RPI) in the acknowledgement file to notify taxpayers of compliance-related issues, the IRS could prevent avoidable defaults on RALs.
- *Debit Cards.* The quickest and cheapest way to distribute tax refunds is electronically.[2] However, a significant number of taxpayers, including Earned Income Tax Credit (EITC) recipients, are unbanked (*i.e.,* do not have an established relationship with a

1 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services*, (Aug. 29, 2008); IRS, Debt Indicator Report to Congress 27 (Oct. 31, 2006), as requested by H.R. Rep. No. 109-307 (2005) (Conf. Rep.). For a discussion of Treasury and the IRS's concerns regarding RALs, see Department of Treasury, Advanced Notice of Proposed Rulemaking, Guidance Regarding Marketing of Refund Anticipation Loans (RALs) and Certain Other Products in Connection with the Preparation of a Tax Return, REG-136596-07 (Jan. 8, 2008); Government Accountability Office (GAO), GAO-08-800R, *Refund Anticipation Loans* (June 5, 2008).

2 The U.S. Treasury Department estimates that by converting the 10.5 million people who still get a paper Social Security check once a month to electronic payments, it could save the federal government up to $42 million a year. Lori Montgomery, Washington Post, *Treasury Dept. Rolling Out Social Security Debit Card* (June 10, 2008) at D3.

financial institution) or need their money quickly.[3] The Department of Treasury and the IRS should develop a program to enable unbanked taxpayers to receive refunds on stored value cards (SVCs). Such a program would support the Financial Literacy and Education Commission's National Strategy for Financial Literacy by providing unbanked taxpayers with a government-sponsored refund delivery option that serves as a steppingstone to ultimately open bank accounts.[4] The IRS needs to evaluate the experience of the existing SVC program administered by the Financial Management Service (FMS) to distribute Social Security benefits, as well as other government-administered SVC programs, with the ultimate goal of developing a similar program for individual taxpayers.[5]

- *Public Awareness Campaign.* Taxpayers need accurate information to make informed decisions regarding refund delivery options. It is in the best interest of taxpayers and tax administration for the IRS to conduct a public awareness campaign rather than relying primarily on private industry to disseminate information.

Example

An EITC recipient with no relationship with any financial institution visits a commercial return preparer early every February to have his federal income tax return prepared. The taxpayer's average refund is $3,000 per year. Because he needs his refund to pay his bills within the week, he purchases a refund anticipation loan product from Bank A. He receives the loan proceeds on a commercial debit card, which has high transactional fees. After he has spent all of the proceeds downloaded onto the debit card, the taxpayer learns he has defaulted on his loan because the IRS froze his refund.

Recommendation

The National Taxpayer Advocate recommends that Congress require the Department of Treasury and the IRS to:

- Evaluate the entire refund process to determine opportunities to shorten the turn-around time;
- Develop a pilot program to determine how the inclusion of a Revenue Protection Indicator in the acknowledgement file will impact tax administration. Evaluate the feasibility of including such information in the current "Where's My Refund" online application;

3 Financial Literacy and Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* 67 (2006); GAO, GAO-08-800R, *Refund Anticipation Loans* (June 5, 2008). The average Adjusted Gross Income (AGI) for taxpayers filing tax year 2004 individual income tax returns with RAL indicators was $22,400. IRS Staff of Research, Analysis, and Statistics, *The Relationship between Bank Products and Individual Taxpayer Compliance*, Slide 4 (Nov. 2008).

4 Financial Literacy and Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* (2006).

5 Eleanor Laise, *Treasury Plans Social Security Debit Card*, Wall Street Journal (Jan. 4, 2008).

- Evaluate existing stored value card programs to distribute government benefits, with particular emphasis on the experience of FMS's Direct Express Program to distribute Social Security benefits;
- Incorporating lessons learned from existing programs, develop a SVC program to distribute refunds to individual taxpayers before the 2010 tax filing season; and
- Conduct an annual public awareness campaign to provide accurate information to taxpayers regarding available refund delivery alternatives, associated turnaround times, and any other pertinent information.

Present Law

Section 6402 of the Internal Revenue Code (IRC) authorizes the IRS to make credits or refunds. Other than the requirement that a taxpayer file a timely claim for refund,[6] and the requirement for the IRS to pay interest on the overpayment in certain circumstances,[7] nothing in the Code or the Treasury Regulations specifies the timing of the refund delivery process. There are, however, many nontax laws that would apply to the electronic payment of tax refunds onto SVCs. These laws include:

- Electronic Funds Transfer Act (Regulation E);[8]
- Federal Deposit Insurance Act;[9]
- U.S. Patriot Act ;[10]
- Bank Secrecy Act;[11]
- Gramm-Leach-Bliley Act;[12] and
- State consumer protection laws.

Reasons for Change

The Refund Delivery Process

An electronically filed return passes through three distinct organizations that process the return and deliver the refund electronically.[13] First, the IRS receives e-filed returns from transmitters on a daily basis. Once received, the returns are analyzed and accepted for

6 IRC §§ 6402(a), 6511.

7 IRC § 6611.

8 15 U.S.C. 1693 et seq.; 12 C.F.R. § 205.1 et seq.

9 Federal Deposit Insurance Act, 12 U.S.C. 1813. FDIC coverage only applies to SVCs if funds are "deposited" in insured financial institutions. Federal Deposit Insurance Corporation (FDIC), General Counsel's Opinion No. 8, 61 Fed. Reg. 40489 (Aug. 2, 1996).

10 Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT Act) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001).

11 The Bank Secrecy Act, 12 U.S.C. 1818, 1829b, 1951-59, and 31 U.S.C. 5311 et seq.

12 Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

13 IRS, Debt Indicator Report to Congress (Oct. 31, 2006), as requested by H.R. Rep. No. 109-307 (2005) (Conf. Rep.).

further processing or rejected back to the transmitter for correction and resubmission. Accepted returns undergo "pipeline" processing and additional analysis. Returns can "fall out" of the processing flow due to errors on the return or processing issues that require correspondence with the taxpayer, and result in refund delays. Compliance checks, such as the Dependent Database and Criminal Investigation (CI) screens, also take place on all returns. If the compliance screens spot an issue, the refund can be delayed for a potential fraud investigation or pre-refund examination. After passing through the compliance screens, returns are routed to either the CADE or IMF for processing by analyzing the return data within the context of the taxpayer's account, posting taxes due, and determining the amount of the refund. CADE returns are processed and posted daily, so it takes only a day and a half to process e-filed returns from receipt to posting. IMF returns are processed weekly, resulting in a processing range of five and a half to 11 and a half days. At the completion of posting, the IRS sends to the FMS of the Department of Treasury a file containing refund information and bank numbers.[14]

The FMS processing takes a half a day. Once FMS receives the refund file, it performs validations, processes the files through the Treasury Offset Program, and creates origination files that are transmitted to the Automated Clearinghouse (ACH) Network for settlement. The clearinghouse performs settlement services, transferring funds electronically from the Treasury to the designated bank account. The process takes two days and the refund is deposited the next day after the ACH processing cycle is complete.[15]

Total refund turnaround depends on when the return is submitted and whether it posts to CADE or IMF. Direct deposit of refunds for problem-free returns processed through CADE take five to seven days from the time of submission. In comparison, direct deposit refunds for returns processed through IMF take nine to 15 days. Each year, the IRS shifts more types of returns from IMF to CADE, including returns with the EITC, which moved to CADE in the 2008 filing season.[16]

TIGTA recently conducted a survey of 350 taxpayers who had RAL indicators on their IRS accounts. Of the 250 respondents who stated they received a RAL, 55 percent indicated they would be willing to wait seven or more days to receive their tax refunds from the IRS. In addition, approximately 64 percent of the respondents were banked, which indicates speed may play an important factor in the decision-making process. Sixty-three percent of the respondents received the EITC, and they paid ten to 39 percent of this amount for tax

14 FMS provides central payment services for federal program agencies, operates the federal government's collections and deposit systems, provides government-wide accounting and reporting services, and manages the collection of delinquent debt. IRS, Debt Indicator Report to Congress 26 (Oct. 31, 2006), as requested by H.R. Rep. No. 109-307 (2005) (Conf. Rep.).

15 *Id.*

16 *Id. See also* TIGTA, Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services* (Aug. 29, 2008); TIGTA, Ref. No. 2008-20-151, *Customer Account Data Engine Project Management Practices Have Improved, but Continued Attention is Needed to Ensure Future Success* (Sept. 11, 2008).

return preparation and RAL fees. Thus, by minimizing the refund turnaround time, the IRS could steer taxpayers away from more expensive refund delivery options.[17]

TIGTA reviewed the processing of the respondents' refunds and found interesting results. The IRS processed approximately 18 percent of the respondents' returns through CADE and released their refunds in five to ten days.[18] Considering that the overwhelming majority of respondents indicated a willingness to wait up to nine days to receive refunds, it appears a significant number of respondents might have chosen a different refund delivery method had they been well-informed.

RAL Defaults

Taxpayers suffer significant harm when they default on RALs. To minimize RAL defaults, the National Taxpayer Advocate has previously recommended that the IRS include a Revenue Protection Indicator in the acknowledgment file.[19] The acknowledgement file currently includes the Debt Indicator, which provides information about whether the taxpayer owes any delinquent debts to federal or state agencies pursuant to the Treasury Offset Program (TOP).[20] The DI can only distinguish between IRS and FMS debt. The IRS has information about tax debts, but for other federal debts, it directs taxpayers to the TOP call center, which can confirm the existence of a debt and refer taxpayers to the specific agency to which the debt is owed for further information.[21]

If the DI shows the taxpayer owes a federal or state debt, FMS has the authority to offset those debts against federal tax refunds.[22] Thus, the IRS will deduct the amount of the delinquent debt from the refund before releasing any remaining amount. If the taxpayer took out a RAL, it will default when the bank does not receive the full amount of the anticipated refund. While the DI certainly benefits taxpayers by reducing RAL defaults, the IRS and Treasury can provide taxpayers additional information to further minimize the default rate. Accordingly, the acknowledgement file should also address whether the IRS plans to hold a portion of the refund due to compliance activity.

17 While the TIGTA report stated that 85 percent of respondents would be willing to wait up to nine days to receive their information, based on TIGTA's reported findings, we believe it is more accurate to state that 55 percent would be willing to wait seven or more days. Forty percent stated they would be willing to wait seven to nine days and 15 percent stated they would be willing to wait greater than nine days. TIGTA Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services* 2-3, 29 (Aug. 29, 2008).

18 TIGTA, Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services* 8 (Aug. 29, 2008).

19 For a detailed discussion of the negative consequences of default, see National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, Vol. II (June 30, 2006).

20 FMS manages liabilities owed by taxpayers to federal or state agencies through the Treasury Offset Program (TOP). FMS has statutory authority to offset such debts against federal income tax refunds. IRC § 6402(d).

21 For more information on the Debt Indicator, see National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, Vol. II (June 30, 2006).

22 FMS manages liabilities owed by taxpayers to federal agencies through the TOP. FMS has the authority to offset such debts against federal income tax refunds and provides weekly information to the IRS. The IRS updates its system to reflect such debts in the form of the Debt Indicator. For more information on the TOP, see IRC § 6402(d); http://www.fms.treas.gov/news/factsheets/benefitoffset.html (last visited June 17, 2008).

Stored Value Cards

National Strategy to Improve Financial Literacy

Approximately ten million households in the United States are unbanked.[23] A significant number of taxpayers do not have an established relationship with a financial institution for a variety of reasons, including personal choice, poor credit history, or immigration status. Unbanked individuals may experience the following negative consequences:

- High fees for check cashing and bill payment;
- Higher risk of theft and robbery due to carrying cash;
- Inability to establish a credit history; and
- Difficulty in building assets.

Title V of the Fair and Accurate Credit Transactions Act of 2003 established the Financial Literacy and Education Commission and required the Commission to "improve the financial literacy and education of persons in the United States through development of a national strategy.[24] A section of the national strategy developed by the Commission encourages the use of public-private partnerships to assist the unbanked in establishing relationships with financial institutions.[25]

The establishment of an SVC program to distribute tax refunds, EITC benefits in particular, would further the national strategy to improve financial literacy. Because SVCs function similarly to traditional checking accounts, introducing these cards to the unbanked or underbanked will provide them with a steppingstone to a relationship with a financial institution with the ultimate goal of converting such accounts into traditional deposit accounts. In addition, access to funds through a debit card provides many tangible benefits, such as:

1. Elimination of the need to stand in line or pay high fees associated with check cashers and commercial refund products;
2. Quick access to funds;
3. Greater safety, as taxpayers do not have to carry as much cash;
4. Reduced risk of stolen paper checks;
5. Branded cards limit cardholder liability for lost or stolen cards;
6. A sense of personal empowerment for cardholders because they can make purchases directly with the card, shop or pay bills online; and
7. Potential to build credit (if the card provider reports accounts to credit bureaus).[26]

23 Financial Literacy and Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* 67 (2006).

24 Section 513(b), Title V, Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, 111 Stat. 1952 (2003).

25 Financial Literacy & Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* 72 (2006).

26 Comptroller of the Currency, Community Developments, *Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked* (June 2005).

Income tax refunds, and EITC benefits in particular, are significant amounts for many taxpayers and should be a prime focus for asset building initiatives. For example, in 2006, approximately 80 percent of individual income tax returns claimed a refund and the average amount was $2,689. For EITC returns with refunds, the average EITC claimed was $2,022 with an average AGI of $15,873.[27] Thus, considering the amounts in question, it is safe to assume that many individual taxpayers, especially EITC recipients, count on tax refunds and would prefer to receive their funds quickly and at low or no cost. Thus, refunds and EITC benefits are prime candidates for delivery on an SVC. In addition, in the above-discussed recent TIGTA survey of taxpayers with RAL indicators on their accounts, approximately 63 percent stated they would have preferred to receive a debit card from the IRS instead of purchasing a RAL.[28]

Finally, Congress has expressed interest in the development of a debit card program to deliver refunds to unbanked taxpayers. Section 10(g) of H.R. 5717, the Taxpayer Bill of Rights Act of 2008, directs Treasury to conduct a study, in consultation with the National Taxpayer Advocate, on payment opportunities to deliver tax refunds to unbanked taxpayers through electronic means, with a focus on debit cards.[29]

Increase Electronic Delivery of Refunds

FMS has stated that one of its 2009 priorities is to "[p]rovide federal payments timely and accurately, and continue to move toward an all-electronic Treasury for payments."[30] The private sector already offers open and closed loop debit cards to receive income tax refunds.[31] However, to realize the advantages of this electronic delivery method, taxpayers must pay the associated transaction fees over which the Department of Treasury has no control. By developing a government–sponsored SVC program, FMS could maintain the level of control necessary to best serve the interests of taxpayers and tax administration. Such a program will allow the IRS to steer taxpayers away from paper refund checks and toward electronic benefit transfers (EBT) because the IRS can endorse its own product. Furthermore, FMS could control the pricing and distribution plans of the product to serve the best interests of taxpayers.

It is important to note that the federal government has a strong incentive to provide an SVC for EITC benefits, because it is analogous to other government benefit programs. Census data illustrate that in 2003, the EITC lifted 4.4 million people out of poverty, including 2.4 million children. The EITC moves more children out of poverty than any other

27 IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF) for Tax Year 2006.

28 TIGTA, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services*, 2008-40-170, 7 (Aug. 29, 2008).

29 H.R. 5716, 110th Cong. §10(g) (April 8, 2008).

30 Financial Management Service, Mission Statement, Program Summary by Budget Activity and FY 2009 Priorities, *available at* http://74.125.47.132/search?q=cache:3aq49izp_0YJ:www.ustreas.gov/offices/management/budget/budget-documents/cj/09/CJ%2520FY09. FMS.pdf+financial+management+service+mission+statement+program+summary+by+budget+activity&hl=en&ct=clnk&cd=1&gl=us (last visited on Dec. 4, 2008).

31 Chase Issuing Debit Cards for Income Tax Refunds (Mar. 6, 2006), *available at* http://www.paymentnews.com/2006/03/chase_issuing_d.html; H&R Block Press Release, H&R Block Adds Mobile Phone Banking to Emerald Card Platform (May 28, 2008).

single program or category of programs.[32] Unbanked EITC recipients should not have to pay a fee to receive their benefit when they do not incur costs to access Social Security, food stamps, and other governmental benefits.[33]

The need for debit cards became increasingly evident when the IRS distributed economic stimulus payments in 2008. In general, the IRS issued the payments electronically if bank account routing information appeared on the taxpayer's 2007 tax return. Because RAL and RAC accounts are temporary and not controlled by the taxpayer, stimulus payments deposited into those accounts would not reach the taxpayer. Fortunately, the IRS receives an electronic indicator when a RAL or RAC is associated with a return and was able to program its systems to send paper checks to all taxpayers whose 2007 returns were accompanied by one of these indicators.[34]

According to IRS data, approximately 20.4 million taxpayers purchased RALs and Refund Anticipation Checks (RACs) during the 2008 filing season (as of June 10, 2008).[35] These taxpayers received their stimulus payments according to the schedule established for the release of paper checks – with some coming as late as mid-July – instead of receiving their payments electronically in May. Thus, more than 20 million taxpayers who purchased RALs and RACs waited up to 2-1/2 months longer to receive their stimulus payments than taxpayers who did not purchase those products. Considering that the AGI for taxpayers who purchased a RAL or RAC is substantially lower than the AGI for taxpayers who did not purchase a bank product, it is clear that the delay affected taxpayers at the lowest income levels.[36] These taxpayers would not have experienced this delay if they had SVCs to receive their refunds.

Taxpayer Awareness of Refund Delivery Options

Taxpayers need to have access to accurate information to make informed decisions about how to receive their refunds. Reducing the refund turnaround time and providing additional electronic delivery options will only impact taxpayer behavior if taxpayers know about all the options, as well as the consequences associated with each one. The information the IRS provides directly to taxpayers about refund delivery options is limited. For

32 Robert Greenstein, Center on Budget and Policy Priorities, *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor* (Aug. 17, 2005).

33 Any such SVC program would likely be put out to bid and administered by a private company, similar to the Direct Express program for Social Security benefits, as discussed below. .

34 In February 2008, one tax-preparation company notified the IRS that it had failed to include RAL indicators on approximately 450,000 electronically filed returns. The company and the bank providing the RALs were able to provide the routing transit numbers (RTNs) used for the RALs. The company provided this information early enough so that the IRS was able to include in its programming a requirement to convert returns bearing those RTNs to paper checks. The IRS reports that the taxpayers whose returns were involved generally did not experience delay in receiving their stimulus payments. IRS response to TAS information request (June 13, 2008).

35 IRS response to TAS information request (June 12, 2008) (Information as of June 10, 2008).

36 For tax year 2004 individual returns, the average AGI for taxpayers with no bank product was $55,200, and the average for RAL and RAC taxpayers was $22,400 and $32,200, respectively. IRS Staff of Research, Analysis, and Statistics, *The Relationship between Bank Products and Individual Taxpayer Compliance*, Slide 4 (Nov. 2008).

example, the IRS website offers a three week refund turnaround time for e-filed returns.[37] In addition, before the 2008 filing season began, the IRS issued a news release stating that taxpayers could receive direct deposited refunds associated with e-filed returns "in as little as ten days."[38] While the information is correct, taxpayers would benefit greatly by receiving more detailed information, such as the average refund turnaround time in the previous filing season for each filing method, broken down by the type of return. Because ten days is a conservative figure, especially when CADE processes the return, the IRS is not conveying a clear picture to the taxpayer and does not equip the taxpayer with enough knowledge to make a well-informed decision in the filing season.

Further, regardless of what information the IRS releases directly, many taxpayers receive information on refund delivery options from their return preparer or software package. It is unclear whether the IRS effectively monitors the accuracy of the information conveyed by these sources.

Explanation of Recommendation

Faster Refunds

The IRS needs to perform an end-to-end analysis of refund processing to identify opportunities for reducing refund turnaround time. This includes the migration to CADE, the ability to run certain processes and compliance screens concurrently rather than sequentially, and external processes (FMS and ACH).

Revenue Protection Indicator in the Acknowledgement File

The IRS should include an RPI in its e-file acknowledgement file. To provide this additional beneficial information, the IRS would need to run further compliance screens, such as the Dependent Database and CI screens, before releasing the acknowledgement file. The proposed reordering of the return processing pipeline would delay the release of the acknowledgement file.

The National Taxpayer Advocate is aware that the IRS considers the quick release of the acknowledgement file to be an incentive to e-file.[39] However, the IRS should also consider the inclusion of additional compliance information in the acknowledgement file as an incentive to e-file. Some taxpayers will learn very early in the process whether they have potential problems on their returns.[40] This knowledge could prevent them from spending

37 *See* http://www.irs.gov/taxtopics/tc152.html (last visited Nov. 30, 2008).

38 IRS News Release, *Tax Packages Arrive in Mail; IRS Reminds Taxpayers to e-file and Watch for Tax Law Changes*, IR-2008-1 (Jan. 2, 2008).

39 IRS, *Advancing E-File Study (Phase 1 Report)* 120 (Draft dated June 6, 2008).

40 The Revenue Protection Indicator (RPI) will only alert taxpayers to problems detected by initial compliance screens. The RPI will not alert taxpayers to problems detected by the IRS after the release of the refund. However, the fact that it detects only some, but not all, compliance issues should not justify abandoning the program. Taxpayers benefit from the information provided, such as by avoiding a RAL default, even if the RPI does not detect all compliance issues.

their anticipated refunds on credit, whether in the form of RAL proceeds or credit card charges. Taxpayers may even have the opportunity to correct errors before the problem escalates.

The IRS needs to weigh the benefits of such a program against the risks. For example, it is unclear how such a delay in the release of the acknowledgement file would impact the e-file rate. In addition, there is risk involved in providing quick information regarding the results of compliance screens. Such information should be general in nature so as not to provide a roadmap for the unscrupulous to work the system. Accordingly, it would be wise to develop a pilot program to test the impact of the RPI on tax administration.

The IRS also can expand the use of the indicator by modifying the current "Where's My Refund" program by including RPI information. The resulting system would have the ability to provide more customized information regarding the timing of that particular taxpayer's refund based on IRS screens as well as the DI.

Including the RPI in the acknowledgement file could potentially affect the commercial market for refund delivery products in a significant manner. First, the delay of the acknowledgement file would decrease the attractiveness of RALs because financial institutions would not approve the loans until the IRS releases the acknowledgement file, unless they are willing to assume greater risk. Thus, the difference in refund turnaround times between RALs and e-file/direct deposit delivery options would become that much smaller. Second, inclusion of the RPI would affect the industry's risk assessment calculations for RALs. Financial institutions would factor the resulting lower loan default rates into their risk analysis and price their products accordingly.

Stored Value Cards

The Department of Treasury needs to assess the feasibility of establishing a SVC program to deliver the EITC portion of federal income tax refunds. Such cards would allow taxpayers to receive their benefits as quickly as direct deposit while avoiding fees associated with many commercial delivery products, such as RALs, RACs, and commercial debit cards.

SVCs use a magnetic stripe to store information about funds prepaid to the card. There are two main categories: (1) single-purpose or "closed-loop" cards and (2) "open-loop" cards. Closed-loop cards, such as mass transit fare cards and college-issued cards, can only be used to buy goods at particular retailers. Open-loop SVCs can make debit transactions at a wide variety of retail locations, and can also receive direct deposits and withdraw cash at ATMs. Some of the open loop cards are branded by Visa or MasterCard and can be used wherever those brands are accepted.[41]

41 Federal Reserve Bank of New York, *Stored Value Cards: An Alternative for the Unbanked?* (July 2004); Katy Jacob, The Center for Financial Services Innovation, *Stored Value Cards: A Scan of Current Trends and Future Opportunities* (July 2004).

Reloadable multipurpose open-loop cards are essentially one step away from a traditional checking account. Users can make payments to a wide variety of merchants and service providers and, most importantly, they can load additional funds to the cards.

Taxpayers can either apply for a government sponsored SVC or utilize an existing commercial card to receive tax refunds. As long as the taxpayer inputs the SVC's routing and account number on the tax return, the IRS can direct deposit the refund onto the card.

The IRS and Treasury need to evaluate existing SVC programs to understand the benefits and disadvantages of such programs. In addition, Treasury should consider merging programs or at least informing taxpayers of the possibility of designating an existing SVC as the refund delivery mechanism. Once the IRS and Treasury have studied this issue, they should apply lessons learned to design and develop an SVC program before the 2010 filing season, including a government-sponsored SVC for EITC recipients.[42]

Existing Electronic Benefit Transfer Programs

EBT programs are well established in a variety of state, federal, and foreign governments. Treasury and the IRS need to evaluate the experience of the programs discussed below to develop an optimal program for tax refunds.

Direct Express for Social Security Payments

In a program designed to encourage approximately 3.9 million unbanked Social Security and Supplemental Security Income (SSI) recipients to switch to electronic payments, FMS has established Direct Express debit cards. The cards are MasterCard-branded and offered by the Department of Treasury's financial agent, Comerica Bank. FMS deposits benefits directly into a prepaid account accessed through the open-loop stored value card, which can be used anywhere a MasterCard debit card can be used (to make purchases or cash withdrawals).[43]

Direct Express cardholders can withdraw an amount up to the entire balance at a teller window at any MasterCard member bank. There is no fee for the first ATM withdrawal per deposit at any Comerica bank or any of the approximately 50,000 ATMs in the Direct Express network. Users pay a $0.90 fee for all subsequent ATM withdrawals. Other charges include $0.50 per bill for online bill payment and a $4.00 replacement card fee, and out-of-network ATMs may impose additional charges. There are no fees for purchases at retail establishments where MasterCard is accepted, overdrafts, declined transactions,

42 The New America Foundation has developed an interesting proposal to distribute tax refunds on SVCs. A summary of this proposal can be found *at* http://www.newamerica.net/publications/articles/2008/tax_refunds_deposited_prepaid_cards_could_provide_financial_access_unbanked_8028 (last visited on Dec. 5, 2008).

43 Lori Montgomery, Washington Post, *Treasury Dept. Rolling Out Social Security Debit Card* (June 10, 2008) at D3.

inactive accounts, ATM inquiries, bank teller withdrawals, customer service, the first annual replacement card, or text/e-mail/phone alerts of deposits and low balances.[44]

Direct Express offers the following protections to cardholders:

- Funds deposited on Direct Express cards are FDIC-insured;
- Electronic Funds Transfer Act protections apply to limit the cardholder's liability to $50.00 in the case of unauthorized withdrawals or purchases upon the loss or theft of the card (as long as the holder reports the loss, theft or unauthorized charge within two business days of learning about it; but no more than 90 days after it occurred);
- MasterCard's "Zero Liability" policy protections; and
- Social Security and SSI benefits deposited on the Direct Express card are not subject to garnishment or freezing, except as authorized by federal law, although the government can collect its own debts from the card.[45]

State Food Stamp Programs

All 50 states, the District of Columbia, the U.S. Virgin Islands, and Guam have food stamp EBTs. Once an application is accepted, most states mail a debit card to the recipient, who can access a food stamp EBT account at authorized food retail outlets. Food stamp benefits are automatically deposited into the food stamp EBT account for each month the recipient is eligible.[46]

Maryland Unemployment Benefits Disbursed on Prepaid Debit Cards

Maryland recently introduced a Visa branded prepaid debit card program for unemployment insurance benefits, contracting with Citigroup to provide the cards and manage the program. New applicants no longer have the option of receiving their unemployment insurance benefits on paper checks. The program costs the state nothing and Citigroup takes a percentage of the fees paid to Visa by retailers. Card users are not charged fees for the first four in-network cash withdrawals or for purchases wherever Visa cards are accepted. The cards have a two-year expiration date and can be used again even after the user temporarily discontinues receiving benefits.[47]

Payroll Cards

Employers and employees are increasingly realizing the benefits of distributing payroll onto SVCs. In 2004, 1.8 million unbanked households used prepaid payroll cards and the

44 FMS, *Direct Express Card, Common Questions, available at* http://fms.treas.gov/directexpress2007/questions3.html (last visited June 17, 2008); National Consumer Law Center, *Consumer Concerns for Older Americans: Prepaid Debit Cards for Social Security and SSI Benefits* (June 2008), *available at* http://www.nclc.org/issues/seniors_initiative/content/CC_Prepaid_Debit_Cards.pdf (last visited Dec. 17, 2008).

45 *Id.*

46 Department of Agriculture, Food Stamp Program, *Electronic Benefits Transfer (EBT) Highlights, available at* http://www.fns.usda.gov/fsp/ebt/ebt_status_highlights.htm (last visited June 17, 2008); United States Department of Agriculture, *Food Stamp Electronic Benefit Transfer Systems: A Report to Congress* (Oct. 2003).

47 Gus G. Sentementes, *Debits In, Checks Out*, Baltimore Sun (Dec. 1, 2008).

trend seems to indicate increased use of such cards. The cards reduce payroll processing costs for employers, provide quick and inexpensive access to payroll funds for unbanked employees, and aid cardholders in the transition to more traditional bank accounts. Banks find these arrangements profitable as well. Besides the obvious reason to move more cardholders to bank accounts, banks earn a portion of the transactional fees charged to retail merchants. They may also charge the employer or employee monthly or service fees, but these fees are often waived.[48]

United Kingdom's Post Office Card Account

The United Kingdom has established the Post Office Card Account (POCA) as a simple way to distribute benefits, state pensions, and tax credit payments. No other money can be paid into the account, including wages. While withdrawals are free, citizens can only make such withdrawals over the counter in post office branches. The response to the POCA was much greater than expected, with approximately 4.3 million customers regularly collecting benefits through a POCA as of April 2006.[49]

Australia's Welfare Card

The Australian government recently announced a new welfare debit card that will contain a portion of a family's welfare payment, which the family can only spend on necessities such as food and clothing. However, the program is considered controversial because it is designed to prevent recipients from using the funds on alcohol, drugs and gambling.[50]

Impact of Government Issued SVCs on Private Industry

Low income taxpayers would likely use the SVC accounts to pay bills, frequently draining the accounts soon after receiving the funds. These frequent transactions and average low balances would not allow the banks to earn much interest revenue. However, banks could view the program as a long-term initiative to establish relationships with potential future account holders and borrowers.[51]

Critics of the debit card proposal are concerned the IRS would be seen as endorsing particular industry products. Yet the IRS already accepts payments on commercial credit cards

48 Comptroller of the Currency, Consumer Affairs Department, *Community Developments, Insights: Payroll Cards: An Innovative Product for Reaching the Unbanked and the Underbanked* 2 (June 2005). Some of the employers offering such cards include McDonalds, FedEx, Sears, Roebuck, Dairy Queen, and Subway. Jennifer Bayot, *To Cash This Paycheck, Find the Nearest A.T.M.*, New York Times (Feb. 24, 2003).

49 The House of Commons, Treasury Committee, *Banking the Unbanked: Banking Services, the Post Office Card Account and Financial Inclusion*, 13th Report of Session 2005-2006, HC 1717 (Nov. 19, 2006), at 50, *available at* http://www.publications.parliament.uk/pa/cm200506/cmselect/cmtreasy/1717/1717.pdf (last visited Dec. 17, 2008); *see also* http://www.postoffice.co.uk/portal/po/content1?catId=19400181&mediaId=19900206&campaignid=PI0038&intcampaignid=PI0038 (last visited Dec. 17, 2008).

50 The Daily Telegraph, *Rudd Defends Welfare Card* (May 10, 2008), *available at* http://www.news.com.au/dailytelegraph/story/0,,23673204-5001021,00.html (last visited on Nov. 30, 2008); ABC News, *ACOSS Rejects Welfare Card Scheme* (May 9, 2008), *available at* http://www.abc.net.au/news/stories/2008/05/09/2239888.htm (last visited June 17, 2008).

51 Daniel M. Leibsohn, Community Development Finance, South Shore Bank of Chicago, *Southern New Hampshire University Roundtable 3, Case Study No. 5* (March 2002).

(MasterCard, VISA, American Express, and Discover), which include the same associations branding the open-loop SVCs.[52]

Improving Taxpayer Awareness

The IRS should conduct a public awareness campaign to give all taxpayers accurate information about refund delivery options. This information should include details of average costs and turnaround times, as well as any additional pertinent information. The IRS itself would control the content and media distribution of this campaign rather than relying primarily on tax return preparers or software providers to convey this information as the IRS does now.

Finally, once Treasury studies and determines the feasibility of distributing tax refunds on SVCs, it needs to get the word out to taxpayers about this additional refund delivery option. The IRS should inform taxpayers both directly and through their preparers how to apply for government-sponsored cards. In addition, taxpayers need to understand that they can utilize the direct deposit option on their returns by inputting the routing number and account number for an existing SVC, whether it is government sponsored or not.[53]

In addition to the public awareness campaign, the IRS should impose strict requirements on authorized IRS e-file providers to convey information to their customers about refund options.[54] The IRS can accomplish this by including communication requirements in Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns.*

Conclusion

To serve the best interests of taxpayers and tax administration, the IRS needs to evaluate current refund processes with an eye toward reducing the refund turnaround time. If the IRS can shorten the time it takes to release refunds, taxpayers would be less inclined to purchase more expensive commercial products.

The IRS should also include an RPI in the e-file acknowledgement file. This additional information regarding IRS compliance activity would benefit taxpayers by allowing them to correct errors early on, as well as avoid additional expenses or debt, based on an anticipated tax refund that the IRS has flagged. The IRS could also incorporate the indicator information in the existing "Where's My Refund" program to provide more customized and accurate information to users.

52 IRS, *Pay Taxes by Credit or Debit Card, available at* http://www.irs.gov/efile/article/0,,id=101316,00.html (last visited on June 17, 2008).

53 At the same time, the IRS should caution taxpayers to review applicable fees for SVCs not sponsored by the federal government.

54 The IRS should require preparers, in conjunction with the National Taxpayer Advocate's proposal to regulate return preparers, to ask their clients if they have an existing SVC to receive the refund and inform the client of the availability of the direct deposit option by using the routing and account numbers of the SVC. In addition, the IRS could include this requirement in IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns.*

The IRS should enable unbanked taxpayers, especially EITC recipients, to receive tax refunds on debit cards. The IRS can learn from the experiences of existing programs, including the FMS Direct Express program, and engage in discussions with the debit card industry to understand the costs of development and issues specific to tax administration. Ideally, the Social Security Administration program would merge with the IRS program in the future to allow both agencies to load benefits onto the same card. The IRS and Treasury should complete their review, design, and implement a program before the 2010 filing season. Taxpayers would either use existing SVCs or apply for and receive new debit cards before the filing season, and the IRS could load refunds onto cards as quickly as if direct deposit was used. Government-sponsored debit cards would have minimal fees and could be reloaded in the future. Through the government debit card program, unbanked taxpayers could familiarize themselves with the banking system and ultimately open bank accounts.

Finally, the IRS needs to increase taxpayer awareness of refund delivery alternatives. First, the IRS should conduct a public awareness campaign to reach taxpayers directly. Second, the IRS should require tax preparers to communicate this information.

LR #13

Crediting an Overpayment Against an Unassessed, Outstanding Tax Liability

Problem

In August 2007, the IRS issued Revenue Ruling 2007-51, permitting the IRS to (1) offset refunds pursuant to Internal Revenue Code (IRC) § 6402(a) against unassessed liabilities, or (2) credit a decrease in tax resulting in a carryback adjustment against an unassessed liability.[1] Permitting the IRS to offset a refund to an unassessed liability allows collection prior to assessment.

The examples described in the Revenue Ruling were limited to corporations, and the Office of Chief Counsel has advised Congress that it is only applying the ruling to corporations.[2] Revenue Ruling 2007-51 undermines taxpayers' right under IRC § 6212 to challenge a proposed deficiency before assessment and payment of the tax. Absent compelling public policy, taxpayers, particularly low income taxpayers who rely on refunds to help pay for basic living expenses, should be protected from this type of premature collection. If Congress shares the IRS's concern that large refunds or credits are being issued when corporations have significant unassessed liabilities, the National Taxpayer Advocate recommends that Congress carve out a specific exception in the Code for these circumstances.

Example

Pam, a single mother, filed her return for tax year 2007, anticipating a $2,500 refund. She received a statutory notice of deficiency for $2,000 for tax year 2006, which she was planning to dispute in the United States Tax Court. Instead of receiving a refund of $2,500, Pam received only $500 because the IRS offset her 2007 refund against her proposed 2006 liability, even though she was planning to dispute the 2006 liability and the window of time for filing a petition to the Tax Court was still open.

Recommendation

Amend IRC § 6402 to change the term "liability" to "assessed liability," thereby permitting the IRS to credit any overpayment only against an assessed tax liability.

1 2007-2 C.B. 573.

2 Letter from Deborah Butler, Associate Chief Counsel (Procedure and Administration), IRS Office of Chief Counsel, to U.S. House of Representatives, Committee on Ways and Means (Nov. 9, 2007).

Present Law

Under IRC § 6212, the IRS is authorized to send a notice to the taxpayer when it is determining a tax deficiency. Once the IRS issues a statutory notice of deficiency, the IRS may not assess the income tax liability for at least 90 days.[3] If the taxpayer does not agree with the notice, he or she generally has 90 days to petition the Tax Court.[4] If the taxpayer does not petition the court within those 90 days, the IRS will assess the tax. If the taxpayer files a petition, the tax is not assessed until the decision of the Tax Court is final. Collection of the liability cannot begin until the liability has been assessed.[5] However, the IRS may assess and collect tax under jeopardy procedures before the issuance of the statutory notice of deficiency, if the IRS determines that delay will jeopardize collection[6] (such as when a taxpayer's solvency is imperiled or if a taxpayer has intentionally attempted to place property out of the IRS's reach).[7]

Under IRC § 6402(a), the IRS may credit any overpayment against an outstanding tax liability, providing the IRS with another alternative for collecting past due liabilities. The statute, however, does not define liability. The IRS addressed this issue in Revenue Ruling 2007-51, which concludes that a liability is determined with specificity no later than the date the IRS sends a statutory notice of deficiency to the taxpayer.[8]

Reason for Change

In response to concerns raised outside the IRS[9] as well as by the National Taxpayer Advocate, the IRS Office of Chief Counsel reaffirmed its position that credits can be offset against an unassessed tax liability,[10] relying on several cases[11] in which the courts have held that crediting an overpayment is proper when a taxpayer's liability for the year of an underpayment is "then due," and that underpayments are "then due" when the IRS has issued a statutory notice of deficiency. Given the strong statutory support for a prepayment forum

3 IRC § 6213(a).

4 IRC § 6213. Within 90 days from the time the notice of deficiency is mailed, the taxpayer may file a petition with the Tax Court for redetermination of the deficiency.

5 IRC §§ 6502 and 6215(a).

6 IRC § 6861. The IRS may, if the collection of any tax is jeopardized by delay, immediately assess such tax, and interest and penalties, and the assessment will be due and payable upon notice and demand. However, the taxpayer can still petition the Tax Court after the jeopardy assessment.

7 *See* IRC § 6861. *See also* Treas. Reg. §§ 301.6861-1(a) and 1.6851-1(a)(1)(ii) and (iii).

8 Rev. Rul. 2007-51, 2007-2 C.B. 573. *See also* IRC § 6212 (requiring the IRS to send taxpayers a statutory notice of deficiency prior to assessment).

9 Letter from Carlton M. Smith, Director of the Cardozo Tax Clinic, Benjamin N. Cardozo School of Law, to Hon. Charles B. Rangel Chairman, House Ways and Means Committee and Hon. Max Baucus Chairman, Senate Finance Committee (Sept. 20, 2007), *published in, Associate Professor Calls IRS Ruling Harmful to Low-Income Taxpayers*, Tax Notes Today, 2007 TNT 185-70 (Sept. 24, 2007).

10 Letter from Deborah Butler, Associate Chief Counsel (Procedure and Administration), to Carlton M. Smith, Director of the Cardozo Tax Clinic, Benjamin N. Cardozo School of Law, (Dec. 31, 2007), *published in, IRS Maintaining Legality of Revenue Ruling on Refund Offsets in Letter to Law Professor*, Tax Notes Today, 2008 TNT 5-9 (Jan. 8, 2008).

11 *See McCarl v. United States*, 42 F.2d 346 (D.C. Cir. 1930), *cert. denied,* 284 U.S. 839 (1930) (interpreting § 284(a) of the Revenue Act of 1926); *Cole v. Helvering*, 78 F.2d 852 (D.C. Cir. 1934) (interpreting § 322(a) of the Revenue Act of 1928); *Standard Oil Co. v. United States*, 5 F. Supp. 976 (Ct. Cl. 1934), *cert. denied*, 293 U.S. 599 (1934). *See also Smith v. Director of Internal Revenue*, 77-2 U.S.T.C. (CCH) ¶ 9599 (S.D. Fla. 1977) (taxpayer's suit for a refund of 1975 tax that had been credited to deficiencies pending before the Tax Court was dismissed without prejudice).

in the Tax Court, the National Taxpayer Advocate is concerned that this interpretation of the term "liability" in IRC § 6402 will vitiate the concept of the prepayment forum, even though the Tax Court retains jurisdiction over the disputed liability. Offsetting a refund against an unassessed liability before going to Tax Court erodes the prepayment forum and eliminates an important check on the substantial power of the IRS to propose, assess, and collect taxes. This longstanding prepayment forum principle, coupled with the congressional limitation on collection prior to assessment (in most circumstances), indicates that Congress believes tax liabilities should be assessed prior to collection, including collection through refund offset under IRC § 6402(a). Therefore, IRC § 6402(a) should be amended to reverse the IRS interpretation and clarify that "liability" means "assessed liability."

The IRS's actual concern appears to be with the corporate net operating loss and the desire to offset an unassessed liability against a refund arising from the loss. If jeopardy authority is not sufficient to justify such action, then IRS should make its case to Congress – providing data to justify abridging the taxpayer's statutory right to a prepayment forum.

One explanation for why the IRS is moving to offset corporate refunds against liabilities that have not yet been assessed is the IRS's concern that the liability will go unpaid. However, if delay will jeopardize collection of tax, the IRS can assess such deficiency immediately using jeopardy assessment procedures.[12] The IRC allows for jeopardy assessments when a taxpayer's solvency is imperiled or if a taxpayer has intentionally attempted to place property out of the IRS's reach.[13] Collecting the liability prior to its assessment is unnecessary, since the IRS already has the authority under jeopardy proceedings to assess and collect on a liability before issuance of the statutory notice of deficiency, if collection is at risk. Outside these special circumstances, Congress has provided taxpayers with the opportunity to dispute their liabilities prior to assessment and collection.

Explanation of Recommendation

This recommendation to amend IRC § 6402(a) prevents the IRS from offsetting a legitimate refund against an uncertain, unassessed liability. This change preserves the prepayment forum established by Congress, so taxpayers will not face the burden of having to satisfy the liability before challenging a liability in court. This approach reflects the basic principle of our tax system – that taxpayers only have to pay what they owe, and only after their liabilities have been determined to a high degree of certainty. Offsetting a refund to a disputed liability before that liability is assessed, and while the taxpayer still has the opportunity to challenge the notice of deficiency in the Tax Court, undermines a fundamental right of taxpayers. If the IRS is concerned about the collection of tax in situations involving unassessed liabilities, it should use its existing jeopardy assessment and collection powers. Where jeopardy assessment powers are inadequate and compelling public policy concerns

12 IRC § 6861. The IRS may, if the collection of any tax is jeopardized by delay, immediately assess such tax, and interest and penalties, and the assessment will be due and payable upon notice and demand. However, the taxpayer can still petition the Tax Court after the jeopardy assessment.

13 *See* IRC § 6861. *See also* Treas. Reg. §§ 301.6861-1(a) and 1.6851-1(a)(1)(ii) and (iii).

warrant offset of a tax refund against an unassessed liability, Congress should explicitly authorize such collection.

LR #14

Waiver of Levy Prohibition Under Internal Revenue Code Section 6331(k)

Problem

Section 6331(k) of the Internal Revenue Code (IRC) generally provides that the IRS cannot levy on a taxpayer's assets while an offer in compromise (OIC) is pending or an installment agreement (IA) is pending or in effect. This prohibition does not apply, however, if the taxpayer files a written notice with the IRS waiving the levy restriction.[1] This aspect of the law creates the risk that the IRS will make such a waiver a necessary condition to obtain an IA or OIC.

Example

A husband and wife who own their home owe federal income tax, interest, and penalties for a number of tax years. They cannot fully pay their liability before the statutory period of limitations for collection will expire, and thus seek to enter into a partial payment installment agreement (PPIA) with the IRS. The IRS initially determines that seizure of the taxpayers' home would impose an economic hardship on the taxpayers and their family. Four months later, however, the IRS determines the taxpayers qualify for a PPIA but nonetheless refuses to allow them to enter into such an agreement unless they agree to waive the levy prohibition so the IRS can seize and sell their home.

Recommendation

Amend IRC § 6331 to prohibit the IRS from requiring the taxpayer to waive the IRC § 6331(k) prohibition on levies as a condition precedent to the IRS's consideration or acceptance of installment payments or an OIC.

Present Law

IRC § 6159 authorizes the IRS to enter into written agreements to allow the taxpayer to pay any liability in installments if the IRS determines that such agreement will facilitate the full or partial collection of such liability. IRC § 7122 provides that the IRS can compromise the taxpayer's liability through an OIC. Paragraphs (1) and (2) of IRC § 6331(k) provide that no levy may be made during:

- The period that a taxpayer's OIC or offer for an IA is pending;
- The 30 days after such an offer has been rejected;

1 IRC §§ 6331(k)(3)(A) and 6331(i)(3)(A)(i).

- The timely filed appeal of such a rejection;
- The period when an IA is in effect; and
- The 30 days after any termination of an IA.

IRC § 6331(k)(3)(A) states that rules similar to IRC § 6331(i)(3) and (4) shall apply for purposes of IRC § 6331(k). Section 6331(i) generally prohibits levies while proceedings for the refund of divisible tax are pending in federal court.[2] Section 6331(i)(3)(A), however, provides that the levy prohibition shall not apply if the taxpayer files a written notice with the IRS waiving this restriction. Thus, by a cross-reference to IRC § 6331(i)(3), IRC § 6331(k)(3)(A) gives taxpayers the ability to waive the ban on levies during the consideration of an IA or OIC and while an IA is in effect.

The prohibitions on levy during the pendency of proceedings for the refund of a divisible tax and while IAs are in effect, and the accompanying provision for taxpayer waiver of such prohibitions, were added to the Code by the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).[3] The Conference Report for RRA 98 suggests Congress gave taxpayers the ability to waive the levy prohibition to allow them to determine when a levy on a particular asset or assets would be in their best interest. Such collection would stop the running of interest and penalties as to the portion of the liability satisfied by the levy. In explaining the prohibition of levies during the pendency of refund proceedings, the Conference Report stated that, "Collection by levy would be withheld unless jeopardy exists or the taxpayer waives the suspension of collection in writing **(because collection will stop the running of interest and penalties on the tax liability)**" (emphasis added).[4]

Reasons for Change

Congress has given taxpayers the unconditional right to waive the prohibition of levies during the consideration of and after the rejection of IAs or OICs, and while IAs are in effect. Without specific direction or any limitations from Congress, the IRS may enter into IAs and OICs by making taxpayers waive the prohibition on levies as a precondition to considering or accepting such agreements. Because Congress intended that taxpayers would control the prohibition on levies to reduce penalties and interest by waiving their rights, any requirement by the IRS to require a waiver before considering or accepting IAs or OICs abrogates Congress' intent with respect to IRC § 6331(k)(3)(A).

The IRS enters IAs and OICs to facilitate full or partial collection of tax liabilities. Congress has not conditioned IAs or OICs on the IRS using intrusive and forced collection measures

2 A divisible tax is one in which the assessment may be divided into portions or separate transactions, such as employment taxes, Trust Fund Recovery Penalties, certain excise taxes and abusive tax shelter penalties. *See* IRM 1.2.14.1.4, *Policy Statement 5-16* (Mar. 1, 1984) and 5.11.1.3.10 (July 1, 2004).

3 Pub. L. No. 105-206, § 3462(b) (July 22, 1998).

4 H.R. Rep. No. 105-599, at 279 (1998) (Conf. Rep.).

to make additional collections. Rather, the conference report mentioned above makes clear that Congress believes collection by IAs or OICs enhances taxpayer compliance.[5]

Taxpayers have a right to decide when to waive the prohibition on levies, and the IRS should not condition the acceptance of an IA or OIC on the taxpayer waiving the collection restrictions. Yet the National Taxpayer Advocate has witnessed occasions when the IRS has attempted to require a waiver in exchange for agreeing to an IA.

Explanation of Recommendation

To protect taxpayers from IRS overreaching, the National Taxpayer Advocate recommends that Congress amend IRC § 6331(k)(3)(A) to clarify that the IRS is prohibited from making a waiver of the levy prohibition a condition for considering or approving an IA or OIC.

5 H.R. Rep. No. 105-599, at 289 (1998) (Conf. Rep.)

LR #15

Mailing Duplicate Notices to Credible Alternate Addresses

Problem

IRS notices often trigger the legal rights and obligations of taxpayers to do many things, such as contest a liability, challenge a deficiency notice, or contest a lien filing. The IRS mails these notices to the taxpayer's last known address.[1] However, with a population that is mobile and transitory, the last known address contained in the IRS's Master File may not reflect the taxpayer's current residence. As a result, taxpayers who are between return filing seasons and have not updated their addresses with the U.S. Postal Service (USPS) may not receive notices from the IRS that provide crucial legal rights and obligations, such as specific time limits on taking some required action. Between 2006 and 2007, about 13 percent of the U.S. population over the age of 16 moved, demonstrating the large number of taxpayers who potentially may not update their addresses with the IRS in any given year.[2] For example, in fiscal years 2007 and 2008 more than five percent of all audit correspondence mailed to taxpayers was returned as undeliverable.[3]

Example

A taxpayer timely files an income tax return for 2005 in 2006. For years beginning in 2006 and beyond, his income consists only of Social Security and minimal interest payments and is below the filing threshold so the taxpayer does not file a return. In 2007, the taxpayer falls ill and moves into a nursing home. Because of the illness, the taxpayer did not update his address with the USPS. The IRS discovers an issue with the taxpayer's last filed return and in early 2008 mails a letter to the taxpayer's last known address as contained in the Master File. The taxpayer no longer lives at this address and does not receive the letter. Had the IRS checked a third party database, it may have discovered a better address for the taxpayer through department of motor vehicle records, credit card billing addresses, or Social Security payment records.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 7701 to add a definition of "last known address" that incorporates case law and current regulations. Congress also should direct the Secretary of Treasury to:

1 Treas. Reg. § 301.6212-2.

2 U.S. Census Bureau, *Geographical Mobility: 2006 to 2007 Detailed Tables, at* http://www.census.gov/population/www/socdemo/migrate/cps2007.html (last visited Dec. 15, 2008).

3 Audit Information Management System (AIMS Database) IRS Compliance Data Warehouse. In fiscal year 2007 5.6 percent of audit correspondence was returned and 5.1 percent returned in fiscal year 2008.

(1.) Develop procedures for checking third party databases for credible alternate addresses prior to sending notices that establish legal rights and obligations (*i.e.*, Statutory Notices of Deficiency, Collection Due Process notices, notices of Federal tax lien filing, *etc.*); and

(2.) When there is a credible alternate address, require the IRS to mail the notice simultaneously to the last known address and to the credible alternate address (as defined by the Secretary).

Present Law

Many provisions of the Internal Revenue Code (IRC) require the IRS to mail notices to the taxpayer's last known address.[4] However, there is no statutory definition of the term "last known address." Treasury Regulations define "last known address" as the address on the taxpayer's last filed return, his or her address as reported to the USPS, or the address provided by clear and concise notice to the IRS.[5] No law or regulation requires the IRS to use third party sources, other than the USPS, to ascertain a credible alternate address for a taxpayer, even when notices that have been mailed to a last known address are returned to the IRS as undeliverable.

Reasons for Change

Taxpayers who move, and who do not update their addresses with the IRS or the USPS, may never receive notices that trigger crucial legal rights and obligations. The burden is on the taxpayer to keep the IRS informed of the taxpayer's whereabouts. The IRS can meet the letter of the law by mailing notices to the last known address, even if it may be many years old and the IRS has had no correspondence from the taxpayer, including filed tax returns, in the intervening years.

If a collection notice comes back as undeliverable, the IRS feeds the taxpayer's previous address into third party software to ascertain if a new address might exist. If it finds a new address, the Collection function mails a letter seeking confirmation that this is the taxpayer's present address, and includes a change of address form for the taxpayer to file if indeed the taxpayer has moved. This is known as an "Are you there?" letter. The IRS Collection function mails a similar letter in cases where the USPS returns mail with a change of address notification. Between Jan. 1, 2008, and Dec. 15, 2008, the IRS mailed over 100,000 Undeliverable Mail - New Address Verification letters, representing only letters sent by the Collection function to taxpayers whose undeliverable mail was returned with change of address notifications.[6] This figure does not include the number of "Are you there?" letters sent to addresses obtained through third party databases. The letter simply asks if the

4 *See, e.g.*, IRC §§ 6212, 6320, 6330, 6303.

5 Treas. Reg. § 301.6212-2.

6 Wage & Investment Division, Office of the Notice Gatekeeper, *L 2788C Undeliverable Mail-New Address Verification, at* http://gatekeeper.web.irs.gov/snipDetail.aspx?pCP=2788C (last visited Dec. 15, 2008). A total of 111,044 of these letters were sent between January 1, 2008, and December 15, 2008.

taxpayer is at the new address, and includes a change of address form for the taxpayer to file if indeed the taxpayer has moved. However, any time period triggered by the initial notice that spurred the "Are you there?" letter continues to run and may expire before the taxpayer responds with an updated address.

Requiring the IRS to perform an address search and to mail a duplicate notice to a credible alternate address (if one exists) simultaneously with the statutorily required notice mailed to the last known address will increase the possibility of reaching that taxpayer at the beginning of the process. Reaching the taxpayer at an earlier juncture would in turn allow the taxpayer to resolve or try to resolve the situation before the time for doing so expires and before further fees and penalties accumulate.

Explanation of Recommendation

Providing a statutory definition of the "last known address" that includes a provision for checking third party databases for credible alternate addresses and sending a duplicate notice will increase the likelihood the taxpayer receives actual notice and reduce the volume of undeliverable mail. The IRS currently uses third party databases to check addresses in the collection context and can develop rules for what constitutes a "credible alternate address" such that the IRS is comfortable mailing a duplicate notice to the taxpayer at that address.[7] This approach will help to protect the taxpayer's privacy as well as increase responsiveness to correspondence.

By requiring the IRS to mail a duplicate notice to a credible alternate address simultaneously with the required notice to the taxpayer's last known address, the IRS would have a better chance of resolving the taxpayer's case early in the process, saving the time and expenditure associated with unnecessary appeals, audit reconsideration, litigation, and collection. Early intervention on the part of the IRS would reduce burden to both the IRS and the taxpayer.

7 In issuing regulations, the Secretary will need to define what constitutes a credible alternate address, what constitutes a third party database, and what a notice with significant legal effect is.

LR #16

Health Insurance Deductions for Self-Employed Individuals

Problem

In her 2001 and 2004 Annual Reports to Congress, the National Taxpayer Advocate recommended that Congress repeal Internal Revenue Code (IRC) § 162(l)(4) to afford sole proprietors the same tax treatment as their wage-earning counterparts.[1] Self-employed individuals cannot deduct health insurance costs when determining net earnings for self-employment tax purposes. While wage-earners can participate in benefit plans that allow them to exclude their contributions from gross income,[2] thereby avoiding Social Security and Medicare taxes, self-employed taxpayers must pay both the employee and employer shares of Social Security and Medicare taxes on their health insurance costs.[3] Further, C corporations can deduct the health insurance premiums paid on behalf of their employees as ordinary and necessary business expenses, and are not subject to Social Security or Medicare taxes on those amounts for either the employer or employee.[4]

Example

Mr. Smith, who is self-employed, spends $7,000 every year on health insurance premiums for himself and his family. At a tax rate of 15.3 percent, Mr. Smith must pay $1,071 in self-employment tax on what he spends for his family's health insurance. Mr. Smith must pay both the employer and employee shares of the Medicare and Social Security taxes associated with his health insurance premiums. In contrast, a wage earner who participates in his employer's cafeteria plan and incurs the same health insurance costs ($7,000) is not required to pay Social Security and Medicare taxes on his premiums. Because Mr. Smith is self-employed, he pays $1,071 more than his wage-earning counterpart. Additionally, the employer of the wage-earning individual can deduct payments made to cover employee health insurance from gross income, thus avoiding Social Security or Medicare taxes on those premiums.

RECOMMENDATION

Congress should repeal IRC § 162(l)(4) to place self-employed taxpayers on an equal footing with their wage-earning counterparts.

1 *See* National Taxpayer Advocate 2004 Annual Report to Congress 388; National Taxpayer Advocate 2001 Annual Report to Congress 223.

2 *See* IRC § 106(a).

3 IRC § 1401. Partners in partnerships and two percent owners in "S" Corporations also must file an IRS Form 1040, Schedule E, which does not allow for the deduction of self-employment tax on insurance premiums paid.

4 IRC § 162(a) and Treas. Reg. § 1.162-10(a).

LR #17

Mileage Deduction for Charitable Activities

Problem

Section 162(a) of the Internal Revenue Code (IRC) generally allows a trade or business to take a deduction for ordinary and necessary expenses paid or incurred during the taxable year in connection with the trade or business. For trade or business expenses associated with operating a passenger automobile, taxpayers have the option of deducting actual expenses or taking the standard mileage deduction.[1]

The IRS annually adjusts the standard mileage rate for business expenses. For 2008, the IRS initially set the rate at 50.5 cents per mile.[2] However, due to the rapidly increasing cost of fuel, the IRS increased the standard mileage rate to 58.5 cents per mile for business expenses incurred during the last six months of 2008.[3]

For passenger automobiles driven for charitable activities, the allowable mileage deduction is governed by IRC § 170,[4] which sets the standard mileage deduction for vehicle expenses associated with a charitable activity at 14 cents per mile. Unlike the standard mileage deduction for business expenses, the mileage deduction for charitable activities is specified in the Code, with no provision to allow the IRS or the Secretary of the Treasury to adjust the rate. As a result, the IRS does not have the discretion to adjust the standard mileage deduction for charitable activities from year to year.

Example

John Doe has been volunteering at his local church for the past six years. The church organizes a food drive each Thanksgiving, collecting groceries from its congregation for volunteers to distribute to needy families. John has a large sport utility vehicle that can hold many bags of groceries and seat several other volunteers. John does not receive reimbursement from the church for his fuel expenditures (which have increased significantly over the years), but is allowed to deduct 14 cents per mile driven for this charitable activity.

John recalls receiving reimbursement at a much higher rate on the few occasions that he has had to drive his car for his company. Upon checking his records, John learns that his company reimbursed him 36 cents a mile in 2003, and each year the mileage rate increased,

1 *See* Rev. Proc. 2007-70, 2007-2 C.B. 1162.

2 *See id.*

3 *See* Announcement 2008-63, 2008-28 I.R.B. 114.

4 IRC § 162(b) provides that no deduction is allowed under IRC § 162(a) for any charitable contribution or gift.

reaching 58.5 cents a mile in 2008. John wonders why the church is only reimbursing him 14 cents a mile this year, the same as in 2003.

Reasons for Change

Many U.S. residents felt the effect of the cost of gasoline reaching all-time highs in 2008. The IRS has recognized this fact and has increased the standard mileage rate for business expenses for the latter part of the year. Each year, the IRS adjusts the standard mileage deduction for business expenses. However, the standard mileage rate for providing services for charitable organizations may not be adjusted without a change in legislation.

Several bills have been introduced in Congress in recent years addressing this concern, including:

- H.R. 2020 introduced April 24, 2007, by Rep. Todd Platts (PA);
- H.R. 6283 introduced June 17, 2008, by Rep. John Lewis (GA); and
- S. 3246 introduced July 10, 2008, by Sen. Benjamin Cardin (MD).

Providing this adjustment will assist charities, especially in difficult times when taxpayers are unable to make cash donations but would make in-kind donations or volunteer their time.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 170(i) to allow the Secretary of the Treasury to determine the standard mileage rate for charitable activities.

Most Litigated Issues: Introduction

Internal Revenue Code (IRC or the 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 the type of taxpayer affected. Through analysis of these issues, the National Taxpayer Advocate will, if appropriate, propose legislative recommendations to mitigate disputes that result in litigation.

TAS used commercial legal research databases to identify the ten most litigated issues in federal courts from June 1, 2007, through May 31, 2008.[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:

- Gross income (IRC § 61 and related Code sections);
- Collection Due Process hearings (IRC §§ 6320 and 6330);
- Summons enforcement (IRC §§ 7602(a), 7604(a), and 7609(a));
- Trade or business expenses (IRC § 162(a) and related Code sections);
- Accuracy-related penalty (IRC § 6662(b)(1) and (2));
- Civil damages for certain unauthorized collection actions (IRC § 7433);
- Failure to file penalty (IRC § 6651(a)(1)) and estimated tax penalty (IRC § 6654);
- Relief from joint and several liability for spouses (IRC § 6015);
- Frivolous issues penalty (IRC § 6673 and related appellate-level sanctions); and
- Family status issues (IRC §§ 2, 24, 32, and 151).

The ten Most Litigated Issues are the same ones identified in 2007,[3] but the order of the issues has shuffled slightly from the 2007 list. Gross income rose from second to first place due to a dramatic increase in the number of cases involving the issue of whether income earned in Antarctica should be excluded from gross income under IRC § 911.[4] The summons enforcement and trade or business expense issues also saw notable increases in litigation, with the latter rising from seventh to fourth place.[5]

1 Federal tax cases are tried in the United States Tax Court, United States District Courts, the United States Court of Federal Claims, 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 courts dismiss other taxpayers' cases for a variety of reasons, including lack of jurisdiction and lack of prosecution. Additionally, courts can issue less formal "bench opinions," which are not published or precedential.

3 *See* National Taxpayer Advocate 2007 Annual Report to Congress 558-61.

4 Gross income cases increased from 112 in 2007 to 205 in 2008. *See* National Taxpayer Advocate 2007 Annual Report to Congress 558-61.

5 The summons enforcement issue had 109 cases in 2007 and 146 cases in 2008. Trade or business expenses had 77 cases in 2007 and 116 in 2008. *See* National Taxpayer Advocate 2007 Annual Report to Congress 558-61.

Once we identified the ten most litigated issues, TAS analyzed each issue in four sections: a summary of findings, description of present law, analysis of the litigated cases, and conclusion. Each case is listed in Appendix III, where we categorize the cases by type of taxpayer (*i.e.*, individual or business).[6] Appendix III also provides the citation for each case, indicates whether the taxpayer was represented at trial or argued the case *pro se* (without counsel), and lists the court's decision in each case.[7]

Beginning with the 2007 Annual Report to Congress, our office expanded the "Most Litigated Issues" section of this report by adding a new "Significant Cases" discussion before the comprehensive analysis of the ten issues. This discussion summarizes important judicial decisions that are not included in the top ten issues but were deemed significantly relevant to tax administration.

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 United States Bankruptcy Courts. With limited exceptions, taxpayers have an automatic right to appeal 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 (CDP), and relief from joint and several liability.[9]

The federal district courts and the United States 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]

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6 Individuals filing Schedules C, E, or F were deemed business taxpayers for purposes of this discussion even if items reported on such schedules were not the subject of litigation.

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. The citations also indicate whether decisions were on appeal at the time this report went to print.

8 *See* IRC § 7482, which provides that, in general, the United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) have exclusive 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 (appeals from a United States District Court are to the appropriate United States Court of Appeals); 28 U.S.C. § 1295(a)(3) (appeals from the United States Court of Federal Claims are heard in the United States Court of Appeals for the Federal Circuit); 28 U.S.C. § 1254 (appeals from the United States Courts of Appeals may be reviewed by the United States Supreme Court).

9 IRC §§ 6214; 7476-7479; 6320; 6330; 6015.

10 28 U.S.C. § 1346(a)(1). *See Flora v. United States*, 362 U.S. 145 (1960), *reh'g denied*, 362 U.S. 972 (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 indicates that many taxpayers appeared before the courts *pro se*.[13] Table 3.1-01 lists the most litigated issues for the period June 1, 2007, through May 31, 2008, and identifies the number of cases, broken down by issue, in which taxpayers appeared *pro se*. As illustrated in the table below, the category of cases with the highest rate of *pro se* taxpayers are those involving family status issues, the frivolous issues penalty, and civil damages for certain unauthorized collection actions.

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
Gross Income	205	68	33%
Collection Due Process	179	104	58%
Summons Enforcement	146	108	74%
Trade or Business Expense	116	78	67%
Accuracy-Related Penalty	87	47	54%
Civil Damages for Certain Unauthorized Collection	78	60	77%
Failure to File and Estimated Tax Penalties	66	47	71%
Joint and Several Liability	50	27	54%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	49	45	92%
Family Status Issues	34	33	97%
Total	**1,010**	**617**	**61%**

Table 3.1-02 demonstrates our belief that overall, taxpayers have a higher chance of prevailing in litigation if they are represented. However, *pro se* taxpayers actually experienced a higher rate of success than represented taxpayers in litigation over gross income and civil damages for certain unauthorized collection actions. The higher success rate for *pro se* taxpayers litigating these issues is noteworthy and indicates a potential failure in communications between taxpayers and the IRS at the administrative level.

13 "*Pro se*" means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* 1236-37 (8th ed. 2004).

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
Gross Income	68	8	12%	137	10	7%
Collection Due Process	104	8	8%	75	10	13%
Summons Enforcement	108	1	1%	38	8	21%
Trade or Business Expense	78	21	27%	38	10	26%
Accuracy-Related Penalty	47	8	17%	40	17	43%
Civil Damages for Certain Unauthorized Collection	60	8	13%	18	1	6%
Failure to File and Estimated Tax Penalties	47	5	11%	19	3	16%
Joint and Several Liability	27	5	19%	23	7	30%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	45	8	18%	4	1	25%
Family Status Issues	33	2	6%	1	0	0%
Totals	**617**	**74**	**12%**	**393**	**67**	**17%**

Significant Cases

The purpose of this section is to summarize certain judicial decisions that generally do not involve any of the ten most litigated issues, but nonetheless highlight important issues relevant to tax administration.[1] These decisions are summarized below.

In *Knight v. Commissioner*, the Supreme Court held that a trust's or estate's miscellaneous itemized deductions are subject to the "two percent floor," unless it would be unusual or uncommon for those costs to be incurred by an individual holding the same assets as the trust or estate.[2]

Knight, the trustee of a trust holding marketable securities, paid $22,241 in investment advisory fees for the trust for the year. The Internal Revenue Code (IRC or Code) provides that individuals, trusts, and estates may take itemized deductions to the extent that they exceed two percent of adjusted gross income.[3] This two percent threshold is commonly referred to as the "two percent floor." The Code further provides that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" are not subject to the two percent floor.[4] On the trust's return, Knight reported total income of $624,816 and deducted the fees in full.

On audit, the IRS disallowed the deduction for the portion of the fees that did not exceed two percent of the trust's adjusted gross income, and assessed a $4,448 deficiency. Knight petitioned the U.S. Tax Court on behalf of the trust, observing that his fiduciary duty under state law required him to obtain investment advisory services for the trust, and therefore to pay an investment advisory fee. Accordingly, he argued, the fees resulted from the fact that the taxpayer was a trust, and should be fully deductible. The Tax Court disagreed, finding that investment advisory fees are commonly incurred by individuals, and consequently, the fees were subject to the two percent floor.[5] The Second Circuit affirmed the Tax Court on the basis that an individual "could" incur investment advisory fees.[6]

The Second Circuit ruling exacerbated a conflict among the circuits. The Sixth Circuit had held that investment advisory fees paid by a trust were fully deductible, reasoning

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2007, and ending on May 31, 2008. For purposes of this section of the report, we generally use the same time period. However, we have included one or more cases decided after May 31, 2008, because the issues involved in those cases are particularly important. We are also discussing one case that is included in one of the ten most litigated issues because the decision was rendered by the United States Supreme Court.

2 *Knight v. Comm'r*, 128 S. Ct. 782 (2008). In response to *Knight*, the IRS provided interim guidance regarding the deductibility of costs "bundled" as part of one commission or fee for taxable years beginning before January 1, 2008. *See* Notice 2008-32, 2008-11 I.R.B. 593.

3 IRC § 67(a) (individuals) and (e) (trusts and estates).

4 IRC § 67(e)(1).

5 *Rudkin Testamentary Trust v. Comm'r,* 124 T.C. 304 (2005), *aff'd,* 467 F.3d 149 (2d Cir. 2006), *aff'd sub nom.*, 128 S. Ct. 782 (2008).

6 *William L. Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 149, 155-56 (2d Cir. 2006), *aff'd sub nom.*, 128 S. Ct. 782 (2008).

that because a trustee has a fiduciary duty to manage trust assets as a "prudent investor," investment-advisory fees are "necessary to" the trust's administration and "caused by" the fiduciary duty of the trustee.[7] In contrast, the Fourth and Federal Circuits previously held that such fees were subject to the two percent floor because they were "commonly" or "customarily" incurred by individuals.[8]

The Supreme Court ultimately affirmed the Second Circuit's decision, but rejected its test. The Supreme Court reasoned that the text of the Code required an inquiry into what expenses an individual holding the trust's or estate's assets "would" be likely to have incurred, *i.e.*, whether it would be "unusual" or "uncommon" for an individual to incur such fees.[9] Because it would not be unusual or uncommon for an individual holding the same assets as the trust to incur investment advisory fees, they were subject to the two percent floor.

In *Swallows Holding, Ltd. v. Commissioner*, the Third Circuit Court of Appeals held that where a statute required a taxpayer to file "in the manner prescribed" to obtain certain deductions, the term "manner" was sufficiently ambiguous that the IRS's regulation, which required the taxpayer to file within 18 months of the due date to obtain the deductions, was reasonable.[10]

Swallows Holding, Ltd. (Swallows Holding), a Barbados corporation, earned rental income from real property located in the U.S. In 1999, it filed tax returns in the U.S. for tax years 1993-1996, electing to claim deductions for taxes and other costs associated with a trade or business of leasing the real property.[11] The IRS denied these deductions on the basis that Swallows Holding's returns were more than 18 months late; and pursuant to Treas. Reg. § 1.882-4(a)(3)(i), a foreign corporation must file its return within 18 months of the due date for such expenses to be deductible.

Swallows Holding petitioned the Tax Court, arguing the regulation was an invalid exercise of the Secretary's rule-making authority.[12] In ruling in favor of Swallows Holding, the Tax Court focused on the language of IRC § 882(c)(2), which requires that foreign corporations file "in the manner prescribed by subtitle F."[13] The Tax Court found the plain meaning of "manner" did not include an element of time, and consequently, relying on the factors

7 *O'Neill v. Comm'r,* 994 F.2d 302, 304 (6th Cir. 1993), *nonacq.*, 1994-2 C.B. 1, *abrogated by, Knight v. Comm'r*, 128 S. Ct. 782 (2008).

8 *See Scott v. United States*, 328 F.3d 132, 140 (4th Cir. 2003); *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001).

9 *Knight v. Comm'r*, 128 S. Ct. 782 (2008).

10 *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162 (3d Cir. 2008).

11 Foreign corporations not engaged in a trade or business in the U.S. are subject to tax at a flat rate under IRC § 881(a)(1) of 30 percent of any amount received from sources within the U.S. Swallows Holding elected under IRC § 882(a)(1) to treat the income as "effectively connected" with a U.S. trade or business in order to claim certain tax deductions (*e.g.*, interest and taxes) that are otherwise unavailable to a foreign corporation that is not engaged in a trade or business in the U.S. *See Swallows Holding, Ltd. v. Comm'r,* 126 T.C. 96, 106-07 (2006), *vacated by* 515 F.3d 162 (3d Cir. 2008).

12 *Swallows Holding, Ltd. v. Comm'r,* 126 T.C. 96 (2006).

13 *Swallows Holding, Ltd. v. Comm'r,* 126 T.C. 96, 107 (2006).

in *National Muffler,*[14] held that the interpretive regulation promulgating the timely filing requirement (Treas. Reg. § 1.882-4(a)(3)(i)) was invalid.[15]

The Third Circuit upheld the regulation after applying the test set forth in *Chevron,* in large part, because the regulations had been subject to public comment, and vacated the Tax Court decision.[16] Pursuant to the *Chevron* test, agency regulations are entitled to deference unless they contradict an unambiguous statute or set forth an unreasonable construction of it. The court reasoned that the statutory term "manner" was ambiguous and the regulatory clarification, that it included a timely filing component, was reasonable. Therefore, at least in the Third Circuit, taxpayers may find it more difficult to successfully challenge Treasury Regulations promulgated after public comment.

In *Ballard v. Commissioner*, the Eleventh Circuit Court of Appeals ordered the Tax Court to adopt the special trial judge's report as the Tax Court opinion because the judge's findings were not manifestly unreasonable.[17]

The IRS alleged that the Ballards (husband and wife) and others engaged in a kickback scheme that generated unreported income, finding them liable for deficiencies and fraud penalties for tax years 1975-1982, 1984, and 1987. In 1994, after a five-week Tax Court trial, a special trial judge found the evidence insufficient to show the Ballards were responsible for a deficiency and had committed fraud. Pursuant to Tax Court procedure, the special trial judge submitted his written findings and opinions to a regular Tax Court Judge for review. On December 15, 1999, a Tax Court judge issued the opinion of the Tax Court, purporting to adopt the opinion of the special trial judge, but ruling in favor of the IRS.[18] After the Tax Court issued the opinion but before it entered the final order, the Ballards filed several motions requesting access to the special trial judge's initial findings. After the Tax Court denied these motions, the Ballards petitioned the Eleventh Circuit for a writ of mandamus, also seeking the report.

The Supreme Court ultimately heard the Ballards' case.[19] It disapproved of the Tax Court's practice of allowing the Tax Court judge to edit the special trial judge's report before it is

14 *National Muffler Dealers Association, Inc. v. United States,* 440 U.S. 472 (1979) (analyzing whether an interpretive regulation is valid based on whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose; relevant considerations are whether the regulation is a substantially contemporaneous construction of the statute, the length of time the regulation has been in effect, reliance placed upon it, consistency of administrative interpretation, and the degree of scrutiny Congress has devoted to regulation during subsequent reenactments of the statute).

15 *Swallows Holding, Ltd. v. Comm'r*, 126 T.C. 96, 130, 136-39 (2006). The court cited cases decided before the regulations were issued that held that the statutory term "manner," as used in a predecessor of IRC § 882, did not include a timely filing requirement.

16 *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162, 168-72 (3d Cir. 2008) (citing *Chevron v. United States*, 467 U.S. 837 (1984)). According to the court, it applied the *Chevron* standard, in large part, because the regulations had been subject to "public comment, a move that is indicative of agency action that carries the force of law." *Id.*

17 *Ballard v. Commissioner,* 522 F.3d 1229 (11th Cir. 2008).

18 *Investment Research Associates, Ltd. v. Comm'r,* T.C. Memo. 1999-407, *aff'd sub nom., Ballard v. Comm'r,* 321 F.3d 1037 (11th Cir. 2003), *rev'd and remanded,* 544 U.S. 40 (2005).

19 *Ballard v. Comm'r*, 544 U.S. 40 (2005).

issued, vacated the earlier judgment, and remanded the case to the Eleventh Circuit.[20] The Court of Appeals for the Eleventh Circuit then remanded the case back to the Tax Court.[21] The Eleventh Circuit instructed the Tax Court to: (1) assign a new regular Tax Court Judge with no prior involvement to review the case, and (2) adopt the special trial judge's findings of fact unless "manifestly unreasonable."[22] The regular Tax Court Judge again rejected the special trial judge's findings and ruled against the Ballards.[23]

The Eleventh Circuit held that although it was a "close call," the regular Tax Court judge had conducted a nearly *de novo* review of the facts, which violated its instructions because the special trial judge's findings were not manifestly unreasonable.[24] Thus, the Eleventh Circuit ordered the Tax Court to adopt the special trial judge's original report as the opinion of the Tax Court.

In *Regents of the University of Minnesota v. United States*, the United States District Court for the District of Minnesota held that a hospital's medical residents' stipends were exempt from Federal Insurance Contributions Act (FICA) taxes because the residents were employed by the university (rather than the hospital where they performed services) and otherwise qualified for the student exemption to FICA.[25]

FICA taxes must generally be paid on all wages.[26] However, payments for services performed by certain students in the employ of a "school, college, or university" are not subject to FICA taxes.[27] In a similar case decided in 2003, the District Court for the District of Minnesota rejected the IRS's argument that the Mayo Clinic was not a "school, college, or university" within the meaning of the FICA statute because education was not its "primary purpose" and awarded a refund of FICA taxes withheld and paid on Mayo's medical residents' stipends.[28] In 2004, the IRS amended the FICA regulations, in part to make clear that an institution would not be considered a "school, college, or university" unless education was its "primary purpose."[29] In another related case brought by the Mayo Clinic, the District Court held the IRS's regulations to be invalid on the basis that the plain meaning of "school, college, or university," as set forth in the statute, was not ambiguous.[30]

20 The Supreme Court observed: "The Tax Court's practice of not disclosing the special trial judge's original report, and of obscuring the Tax Court judge's mode of reviewing that report, impedes fully informed appellate review of the Tax Court's decision." *Id*. at 59-60.

21 *Ballard v. Comm'r*, 429 F.3d 1026 (11th Cir. 2005).

22 *Estate of Kanter v. Comm'r*, T.C. Memo. 2007-21 (the Ballards' case was consolidated with other participants in the kickback scheme).

23 *Id.*

24 *Ballard v. Commissioner*, 522 F.3d 1229 (11th Cir. 2008).

25 *Regents of the University of Minnesota v. United States*, 101 A.F.T.R.2d (RIA) 2008-1532 (D. Minn. 2008), *appeal docketed*, No. 08-2193 (8th Cir. May 28, 2008). There are a number of similar cases. *See, e.g., Ctr. for Family Med. v. United States*, 102 A.F.T.R.2d (RIA) 5623 (D. S.D.S.D. 2008).

26 *See* IRC § 3101 *et. seq.*

27 IRC § 3121(b)(10).

28 *United States v. Mayo Found. for Med. Educ. and Research*, 282 F. Supp. 2d 997 (D. Minn. 2003).

29 Treas. Reg. § 31.3121(b)(10)-2(c); T.D. 9167, 69 Fed. Reg. 76,404 (Dec. 21, 2004).

30 *Mayo Found. for Med. Educ. and Research v. United States*, 503 F. Supp. 2d 1164 (D. Minn. 2007), *appeal docketed*, No. 07-3242 (8th Cir. Sept. 28, 2007).

In this case, the IRS argued the residents were ineligible for the FICA exemption because they were employees of the hospital where they rendered services, rather than the university, and because they were not "enrolled and regularly attending classes"[31] or performing services "for the purpose of pursuing a course of study,"[32] as required to qualify for the exemption. The District Court rejected these arguments, finding the residents were common law employees of the university, were enrolled and regularly attending classes, and were performing services at the hospital for the purpose of pursuing a course of study. Thus, the court held they were eligible for the exemption and the IRS's regulations were invalid.

In *United States v. Clintwood Elkhorn Mining Co.*, the Supreme Court held that a taxpayer must file a timely administrative claim for refund or credit within the period provided by the Code, rather than the longer period provided in the Tucker Act, even if the taxpayer is seeking a refund of a tax that was determined to be unconstitutional.[33]

The taxpayer, a coal company, paid export taxes that were later determined to be unconstitutional under the Export Clause.[34] The issue was whether the taxpayer's claims for refund were timely. The Code provides: "No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax ... until a claim for refund or credit has been duly filed with the [IRS]."[35] The Code further provides that such administrative claims must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever is later.[36] In contrast, the Tucker Act – which authorizes various claims against the government – provides a longer six-year period of limitations for filing a claim.[37]

The coal company did not file administrative claims within the period provided by the Code for its 1994-1996 taxes. Instead, it filed suit in the Court of Federal Claims, seeking refunds of those taxes, arguing its claim was timely because the longer period provided by the Tucker Act applied to refunds for taxes determined to be unconstitutional.

The Court of Federal Claims agreed with the taxpayer that the longer six-year period applied, and the Court of Appeals for the Federal Circuit affirmed the decision.[38] The

31 IRC § 3121(b)(10).

32 Treas. Reg. § 31.3121(b)(10)-2(c) (pre-Apr. 1, 2005).

33 *United States v. Clintwood Elkhorn Mining Co.*, 128 S. Ct. 1511 (2008).

34 The Export Clause provides that "No Tax or Duty shall be laid on Articles exported from any State." *See* U.S. Const. art. I, § 9, cl. 5. The export taxes were declared unconstitutional in *Ranger Fuel Corp. v. United States*, 33 F. Supp. 2d 466 (E.D. Va.1998).

35 IRC § 7422(a).

36 IRC § 6511(a).

37 28 U.S.C. § 2501 (stating that "[E]very claim of which the United States Court of Federal Claims has jurisdiction shall be barred unless the petition thereon is filed within six years after such claim first accrues.").

38 *Andalex Res., Inc. v. United States*, 54 Fed. Cl. 563 (2002), *aff'd sub nom., Clintwood Elkhorn Mining Co. v. United States*, 473 F.3d 1373 (Fed. Cir. 2007), rev'd, 128 S. Ct. 1511 (2008).

Supreme Court reversed, however, reasoning that the unambiguous plain language of the Code (IRC § 7422(a)) requires claims to be filed within the shorter period.

In *Pennoni v. United States*, the Court of Federal Claims held that a suit challenging the IRS's use of levy and garnishment to recoup an erroneous refund is an "illegal exaction" claim, rather than a refund claim under the Code, and is therefore subject to the longer statute of limitations provided by the Tucker Act.[39]

As the result of a stipulated decision, the IRS owed Lawrence Pennoni a refund of approximately $2,800 for the 1998 tax year, but sent him a check for approximately $80,000. After discovering its mistake, the IRS did not follow standard procedures for recovering erroneous payments: It did not file suit to recover the payment,[40] or timely reassess and collect the liability for the relevant tax year.[41] Instead, beginning on August 4, 2003, the IRS simply garnished Pennoni's wages and levied his bank account.

On December 15, 2006, Pennoni filed suit seeking to recover the wrongfully garnished and levied funds. The government filed a motion to dismiss, characterizing Pennoni's action as a refund suit under IRC § 7422, and arguing Pennoni had failed to file an administrative refund claim as required by IRC § 7422(a), and had also failed to bring his suit within the two-year limitations period applicable to refund suits.[42]

Pennoni maintained his action was not a tax refund suit subject to the Code's provisions, but was instead a claim for the return of an "illegal exaction." As such, he was not required to file an administrative refund claim and his suit was timely under the Tucker Act's six-year statute of limitations.[43]

The Court of Federal Claims agreed with Pennoni and denied the government's motion. It concluded the Code's refund suit provisions apply only to actions for the recovery of overpayments of tax and erroneous refunds recovered by the IRS via levy or garnishment do not constitute overpayments of tax.

In *Commissioner v. Dunkin*, the Ninth Circuit held that a retirement-eligible employee who continued to work must pay federal income tax on wages he

39 *Pennoni v. United States*, 79 Fed. Cl. 552 (2007).

40 *See* IRC § § 7405 (providing for recovery of erroneous refunds by instituting a civil action) and 6532(b) (providing a period of limitation on suits by the government for the recovery of erroneous refunds).

41 *See* IRC § § 6501(a) (providing a period of limitation on assessment and collection) and 6502(a)(1) (providing a period limitation on collection).

42 *See* IRC § 6532(a) (providing a period of limitation on refund suits).

43 *See* 28 U.S.C. § 2501. Interestingly, according to the court, an "illegal extraction" includes money that was improperly paid in contravention of the Constitution. Thus, it appears that the period of limitations provided by the Tucker Act applies to some "illegal extraction" claims but not others. *See United States v. Clintwood Elkhorn Mining Co.*, 128 S. Ct. 1511 (2008) (holding that the shorter period of limitations provided by the Code (rather than the longer period provide by the Tucker Act) applied to a suit to recover a tax later declared unconstitutional).

used to reimburse his former spouse for her community property law interest in his pension benefits.[44]

When John Dunkin and his wife divorced in 1997, he was eligible to receive full pension benefits from the Los Angeles Police Department. Rather than retire, however, Dunkin chose to continue working.

Under California community property law, Dunkin's spouse was entitled to one-half of the retirement benefits Dunkin earned during the marriage. Although the state court did not award alimony to his former spouse, because Dunkin decided to delay retirement it ordered him to make so-called "Gillmore" payments to his former spouse in an amount equal to the benefits she would have received had he retired on the date of the divorce.[45]

In 2000, Dunkin used $25,511 of his wages to make the court-ordered Gillmore payments and deducted the payments as alimony on his return for that year. The IRS denied the deduction. The Tax Court determined Dunkin was entitled to exclude the $25,511 from his gross income.[46]

A majority of the Ninth Circuit panel disagreed with the Tax Court, concluding that Dunkin had to include the $25,511 in gross wages and was not entitled to an alimony deduction. The court reasoned that post-divorce wages, unlike actual distributions of pension benefits, are not community property under California law. Moreover, because Dunkin was required to make the court-ordered payments as long as he continued working, even if his ex-spouse remarried or died, the payments did not qualify as deductible alimony.[47]

In *Menard, Inc. v. Commissioner*, the Tax Court held that it had jurisdiction to consider an equitable recoupment defense and offset time-barred overpayments against deficiencies arising out of the same transaction, even though the Tax Court would not otherwise have jurisdiction over the type of tax overpayment at issue.[48]

In an earlier opinion, the Tax Court concluded that a portion of the amount that Menard, Inc. (Menard) paid to its president and chief executive officer and deducted as a compensation expense on its 1998 return was unreasonable and recharacterized it as a deemed

44 *Comm'r v. Dunkin,* 500 F.3d 1065 (9th Cir. 2007), *rev'g* 124 T.C. 180 (2005).

45 *See In re Marriage of Gillmore*, 29 Cal. 3d 418, 629 P.2d 1 (Cal. 1981).

46 *Comm'r v. Dunkin*, 124 T.C. 180 (2005), *rev'd*, 500 F.3d 1065 (9th Cir. 2007).

47 *See* IRC §§ 71; 215. If such payments are not deductible by the ex-husband and are income to the ex-wife, they may be taxed twice – once to the ex-husband when he earns them and again to the ex-wife when she receives them. In a strongly worded dissent, Judge Stephen Reinhardt commented that requiring Dunkin to pay income taxes on the part of his salary that he paid to his former wife as her community property interest in his pension benefits "defies reason, not to mention fairness." He also expressed policy concerns that the majority's holding may encourage divorced employees to retire "[a]t a time when the federal government is encouraging postponing retirement due to a looming Social Security shortfall, and police forces nationwide are facing officer shortages as officers retire at a younger and younger age and take (or divide) their pension benefits and go off to obtain higher paying jobs in private industry." *Comm'r v. Dunkin*, 500 F.3d 1065, 1072-74 (9th Cir. 2007).

48 *Menard, Inc. v. Comm'r,* 130 T.C. 54 (2008).

dividend.[49] The IRS's deficiency computation eliminated the compensation deduction, but did not give Menard credit for the hospital insurance tax it paid in connection with the putative compensation.[50]

The period for making an overpayment claim for 1998 had expired.[51] In addition, the Tax Court normally does not have deficiency jurisdiction over hospital insurance taxes.[52] However, IRC § 6214(b) expands the Tax Court's jurisdiction by allowing it to apply the doctrine of "equitable recoupment" to offset a deficiency against an overpayment arising out of the same transactions that would otherwise be time-barred.[53] The IRS argued the Tax Court's equitable recoupment jurisdiction did not extend to taxes that do not normally fall within the court's deficiency or overpayment jurisdiction.

The Tax Court disagreed with the IRS, holding that it had equitable recoupment jurisdiction to offset the hospital tax overpayment against the deficiency. The Tax Court reasoned that if Congress had intended to so limit its jurisdiction, it would have done so explicitly, and such a limit would be at odds with the purpose of the provision: to prevent an inequitable windfall due to inconsistent tax treatment of a single transaction under two different code provisions. Because Menard had previously deducted its hospital insurance payments, the Tax Court ruled it had to eliminate that deduction, compute its tax liability as if it paid a dividend to its president rather than compensation, and then offset the resulting deficiency by the amount of the hospital tax that it previously paid.

In *Jade Trading, LLC v. United States*, the Court of Federal Claims held that although it had jurisdiction to impose the negligence penalty in a partnership level proceeding, it did not have jurisdiction to consider the reasonable cause defenses of the partners.[54]

The Ervin brothers invested in a "Son of Boss" tax shelter[55] designed to generate an inflated outside basis in their interests in Jade Trading LLC (Jade). The Ervins then used this inflated basis in Jade to generate tax losses. The IRS issued a Final Partnership Administrative Adjustment (FPAA) asserting that the entire series of transactions should be disregarded

49 *Menard, Inc. v. Comm'r*, T.C. Memo. 2004-207.

50 *See* IRC §§ 3111(b); 3501.

51 Any claim for credit or refund must normally be made within three years from the time the return was filed or two years from the time the tax was paid, whichever is later. IRC § 6511(a).

52 *See* IRC § § 6213(a) (providing for deficiency jurisdiction); 6211(a) (limiting the Tax Court's deficiency jurisdiction to enumerated sections); 6512(b)(1) (providing for overpayment jurisdiction for years in which the Commissioner has issued a notice of deficiency and for specifically enumerated Code sections).

53 As a general rule, according to the Tax Court, a party claiming an equitable recoupment defense must show: (1) the overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the court; (3) the transaction item or taxable event has been inconsistently subject to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one. *Menard, Inc. v. Comm'r,* 130 T.C. 54, 62-63 (2008) (citations omitted).

54 *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007). The same court later denied a motion for reconsideration. *Jade Trading, LLC v. United States*, 81 Fed. Cl. 173 (2008).

55 For a description of this shelter, *see* Notice 2000-44, 2000-2 C.B. 255.

for federal income tax purposes as lacking economic substance. It also asserted various penalties in the alternative, including the negligence and substantial understatement penalties.

Jade and the Ervin brothers brought a tax refund suit challenging the FPAA. The Court of Federal Claims agreed with the IRS, holding that the transaction lacked economic substance. It also affirmed the IRS's assertion of various penalties, including the negligence penalty. The court based its conclusion that the negligence penalty applied on the conduct of Jade, its managing member, and its tax matters partner, rather than on the conduct of any particular partner whose return reflected an understatement.

The court went on to hold that it had no jurisdiction to consider any reasonable cause exceptions to these penalties in a partnership-level proceeding under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) because such defenses would be unique to each partner. As a result, the only way for a partner to avoid these penalties based on a reasonable cause defense would be to pay the penalty and file an individual refund action.[56]

In a subsequent motion for reconsideration and clarification of the decision, Jade's tax matters partner argued the court erred in applying the negligence penalty at the partnership level because the partnership return was not inaccurate and did not report an understatement, and that the court improperly considered its behavior (rather than the taxpayers whose returns contained understatements) in applying the penalty.[57] The tax matters partner also argued that Treas. Reg. § 1.6221-1T (1999), which purported to limit the court's jurisdiction to consider a partner level defense, was invalid.[58] The court denied these motions.

In *Philadelphia Marine Trade Association-International Longshoremen's Association Pension Fund v. Commissioner*, the Third Circuit Court of Appeals held that even if a taxpayer did not use registered mail or other methods provided by IRC § 7502 to establish a presumption of timely filing, he or she may do so by establishing that he or she mailed a document early enough to allow for physical delivery by the due date, pursuant to the common law "mailbox rule."[59]

After the Philadelphia Marine Trade Association-International Longshoremen's Association Pension Fund (Fund) failed to make timely tax payments, the IRS assessed penalties and on June 25, 2001, levied on its funds to collect the penalties. According to the Fund, when it discovered the levy, it called the IRS and sent two letters requesting a refund, one on May

56 *See* IRC § 6230(c)(4).

57 *Jade Trading, LLC v. United States*, 81 Fed. Cl. 173 (2008).

58 *Id.* Practitioners representing clients who will be affected by the *Jade Trading* decision have expressed similar arguments and an interesting critique of the decision. *See* Thomas A. Cullinan and Julie P. Bowling, *This One Left Us Jaded*, 118 Tax Notes 422 (Jan. 21, 2008).

59 *Philadelphia Marine Trade Association-International Longshoremen's Ass'n Pension Fund v. Comm'r,* 523 F.3d 140 (3d Cir. 2008).

8, 2003, and one on June 13, 2003, but could not produce direct proof of mailing such as a registered mail receipt. The IRS did not keep the letters if it received them. However, various circumstantial evidence supported the Fund's contention that it mailed the letters to the IRS on the dates it claimed.

To be timely, the request for refund had to be filed by June 25, 2003.[60] The Fund argued that because it could establish based on circumstantial evidence that the letters were placed in the mail in time to be delivered before this deadline, the court should presume they were timely delivered pursuant to the common law "mailbox rule." Citing cases from the Second and Sixth Circuits,[61] the IRS argued that proof of registration received in connection with registered mail (and similar delivery confirmation services) provided by the statutory mailbox rule of IRC § 7502 is the exclusive type of evidence that can be used to establish a presumption that a document was delivered on or before a given date.[62] Because the Fund did not have such proof, the IRS reasoned, the claim could not be presumed to be timely pursuant to any mailbox rule.

The District Court agreed with the IRS,[63] but the Third Circuit Court of Appeals did not.[64] The Third Circuit held that the statutory mailbox rule supplemented (rather than supplanted) the common law mailbox rule, at least in cases where the taxpayer placed a document in the mail in time for the IRS to physically receive it before the due date. It reasoned that unlike the statutory rule, which requires the IRS to treat the postmark date as the filing date, expressly excusing delivery after the deadline, the common law mailbox rule is simply a presumption that items placed in the mail are delivered within ordinary timeframes, which helps taxpayers show that a document was actually physically delivered on or before the due date. As a result, it is not inconsistent for the two rules to coexist, especially because there is no legislative history suggesting that Congress intended to eliminate the common law mailbox rule when it enacted the statutory rule.

In *Fisher v. United States,* the Court of Federal Claims held the "open transaction doctrine" applied to allow a policyholder of a mutual life insurance company to recover tax basis in the policy when it received cash upon the company's demutualization, which constituted severance of the policyholders' rights to payment on death from their ownership rights in the insurance company.[65]

Prior to March of 2000, Sun Life Assurance Company (Sun Life), was a mutual life insurance company owned by its policyholders. A mutual insurance company's policy confers

60 IRC § 6511(a) (requiring taxpayers to file refund requests within three years from the time the return was filed or two years from the time the tax was paid, whichever is later).

61 *See, e.g., Deutsch v. Comm'r,* 599 F.2d 44 (2d Cir. 1979); *Miller v. United States,* 784 F.2d 728 (6th Cir. 1986).

62 IRC § 7502(a) and (c).

63 *Philadelphia Marine Trade Association-International Longshoremen's Ass'n Pension Fund v. Comm'r*, 98 A.F.T.R.2d (RIA) 5483 (E.D. Pa. 2006).

64 *Philadelphia Marine Trade Association-International Longshoremen's Ass'n Pension Fund v. Comm'r,* 523 F.3d 140 (3d Cir. 2008).

65 *Fisher v. United States,* 82 Fed. Cl. 780 (2008), *appeal docketed*, No. 09-5001 (Fed. Cir. Oct. 6, 2008).

ownership rights in the company, such as the right to vote and the right to dividends and liquidating distributions, if any, as well as typical insurance contract rights to payment on death of the insured. In 1990, a trust became a policyholder by purchasing a policy and beginning to pay annual premiums of $19,763 to Sun Life. In March of 2000, when Sun Life demutualized, it distributed shares of stock in exchange for the ownership rights of the policyholders, who could elect to immediately sell the stock (*i.e.*, receive cash in lieu of stock). Pursuant to an IRS private letter ruling, the basis of the stock would be the same as the basis in the ownership rights – "zero," according to the ruling.[66] Thus, any cash that policyholders elected to receive would be fully taxable, unreduced by the policyholders' cost basis in the policy. The trust elected to receive cash in lieu of stock. It reported the demutualization proceeds as income on its 2000 return, unreduced by any basis, paid the resulting tax, and filed a refund claim. The trust asserted the gain on the demutualization transaction should be offset by the trust's basis in the policy.

The IRS denied the claim. It reasoned that pursuant to Treasury Regulation § 1.61-6(a), the trust was required to allocate its basis in the policy among the ownership and contract rights in accordance with their relative values when acquired. Thus, the trust could not allocate any basis to the ownership rights unless it established that they were worth more than zero when acquired.

The trust argued it should be entitled to recover its basis pursuant to the common law "open transaction" doctrine instead, because the ownership rights acquired by policyholders were impractical or impossible to value.[67] If applicable, the doctrine would allow the trust to use its full basis in the policy to offset any gain on the demutualization payment.

The court agreed that the open transaction doctrine would apply if the ownership rights were impractical or impossible to value. At trial, an IRS expert testified the value of the policyholders' ownership rights was zero, while the trust's expert testified the rights were impractical or impossible to value. The court agreed with the trust's expert, holding that the "open transaction" doctrine applied.[68] Because the amount received by the trust was less than its cost basis in the insurance policy, the trust did not realize any income on the sale of the stock in question and, therefore, was entitled to a refund.

66 P.L.R. 200020048 (May 19, 2000).

67 *See, e.g., Burnet v. Logan*, 283 U.S. 404 (1931); *Pierce v. United States*, 49 F. Supp. 324 (Ct. Cl. 1943).

68 The IRS expert concluded the rights should be valued at zero, in part, because the ownership rights were "neither separable [from other policy rights] nor alienable," Sun Life had not incurred any expenses in establishing those rights, and it was relatively unlikely that demutualization would occur at the time the rights were acquired. The court characterized this conclusion as an "illogical view" due, in part, to the fact that those rights were valued at more than $5.7 billion (Canadian) in connection with the demutualization. *Fisher v. United States*, 82 Fed. Cl. 780, 797 (2008), *appeal docketed*, No. 09-5001 (Fed. Cir. Oct. 6, 2008). We wonder if the court would have reached a different conclusion if the IRS's expert had valued the ownership components of the policy at an amount greater than zero. Such an approach would demonstrate that they were subject to a reasonable valuation.

MLI #1

Gross Income Under Internal Revenue Code Section 61 and Related Sections

Summary

When preparing tax returns, taxpayers must make the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.[1] Common issues in the 205 cases decided between June 1, 2007, and May 31, 2008, that we reviewed include:

- Foreign earned income;
- Damage awards; and
- Disability and Social Security benefits.

Present Law

Internal Revenue Code (IRC) § 61 broadly defines gross income as "all income from whatever source derived."[2] The U.S. Supreme Court has broadly defined gross income as any accession to wealth.[3] However, over time, Congress has carved out numerous exceptions and exclusions to this definition.[4]

Analysis of Litigated Cases

We analyzed 205 opinions involving gross income issued by the federal courts between June 1, 2007, and May 31, 2008.[5] Gross income issues most often fall into two categories: what is included in gross income under IRC § 61 and what can be excluded under other statutory provisions. A detailed list of all cases appears in Table 1 of Appendix III. In 137 cases (nearly 67 percent) taxpayers were represented by attorneys, while the rest were *pro se*. Ten of the 137 represented taxpayers (about seven percent) prevailed in full or in part of their cases, while overall, taxpayers prevailed in full or in part in 18 of the 205 cases (about nine percent). *Pro se* taxpayers prevailed in eight of the 68 cases (about 12 percent).

1 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 582-87.

2 IRC § 61(a).

3 *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955) (interpreting § 22 of the Internal Revenue Code of 1939, the predecessor to IRC § 61).

4 *See, e.g.*, IRC §§ 104 (compensation for injuries or sickness), 105 (amounts received under accident and health plans), and 108 (income from discharge of indebtedness).

5 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.

The vast majority of the cases we reviewed this year involved taxpayers failing to report items of income, including some that are specifically mentioned in IRC § 61 such as rents,[6] pensions,[7] and interest.[8] In the context of items that can be excluded from gross income, the following issues were commonly raised in the cases we analyzed.

Foreign Earned Income

In the 2007 Annual Report to Congress, we addressed one case in which the taxpayer argued that income he earned in Antarctica should be excluded from gross income under IRC § 911.[9] We mentioned this case last year because it served as the prelude to a number of cases addressing the identical issue this year. IRC § 911 permits a qualified taxpayer to elect to exclude foreign earned income, within statutory limits, earned while residing in a foreign country.[10] However, only a territory under the sovereignty of a foreign nation is considered a "foreign country."[11] Because the United States does not recognize a sovereign authority over Antarctica, it is not considered a foreign country qualifying for income exclusion under IRC § 911.[12] Taxpayers in at least 96 cases raised the issue of excluding income earned in Antarctica.[13] In all but three cases,[14] the taxpayers raising this argument were represented by the same attorney, and the IRS prevailed in all of the cases.[15]

The cases involving income earned in Antarctica significantly changed the gross income statistics included in this year's Annual Report. If not for the Antarctica cases, where only three taxpayers were not represented and the IRS prevailed in all 96 cases, the statistics for this year's Annual Report would more closely mirror the gross income case statistics in previous Annual Reports. Without the Antarctica cases, there would have been only 109 cases, taxpayers would have prevailed in full or in part in 18 cases (about 17 percent) and taxpayers would have been represented by counsel in 44 cases (about 40 percent).[16] We believe this year's numbers are an anomaly, as we have not identified any cases involving Antarctica falling within our timeframe of analysis for next year's Annual Report.

6 IRC § 61(a)(5). *See, e.g., McGowan v. Comm'r*, T.C. Memo. 2008-125.

7 IRC § 61(a)(11). *See, e.g., Joubert v. Comm'r*, T.C. Memo. 2007-292.

8 IRC § 61(a)(4). *See, e.g., Callahan v. Comm'r*, T.C. Memo. 2007-301, *motion to vacate or revise decision denied* (May 9, 2008).

9 *See* National Taxpayer Advocate 2007 Annual Report to Congress 586-87 (discussing *Arnett v. Comm'r,* 473 F.3d 790 (7th Cir. 2007), *aff'g* 126 T.C. 89 (2006)).

10 IRC § 911.

11 Treas. Reg. § 1.911-2(h).

12 Rev. Rul. 67-52, 1967-1 C.B. 186.

13 *See, e.g., Booth v. Comm'r*, T.C. Memo. 2007-253; *Charpentier v. Comm'r*, T.C. Memo. 2007-314.

14 *See, Brown v. Comm'r*, T.C. Summ. Op. 2007-166, *Macala v. Comm'r*, T.C. Summ. Op. 2008-7, and *Yamasaki v. Comm'r*, T.C. Memo. 2008-7.

15 *See, e.g., Hamann v. Comm'r*, T.C. Memo. 2007-246; *Minor v. Comm'r*, T.C. Memo. 2008-35.

16 *See* National Taxpayer Advocate 2007 Annual Report to Congress 582-87 (analyzing 112 cases with taxpayers prevailing in whole or in part in 14 cases (about 14 percent) and being represented by counsel in 36 cases (about 32 percent)); National Taxpayer Advocate 2006 Annual Report to Congress 575-81 (analyzing 106 cases with taxpayers prevailing in whole or in part in nine cases (about eight percent) and being represented by counsel in 31 cases (about 30 percent)); National Taxpayer Advocate 2005 Annual Report to Congress 488-97 (analyzing 108 cases with taxpayers prevailing in whole or in part in 25 cases (about 23 percent) and being represented by counsel in 48 cases (about 44 percent)).

Several other taxpayers raised issues involving foreign earned income.[17] In *Clark v. Commissioner*, the taxpayer resided in Scotland but was a U.S. citizen.[18] During the tax years at issue, the taxpayer worked for a shipping company and spent time at port and in international waters. The taxpayer argued that any income earned in international waters could be excluded from his gross income under IRC § 911. The U.S. Tax Court, using a similar rationale to its decisions in the Antarctica cases, held that to qualify for an exclusion, the income must be earned in a foreign country, defined as any territory or territorial waters under the sovereignty of a nation other than the United States. Because international waters are not under the sovereignty of any foreign country, income earned while in international waters is not foreign earned income for the purposes of IRC § 911. Clark further argued IRC § 911 should be read in conjunction with IRC § 863(c), which provides a special transportation income exception for income earned when the transportation begins or ends in the United States or one of its possessions. The court noted, however, that IRC § 863(c) does not generally apply to U.S. citizens, and even if it did, Clark's transportation neither began nor ended in the United States or one of its possessions. Thus, the court held that Clark owed tax on his income earned while working in international waters.[19]

Damage Awards

Taxation of damage awards spurs litigation every year.[20] Taxpayers in at least 17 cases raised this issue,[21] an increase over the seven cases that addressed damage awards last year.[22] In the 2007 Annual Report, all the damage award cases addressed the issue of excluding the award under IRC § 104(a)(2).[23] This year, we identified at least three cases in which taxpayers did not attempt to exclude the award under IRC § 104(a)(2), but nonetheless failed to report the settlement proceeds.[24]

In one of these cases, *Eckersley v. Commissioner*, the taxpayer worked for a company that purchased a life insurance policy on his life.[25] Under its contract with the taxpayer, the company was to make his wife the beneficiary. The taxpayer resigned from the company and the policy remained in the company's name. The couple sued the company and settled for an amount including the $500,000 in dispute in the Tax Court. The taxpayers argued

17 *See Clark v. Comm'r*, T.C. Memo. 2008-71; *Langroudi v. Comm'r*, T.C. Summ. Op. 2007-156; *Rusten v. Comm'r*, T.C. Summ. Op. 2008-16.

18 *Clark v. Comm'r*, T.C. Memo. 2008-71.

19 *Id.*

20 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 582-87; National Taxpayer Advocate 2006 Annual Report to Congress 576-78; National Taxpayer Advocate 2005 Annual Report to Congress 489-90.

21 *See, e.g., Wright v. Comm'r*, T.C. Memo. 2007-278; *Polone v. Comm'r*, 505 F.3d 966 (9th Cir. 2007), *withdrawing and superseding* 479 F.3d 1019 (9th Cir. 2007), 449 F.3d 1041 (9th Cir. 2006) *withdrawn and superseded, aff'g* T.C. Memo. 2003-339, *writ of certiorari denied* (S. Ct. Mar. 24, 2008); *Phelps v. Comm'r*, T.C. Memo. 2008-86.

22 *See* National Taxpayer Advocate 2007 Annual Report to Congress 582-87.

23 National Taxpayer Advocate 2007 Annual Report to Congress 582-87.

24 *See Eckersley v. Comm'r*, T.C. Memo. 2007-282, *appeal docketed,* No. 08-70934 (9th Cir. Feb. 25, 2008); *Messina v. Comm'r*, 232 Fed. Appx. 254 (4th Cir. 2007), *superseding* 219 Fed. Appx. 328 (4th Cir. 2007), *aff'g in part and vacating and remanding in part* T.C. Memo. 2006-107; *Halliburton v. Comm'r*, T.C. Summ. Op. 2007-203.

25 *Eckersley v. Comm'r*, T.C. Memo. 2007-282, *appeal docketed* No. 08-70934 (9th Cir. Feb. 25, 2008).

the entire amount should be taxable to them as capital gain income rather than ordinary income. The court determined the taxpayers had no basis in the insurance policy, nor did the policy have any cash value, and in exchange for the $500,000, the company received nothing more than the extinguishment of the taxpayers' claim to the policy. The court held that based on these factors, the settlement income was ordinary income, not capital gain.[26]

The remaining 14 cases identified this year that addressed damage awards all challenged the IRS's determination that the taxpayers' awards were not excludible from gross income under IRC § 104(a)(2).[27] 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 sickness.[28] It makes no difference whether the award is received by suit or settlement agreement, or whether the award is paid as a lump sum or in periodic payments, because all such awards are excludible unless they represent punitive damages.

Congress amended IRC § 104(a)(2) in 1996, to clarify the conditions under which a damage award may be excluded from income, making an award excludible only if the damages are received on account of personal physical injury or physical sickness.[29] Prior to 1996, the word "physical" did not appear in the statute. The change in law was effective for amounts received after enactment on August 20, 1996,[30] but not for amounts received under a written, binding agreement, court decree, or mediation award in effect (or issued on or before) September 13, 1995.[31] The legislative history to the 1996 amendment to IRC § 104(a)(2) provides that "[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness . . . [but] emotional distress is not considered a physical injury or physical sickness."[32]

Taxpayers in the 14 cases addressing taxation of damage awards under IRC § 104(a)(2) all argued that all or part of the damage award was received on account of physical injury or physical sickness and should be excluded from gross income. The IRS prevailed in full or in part in all cases addressing the characterization of the damage award under IRC § 104(a)(2). We identified one case where the taxpayer prevailed in part.[33]

In *Wright v. Commissioner*, the court overturned the determination of the IRS that the taxpayer's award was not excludible under IRC § 104(a)(2).[34] The award occurred before

26 *Eckersley v. Comm'r*, T.C. Memo. 2007-282, *appeal docketed* No. 08-70934 (9th Cir. Feb. 25, 2008).

27 *See, e.g., Phelps v. Comm'r*, T.C. Memo. 2008-86; *Pettit v. Comm'r*, T.C. Memo. 2008-87.

28 IRC § 104(a)(2).

29 Pub. L. No. 104-188, § 1605(a).

30 Pub. L. No. 104-188, § 1605(d)(1).

31 Pub. L. No. 104-188, § 1604(d)(2).

32 H.R. Rep. No. 104-586, at 143-44 (1996).

33 *Wright v. Comm'r*, T.C. Memo. 2007-278.

34 *Id.*

the 1996 change in the law, and is thus governed under the pre-1996 version of IRC § 104(a)(2). Wright entered a settlement agreement with his former partners that provided in part for a damage award for personal injuries suffered. The IRS determined the award was fully includible in gross income and contended that although the settlement provided a portion of the award was for personal injuries, the actual dispute was purely a business matter, and therefore did not meet the requirement that the action be based in tort or tort type rights to be excludible from gross income under IRC § 104(a)(2). The court disagreed with the IRS, determining that the portion of the award intended for emotional distress was in the plain language of the settlement agreement; it was not added at the last minute to achieve favorable tax treatment, but had been part of the settlement negotiations from the beginning, and it was undeniable that Wright suffered emotional distress as a result of the actions of his former partners. The court held for Wright in part, excluding the portion of the damage award specifically allocated to personal injuries from gross income under IRC § 104(a)(2).[35]

Disability and Social Security Benefits

Taxpayers continue to litigate the issue of the characterization of Social Security and other disability benefits because portions of these benefits may be excludible from gross income. In *Connors v. Commissioner*, the taxpayer argued the disability benefits he received were excludible under IRC §§ 105 and 104(a)(3).[36] IRC § 105 provides that amounts received from a disability plan that are attributable to employee contributions are excludible from gross income.[37] IRC § 104(a)(3) provides that amounts received from accident or health insurance that are attributable to employee after-tax contributions are excludible from gross income.[38] The Court of Appeals for the Second Circuit upheld the finding of the Tax Court that Connors' disability insurance premium payments were made either by his employer or with pre-tax dollars, and therefore benefits from the policies were not excludible from gross income.[39]

Conclusion

Taxpayers consistently litigate many of the same gross income issues year after year due to the complex nature of what is and is not gross income and what can or cannot be excluded. The characterization of disability benefits and the nature of damage awards frequently cause confusion. The increase in cases litigating the issue of damage awards could suggest that *Murphy v. Commissioner*, discussed in detail in the 2006 and 2007 Annual Reports to

35 *Wright v. Comm'r*, T.C. Memo. 2007-278

36 *Connors v. Comm'r*, 2008 U.S. App. LEXIS 10632 (2d Cir. 2008), *aff'g* T.C. Memo. 2006-239.

37 IRC § 105.

38 IRC § 104(a)(3).

39 *Connors v. Comm'r*, 2008 U.S. App. LEXIS 10632 (2d Cir. 2008), *aff'g* T.C. Memo. 2006-239. *See also* Tuka v. Comm'r, 120 T.C. 1 (2003), aff'd, 85 Fed. Appx. 875 (3d Cir. 2003) (exclusion under IRC § 104(a)(3) is available only to employees who make after-tax contributions to insurance premiums).

Congress,[40] did not help to resolve the confusion surrounding the treatment of settlement and damage awards.[41]

The increase in the number of cases litigating gross income issues can be attributed almost entirely to the Antarctica foreign earned income cases. We expect future case numbers to be similar to those of previous years, as it appears no more Antarctica cases have been filed.

40 *See, e.g.*, National Taxpayer Advocate 2006 Annual Report to Congress 575-81; National Taxpayer Advocate 2007 Annual Report to Congress 582-87.

41 *Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007), *rev'g* 460 F.3d 79 (D.C. Cir. 2006), *aff'g* 362 F.Supp. 2d 206 (D. D.C. 2005), *vacated*, 2007-1 U.S.T.C. (CCH) ¶ 50,228 (D.C. Cir. 2006), *reh'g en banc denied*, 2007 U.S. App. LEXIS 22173 (D.C. Cir. Sept. 14, 2007), *writ of certiorari denied*, No. 05-5139 (S. Ct. Apr. 22, 2008). In *Murphy*, the taxpayer entered into a $70,000 settlement agreement for an employment discrimination suit. The agreement allocated $45,000 to "emotional distress and mental anguish" and the remaining $25,000 to "injury to professional reputation." The taxpayer included the entire $70,000 in gross income and later initiated a refund suit. After a lengthy legal battle, substantial adverse commentary, and a conclusion that IRC § 104(a)(2) was unconstitutional, the Court of Appeals for the District of Columbia Circuit ultimately held that the tax on compensatory damages was an excise tax on an involuntary conversion transaction (*i.e.*, Murphy had to surrender part of her mental health and reputation in return for monetary damages), and as such was not subject to the constitutional requirements for a tax on "income." Consequently, Murphy's entire $70,000 settlement award was not excludible from gross income.

MLI #2

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] CDP hearings provide taxpayers with an independent review by the Office of Appeals of the IRS's decision to file a lien or its proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for meaningful hearings in front of independent appeals officers before the IRS deprives them of property. At the CDP hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of collection action, collection alternatives, spousal defenses, and under certain 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, the IRS stays collection action during the CDP hearing process and any judicial review that may follow.[4]

Since 2003, CDP has been one of the tax issues most frequently litigated in the federal courts and analyzed for the National Taxpayer Advocate's Annual Report to Congress. This year continues the trend, with the courts issuing at least 179 opinions during the review period of June 1, 2007, through May 31, 2008.[5] Some critics have argued the CDP process stalls the IRS collection process and allows taxpayers to raise frivolous arguments. However, the CDP process serves an important function by providing taxpayers with a forum to raise legitimate issues before the IRS deprives them of property. The opinions reviewed this year support this view. Many of these decisions provide useful guidance on substantive issues. Where taxpayers attempted to use the CDP process inappropriately, courts imposed sanctions or warned taxpayers about the possibility of sanctions being imposed in the future.

1 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685 (1998).

2 Internal Revenue Code (IRC) §§ 6320(c); 6330(c).

3 IRC §§ 6320(a)(3)(B); 6330(a)(3)(B). These provisions set forth the time requirements for requesting a CDP hearing. IRC §§ 6320(c); 6330(d). These provisions set forth the time requirements for obtaining judicial review of Appeals' determination.

4 IRC § 6330(e)(1) provides that generally, levy actions are suspended during the CDP process (along with a corresponding suspension in the running of the 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 For a list of all of the cases reviewed, *see* Appendix III Table 1, *infra.*

Present Law

Current law provides taxpayers an opportunity for independent review of a notice of federal tax lien (NFTL) filed by the IRS,[6] or of a proposed levy action.[7] The purpose of CDP rights is to give taxpayers adequate notice of IRS collection activity and a meaningful hearing *before* the IRS deprives them of property.[8] The hearing allows taxpayers an opportunity to raise issues relating to the collection of the subject tax, including:

- Appropriateness of collection actions;[9]
- Collection alternatives such as an 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]

Procedural Collection Due Process Requirements

Procedurally, the IRS must provide notice to the taxpayer of the lien filing and its intent to levy. The IRS must provide the NFTL to the taxpayer not more than five business days after the day of filing the notice of the lien,[15] and must provide 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 NFTL and before any levy action can take place. In the case of a lien, the IRS must provide the CDP hearing notice 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

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); 6320(c).

10 IRC §§ 6330(c)(2)(A)(iii); 6320(c).

11 IRC §§ 6330(c)(2)(A)(i); 6320(c).

12 IRC §§ 6330(c)(2)(B); 6320(c).

13 IRC §§ 6330(c)(2)(A); 6320(c).

14 IRC §§ 6330(c)(4); 6320(c).

15 IRC § 6320(a)(2). The NFTL 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.

16 IRC § 6331(d)(2). *Id.*

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 the notice is sent.[18]

Requesting a Collection Due Process Hearing

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 (generally 30 days from the date of the notice) will receive an "equivalent hearing," which is similar to a CDP hearing but with no judicial review.[20] Regulations that took effect in November 2006 require taxpayers to provide in writing their reasons for requesting a CDP hearing (preferably using Form 12153, *Request for a Collection Due Process or Equivalent Hearing*); the failure to provide the basis for the hearing may result in a denial of a face-to-face hearing.[21] The regulations also provide that untimely requests are no longer automatically treated as requests for an equivalent hearing, and eliminate the availability of equivalent hearings if the taxpayer does not request a hearing within a certain time. The period for requesting 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 notice,[22] while the period for requesting an equivalent hearing with respect to a levy is one year from the date the IRS issued the CDP notice.[23]

Conduct of a Collection Due Process Hearing

The IRS will suspend collection action throughout the CDP hearing process unless it determines the collection of tax is in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS has served a disqualified employment tax levy.[24] Collection activity is also suspended throughout any judicial review of Appeals' determination, unless the

17 IRC §§ 6320(a)(2) and (a)(3)(B).

18 IRC §§ 6330(a)(2) and (a)(3)(B). The CDP hearing notice can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail (return receipt requested) to the taxpayer's last known address.

19 IRC §§ 6330(a)(3)(B); 6320(a)(3)(B); Treas. Reg. §§ 301.6320-1(c); 301.6330-1(c).

20 Treas. Reg. §§ 301.6320-1(i); 301.6330-1(i).

21 Treas. Reg. §§ 301.6320-1(c)(2) Q&A-D8; 301.6330-1(c)(2) Q&A-C1; 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 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 current form also includes a description of common alternatives so taxpayers can apply them to the specific facts of their cases. *See* Form IRS 12153, *Request For Collection Due Process or Equivalent Hearing* (Rev. 11-2006). Additionally, IRC §§ 6320(b)(1) and 6330(b)(1) were recently amended to require taxpayers to include, in writing, in their CDP hearing request the grounds for requesting the hearing. *Id.*

22 Treas. Reg. § 301.6320-1(i)(2) Q&A-17.

23 Treas. Reg. § 301.6330-1(i)(2) Q&A-17.

24 IRC § 6330(e)(1) provides the general rule for suspending collection activity. IRC § 6330(f) provides that if collection of the tax is deemed in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS served a disqualified employment tax levy, IRC § 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 *Dora v. Comm'r*, 119 T.C. 356 (2002)).

underlying tax liability is not at issue and the IRS can demonstrate to the court good cause to resume collection activity.[25]

CDP hearings are informal. When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the IRS Appeals office will attempt to conduct one hearing.[26] The Office of Appeals presumptively establishes telephonic CDP hearings, so 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 office, but can take place by telephone or by an exchange of correspondence.[28] The CDP regulations clarify when the IRS will grant a face-to-face hearing and state that taxpayers who provide non-frivolous reasons for opposing the IRS collection action will ordinarily be offered, but not guaranteed, a face-to-face conference.[29] Taxpayers making only frivolous arguments or only requesting collection alternatives for which they cannot qualify are not entitled to a face-to-face conference.[30]

The CDP hearing is to be held by an impartial officer from the Appeals function of the IRS, who is barred from engaging in *ex parte* communication with IRS personnel regarding the substance of the case.[31] The officer must also be an individual who has had "no prior involvement" in the case.[32] In addition to the issues described above, which the taxpayer is permitted to address in the CDP hearing, the Appeals officer must verify that the requirements of all applicable laws and administrative procedures have been satisfied for the IRS to proceed with collection activity.[33] In its determination, Appeals must weigh the issues raised by the taxpayer and decide whether the proposed collection action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection be no more intrusive than necessary.[34]

On December 6, 2006, Congress passed the Tax Relief and Health Care Act of 2006 (TRHCA).[35] Section 407 of the TRHCA significantly changed the CDP process by providing that the IRS may disregard any portion of a hearing request that is based on a position identified as frivolous by the IRS or reflects a desire to delay or impede the administration

25 IRC §§ 6330(e)(1) and (e)(2).

26 IRC § 6320(b)(4).

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; 301-6330-1(d)(2) Q&A-D6, D8.

28 *Katz v. Comm'r,* 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the Appeal officer constituted a hearing as provided in IRC § 6320(b)). *See, e.g., Simien v. IRS*, 99 A.F.T.R.2d (RIA) 495 (W.D. La. 2007); *Industrial Investors v. Comm'r*, T.C. Memo. 2007-93.

29 Treas. Reg. §§ 301.6320-1(d)(2) Q&A-D7; 301.6330-1(d)(2) Q&A D7.

30 *Id.*

31 IRC §§ 6320(b)(1); 6320(b)(3); 6330(b)(1); 6330(b)(3). *See also* Rev. Proc. 2000-43, 2000-2 C.B. 404. *See, e.g., Industrial Investors v. Comm'r,* T.C. Memo. 2007-93; *Moore v. Comm'r*, T.C. Memo 2006-93, *action on dec.*, 2007-2 (Feb. 27, 2007).

32 IRC §§ 6320(b)(3); 6330(b)(3).

33 IRC §§ 6330(c)(1); 6320(c).

34 IRC §§ 6330(c)(3)(C); 6320(c).

35 Pub. L. No. 109-432, 120 Stat. 2922 (2006). The provisions set forth in section 407 are effective for submissions made and issues raised after the date on which the IRS first prescribed a list of frivolous positions. Notice 2007-30, 2007-1 C.B. 883, provides the first published list of frivolous positions.

of federal tax laws.[36] Section 407 also amended IRC § 6702 to create a new frivolous submission penalty that applies to frivolous CDP hearing requests.[37] A CDP hearing request is subject to the penalty if any portion of the request "(i) is based on a position which the Secretary has identified as frivolous...or (ii) reflects a desire to delay or impede the administration of the Federal tax laws."[38]

Section 407 also amended IRC §§ 6320(b)(1) and 6330(b)(1) to require taxpayers to include within their CDP hearing requests the grounds for requesting the hearing in writing.[39] Section 6330(c)(4) was amended to provide that an issue may not be raised at a hearing if the issue is based on a position identified as frivolous by the IRS or reflects a desire to delay or impede the administration of federal tax laws.[40] These provisions were passed to assist the IRS in combating the problems associated with the submission of frivolous documents.[41]

On May 25, 2007, Congress again modified CDP procedures for employment tax liabilities by amending IRC § 6330(f) to permit a levy to collect employment taxes without first giving a taxpayer a pre-levy CDP notice if the levy is a "disqualified employment tax levy."[42] A disqualified employment tax levy is

> [A]ny levy in connection with the collection of employment taxes for any taxable period if the person subject to the levy (or any predecessor thereof) requested a hearing under this section with respect to the unpaid employment taxes arising in the most recent 2-year period before the beginning of the taxable period with respect to which the levy is served.[43]

Judicial Review of Collection Due Process Determination

Within 30 days of the Appeals determination, the taxpayer may petition the United States Tax Court for judicial review of IRS Appeals' determination.[44] Where the validity of the tax liability is properly at issue in the CDP hearing, the court will review the amount of the tax

36 IRC § 6330(g).

37 The frivolous submission penalty applies to the following submissions: CDP hearing request, offer in compromise, installment agreement request, and application for a taxpayer assistance order.

38 IRC § 6702(b)(2)(a). Before assertion of the penalty, the IRS must notify the taxpayer that it has determined that the taxpayer filed a frivolous hearing request. The taxpayer then has 30 days to withdraw the submission in order to avoid assertion of the penalty. IRC § 6702(b)(3).

39 IRC §§ 6320(b)(1); 6330(b)(1).

40 IRC § 6330(c)(4).

41 S. Rep. No. 109-336, at 49 (2006).

42 Pub. L. No. 110-28, § 8243(a), (b), 121 Stat. 112, 200 (2007). This amendment is effective for such levies served on or after September 22, 2007.

43 IRC § 6330(h).

44 IRC §§ 6330(d)(1); 6320(c). Prior to October 17, 2006, the taxpayer could also petition the federal district court if the Tax Court did not have jurisdiction over the underlying tax liability.

liability on a *de novo* basis.[45] Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.[46]

Analysis of Litigated Cases

CDP was one of the most litigated tax issues in the federal court system between June 1, 2007, and May 31, 2008. We reviewed 179 CDP court opinions, a 17.5 percent decrease from the 217 cases in last year's analysis. Moreover, the 179 decided cases do not reflect the full measure of CDP litigation because not all CDP cases result in court opinions. Some cases are resolved through pre-litigation 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. Other cases are disposed of by unpublished order. Table 2 in Appendix lll provides a detailed list of the 179 CDP opinions reviewed, including specific information about the issue(s) considered, the types of taxpayers involved, and the outcomes of the cases.

Litigation Success Rate

Taxpayers prevailed in 15 of the 179 cased reviewed (approximately eight percent), and prevailed in part in an additional three cases.[47] Of those cases in which the courts found for the taxpayer in whole or in part, the taxpayers appeared *pro se* in eight cases[48] and were represented in the remaining ten.[49]

Table 3.2.1 compares litigation success rates in CDP cases reported in the 2003 through 2008 Annual Reports to Congress.[50]

45 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. 105-99, at 266 (Conf. Rep.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

46 *See, e.g., Murphy v. Comm'r*, 469 F.3d 27 (1st Cir. 2006).

47 *Graham v. Comm'r,* T.C. Memo. 2008-129; *Ulloa v. U.S.*, 100 A.F.T.R.2d (RIA) 6119 (N.D.N.Y. 2007); *Wagenknecht v. Comm'*r, 509 F.3d 729 (6th Cir. 2007).

48 *Butti v. Comm'r,* T.C. Memo. 2008-82; *Callahan v. Comm'r*, 130 T.C. No. 3 (2008); *Golub v. Comm'r,* T.C. Memo. 2008-122; *Kennedy v. Comm'r,* T.C. Memo. 2008-33; *Kuykendall v. Comm'r*, 129 T.C. No. 9 (2007); *Perkins v. Comm'r,* T.C. Memo. 2008-103; *Ulloa v. U.S.*, 100 A.F.T.R.2d (RIA) 6119 (N.D.N.Y. 2007); *Wagenknecht v. U.S.*, 509 F.3d 729 (6th Cir. 2007).

49 *Blosser v. Comm'r,* T.C. Memo. 2007-323; *Cotler v. Comm'r,* T.C. Memo. 2007-283; *Downing v. Comm'r,* T.C. Memo. 2007-291; *Ellison v. Comm'r,* 101 A.F.T.R.2d (RIA) 1661 (S.D. W. Va. 2008); *Graham v. Comm'r*, T.C. Memo. 2008-129; *Imarah v. Comm'r,* T.C. Memo. 2008-137; *Samuel v. Comm'r,* T.C. Memo. 2007-312; *Don Johnson Motors, Inc. v. U.S.*, 532 F. Supp. 2d 844 (S.D. Tex. 2007); *Lofgren Trucking Service, Inc. v. Comm'r,* 508 F. Supp. 2d 734 (D. Minn. 2007); *Shelter Mutual Insurance v. Gregory*, 2008 U.S. Dist. Lexis 1963 (M.D. Tenn.).

50 See National Taxpayer Advocate 2007 Annual Report to Congress 569, Table 1, for 2003, 2004, 2005, 2006, and 2007 statistics.

TABLE 3.2.1, Success Rates in CDP Cases

Court Decision	2003 Percentage	2004 Percentage	2005 Percentage	2006 Percentage	2007 Percentage	2008 Percentage[51]
Decided for IRS	96%	95%	89%	90%	92%	90%
Decided for Taxpayer	1%	4%	8%	8%	5%	8%
Split Decision[52]	3%	1%	3%	2%	3%	2%
Neither[53]	N/A	N/A	N/A	N/A	Less than 1%	N/A

Issues Litigated

The cases discussed below are those which the National Taxpayer Advocate believes are significant or noteworthy. The outcomes of these cases can provide important information to Congress, the IRS, and taxpayers about the rules and operation of CDP hearings. Equally important, all of the cases reviewed offer the opportunity to examine the CDP process and look for opportunities for improvement, both in its application and execution.

Procedural Rulings

Leahy v. Commissioner

In *Leahy v. Commissioner*,[54] the taxpayers filed a Tax Court petition under the small tax case procedures[55] seeking judicial review of a notice of determination concerning a notice of intent to levy. The total unpaid balance the IRS sought to collect in the notice of determination was over $50,000. The taxpayers contended that because they disputed only a portion of the total of the unpaid tax liability, which was less than $50,000, they were eligible for small tax case procedures.[56] Section 7463(f)(2) provides that a CDP case may be conducted under "S case" procedures with respect to "a determination in which the unpaid tax does not exceed $50,000." Applying IRC § 7463(f)(2), the court in *Leahy* held that for a case to qualify for small tax case procedures under IRC § 7463(f)(2), the total amount of "unpaid tax," including interest and penalties, cannot exceed $50,000 as of the date of the notice of determination.[57] The court also concluded the fact that the taxpayers disputed only a portion of the amount at issue is irrelevant; it is the amount that the IRS seeks to collect in

51 Numbers have been rounded to nearest percentage.

52 A "split" decision refers to a case with multiple issues where both the IRS and the taxpayer prevail on one or more substantive issues.

53 A "neither" decision refers to a case where the court's decision was not in favor of either party. 129 T.C. 71 (2007).

54 129 T.C. 71 (2007).

55 Small tax cases, often referred to as "S" cases, as discussed in IRC § 7463, are limited to certain types of cases involving $50,000 or less. Small tax cases are typically less formal in nature than a regular Tax Court case and often result in speedier disposition of the case. Decisions entered in small tax cases, however, are not appealable.

56 *Leahy v. Comm'r*, 129 T.C. 71 at 72.

57 *Leahy v. Comm'r*, 129 T.C. 71 at 72 (citing *Schwartz v. Comm'r*, 128 T.C. 6 at 12).

the Notice of Determination that controls. Thus, the case was not eligible for small tax case status.[58]

Downing v. Commissioner

In *Downing v. Commissioner*,[59] a taxpayer filed a Tax Court petition seeking review of the IRS determination to uphold its filing of an NFTL for the 1995 and 1999 tax years. The taxpayer claimed he never received the notice of intent to levy and right to a CDP hearing notice previously issued to him for the 1995 and 1999 tax years because the IRS sent the notice to the wrong address. Between the filing of the original return and the notice of intent to levy, the taxpayer submitted a Form 2848, *Power of Attorney and Declaration of Representative*, which directed the IRS to contact him at his address and not at the address of his accountant. The IRS, however, continued to send notices to the taxpayer's accountant. The court found the IRS should have known of the address change, and thus, the notice of intent to levy was invalid as it was not sent to the taxpayer's last known address. Because the notice of intent to levy was invalid, the court found the taxpayer did not have a prior opportunity to challenge the merits of the underlying liabilities, and therefore could challenge them in the CDP proceeding.[60] The Tax Court then found the 1995 tax liability was improperly assessed because no statutory notice of deficiency was issued prior to assessment, and thus, the notice of determination sustaining the filing of the NFTL was invalid with respect to the 1995 tax year.[61]

Imarah v. Commissioner

In *Imarah v. Commissioner*,[62] the taxpayers filed a Tax Court petition seeking review of the IRS determination to uphold its filing of an NFTL for the 1996 and 1998 tax years. The taxpayers claimed that the 1996 and 1998 tax liabilities had been discharged in bankruptcy, and hence the filing of the NFTL was improper. During the CDP hearing, the appeals officer refused to consider the dischargeability issue on the grounds that the taxpayers had a prior opportunity to address this issue in the bankruptcy court, and thus, the taxpayers were precluded from raising this issue as it was a challenge to the underlying liability.[63] The Tax Court disagreed with the IRS, finding that dischargeability was an issue concerning the appropriateness of the collection action, not the underlying tax liability, and thus, the appeals officer erred in not addressing this issue during the CDP proceeding. The Tax Court then concluded the taxpayers' 1996 and 1998 income tax liabilities were in fact discharged, and consequently, the Tax Court did not sustain the IRS's determination to proceed with collection.[64]

58 *Leahy v. Comm'r*, 129 T.C. at 76.

59 T.C. Memo. 2007-291 (2007).

60 *Id.*

61 *Id.*

62 T.C. Memo. 2008-137 (2008).

63 *Id.* at 21.

64 *Id.*

Baltic v. Commissioner

In *Baltic v. Commissioner*,[65] the taxpayers requested a CDP hearing in response to the IRS filing an NFTL against them. At the CDP hearing, the taxpayers requested an offer in compromise based on doubt as to liability (OIC-DATL). The appeals officer refused to consider the OIC-DATL, finding the taxpayers had already had an opportunity to challenge the underlying liability and were thus precluded from challenging the liability during the CDP proceeding. The appeals officer, however, informed the taxpayers that another IRS office would consider the OIC-DATL separately and that a third office would consider the taxpayers' amended return during the audit reconsideration process.[66] The appeals officer issued a notice of determination, finding that the IRS should postpone levy action until the IRS decided whether to accept the OIC-DATL and finished its audit reconsideration, but that the filing of the NFTL would be sustained. The taxpayers petitioned the Tax Court to challenge the appeals officer's determination not to consider the OIC-DATL during the CDP process. The Tax Court held that an OIC-DATL is a challenge to the underlying tax liability and that the IRS did not abuse its discretion in sustaining the filing of the NFTL because the taxpayers had a prior opportunity to challenge their liability when they received the statutory notice of deficiency.[67]

Appeals Impartiality

IRC §§ 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. As noted in this report and previous reports, the National Taxpayer Advocate is concerned about the lack of independence of the Office of Appeals from the IRS compliance function, which can impair Appeals' ability to act impartially.[68] In previous reports, the National Taxpayer Advocate has focused on cases where employees engage in inappropriate *ex parte* communications that can compromise Appeals' independence. While *ex parte* communications remain a concern, the following case illustrates a slightly different problem facing taxpayers whose cases are reviewed by IRS Appeals employees who have previously worked on cases brought by the taxpayers.

Cox v. Commissioner

In *Cox v. Commissioner*,[69] the IRS sent the taxpayer a Notice of Intent to Levy to collect the taxpayer's 2001 and 2002 tax liabilities, and in response the taxpayer requested a CDP hearing. The appeals officer assigned to handle the case was the same officer who had worked on the taxpayer's prior CDP case involving collection of the taxpayer's 2000 tax liability.

65 129 T.C. 178 (2007).

66 *Id.* at 180.

67 *Id.* at 184.

68 *See* National Taxpayer Advocate 2006 Annual Report to Congress 266 (Most Serious Problem, *Concerns with the IRS Office of Appeals*); National Taxpayer Advocate 2005 Annual Report to Congress 136 (Most Serious Problem, *Appeals Campus Centralization*); National Taxpayer Advocate 2004 Annual Report to Congress 264 (Most Serious Problem, *Independence of the Office of Appeals*).

69 514 F.3d 1119 (10th Cir. 2008), *rev'g* 126 T.C. 237 (2006).

The taxpayer objected to this officer handling the subsequent case, claiming the appeals officer had impermissible "prior involvement" because during the course of the first case, he had reviewed the taxpayer's 2001 and 2002 tax returns to evaluate possible collection alternatives.[70] Relying on the Treasury Regulation's definition of "prior involvement,"[71] the IRS determined the appeals officer was not precluded from handling the subsequent case, and the Tax Court upheld this determination.[72]

The taxpayer appealed to the United States Court of Appeals for the Tenth Circuit. In the time between the Tax Court ruling and the appeal to the Tenth Circuit, the IRS modified the regulations under IRC § 6330 to clarify that an appeals officer was deemed to have "prior involvement" only in situations where the officer had considered the identical liability (same type of tax and same tax period) in a prior non-CDP matter.[73] The Tenth Circuit reversed the Tax Court's decision, holding that the appeals officer's review of the taxpayer's 2001 and 2002 tax liabilities during the first proceeding constituted prohibited "prior involvement" under IRC § 6330(b)(3) and the definitions of "prior involvement" contained in the 2004 regulations and as clarified in the 2006 regulations were invalid as these regulations were inconsistent with the intention of the statute.[74]

The Administrative Record

Giamelli v. Commissioner

In *Giamelli v. Commissioner*,[75] the Tax Court held that it did not have the "authority to consider IRC § 6330(c)(2) issues that were not raised before the Appeals Office."[76] In *Giamelli*, the taxpayer and his wife filed a joint federal income tax return in 2001 and failed to pay the tax due at the time of filing. The IRS assessed the tax due and also filed an NFTL. In response to the filing of the NFTL, the taxpayer requested a CDP hearing and during that proceeding argued that he should be allowed to enter into an installment agreement with the IRS for the 2001 tax year. The IRS rejected the proposed agreement after the taxpayer failed to make estimated tax payments in subsequent years. Shortly after the CDP hearing, the taxpayer died, and his estate sought to challenge the determination to reject the installment agreement and the amount of the 2001 tax liability. The Tax Court held that since the taxpayer did not challenge the amount of the 2001 liability during the CDP hearing, the estate could not challenge the underlying liability in the Tax Court proceeding.[77]

70 *Cox v. Comm'r*, 514 F.3d 1119 (10th Cir. 2008); IRC § 6330(b)(3) guarantees taxpayers a right to an appeals officer who has had "no prior involvement with respect to the unpaid tax specified before the first hearing under this section or section 6320."

71 Treas. Reg. § 301.6330-1(d)(2) (2004).

72 *Cox v. Comm'r,* 126 T.C. 237 (2006).

73 Treas. Reg. § 301.6330-1(d)(2) Q&A -D4 (2006) provides that "Prior involvement exists only when the taxpayer, the tax and the tax period at issue in the CDP hearing also were at issue in the prior non-CDP matter, and the Appeals officer or employee actually participated in the prior matter." *Id.*

74 *Cox v. Comm'r*, 514 F.3d 1119, 1127 (10th Cir. 2008).

75 129 T.C. 107 (2007).

76 *Id.* at 115.

77 *Id.* at 115-16.

Perkins v. Commissioner

In *Perkins v. Commissioner*,[78] the taxpayer and his wife filed joint returns for tax years 1995 and 2000. The IRS assessed the taxes owed for those years. For the 1999 tax year, the taxpayer was due a refund, which he sought to have applied to his liabilities for 1995 and 2000. The IRS determined the 1999 refund claim was not timely filed and thus the taxpayer was not entitled to a refund for that year. The taxpayer then inquired as to whether his medical disability would suspend the limitations period for filing a refund claim under IRC § 6511(h), which suspends the period of limitations for filing a refund claim for any period of time that the taxpayer is financially disabled. The appeals officer concluded that IRC § 6511(h) did not apply because the taxpayer was not disabled at the time the 1999 return was filed. The Tax Court found the appeals officer had incorrectly interpreted the requirements for suspension of the statute of limitations under IRC § 6511(h); thus, the administrative record was incomplete with regard to whether the taxpayer had met the requirements of this provision. The case was remanded to Appeals so it could reconsider the taxpayer's claim that his 1999 refund claim was timely as a result of the application of IRC § 6511(h).

Imposition of Sanctions

One notable issue emerging from the review of CDP decisions during the time period is the extent to which the courts imposed sanctions on taxpayers for frivolous positions. Section 6673(a)(1) authorizes the Tax Court to impose sanctions when it appears that proceedings have been instituted primarily for delay.[79] Our analysis of decisions demonstrates that courts are trying to deter the filing of frivolous CDP hearing requests by imposing sanctions under IRC § 6673 or by warning taxpayers of the possible imposition of sanctions in the future. Of the 179 cases decided during the review period, the courts imposed sanctions in 14 cases – or over seven percent – and threatened IRC § 6673 sanctions in three additional cases.[80]

Pro Se Analysis

One hundred and four (or 58 percent) of the 179 cases litigated were brought before the courts by the taxpayer *pro se*. This is a decrease from 65 percent in the previous year and 73 percent in 2006.[81] Table 3.2.2 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 received some relief on judicial review while approximately 13 percent of represented taxpayers received full or partial relief from their CDP appeals.

78 T.C. Memo. 2008-103.

79 For a more detailed discussion of IRC § 6673, *see* Most Litigated Issue, *Frivolous Issues Penalty and Related Appellate Level Sanctions Under Internal Revenue Code Section 6673, infra.*

80 *Anderson v. Comm'r*, T.C. Memo. 2007-265; *McGowan v. Comm'r*, T.C. Memo. 2008-125; *Moore v. Comm'r*, T.C. Memo. 2007-200.

81 National Taxpayer Advocate 2007 Annual Report to Congress 569.

TABLE 3.2.2, *Pro Se* and Represented Taxpayer Cases and Decisions

Court Decisions	*Pro Se* Taxpayers		Represented Taxpayers	
	Volume	Percentage of Total	Volume	Percentage of Total
Decided for IRS	96	92%	65	87%
Decided for Taxpayer	6	6%	9	12%
Split Decisions	2	2%	1	1%
Totals	**104**		**75**	

Conclusion

CDP hearings continue to provide a critical means for taxpayers to challenge IRS attempts to deprive them of property. Given the important protection that CDP hearings offer, it should be of little surprise that CDP remains one of the most frequently litigated tax issues in the federal courts – a trend that is not likely to change anytime soon. The cases reviewed illustrate the need for both taxpayers and the IRS to comply with the basic CDP requirements, such as the need for the notice of determination to be sent to the taxpayer's last known address, the need for an impartial appeals officer, and the role of the administrative record. The issue of what constitutes a challenge to the underlying liability remains a developing issue as illustrated by the *Imarah*[82] and *Baltic*[83] cases discussed previously.

Because of the important role of CDP hearings in protecting taxpayer rights, taxpayers and their representatives will likely continue to pursue their CDP rights in court. However, the courts have demonstrated a decreasing tolerance for taxpayers making frivolous claims designed to stall the collection process. The new legislation designed to deter taxpayers from making frivolous arguments during the CDP process, along with the courts' trend of imposing sanctions, may reduce the number of reported decisions discussing only frivolous arguments. The National Taxpayer Advocate will continue to monitor how this legislation plays out and its effect on the CDP process.

82 T.C. Memo 2008-137 (2008).

83 129 T.C. No. 19 (2007).

MLI #3

Summons Enforcement Under Internal Revenue Code Sections 7602, 7604, and 7609

Summary

The IRS may examine any books, records, or other data relevant to an investigation of a civil or criminal tax liability.[1] The IRS may serve a summons for this information directly on the individual who is the subject of the investigation or any third party who may possess relevant information.[2]

A person who has a summons served upon him or her may contest the legality of the summons if the government petitions a court to enforce it.[3] If the IRS serves a summons upon a third party, any person entitled to notice of the summons may challenge the legality of the summons by filing a motion to quash or by intervening in any proceeding regarding the summons.[4] Generally, the burden on the taxpayer to establish the illegality of the summons is formidable.[5] We reviewed 146 federal court opinions discussing issues related to IRS summons enforcement during the 12 months from June 1, 2007, through May 31, 2008. The party contesting the summons prevailed in full in only three of these cases, while six cases resulted in split decisions.

Present Law

The IRS has broad authority under IRC § 7602 to issue a summons to examine a taxpayer's books and records or direct testimony under oath.[6] Further, the IRS may obtain information related to an investigation from a third party if, subject to the exceptions of IRC § 7609(c), it provides notice to those identified in the summons.[7] However, the IRS may not issue a summons *after* referring the matter to the Department of Justice (DOJ).[8] If the recipient of a summons fails to comply, the IRS may commence an action under IRC § 7604 in the appropriate United States District Court to compel production or testimony.[9] If the IRS files a petition to enforce the summons, the taxpayer may contest the

1 Internal Revenue Code (IRC) § 7602(a)(1); Treas. Reg. § 301.7602-1.

2 IRC § 7602(a).

3 *U.S. v. Powell,* 379 U.S. 48, 58 (1964).

4 IRC § 7609(b).

5 *Bodensee Fund, LLC v. U.S. Dept. of Treasury-I.R.S.*, 101 A.F.T.R.2d (RIA) 2092 (E.D. Pa. 2008).

6 *LaMura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985) (citing *U.S. v. Bisceglia*, 420 U.S. 141, 145-146 (1975)).

7 IRC § 7602(a). Those entitled to notice of a third party summons (other than the person summoned) must be given notice of the summons within three days of the day on which the summons is served to the third party, but no later than the 23rd day before the day fixed on the summons on which the records will be reviewed. IRC § 7609(a).

8 IRC § 7602(d). This restriction applies to "any summons, with respect to any person if a [DOJ] referral is in effect with respect to such person." IRC § 7602(d)(1).

9 IRC § 7604.

validity of the summons in that proceeding.[10] Also, if the summons is served upon a third party, any person entitled to notice may initiate a petition to quash the summons in an appropriate U.S. District Court, or may intervene in any proceeding regarding the enforceability of the summons.[11]

Generally, every person named in a third party summons is entitled to notice.[12] However, several exceptions may apply. First, the IRS is not required to give notice if the summons is issued to aid in the collection of "an assessment made or judgment rendered against the person with respect to whose liability the summons is issued."[13] This exception reflects congressional recognition of a difference between a summons issued where the IRS has made an assessment or obtained a judgment (and is attempting to determine, for example, whether the taxpayer has an account in a certain bank and whether the account has sufficient funds to pay the tax), and a summons issued in an attempt to compute the taxpayer's taxable income. Giving taxpayers notice in the former case would seriously impede the IRS's ability to collect the tax.[14] The courts have interpreted the "aid of collection" exception to apply only where the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.[15] Second, for the same reason, a summons issued by an IRS criminal investigator in connection with a criminal investigation is also exempt from IRC § 7609 notice procedures if the summons is served on any person who is not a third party record keeper.[16]

Regardless of whether the taxpayer contests the summons in a motion to quash or a response to an IRS petition to enforce, the legal standard is the same.[17] In *United States v. Powell*, the Supreme Court set forth four threshold requirements that must be satisfied to enforce an IRS summons:

- The investigation must be conducted for a legitimate purpose;
- The information sought must be relevant to that purpose;
- The IRS must not already possess the information; and
- All required administrative steps must have been taken.[18]

10 *U.S. v. Powell,* 379 U.S. 48, 58 (1964).

11 IRC § 7609(b). The petition to quash must be filed not later than the 20th day after the date on which notice was served. IRC § 7609(b)(2)(A).

12 IRC § 7609(a)(1).

13 IRC § 7609(c)(2)(D)(i). The exception also applies to the collection of a liability of "any transferee or fiduciary of any person referred to in clause (i)." IRC § 7609(c)(2)(D)(ii).

14 H.R. Rep. No. 94-658, at 310, *reprinted in* 1976 U.S.C.C.A.N. at 3206; *see also* S. Rep. No. 94-938, pt. 1, at 371-372, *reprinted in* 1976 U.S.C.C.A.N. at 3800-3801 (containing essentially the same language).

15 *Ip v. U.S.*, 205 F.3d 1168, 1172-76 (9th Cir. 2000).

16 IRC § 7609(c)(2)(E). A third party record keeper is broadly defined and includes: banks, consumer reporting agencies, persons extending credit by credit cards, brokers, attorneys, accountants, enrolled agents, and owners or developers of computer source code but only when the summons "seeks the production of the source or the program or data to which the source relates." IRC § 7603(b)(2).

17 *Phillips v. Comm'r*, 99 A.F.T.R.2d (RIA) 3487 (D. Ariz. 2007).

18 *U.S. v. Powell*, 379 U.S. 48, 57-58 (1964).

The IRS bears the initial burden of establishing that these requirements have been met.[19] However, this burden is minimal, and the government need only introduce a sworn affidavit of the agent who issued the summons declaring that each of the *Powell* requirements has been satisfied.[20] The burden then shifts to the person contesting the summons to demonstrate that the IRS did not meet the *Powell* requirements or that enforcement of the summons would be an abuse of process.[21]

A taxpayer may also allege that the information requested by the IRS is protected by a statutory or common law privilege, such as the:

- Attorney-client privilege;[22]
- Work product privilege;[23] or
- Tax practitioner privilege.[24]

However, these privileges are limited. For example, they extend to "tax advice" but not to tax return preparation materials.[25] Another limitation is the "tax shelter" exception, which permits discovery of communications between a tax practitioner and client that promote participation in any tax shelter.[26]

Analysis of Litigated Cases

Summons enforcement has appeared as a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress every year since 2005. At that time, we reviewed only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. Our prediction was accurate, as the volume of cases grew to 101 in 2006, 109 in 2007, and 146 in 2008. A detailed list of this year's cases appears in Table 3 in Appendix lll.

The IRS prevailed in full in 137 cases, while taxpayers prevailed in only three cases; six cases resulted in split decisions. Attorneys represented taxpayers in 38 cases, while taxpayers

19 *Fortney v. U.S.*, 59 F.3d 117, 119-20 (9th Cir. 1995).

20 *U.S. v. Dynavac, Inc.*, 6 F.3d 1407, 1414 (9th Cir. 1993).

21 *Id.*

22 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, 1461 (7th Cir. 1997) (citing John Henry Wigmore, *Evidence in Trials at Common Law* § 2292 (John T. McNaughten rev. 1961)).

23 The work product doctrine protects against the discovery of documents and other tangible things prepared in anticipation of litigation. Fed. R. Civ. P. 26(b)(3).

24 IRC § 7525 extends the protection of the common law attorney-client privilege to federally authorized tax practitioners in federal tax matters. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525 (a)(2), (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, 810-12 (7th Cir. 2003).

25 *U.S. v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999).

26 IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 100 A.F.T.R.2d (RIA) 6473 (N.D. Ill. 2007).

appeared *pro se* (*i.e.,* without counsel) in the other 108 cases. One hundred fourteen cases involved individual taxpayers, while the remaining 32 involved business taxpayers. Twenty of the represented taxpayers were business taxpayers. Arguments raised by litigants against IRS summonses generally fell into the following categories:

- ***Powell* Requirements:** Although we reviewed no cases in which the taxpayer successfully challenged the government's *prima facie* showing, taxpayers frequently argued that one or more of the *Powell* requirements had not been met. For example, a court found that assisting a foreign tax investigation was a legitimate purpose and the IRS does not need to establish the good faith of the requesting country so long as the IRS itself acted in good faith and complied with applicable statutes.[27] In addition, so long as the matter has not been referred to the DOJ, the IRS may issue a summons for the sole purpose of determining criminal liability.[28] Taxpayers also argued the summonses were overbroad or ambiguous but failed to substantiate their claims with evidence the information sought was irrelevant.[29] Taxpayers also claimed the IRS already possessed the requested documents, but were unable to provide sufficient evidence to refute the IRS agent's affidavit to the contrary.[30]
- **Criminal Referral:** Taxpayers argued that because the IRS issued the summons pursuant to a possible criminal investigation, the IRS violated the IRC § 7602(d) restriction on issuing a summons after referring the matter to the DOJ. However, the courts were careful to distinguish between a *referral* to the DOJ, which prevents the issuance of a summons, and a criminal investigation by the IRS, which does not.[31] Generally, courts accepted the testimony of the IRS agents who issued the summonses concerning whether the IRS had made criminal referrals to the DOJ.[32] One court, however, granted a motion to quash six summonses issued to the taxpayers' lawyer when the government only provided testimony regarding whether a referral had been made to the DOJ with respect to the taxpayers, and refused to disclose if a DOJ referral was made with respect to the lawyer. The court held the prohibition against issuing a summons if a DOJ referral is in effect applied, not only to the taxpayers, but to the lawyer.[33]
- **Constitutional Arguments:** Taxpayers also asserted several generally unsuccessful constitutional arguments. For example, the courts rejected the argument that the Fourth Amendment requires the IRS to establish probable cause to issue a summons,

27 *U.S. v. Hiley*, 100 A.F.T.R.2d (RIA) 6224 (S.D. Cal. 2007).

28 *Hopkins v. I.R.S.*, 101 A.F.T.R.2d (RIA) 1906 (D.N.M. 2008), *appeal docketed*, No. 08-2127 (10th Cir. June 6, 2008).

29 *U.S. v. Bright*, 100 A.F.T.R.2d (RIA) 5905 (D. Haw. 2007), *adopting* 100 A.F.T.R.2d (RIA) 6109 (D. Hawaii 2007), *reh'g denied*, 100 A.F.T.R.2d (RIA) 6615 (D. Haw. 2007).

30 *Bodensee Fund, LLC v. U.S. Dept. of Treasury-I.R.S.*, 101 A.F.T.R.2d (RIA) 2092 (E.D. Pa. 2008) (requesting essentially the same document from two separate sources allows the IRS to "double check" the records for consistency).

31 *Hennessy v. C.I.R.,* 100 A.F.T.R.2d (RIA) 7055 (E.D. Mich. 2007), *adopting* 100 A.F.T.R.2d (RIA) 5130 (E.D. Mich. 2007); *Hopkins v. I.R.S.*, 2008 WL 2079151 (D.N.M. 2008), *appeal docketed*, No. 08-2127 (10th Cir. June 6, 2008).

32 *Hopkins v. I.R.S.*, 101 A.F.T.R.2d (RIA) 1906 (D.N.M. 2008), *appeal docketed*, No. 08-2127 (10th Cir. June 6, 2008); *Speelman v. U.S.*, 2008 WL 148935 (S.D. Ohio 2008).

33 *Khan v. U.S. ex rel. I.R.S.*, 537 F. Supp. 2d 944 (N.D. Ill. 2008), *appeal docketed,* No. 08-1743 (7th Cir. Mar. 27, 2008).

and recognized that a taxpayer has no Fourth Amendment right in information sought by the IRS from a third party.[34] Also, although taxpayers may have a valid Fifth Amendment claim regarding specific documents or testimony, the courts routinely rejected blanket assertions of a Fifth Amendment privilege.[35] Finally, the courts found that where the taxpayer received notice and was given an opportunity to respond, there was no due process violation.[36]

- **Privilege:** Generally, taxpayers were most successful when arguing privilege as a bar to disclosure of the summoned information. For example, in *United States v. Textron*, the IRS issued a summons seeking all of the taxpayer's "tax accrual work papers," and the taxpayer moved to quash the summons on the grounds that the attorney-client and work product privileges protected the materials from disclosure.[37] The papers at issue consisted of a list of items that in counsel's opinion might be challenged by the IRS because they involved unsettled areas of the law, and also counsel's opinion as to the taxpayer's chances of prevailing with respect to each item if the matter was ever litigated. The court held that while the attorney-client privilege applies to tax accrual work papers, the privilege was waived when the documents were disclosed to the taxpayer's independent auditors.[38] Further, the work product privilege does not apply to documents prepared in the ordinary course of business or that would have been created in essentially the same form irrespective of anticipated litigation. The court found, however, that the work papers were protected from disclosure by the work product privilege as the work papers were prepared in anticipation of litigation.[39]

  In *Regions Financial Corp. v. United States*, the taxpayer successfully argued the work product privilege applied to documents containing the legal analysis of the tax implications of a corporate transaction that the taxpayer felt might result in litigation.[40] Also, a court partially granted a taxpayer's motion to quash a summons on the grounds that the requested documents were confidential communications between the taxpayer and a federally authorized tax practitioner, and were therefore protected by the tax practitioner privilege.[41]

The IRS prevailed in 28 of the 54 cases initiated by filing motions to quash the summonses, in part because the courts lacked jurisdiction to hear the cases. The courts dismissed these cases for lack of jurisdiction for the following reasons:

34 *Palmer v. U.S.*, 101 A.F.T.R.2d (RIA) 623 (E.D. Tenn. 2008); *Bandy v. U.S.*, 101 A.F.T.R.2d (RIA) 1916 (D. Kans. 2008).

35 *U.S. v. Benoit*, 101 A.F.T.R.2d (RIA) 2167 (9th Cir. 2008); *U.S. v. Bowers*, 259 Fed. Appx. 89 (10th Cir. 2007); *U.S. v. Rinehart*, 539 F. Supp. 2d 1334 (W.D. Okla. 2008) (granting IRS petition to enforce subject to specific assertions of taxpayer's Fifth Amendment privilege).

36 *U.S. v. Benoit*, 101 A.F.T.R.2d (RIA) 2167 (9th Cir. 2008).

37 *U.S. v. Textron, Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007), *appeal docketed*, No. 07-2631 (1st Cir. Oct. 31, 2007).

38 *Id.*

39 *Id.*

40 *Regions Financial Corp. v. U.S.*, 101 A.F.T.R.2d (RIA) 2179 (N.D. Ala. 2008).

41 *Valero Energy Corp. v. U.S.*, 100 A.F.T.R.2d (RIA) 6473 (N.D. Ill. 2007) (recognizing that the tax shelter privilege exception only applies were tax avoidance is a "significant purpose," not just "one of the purposes" of a transaction).

- **Lack of Jurisdiction Due to Procedural Requirements:** The United States is immune from suit unless Congress has expressly waived its sovereign immunity.[42] Since a motion to quash is a suit against the United States, a court has jurisdiction only when Congress has expressly waived the sovereign immunity of the United States.[43] Accordingly, the courts have strictly construed IRC § 7609 when determining if sovereign immunity has been waived.[44] For example, a court denied a motion to quash for lack of jurisdiction because the taxpayer filed by regular mail instead of registered or certified mail as required by statute.[45] Also, a court dismissed a *pro se* taxpayer's motion to quash because the motion was filed two days after the 20-day limitation period had expired.[46]
- **Lack of jurisdiction due to notice requirements:** Courts denied several motions to quash because the party contesting the summons was not entitled to notice of the summons due to one of the IRC § 7609(c) exceptions, and therefore lacked standing to contest the validity of the summons.[47] For example, the U.S. Court of Appeals for the Ninth Circuit dismissed a motion to quash as it related to the taxpayer's wife because the wife was not entitled to notice of the summonses.[48]
- **Lack of jurisdiction due to no actual controversy:** The courts dismissed motions to quash with respect to two taxpayers because the IRS withdrew the contested summons, leaving no ripe case or controversy.[49] Because the motions were dismissed, the taxpayers never received rulings regarding the validity of the summons. If the IRS issues another summons, the taxpayer will be required to file another motion to quash to contest the validity of the new summons.[50]

Conclusion

The IRS may issue a summons to obtain information needed to determine the correctness of a tax return, determine if a return should have been filed, determine a taxpayer's tax liability, or collect a liability.[51] Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information to the IRS voluntarily. Taxpayers and third parties continue to contest IRS summonses, but rarely succeed due to the significant burden of proof and strict procedural requirements. It appears that as the

42 *U.S. v. Dalm,* 494 U.S. 596, 608 (1990).

43 *Huffman v. U.S.*, 100 A.F.T.R.2d (RIA) 7089 (S.D. Fla. 2007).

44 *Luongo v. U.S.*, 2008 WL 1326953 (M.D. Fla. 2008).

45 *Id.*

46 *Neuger v. U.S.*, 2008 WL 697342 (D. Colo. 2008).

47 *Grant v. Comm'r*, 100 A.F.T.R.2d (RIA) 5327 (E.D. Ky. 2007) (taxpayer not entitled to notice because summons was issued in aid of collection); *Daniel v. U.S.*, 101 A.F.T.R.2d (RIA) 1541 (D. Ariz. 2008) (taxpayer not entitled to notice because summons was issued as part of a criminal investigation meeting requirements of IRC § 7609(c)(2)(E)).

48 *Stewart v. U.S.*, 511 F.3d 1251 (9th Cir. 2008).

49 *Thompson v. U.S.*, 100 A.F.T.R.2d (RIA) 2007-6133; *Thompson v. U.S.*, 2007 WL 1891167 (D.D.C. 2007); *Tift v. Comm'r,* 101 A.F.T.R.2d (RIA) 2008-2645 (W.D. Wash. 2008).

50 *Thompson v. U.S.*, 100 A.F.T.R.2d (RIA) 6133 (S.D. Ohio 2007).

51 IRC § 7602(a).

IRS continues its aggressive enforcement policy, it will continue to rely heavily on the summons enforcement tool, and we expect the courts will continue to see increased numbers of these cases.[52]

[52] For a more detailed discussion of IRS collection enforcement actions, see Most Serious Problem, *The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties, supra*.

MLI #4

Trade or Business Expenses Under Internal Revenue Code Section 162 and Related Sections

Summary

The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the federal courts. We identified 116 cases that included a trade or business expense issue and were litigated between June 1, 2007, and May 31, 2008. The courts affirmed the IRS position in nearly three-fourths of the cases, while taxpayers prevailed about 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 cases analyzed for this report illustrate that this process is ongoing and involves a facts and circumstances analysis. 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 common law, where the concepts have been developed and refined by the courts.[3] The United States 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 earning income or making 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 relation to the taxpayer's trade or business in order to be deductible. In *Welch v. Helvering,*

1 The IRS prevailed in full in 85 of the 116 cases, while taxpayers prevailed in full in only six cases.

2 In 1986, the term "trade or business" appeared in at least 492 subsections of the Code and 664 Treasury Regulation provisions. *See* 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).

the Supreme Court stated that the words "ordinary" and "necessary" have different meanings, both of which must be satisfied for a taxpayer to benefit from the deduction.[5] The Supreme Court describes an "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]

Common law also requires that in addition to being ordinary and necessary, the amount of the expense be reasonable for the expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held "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 an unlimited amount."[8]

Is the expense a currently deductible expense or a capital expenditure?

A currently deductible expense is an ordinary and necessary expense that is paid or incurred during the taxable year in the course of carrying on a trade or business.[9] No deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset that is expected to last more than one year.[10] Instead, capital expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property.[11]

Determining whether to deduct expenditures under IRC § 162(a) or to capitalize them under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach to applying principles of capitalization and deductibility.[12]

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" 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.[13] 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.

5 290 U.S. 111, 113 (1933).

6 *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940).

7 *Comm'r v. Tellier*, 383 U.S. 687, 689 (1966).

8 176 F.2d 815, 817 (6th Cir. 1949).

9 IRC § 162(a).

10 IRC § 263. *See also INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992).

11 IRC § 167.

12 *See PNC Bancorp, Inc. v. Comm'r*, 212 F.3d 822 (3d Cir. 2000); *Norwest Corp. v. Comm'r,* 108 T.C. 265 (1997).

13 IRC § 6001. *See also* Treas. Reg. §§ 1.6001-1 and 1.446-1(a)(4).

The *Cohan* rule is a rule of "indulgence" established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.[14] 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."[15]

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."[16]

A taxpayer must substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence to corroborate the taxpayer's statement establishing the amount, time, place, and business purpose of the expense.[17]

Who has the burden of proof in a substantiation case?

Generally, a taxpayer bears the burden of proving that he or she is entitled to the business expense deductions and the IRS's proposed determination of tax liability is incorrect.[18] IRC § 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.[19]

14 39 F.2d 540 (2d Cir. 1930).

15 *Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

16 "Listed property" means any passenger automobile; any property used as a means of transportation; any property of a type generally used for purposes of entertainment, recreation, or amusement; any computer or peripheral equipment (except when used exclusively at a regular business establishment and owned or leased by the person operating such establishment); any cell phones (or similar telecommunications equipment); or other property specified by regulations. IRC § 280F(d)(4)(A) and (B).

17 Treas. Reg. § 1.274-5T(b).

18 *See Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citation omitted) and U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

19 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.

Analysis of Litigated Cases

Trade or business expenses 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.[20] We reviewed 116 cases involving various trade or business expense issues that were litigated in federal courts from June 1, 2007, through May 31, 2008. Table 4 in Appendix III contains a detailed listing of those cases. Table 3.4.1 (below) categorizes the main trade or business expense issues raised by taxpayers in the cases reviewed. Cases involving more than one issue are included in more than one category. In *Lebloch v. Commissioner*,[21] for example, the taxpayer raised four distinct trade or business expense issues, so *Lebloch* appears in four categories in Table 3.4.1.

TABLE 3.4.1, Trade or Business Expense Issues in Cases Reviewed

Issue	Type of Taxpayer	
	Individual	Business (including sole proprietors)
Substantiation of expenses, including application of the *Cohan* rule[22]	29	46
Profit objective[23]	0	19
Ordinary and necessary trade or business expenses[24]	4	18
Personal vs. business expenses[25]	16	12
Travel, entertainment and gift expenses[26]	15	6
Medical and dental expenses[27]	7	4
Business expenses vs. capital expenditures[28]	2	3
Compensation expenses[29]	0	6
Self-employed health insurance deduction[30]	0	2
Education expenses[31]	2	2

20 See National Taxpayer Advocate 1998-2007 Annual Reports to Congress.

21 T.C. Memo. 2007-145.

22 IRC § 6001 and Treas. Reg. § 1.6001-1 require a taxpayer to maintain books and records that substantiate income, deductions, and credits. Treas. Reg. § 1.162-17 provides guidance regarding maintaining adequate records to substantiate deductions claimed as trade or business expenses in connection with the performance of services as an employee. The *Cohan* rule allows courts to estimate certain expenses not properly substantiated. *See Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

23 IRC § 183(a) provides that no deduction attributable to an activity shall be allowed if such activity is not engaged in for profit.

24 IRC § 162(a) allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.

25 IRC § 262(a) provides that personal, living, and family expenses are generally not deductible.

26 IRC § 162(a)(2) allows a deduction for ordinary and necessary business-related expenses for traveling "while away from home in the pursuit of a trade or business"; entertaining clients and customers; and giving gifts to customers, employees, and others with whom they have a business relationship. A taxpayer's "home" for purposes of IRC § 162(a)(2) is his or her principal place of business. *See Kroll v. Commissioner*, 49 T.C. 557, 561-62 (1968) (citations omitted). *See also* IRS Fact Sheet FS-2007-10, Jan. 2007.

27 IRC § 213(a) allows a deduction for a portion of medical and dental expenses not compensated by insurance or otherwise, which exceeds seven and half percent of the taxpayer's adjusted gross income. Qualified medical expenses are not subject to the two-percent floor on miscellaneous itemized deductions under IRC § 67(b).

Over two-thirds of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). In terms of percentage, represented taxpayers did not fare any better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 26 percent of litigated cases (ten of 38), while *pro se* taxpayers received partial relief in approximately 26 percent of litigated cases (20 of 78). Only one of the *pro se* taxpayers received full relief.

Individual Taxpayers

Thirty-four of the 116 cases analyzed were litigated by individual taxpayers, over three-quarters of whom appeared *pro se*.[32] None of these taxpayers received full relief, although 14 of the 34 cases resulted in split decisions. The most prevalent issue was the substantiation of the claimed trade or business expense deductions, which appeared in 29 cases. For example, in *Boltinghouse v. Commissioner*,[33] the taxpayer failed to provide consistent and credible documentation to satisfy the strict substantiation requirements of IRC § 274(d). His claims for transportation and travel expenses, entertainment and business meals, and business gifts were denied for lack of strict substantiation, as well as failure to provide proof that such expenses were not reimbursed by his employer.[34] The court partly allowed claimed deductions for medical and dental expenses, but not for vitamins because they were not prescribed medications.[35] Consequently, this case ended in a split decision.

None of the 34 decisions involving individual taxpayers was issued as a regular opinion of the Tax Court.[36] In the only appellate court decision involving individual taxpayers, *Cargill v. Commissioner*,[37] the Court of Appeals for the Eleventh Circuit affirmed the Tax Court's

28 Under IRC § 263(a), generally no deduction is allowed for capital expenditures, where capital expenditures include any amount paid for permanent improvements made to increase the value of any property. Under IRC § 195(a), startup expenditures generally cannot be deducted unless a taxpayer makes an expense/amortization election according to IRC § 195(b). Taxpayers who made the election may generally deduct up to $5,000 of startup expenditures in the tax year in which an active trade or business begins and amortize any excess expenditures over 180 months. The $5,000 deduction is reduced by a dollar for every dollar that total start-up expenditures exceed $50,000

29 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."

30 Under IRC § 162(l), a self-employed taxpayer may deduct the cost of medical insurance premiums under certain conditions. A self-employed taxpayer may not deduct the cost of medical insurance premiums, however, if he or she is eligible to participate in a subsidized health plan of another employer or of the spouse's employer. *See* IRC § 162(l)(2)(B).

31 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.

32 Individual taxpayers were represented by counsel in only seven of the 34 cases.

33 T.C. Memo. 2007-32, *appeal dismissed*, No. 08-1195 (4th Cir. Apr. 24, 2008). This case illustrates the typical outcome in a substantiation case where the taxpayer has failed to provide adequate records for travel, meal, and other miscellaneous expenses that cannot be estimated under the *Cohan* rule and are subject to the strict substantiation requirements of IRC § 274(d).

34 Fifteen of 34 cases involved travel, entertainment, and gift expenses issues.

35 *See* IRC § 213(a). Medical and dental expenses issues were raised in seven cases involving individual taxpayers.

36 Tax Court reported decisions fall into three categories: regular decisions, memorandum decisions, and small tax case ("S") decisions. The regular decisions of the Tax Court include cases which have some new or novel point of law, or in which there may not be general agreement, and therefore have the most legal significance. In contrast, memorandum decisions generally involve fact patterns within previously settled legal principles and therefore are not as significant. In addition, "S" case decisions (for disputes involving $50,000 or less) are not appealable and, thus, have no precedential value. *See generally* IRC §§ 7459 and 7463(b). *See also* U.S. Tax Court Rules of Practice and Procedure, Rules 170-175.

37 272 Fed. Appx. 756 (11th Cir. 2008).

order dismissing the taxpayer's petition for redetermination of a deficiency involving claimed itemized deductions and business expenses not properly substantiated. The taxpayer failed to provide any substantiation to support the claimed deductions and expenses on her unsigned joint return. Even during the Tax Court proceedings, the taxpayer failed to produce any evidence that she was entitled to those deductions. As a result, the appellate court did not find an abuse of discretion in the Tax Court's prior dismissal of the case.

In a number of cases, the IRS disallowed deductions for various expenses claimed by airline mechanics who had to work at different locations throughout the country or risk being laid off.[38] For example, in *Bogue v. Commissioner,* an airline mechanic received a "bump" notice with a choice between being laid off or bumping other employees and moving to different cities to continue working. The airline gave the taxpayer no end date for his positions in these cities and no longer required him to perform any services whatsoever in his home city where his post of duty was initially located. The IRS denied the deductions because the taxpayer was not "away from home" in the pursuit of a trade or business.[39] The Tax Court concluded there was no business reason for the taxpayer to maintain a family residence in his hometown and that he kept it for purely personal reasons. Consequently, the Tax Court upheld the IRS's denial of the taxpayer's deductions because he did not have a tax home in the tax year at issue.[40]

Business Taxpayers

Eighty-two of the 116 litigated trade or business expense cases involved business taxpayers. These taxpayers had less success than individual taxpayers in obtaining a favorable outcome, receiving full or partial relief in approximately 21 percent of cases (17 of 82) compared to 41 percent for individuals (14 of 34). Notably, however, six business taxpayers obtained full relief, while none of the individual taxpayers prevailed in full. In five favorably decided cases, business taxpayers were represented by counsel.

As with individual taxpayers, substantiation of expenses was the most prevalent issue,[41] and in some instances, the courts denied business taxpayers' deductions for failure to substantiate.[42] In other cases, however, where taxpayers did not have contemporaneous records but nonetheless demonstrated that they incurred business expenses, the courts permitted taxpayers to claim a reasonable amount of deductions through application of the

38 *See, e.g., Bogue v. Comm'r*, T.C. Memo. 2007-150; *Farran v. Comm'r,* T.C. Memo. 2007-151. *Bogue* involved vehicle, lodging, and meals expenses as well as expenses for Internet access, safety glasses and safety shoes, uniform cleaning, and cellular telephone, while *Farran* involved expenses for vehicle, lodging, meals, Internet access, uniform cleaning, tools, depreciation of tools, personal property taxes, job searching, supplies, parking, publications, cellular telephone, and education mileage. *See also McKeown v. Comm'r*, T.C. Summ. Op. 2007-95; *Riley v. Comm'r*, T.C. Memo. 2007-153; *Stephens v. Comm'r*, T.C. Summ. Op. 2007-94; *Stockwell v. Comm'r*, T.C. Memo. 2007-149; *Wasik v. Comm'r,* T.C. Memo. 2007-148; and *Wilbert v. Comm'r,* T.C. Memo. 2007-152.

39 *See* IRC §§ 162(a)(2) and 262(a).

40 *Bogue* resulted in a split decision. The Tax Court denied deductions for miscellaneous unsubstantiated expenses while allowing estimated amounts of deductible cleaning expenses under the *Cohan* rule. *See Bogue v. Comm'r*, T.C. Memo. 2007-150; *Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

41 Substantiation of expenses issue appeared in 46 of 83 cases involving business taxpayers.

42 *See, e.g., Arnold v. Comm'r*, T.C. Memo. 2007-168; *Osborne v. Comm'r*, T.C. Memo. 2008-40; *Sita v. Comm'r,* T.C. Memo. 2007-363.

Cohan rule.[43] At least one taxpayer prevailed on appeal when the Tax Court denied certain deductions associated with the taxpayer's unincorporated car racing business. For example, in *Maciel v. Commissioner,*[44] the IRS refused to permit deductions associated with the unincorporated businesses of a taxpayer who did not report any income from these businesses and pled guilty to tax evasion in a separate criminal proceeding. The Tax Court summarily determined the taxpayer failed to substantiate claimed business deductions. The United States Court of Appeals for the Ninth Circuit reversed the decision because the taxpayer did substantiate some of his expenses with adequate records.[45]

Another common issue litigated by business taxpayers was the question of whether the business expense deductions were attributable to a legitimate "for profit" activity constituting an actual trade or business. In *Smith v. Commissioner,*[46] the taxpayers were involved in dog breeding, cow and dairy farming, and horse breeding activities, and claimed deductions for expenditures related to these businesses.[47] The IRS disallowed the deductions on the grounds that these activities were not conducted for profit under IRC § 183. The Tax Court used a nine-factor test to analyze each of these activities.[48] Based on all facts and circumstances, the court upheld the IRS determination for the taxpayers' horse and dog breeding activities. The court concluded these activities were not for profit because the taxpayers failed to maintain adequate records or develop business plans for them, and used losses from the activities to offset their large incomes from other sources. However, the court found the cow and dairy farm was for profit activity for purposes of IRC § 183(a) because the taxpayer who engaged in this activity approached the operation in a businesslike manner. The taxpayer gained expertise in breeding cows through extensive study and spent an average of 20 to 30 hours per week on the activity. In addition, the Tax Court found that, unlike the horse and dog breeding, the cow and dairy farm was more business than pleasure oriented. Consequently, the court allowed deductions related to the farm activity under IRC § 162(a).

Although none of the 82 business taxpayer cases was issued as a regular opinion of the Tax Court, five cases resulted in appellate court decisions and one case led to a decision of the

43 *See, e.g., Tash v. Comm'r,* T.C. Memo. 2008-120.

44 489 F.3d 1018 (9th Cir. 2007), *rev'g in part* T.C. Memo. 2004-28.

45 489 F.3d at 1029.

46 T.C. Memo. 2007-368, *appeal docketed*, No. 08-72402 (9th Cir. May 23, 2008).

47 This case consolidated related petitions of three married couples related by blood and marriage – the parents and their children's families.

48 The nine-factor test to determine whether an activity is engaged in for profit includes: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) the elements of personal pleasure or recreation. All facts and circumstances are to be taken into account and no single factor or group of factors is determinative. *See Indep. Elec. Supply, Inc. v. Commissioner*, 781 F.2d 724, 726-727 (9th Cir. 1986), *aff'g. Lahr v. Commissioner*, T.C. Memo. 1984-472; *Golanty v. Commissioner*, 72 T.C. 411, 425-426 (1979), *aff'd. in unpublished opinion*, 647 F.2d 170 (9th Cir. 1981); *see also* Treas. Reg. § 1.183-2(b).

United States Supreme Court.[49] In *Knight v. Commissioner*,[50] the Supreme Court settled the long-standing split of authority regarding the applicability of the two percent adjusted gross income limitation to the deductibility of investment fees by trusts. In this case, the trust claimed deductions for the full amount of the investment advisory fees incurred by the trust to satisfy the trustee's fiduciary obligation of prudent investment. The IRS allowed a deduction only for the portion of the fees that exceeded two percent of the trust's adjusted gross income according to IRC § 67(a). The trustee appealed, arguing the full amount of the investment advisory fees is deductible under the IRC § 67(e)(1) exception to the IRC § 67(a) two-percent floor.[51] The Supreme Court upheld the Tax Court and the Court of Appeals for the Second Circuit, holding that the deductibility of the fees paid by the trust is limited to fees in excess of the two-percent floor, since IRC § 67(e)(1) exception only allows full deductibility if the costs would not have been incurred had the property not been held in trust.

Another important case, *BB&T Corp. v. United States*, involved business expense deductions in a tax shelter transaction.[52] The United States Court of Appeals for the Fourth Circuit upheld the decision of the district court denying the corporate taxpayer's deduction for rent and related expenses under IRC § 162(a)(3)[53] associated with the company's participation in a lease-in/lease-out (LILO) transaction.[54] The financial services company entered into a LILO transaction of manufacturing equipment with the manufacturer that owned the equipment and claimed rent expense deductions. The court upheld disallowance of the rental deduction because the rent was not in substance an ordinary and necessary business expense, but rather a device through which the taxpayer duplicated deductible expenses.

Conclusion

Taxpayers continued to challenge IRS denials of trade or business expense deductions, and represented taxpayers again fared better than their *pro se* counterparts. While the IRS generally prevailed, 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 remains open to interpretation and highly fact-specific.

49 *See BB&T Corp. v. U.S.*, 523 F.3d 461 (4th Cir. 2008); *E. J. Harrison & Sons, Inc. v. Comm'r,* 270 Fed. Appx. 667 (9th Cir. 2008); *Green v. Comm'r*, 507 F.3d 857 (5th Cir. 2007); *Kanofsky v. Comm'r*, 101 A.F.T.R.2d (RIA) 1501 (3d Cir. 2008); *Maciel v. Comm'r*, 489 F.3d 1018 (9th Cir. 2007). *See also Knight v. Comm'r*, 128 S. Ct. 782 (2008).

50 128 S. Ct. 782 (2008). For a detailed discussion of this case, see Most Litigated Issues, *Significant Cases, supra.*

51 IRC § 67(e)(1) excepts from the two-percent floor of IRC § 67(a) expenses incurred by a trust that could not have been incurred if the property were held by an individual.

52 *See BB&T Corp. v. U.S.*, 523 F.3d 461 (4th Cir. 2008), *reh'g en banc denied* (4th Cir. June 27, 2008).

53 IRC § 162(a)(3) allows a deduction for "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." *Id.*

54 In this LILO transaction, a manufacturer owned and used the equipment and retained, in substance, all of the rights it possessed in the equipment before the transaction and during the term of the lease. The rights that the manufacturer transferred to the taxpayer under the lease were identical to the rights that the corporate taxpayer transferred back to the manufacturer under the sublease. *See BB&T*, 523 F.3d 461, 465-470.

Many of the analyzed cases demonstrate taxpayer confusion over the legal requirements. The IRS can minimize litigation by providing clear guidance on the deductibility of trade or business expenses. Through education, outreach, and collaboration with stakeholders, the IRS can help taxpayers understand what trade or business expense deductions are allowable and how to substantiate them. By helping self-employed and small business taxpayers understand these requirements, the IRS will encourage compliance and minimize litigation. The IRS may stop or substantially limit the abuse of business expense deductions by vigorously litigating tax shelter and sham transaction cases.

MLI #5

Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2)

Summary

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if, under § (b)(1) a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if under § (b)(2) an underpayment of tax exceeded a computational threshold called a substantial understatement. IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties.[1] However, during our review period of June 1, 2007, through May 31, 2008, taxpayers litigated these other penalties less frequently than the negligence and substantial understatement penalties; therefore, this analysis does not address the three other accuracy-related penalties.

Present Law

The amount of the accuracy-related penalty equals 20 percent of the portion of the underpayment that is attributable to the taxpayer's negligence or disregard of rules or regulations or a substantial understatement.[2] For example, if a taxpayer wrongly reports a handful of income tax items, some errors may be justifiable mistakes while others might be the result of negligence. The 20 percent penalty would apply only against the underpayment attributable to negligence.

The IRS may assess penalties under both subsections of the accuracy-related statute. The total penalty rate, however, may not exceed 20 percent (*i.e.*, the penalties are not "stackable").[3] Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.[4]

Negligence

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes a taxpayer's negligence or disregard of the rules or regulations caused the underpayment. Negligence includes a failure to make a reasonable attempt to comply with the internal revenue laws, including a failure to keep adequate books and records or to substantiate items that gave rise to the underpayment.[5] Strong indicators of negligence include instances where a

1 IRC § 6662(b)(3) authorizes a penalty for substantial valuation misstatement for income taxes; IRC § 6662(b)(4) authorizes a penalty for substantial overstatement of pension liabilities; and IRC § 6662(b)(5) authorizes a penalty for substantial valuation understatements of estate and gift taxes.

2 IRC § 6662(a).

3 Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a gross valuation misstatement. *See* IRC § 6662(h)(1).

4 IRC § 6664(c)(1).

5 Treas. Reg. § 1.6662-3(b)(1).

taxpayer failed to report income on a tax return that a payer reported on an information return, as defined in IRC § 6724(d)(1),[6] or the taxpayer failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return.[7] The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.[8]

Substantial Understatement

In general, an "understatement" is the difference between (1) the correct amount of tax and (2) the amount the taxpayer reported on the return, reduced by any rebate.[9] Understatements are generally reduced by the portion of an understatement attributable to (1) an item for which the taxpayer had substantial authority; or (2) any item if the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment in the return or in an attached statement, and the taxpayer had a reasonable basis for the tax treatment of the item.[10] For individuals, the understatement of tax is substantial if it exceeds the greater of $5,000 or ten percent of the correct amount of tax.[11] For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return or $10,000,000.[12]

For example, if the correct amount of tax should have been $10,000 and the taxpayer reported $6,000, the substantial understatement penalty would not apply because although the $4,000 shortfall is more than the ten percent test ($1,000 is ten percent of $10,000), it is less than the fixed $5,000 threshold. Conversely, if the same taxpayer reported a tax of $4,000, the substantial understatement penalty would apply because the $6,000 shortfall is more than $1,000 (ten percent of $10,000), and is also greater than $5,000.

Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.[13] A reasonable cause determination takes into account all of the pertinent facts and circumstances.[14] The most important factor is the extent of the taxpayer's effort to determine the proper tax liability.[15]

6 IRC § 6724(d)(1) cross-references other subsections that define various information returns, *e.g.*, IRC § 6724(d)(1)(A)(ii) references IRC § 6042(a)(1) for reporting of dividend payments.

7 Treas. Reg. § 1.6662-3(b)(1)(i) and (ii).

8 These factors include the taxpayer's history of noncompliance; failure to maintain adequate books and records; actions taken by the taxpayer to ensure the tax was correct; and whether the taxpayer had an adequate explanation for underreported income. Internal Revenue Manual (IRM) 4.10.6.2.1 (May 14, 1999).

9 IRC § 6662(d)(2)(A).

10 IRC § 6662(d)(2)(B). No reduction is permitted, however, for any item attributable to a tax shelter. *See* IRC § 6662(d)(2)(C).

11 IRC § 6662(d)(1)(A)(i) and (ii).

12 IRC § 6662(d)(1)(B)(i) and (ii).

13 IRC § 6664(c)(1).

14 Treas. Reg. § 1.6664-4(b)(1).

15 Treas. Reg. § 1.6664-4(b)(1).

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[16] and through its Automated Underreporter (AUR) computer system.[17] Before a taxpayer receives a notice of deficiency, he or she has opportunities to engage the IRS on the merits of the penalty.[18] Once the IRS concludes an accuracy-related penalty is warranted, it must follow the same deficiency procedures, *i.e.*, IRC §§ 6211-6213, that it follows with other assessments.[19] Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the U.S. Tax Court.[20] Alternatively, taxpayers may seek judicial review through refund litigation.[21] Generally later, in response to IRS collection actions, *e.g.*, a notice of intent to levy, the taxpayer may under certain circumstances request an administrative appeal of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.[22]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.[23] The IRS must first present sufficient evidence to establish that the penalty is warranted. The burden of proof then shifts to the taxpayer to establish any exception to the accuracy-related penalty, such as reasonable cause.[24]

16 IRM 20.1.5.3(1) and (2) (July 1, 2008).

17 The AUR is an automated program that the IRS utilizes to identify discrepancies between amounts that taxpayers reported on a tax return and amounts that payers reported via Form W-2, Form 1099, and other information returns. IRC § 6751(b)(1) provides that IRS employees must have written supervisory approval before assessing any penalty. However, IRC § 6751(b)(2)(B) provides an exception for situations where the IRS is able to calculate a penalty automatically "through electronic means." The IRS interprets the exception language as allowing the IRS to use its AUR system to propose the substantial understatement and negligence components of the accuracy-related penalty without human review. If a taxpayer responds to an AUR-proposed assessment, then at that point, the IRS first involves its employees to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, then the IRS computers automatically convert the proposed penalty to an assessment. *See* National Taxpayer Advocate 2007 Annual Report to Congress 277 ("Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS's over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs").

18 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 IRS Appeals, during which time he or she may 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 ("90 day letter") to the taxpayer. *See* IRS Publication 5, *Your Appeal Rights and How to Prepare a Protest if You Don't Agree* (Rev. Jan. 1999); IRS Publication 3498, *The Examination Process* (Rev. Nov. 2004).

19 IRC § 6665(a)(1).

20 IRC § 6213(a).

21 Taxpayers may litigate an 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 for jurisdiction over refund litigation).

22 IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer may 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).

23 IRC § 7491(c) provides that "the Secretary shall have the 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."

24 IRC § 7491(c).

Analysis of Litigated Cases

For the period from June 1, 2007, through May 31, 2008, we identified 87 cases where taxpayers litigated the negligence or disregard of rules or regulations or the substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 61 cases (70 percent), the taxpayers prevailed in full in 22 cases (25 percent), and three cases (three percent) resulted in split decisions. Finally, one case (one percent) was indeterminate because it was remanded for further consideration. Thus, taxpayers prevailed partially or fully in 29 percent of the penalty disputes.

Taxpayers appeared *pro se* (without representation) in 47 of the 87 cases (54 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalty in 17 percent of their cases.[25] In contrast, represented taxpayers achieved full or partial relief from the penalty 43 percent of the time. Thus, representation appears to be a major factor in the outcome of penalty litigation.[26]

In some cases, the court ruled on the accuracy-related penalty without specifying whether subsection (b)(1) or (b)(2) applied. Where possible, in Table 5 of Appendix III we indicate which subsection was at issue. The analysis of reasonable cause is the same regardless of which subsection is at issue. Therefore, we have combined our analysis of the negligence and substantial understatement cases.

Reasonable Cause

Adequacy of Records and Substantiation of Deductions for Reasonable Cause and as Proof of Taxpayer's Good Faith

Reasonable cause and good faith were proven most frequently by the adequacy of taxpayers' records. For example, in *Bigler v. Commissioner*,[27] because the taxpayer kept detailed records and his bookkeeping was generally accepted and complied with industry standards, the court determined that the taxpayer acted reasonably and in good faith. Even though the taxpayer erred in his computation of tax, his accounting practices helped to establish that he had reasonable cause and acted in good faith.

In other cases, the court held that taxpayers did not show good faith in attempting to comply with tax laws, and had no reasonable cause when presenting inadequate records or insufficient substantiation. In *Agbaniyaka v. Commissioner*,[28] the Tax Court sustained

25 In determining the taxpayer success rates, we included those cases that were split between the taxpayer and the IRS because the taxpayer achieved a reduction in penalties, and excluded the one case which was remanded (taxpayer appeared *pro se*) as the case was remanded to the tax court for a determination of whether the taxpayer's reliance on experts was in good faith. *See Thompson v. Comm'r*, 100 A.F.T.R.2d (RIA) 5792 (2d Cir. 2007), *vacating and remanding* T.C. Memo. 2003-174, *cert. denied* (June 16, 2008).

26 Taxpayers achieved some relief in eight of the 47 *pro se* litigated cases, whereas 17 of the 40 represented taxpayers achieved success (including split decisions). Similarly, 32 percent of the taxpayers who convinced the court to dismiss or reduce the penalty were *pro se*, while 68 percent of the taxpayers who won full or partial relief were represented.

27 T.C. Memo. 2008-133.

28 T.C. Memo. 2007-300.

the IRS's denial of business and educational deductions and imposition of accuracy-related penalties because the taxpayer did not keep adequate records. Even though the taxpayer held a master's degree in accounting with a concentration in tax, he failed to keep records establishing trade and business expenses under IRC § 162. The taxpayer failed to keep records of business expenses such as continuing education classes, travel receipts, depreciation schedules, and calculations of the cost of goods sold. The court held that the taxpayer's lack of record keeping amounted to negligence.

Reliance on Advice of Tax Professional for Reasonable Cause

Reliance on a tax professional was the second most commonly litigated element of reasonable cause. To qualify for reliance on a tax professional under the reasonable cause exception to accuracy-related penalties, the taxpayers established three factors: (1) they provided all necessary information to the professional; (2) the tax professional was competent with sufficient expertise; and (3) the taxpayers actually relied in good faith on the professional's opinion or tax return preparation.[29]

Three examples of where taxpayers successfully claimed reasonable reliance on a tax professional include:

1. Although the taxpayer's accountant mischaracterized the taxpayer as a sole proprietor rather than the landlord of a bar for several years, the court found reasonable cause and that the taxpayer acted in good faith by providing correct information to the accountant who made an understandable error.[30]
2. Even though a taxpayer failed to report alimony payments from her ex-husband in her gross income, the court found she reasonably and in good faith relied on the advice of her tax and divorce attorneys, who erroneously determined the payments were not alimony.[31]
3. Although a taxpayer failed to report all of his gambling winnings on his tax returns, the taxpayer proved he acted in good faith and reasonably relied on his tax preparer by demonstrating that he provided documents and records supporting his gambling winnings and losses to his tax preparer.[32]

Three examples where taxpayers unsuccessfully claimed reliance on a tax professional include:

1. The taxpayer failed to present evidence of the tax preparer's competence;[33]

29 *Neufeld v. Comm'r*, T.C. Memo. 2008-79; *Neonatology Associates, P.A. v. Comm'r,* 115 T.C. 43, 99 (2000) (citations omitted); Treas. Reg. § 1.6664-4(c)(1).

30 *Monk v. Comm'r,* T.C. Memo. 2008-64.

31 *Perkins v. Comm'r*, T.C. Memo. 2008-41.

32 *Gagliardi v. Comm'r*, T.C. Memo. 2008-10.

33 *See G. Kierstead Family Holdings Trust v. Comm'r*, T.C. Memo. 2007-158 (taxpayers failed to show that the attorney they relied on was competent); *Tash v. Comm'r*, T.C. Memo. 2008-120 (taxpayer provided no evidence establishing tax preparer as a competent tax professional); *Burkley v. Comm'r*, T.C. Summ. Op. 2008-20 (tax preparer was unfamiliar with software and was not an accountant).

2. The taxpayer failed to provide the preparer with all of the necessary documentation for the tax return;[34] and
3. The court found the taxpayers did not rely in good faith on their preparer's advice and failed to oversee the preparer; the taxpayers signed their tax return without examining it or discussing it with the preparer.[35]

Although reliance on a tax professional may be evidence of reasonable cause or acting in good faith, it does not entitle the taxpayer to an exception from accuracy-related penalties. In *Oria v. Commissioner*,[36] the court upheld the accuracy-related penalty because the taxpayer knew his S corporation was making payments to his CPA so the CPA could make accounting entries to inflate the corporation's expenses and reduce the taxpayer's salary for his income taxes. The court held a reasonably prudent person would not rely on the advice of a person with a financial interest in that advice, and therefore the taxpayer's reliance on his CPA was not reasonable cause for the understatement of taxes.

Other Circumstances for Reasonable Cause

Tax Sophistication of the Taxpayer

A taxpayer's education and sophistication relating to business and tax issues is of great concern to the court. For taxpayers with special knowledge or experience in tax law, the court sustained the penalty because the taxpayers should have known better. For example, the court held that taxpayers sophisticated in tax matters lacked reasonable cause and did not act in good faith in the following instances:

- A taxpayer with a master's degree in accounting with a concentration in taxation negligently failed to keep adequate records and receipts for his business-related deductions, including travel, continuing education, and union dues.[37]
- A former tax auditor for the IRS tried to deduct an uncollectible personal settlement as an IRC § 165(c) casualty loss.[38]
- A licensed attorney and former IRS employee failed to report income received as part of a settlement paid by a former employer. The Tax Court found the taxpayer failed to make a reasonable inquiry into whether his decision not to include the settlement in his gross income was correct. Therefore, the court held that the taxpayer failed to act with reasonable cause and in good faith.[39]

34 *See King v. Comm'r*, 100 A.F.T.R.2d (RIA) 6481 (11th Cir. 2007) (taxpayers failed to provide their accountants with records and receipts); *Muller v. Comm'r*, T.C. Summ. Op. 2007-207 (taxpayer did not tell tax preparer about IRA withdrawal); *Prudhomme v. Comm'r*, T.C. Memo. 2008-83 (taxpayers failed to provide information regarding the sale of their S corporation to their tax preparer).

35 *Neufeld v. Comm'r*, T.C. Memo. 2008-79.

36 T.C. Memo. 2007-226.

37 *Agbaniyaka v. Comm'r*, T.C. Memo. 2007-300.

38 *Green v. Comm'r*, T.C. Memo. 2007-217.

39 *MacMurray v. Comm'r*, T.C. Summ. Op. 2007-118.

In contrast, taxpayers without specialized tax knowledge achieved better results. For example, the Tax Court in *Thompson v. Commissioner*[40] disallowed the accuracy-related penalty imposed on a taxpayer who incorrectly deducted education expenses. The court found the taxpayer, an aeronautical engineer, acted reasonably in purchasing tax software to help him prepare his return. Additionally, in *Dawson v. Commissioner*,[41] the court found the taxpayers, a building inspector and a registered nurse, reasonably attempted to comply with their reporting requirements by offsetting their gambling winnings with gambling losses. The taxpayer's use of "logic" sufficed for the court.

Complex Issues or Extraordinary Circumstances

The court found reasonable cause to dismiss the penalty when taxpayers litigated a complex issue or were victims of extraordinary circumstances. In *Tateosian v. Commissioner*,[42] the court upheld the IRS's determination that the payments received by the taxpayer were taxable retirement income, not exempt disability payments. However, the court held the taxpayer was not liable for the accuracy-related penalty due to the complex nature of the state retirement laws, compounded by a confusing change in the taxpayer's pension.

Similarly, in *Langroudi v. Commissioner*,[43] the Tax Court sustained the IRS's determination that the tax convention between the United States and Belgium did not apply to the taxpayer's income earned as an anesthetist trainee. However, the court held the taxpayer was not liable for the accuracy-related penalty because the complex nature of the tax treaty caused his tax deficiencies.

Finally, reasonable cause may exist in the extraordinary circumstances in the life of the taxpayer. In *Smith v. Commissioner*,[44] the Tax Court found the taxpayer's life circumstances constituted reasonable cause for failing to report income received from a settlement. After the taxpayer received a small settlement, he lost his job, became temporarily homeless, and suffered expensive health issues for which he had no insurance. The court found these circumstances, coupled with the taxpayer's education level, knowledge, and experience, constituted reasonable cause.

Taxpayers Who Deducted Personal Expenses

The court sustained the accuracy-related penalty in instances where a taxpayer deducted personal expenses. For example, in *Berryman v. Commissioner*,[45] the court sustained the penalty under IRC § 6662(b)(1) because the taxpayers' deductions showed a disregard for the rules and regulations. The taxpayers deducted items such as cat litter, golf balls, college

40 T.C. Memo. 2007-174.
41 T.C. Summ. Op. 2008-17.
42 T.C. Memo. 2008-101.
43 T.C. Summ. Op. 2007-156.
44 T.C. Summ. Op. 2007-106.
45 T.C. Summ. Op. 2007-138.

football tickets, and satellite TV, which the taxpayers claimed related to their association with a direct marketing company that sells health and wellness products.

Son of Boss Litigation

After a decade, Son of Boss[46] tax shelters are finding their way to court. The IRS has assessed negligence and substantial understatement penalties (IRC § 6662(b)(1) & (2)) in most, if not all, Son of Boss cases. The courts, however, came out very differently on Son of Boss cases during our review period. In *Jade Trading, LLC v. Commissioner*,[47] the Court of Federal Claims upheld the IRS's imposition of IRC § 6662 penalties because the transactions yielded tax benefits that were "too good to be true" and a reasonably prudent person, acting as the "tax matters partner," would not have supported such substantial tax losses from a fictional transaction. Additionally, the court found the tax deficiencies met the substantial understatement standard of IRC § 6662(b)(2) in the alternative.

The United States District Court reached a different opinion in *Sala v. United States*.[48] The court found the disputed transaction had legitimate business purposes other than the favorable tax consequences, and therefore the taxpayer was entitled to a full refund of taxes, interest, and penalties. The IRS also sought to offset the taxpayer's refund with an accuracy-related penalty that was never assessed. The court held the government could not assess the penalty because the taxpayer had filed a qualified amended return.[49]

Conclusion

In the cases reviewed for this report, the court often sustained the IRS's determination of a deficiency or a portion of the deficiency, but from time to time the court overruled the IRS on the accuracy-related penalty. The court dismissed or reduced the penalty in 29 percent of the cases. Further, taxpayers who had representation were more than twice as successful in contesting the penalty as were those who were *pro se*.

The results indicate that the court finds reasonable cause where taxpayers make a legitimate effort to determine the correct amount of tax, even though the taxpayers are wrong on the underlying tax issue. In finding reasonable cause, the preeminent factors were

46 Son of Boss transactions were designed to inflate the basis of a partnership interest through the partner's contribution of offsetting short-term options. The partner would write and sell a call option and use the proceeds to purchase a counterpart put option. The partner would then contribute the put option to the partnership as an asset and take a higher basis in the partnership. The partner would contribute the call option but take advantage of the classification of call options as contingent obligations so the partner would not have to treat the call as a liability which ordinarily would decrease the partner's basis under IRC § 752(b). The partner would encounter a substantial loss when the put option expired. The net result would be that the partner would recognize this loss to offset a substantial prior or future gain. *See* IRS Notice 00-44, 2000-2 C.B. 255; *Kligfeld Holdings v. Comm'r,* 128 T.C. 192 (2007).

47 100 A.F.T.R.2d (RIA) 7123 (Fed. Cl. 2007), *reconsideration denied by* 101 A.F.T.R.2d (RIA) 1411 (2008).

48 552 F. Supp. 2d 1167 (D. Colo. 2008), *motion for new trial denied*, 102 A.F.T.R.2d (RIA) 5292 (2008).

49 *See* Treas. Reg. § 1.6664-2(c)(2). The underpayment for purposes of assessing the accuracy-related penalty does not include the underpayment reported on a "qualified amended return," which is filed after the due date for the taxable year and before the earliest of (1) the date the IRS first contacts the taxpayer to examine the return; (2) the date that the promoter of a shelter transaction upon which the taxpayer relied on his tax return is contacted by the IRS; (3) the date on which the IRS serves a summons for any activity upon which the taxpayer received a tax benefit for the taxable year; or (4) the date on which the IRS announces a settlement initiative for an abusive transaction for which the taxpayer has received a tax benefit.

whether the taxpayer relied on a competent tax professional and whether the taxpayer had adequate records for claimed deductions. The court also weighed the breadth and sophistication of the taxpayer's tax knowledge, novelty of the substantive legal issues, and extraordinary circumstances.

The IRS should review cases where the court rejected the penalty and incorporate the court's rationale into training and Internal Revenue Manual provisions for its employees. Thereafter, the accuracy-related penalty will not be at issue when cases go to trial on an understatement of tax, thereby lessening the burden on taxpayers, the government, and the court.

MLI #6

Civil Damages for Certain Unauthorized Collection Actions Under Internal Revenue Code Section 7433

Summary

Internal Revenue Code (IRC or the "Code") § 7433 establishes jurisdiction for the United States District Courts, and in certain circumstances the bankruptcy courts, to hear cases for damages sustained in connection with the wrongful collection of any federal tax because an IRS employee recklessly or intentionally, or by reason of negligence, disregarded any provision of the IRC, any IRS regulations, or certain provisions of the Bankruptcy Code. We identified 78 opinions issued between June 1, 2007, and May 31, 2008, that involved a claim for damages for unauthorized collection action under IRC § 7433. The courts affirmed the IRS position in the majority of cases. Taxpayers prevailed in six cases, while three cases resulted in split decisions.

Present Law

IRC § 7433 allows a taxpayer to seek monetary damages in United States District Court in connection with the collection of federal tax if an IRS employee recklessly or intentionally, or by reason of negligence, disregarded any provision of the Code or IRS regulations.[1] An action under IRC § 7433 is the taxpayer's exclusive remedy for recovering damages for wrongful collection resulting from the IRS employee's reckless, intentional, or negligent[2] disregard of such provisions and regulations.[3] A taxpayer may bring suit under IRC § 7433 if the IRS does not follow the rules for proper communication with the taxpayer in connection with the collection of tax in violation of the Fair Debt Collection Practices Act.[4] A taxpayer may also bring suit under IRC § 7433 in connection with the failure to follow the statutory requirements for sale of seized property under IRC § 6335.[5]

A taxpayer may bring an action under IRC § 7433 in a bankruptcy court for pecuniary damages if the IRS willfully violates the automatic stay[6] or discharge[7] provisions of the Bankruptcy Code and any applicable regulations.[8] Notwithstanding § 105 of the

1 IRC § 7433.

2 Taxpayers may bring damage actions for negligent disregard of the Code or regulations that occurred after July 22, 1998. The prior version of IRC § 7433 did not provide a remedy for negligent actions by IRS employees. *See* IRC § 7433(a), prior to amendment by the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3102(a)(1)(A) (July 22, 1998).

3 IRC § 7433(a) and (e)(2). In certain circumstances, taxpayers also can obtain a damage award for the IRS's failure to release a lien. *See* IRC § 7432.

4 IRC § 6304(c).

5 IRC § 6335(e)(4).

6 *See* 11 U.S.C. § 362.

7 *See* 11 U.S.C. § 524.

8 *See* IRC § 7433(e)(1); Treas. Reg. § 301.7433-2.

Bankruptcy Code, an IRC § 7433 damage action is the exclusive remedy for pecuniary damages resulting from such violations.[9]

A taxpayer may recover the actual, direct economic damages sustained as a proximate result of intentional, reckless, or negligent actions of the IRS employee and costs of the action. Economic damages are capped at $100,000 for negligent actions and $1,000,000 for reckless or intentional actions, plus the costs of the action.[10] However, the damages awarded to a taxpayer will be reduced by the amount that reasonably could have been mitigated.[11]

The statutory period for bringing a suit for damages under IRC § 7433 is two years after the right of action accrues.[12] Before bringing a suit, the taxpayer must first exhaust administrative remedies.[13] Treasury Regulations provide that administrative remedies are considered exhausted on the earlier of the date the IRS renders a decision on a properly filed administrative claim for actual, direct economic damages, or if the IRS has not acted on the claim, six months from the date the claim is filed.[14] However, the regulations provide an exception if a taxpayer files an administrative claim in the last six months before the two-year limitations period expires. In such cases, a taxpayer may file the suit at any time from the date when the administrative claim is properly filed and before the limitations period expires.[15]

The regulations establish comprehensive procedures for filing an administrative claim.[16] Such claims must be filed with the IRS Area Director, Attn: Compliance Technical Support Manager, of the area in which the taxpayer resides[17] and must include the following information:[18]

- The taxpayer's name, taxpayer identification number, current address, current home and work telephone numbers, and any convenient times to be contacted;
- The detailed grounds of the claim for damages, including copies of all substantiating documentation and correspondence with the IRS;

9 *See* IRC § 7433(e)(2)(A); Treas. Reg. § 301.7433-2(a)(2); 11 U.S.C. § 105.

10 *See* IRC § 7433(b); Treas. Reg. §§ 301.7433-1 and 301.7433-2.

11 *See* IRC § 7433(d)(2).

12 IRC § 7433(d)(3); Treas. Reg. §§ 301.7433-1(g) and 301.7433-2(g). The regulations provide that a right of action accrues at the time when the taxpayer has had a reasonable opportunity to discover all essential elements of a possible cause of action. *See* Treas. Reg. §§ 301.7433-1(g)(2) and 301.7433-2(g)(2).

13 *See* IRC § 7433(d)(1); Treas. Reg. §§ 301.7433-1(d) and 301.7433-2(d) (actions for the violation of the bankruptcy rules).

14 *See* Treas. Reg. §§ 301.7433-1(d)(i), (ii) and 301.7433-2(d)(i), (ii).

15 *See* Treas. Reg. §§ 301.7433-1(d)(2) and 301.7433-2(d)(2).

16 *See* Treas. Reg. §§ 301.7433-1(e) and 301.7433-2(e).

17 *See* Treas. Reg. §§ 301.7433-1(e)(1) and 301.7433-2(e)(1) (in actions for violation of bankruptcy rules, the administrative claim must be filed with the Chief, Local Insolvency Unit, for the judicial district in which the taxpayer filed the underlying bankruptcy case giving rise to the alleged violation).

18 *See* Treas. Reg. §§ 301.7433-1(e)(2) and 301.7433-2(e)(2) (in actions for violation of bankruptcy rules, the administrative claim must also include the location of the bankruptcy court in which the underlying bankruptcy case was filed and the case number of the case in which the violation occurred).

- A description of the taxpayer's damage-related injuries associated with the claim, including copies of all available substantiating documentation and evidence;
- The amount of the damages, including any reasonably foreseeable future damages related to the claim; and
- The taxpayer's signature or the signature of the duly authorized representative.[19]

Analysis of Litigated Cases

We reviewed 78 cases involving damages for unauthorized collection actions that were litigated between June 1, 2007, and May 31, 2008. Table 6 in Appendix III contains a detailed list of those cases.

Although most taxpayers litigating damages for wrongful collection activity represented themselves (*pro se*), representation did not negatively impact the outcome in cases litigated under IRC § 7433.[20] Taxpayers with representation received full relief in only one case, while *pro se* taxpayers received full or partial relief in eight cases.[21] Exhaustion of administrative remedies, which was litigated in 50 cases, was the most common issue. In 42 of the 50 cases where the issue was raised, the government prevailed.[22] As the court stated in *Hallinan v. United States*, *pro se* taxpayers filed numerous "boilerplate" complaints in the United States District Court for the District of Columbia alleging violation of IRC § 7433, and many of these "nearly identical" filings were dismissed for failure to exhaust administrative remedies.[23] In four of these cases, taxpayers prevailed on procedural grounds based on the recent United States Supreme Court decision in *Jones v. Bock*,[24] which held that failure to exhaust administrative remedies is an affirmative defense rather than a pleading requirement, and thus, taxpayers "are not required to specially plead or demonstrate exhaustion in their complaints."[25]

For example, in *Olender v. U.S.*, a taxpayer received a letter from the IRS stating that the taxpayer had exhausted all available administrative remedies and should file a civil action for

19 A duly authorized representative is an attorney, certified public accountant, or an enrolled preparer, permitted to represent the taxpayer before the IRS in a good standing, who has a written power of attorney executed by the taxpayer. *See* Treas. Reg. §§ 301.7433-1(e)(2)(v) and 301.7433-2(e)(3); Treas. Cir. 230 § 10.3 (Sept. 26, 2007) (for the definition of enrolled preparers).

20 Eighteen of 78 taxpayers were represented by counsel. Of those 18 cases, the IRS prevailed in 17, and only one resulted in a victory for a taxpayer.

21 *Pro se* taxpayers prevailed in five cases and three cases resulted in split decisions.

22 In one case, the Court of Appeals affirmed the trial court's decision in favor of the government. *See Dorn v. U.S.*, 249 Fed. Appx. 164 (11th Cir. 2007), *aff'g, per curiam*, 99 A.F.T.R.2d (RIA) 1495 (M.D. Fla. 2007), *petition for cert. filed,* No. 07-1445, 76 USLW 3630 (May 12, 2008).

23 *See Hallinan v. U.S.*, 498 F. Supp. 2d 315, 317 (D.D.C. 2007), *appeal dismissed*, 2007 U.S. App. LEXIS 28445 (D.C. Cir. Dec. 4, 2007); *Bennett v. U.S.*, 530 F. Supp. 2d 340, 343 (D.D.C. 2008), *denying reconsideration*, 462 F. Supp. 2d 35 (D.D.C. 2008). *See also Eleson v. U.S.*, 518 F. Supp. 2d 279, 283 (D.D.C. 2007); *Lutz v. U.S.,* 100 A.F.T.R.2d (RIA) 5114 (D.D.C. 2007); *Rae v. U.S.*, 530 F. Supp. 2d 127, 131 (D.D.C. 2008); *Wesselman v. U.S.*, 498 F. Supp. 2d 326, 328 (D.D.C. 2007).

24 549 U.S. 199 (2007).

25 *See Scott v. U.S.*, 275 Fed. Appx. 21 (D.C. Cir. 2008), *remanded per curiam,* 100 A.F.T.R.2d (RIA) 5876 (D.D.C. 2007), *petition for reh'g filed*, No. 07-5310 (D.C. Cir. June 9, 2008). *See also Lindsey v. U.S.*, 532 F. Supp. 2d 144, 149 (D.D.C. 2008); *prior action*, 448 F. Supp. 2d 37 (D.D.C. 2006), *dismissed with prejudice,* 100 A.F.T.R.2d (RIA) 5220 (D.D.C. 2007); *Pollinger v. U.S.*, 539 F. Supp. 2d 242 (D.D.C. 2008), *dismissed without prejudice*, No. 06-1885 (D.D.C. Apr. 16, 2008); *Shane v. U.S.*, 101 A.F.T.R.2d (RIA) 449 (D.D.C. 2008).

damages if he wanted to take further action.[26] Based on the statement the IRS made in the letter, the court found the taxpayer had exhausted his administrative remedies and could recover the costs of the action and any actual economic damages incurred as a proximate result of an IRS employee's actions.[27]

Another common issue litigated by taxpayers was the question of whether the alleged improper IRS conduct arose from activities other than collection.[28] For example, in *Henry v. United States*, the U.S. Court of Appeals for the Seventh Circuit affirmed the district court's dismissal of the taxpayer's claims relating to the IRS's improper assessment of the taxpayer's 1999 tax liability.[29] In that case, the taxpayer sued the IRS and its employees, alleging he was entitled to damages stemming from the issuance of a purportedly fraudulent notice of deficiency. The district court dismissed the suit on other grounds, and the taxpayer appealed. The appellate court concluded that a taxpayer can only recover damages under IRC § 7433 with respect to improper tax collection, but not with respect to improper tax assessment.[30]

Nine of the 78 cases involved a statute of limitations issue. For example, in *Eastman v. United States*, the court considered the issue of whether the taxpayer's action commenced after the applicable statutory period had expired.[31] Generally, a taxpayer may not commence an action under IRC § 7433 before the IRS acts on the administrative claim or six months after the date an administrative claim is filed, whichever is earlier.[32] Although the taxpayers in *Eastman* did not commence their action within either of these periods, the court held the action was still timely because under the applicable regulations, if an administrative claim is filed during the last six months of the two year period for filing suit, as was the case in *Eastman*, the taxpayer may file an action after the administrative claim is filed and before the period of limitations expires.[33]

26 *Olender v. U.S.*, 100 A.F.T.R.2d (RIA) 6047 (M.D. Fla. 2007), *summary judgment granted*, 101 A.F.T.R.2d (RIA) 2519 (M.D. Fla. 2008). The court dismissed the taxpayer's prior complaint because the taxpayer "presented no evidence that he exhausted administrative remedies as required by IRC § 7433(d)(1) and Treas. Reg. § 301.7433-1(d)(1)." *See Olender v. U.S.*, 97 A.F.T.R.2d (RIA) 2196 (M.D. Fla. 2006).

27 *Olender v. U.S.*, 100 A.F.T.R.2d (RIA) 6047 (M.D. Fla. 2007), *summary judgment granted*, 101 A.F.T.R.2d (RIA) 2519 (M.D. Fla. 2008). The court noted that "the Internal Revenue Service cannot explicitly deny further administrative action to the [taxpayer] and then claim administrative remedies have not been exhausted." Id.

28 This issue was raised in 20 of 78 cases. The statute does not provide a cause of action for wrongful tax assessment or other actions that are not specifically related to the collection of tax. *See* IRC § 7433(a) and (e).

29 *Henry v. U.S.*, 101 A.F.T.R.2d (RIA) 2098 (7th Cir. 2008).

30 *Id.* The court also stated that a notice of deficiency merely informs the taxpayer of the amount of the liability and always precedes enforcement, while collection, by contrast, enforces an assessed liability. *See Henry v. U.S.*, 101 A.F.T.R.2d (RIA) 2098 (7th Cir. 2008) (citing *Murray v. Comm'r*, 24 F.3d 901, 903 (7th Cir. 1994); see also IRC § 6213(a).

31 *Eastman v. U.S.*, 101 A.F.T.R.2d (RIA) 1566 (W.D. Ark. 2008).

32 Treas. Reg. §§ 301.7433-1(d)(2)(i), (ii) and 301.7433-2(d)(2)(i), (ii).

33 *Eastman v. U.S.*, 101 A.F.T.R.2d (RIA) 1566 (W.D. Ark. 2008). The government claimed that the taxpayer did not exhaust his administrative remedies before filing the petition although the regulations contain an exception to this requirement if an administrative claim is filed during the last six months of the two year statute of limitations. *Id. See also* Treas. Reg. §§ 310.7433-1(d)(2); 310.7433-1(g).

In another case, *Cox v. United States*,[34] the taxpayers filed suit seeking damages under IRC § 7433 to recover damages for the profits and dividends they allegedly lost as a result of the IRS's improper collection actions. The court concluded the action was untimely and subject to dismissal, as it was commenced more than two years after the alleged improper collection took place.[35]

Three cases involved damage claims stemming from alleged violations of certain bankruptcy procedures.[36] The predominate issue in these three cases was exhaustion of administrative remedies. In *In re Abate*,[37] the United States District Court for the District of New Jersey vacated the bankruptcy court's holding to compel the return of the tax refund seized by the IRS in violation of the bankruptcy discharge and automatic stay provisions of the Bankruptcy Code, because the taxpayer had failed to exhaust his administrative remedies.[38]

In *Cherbanaeff v. United States*,[39] the taxpayers sought damages under IRC § 7433 alleging the IRS had wrongfully levied their Social Security benefits after the statutory period for collection had expired and the IRS had violated the bankruptcy discharge injunction. The Court of Federal Claims dismissed the IRC § 7433 claims, finding the taxpayers' claims involving the alleged wrongful levy needed to be brought in district court and the claims stemming from alleged violations of the bankruptcy discharge injunction needed to be brought in bankruptcy court.[40]

In *Acacia Corporate Mgmt., LLC v. United States*,[41] a corporation filed suit alleging, among other things, that it was entitled to damages under IRC § 7433 stemming from alleged wrongful collection actions the IRS had taken against two individuals who had owned assets that the corporation subsequently acquired. The court dismissed the IRC § 7433 claims, finding the corporation lacked standing to sue for damages because only a taxpayer, and not a third party, can sue for damages under IRC § 7433.[42]

Conclusion

This is the second year that the issue of damages for unauthorized collection actions under IRC § 7433 has appeared in the National Taxpayer Advocate's Annual Report to Congress. The increase in these cases is due in large part to the filing of the series of nearly identical complaints dismissed for failure to exhaust administrative remedies, which were

34 *See Cox v. U.S.*, 101 A.F.T.R.2d (RIA) 991 (E.D. Cal. 2008).

35 *See Id.*

36 IRC § 7433(e).

37 *In re Abate*, 101 A.F.T.R.2d (RIA) 1806 (D.N.J. 2008), *vacating* No. 05-19745, 2007 Bankr. LEXIS 2139 (Bankr. D.N.J. May 29, 2007).

38 *Id.*

39 98 A.F.T.R.2d (RIA) 6772 (S.D.Miss. 2006).

40 *See Cherbanaeff v. U.S.*, 77 Fed. Cl. 490 (2007), *appeal docketed*, No. 2007-5166 (Fed. Cir. Aug. 29, 2007), *appeal dismissed*, 253 Fed. Appx. 23 (Fed. Cir. 2007), *appeal reinstated*, 257 Fed. Appx. 275 (Fed. Cir. 2007); *see also* IRC § 7433(e)(1); Treas. Reg. § 301.7333-2.

41 101 A.F.T.R.2d (RIA) 772 (E.D. Cal. 2008).

42 *Id.*

apparently inspired by templates found on the Internet. Although the cases discussed herein were dismissed primarily on procedural grounds, it is unclear whether taxpayers will continue to file these complaints in such high numbers. The courts' routine rejection of the arguments contained in these complaints may curtail them in the future.

MLI #7

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 66 decisions issued by the federal court system from June 1, 2007, to May 31, 2008, regarding the addition to tax under Internal Revenue Code (IRC) § 6651(a)(1) for failure to timely file a tax return, or the addition to tax under IRC § 6654 for failure to pay estimated income tax.[1] The phrase "addition to tax" is commonly referred to as a penalty, so we will refer to these two additions to tax as the failure to file penalty and the estimated tax penalty. The Tax Court remanded one case to determine a preliminary issue not addressed in the original hearing. Eight of the cases resulted in split decisions. Thirty-five cases involved imposition of the estimated tax penalty in conjunction with the failure to file penalty, three cases involved the estimated tax penalty without the failure to file penalty, and the remaining 28 cases involved only the failure to file penalty.

The failure to file penalty is mandatory unless the taxpayer can demonstrate the failure is due to reasonable cause and not willful neglect.[2] The estimated tax penalty is mandatory unless the taxpayer can meet one of the statutory exceptions.[3] In the cases analyzed, taxpayers were largely unsuccessful in their attempts to avoid the failure to file penalty or the estimated tax penalty.

Present Law

Under IRC § 6651(a)(1), a taxpayer that fails to file a tax return on or before its due date (including extensions) will be subject to a five percent penalty for each month or partial month the return is late, up to a maximum of 25 percent, unless such failure is due to reasonable cause and not willful neglect.[4] 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.[5] The failure to file penalty applies to income, estate, gift, and certain excise tax returns.[6] To establish reasonable cause, the taxpayer must show that he or she exercised ordinary business care and prudence but was still unable to file by the due date.[7]

1 IRC § 6651(a)(2) and (a)(3) also impose additions to tax for failure to pay a tax liability shown on a return and for failure to pay a required tax liability not shown on a return, respectively. However, because only a small number of cases involved these penalties, we did not include them in our analysis.

2 IRC § 6651(a)(1).

3 IRC § 6654(e).

4 IRC § 6651(a)(1). 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).

5 IRC § 6651(b)(1).

6 IRC § 6651(a)(1).

7 Treas. Reg. § 301.6651-1(c)(1).

IRC § 6654 imposes a penalty on any underpayment of a required installment of estimated tax by an individual.[8] There are four required installments per taxable year, and each amount is generally 25 percent of the taxpayer's total required annual payment.[9] The required annual payment is the lesser of 90 percent of the tax for the current year or 100 percent of the tax shown on the taxpayer's return for the previous year.[10] The IRS will determine the amount of the penalty by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the period of the underpayment.[11] The estimated tax penalty applies to income tax returns of individuals and certain estates and trusts.[12] To avoid the estimated tax penalty, the taxpayer has the burden of proving one of the following exceptions:

- The tax due is less than $1,000;[13]
- The taxpayer has no tax liability for the preceding year;[14]
- The IRS determines that by reason of casualty, disaster, or other unusual circumstances the imposition of the penalty would be against equity and good conscience;[15] or
- The taxpayer retired after reaching age 62 or became disabled in the taxable year for which estimated payments were required or in the taxable year preceding such year, and the underpayment was due to reasonable cause and not willful neglect.[16]

In any court proceeding, the IRS has the initial burden of production to provide sufficient evidence regarding the failure to file penalty and the estimated tax penalty.[17] If the IRS meets this burden, the taxpayer may produce evidence to establish any exception to the penalty.[18]

Analysis of Litigated Cases

We analyzed 66 opinions issued between June 1, 2007, and May 31, 2008, where the failure to file penalty or the estimated tax penalty was in dispute. All but four of these cases were litigated in the United States Tax Court. A detailed list of these cases appears in Table 7 in Appendix III. Forty-three cases involved individual taxpayers and 23 involved businesses

8 IRC § 6654(a) and (b).

9 IRC § 6654(c) and (d)(1).

10 IRC § 6654(d)(1).

11 IRC § 6654(a)(1) – (3).

12 IRC § 6654(a) and (l).

13 IRC § 6654(e)(1).

14 IRC § 6654(e)(2).

15 IRC § 6654(e)(3)(A).

16 IRC § 6654(e)(3)(B).

17 *Higbee v. Comm'r,* 116 T.C. 438, 446 (2001) (quoting 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).

18 *Higbee v. Comm'r,* 116 T.C. 438, 447 (2001).

(including individuals engaged in self-employment or partnerships). Of the 47 cases in which taxpayers appeared *pro se*, or without counsel, five cases resulted in split decisions, and the Tax Court remanded one for a rehearing. Of the 19 cases in which taxpayers appeared with representation, none were resolved in the taxpayer's favor, and only three ended in split decisions.

Failure to File Penalty

A common basis for the courts ruling against taxpayers was the lack of evidence that the failure to file was due to reasonable cause. In fact, in 34 of the 66 cases analyzed, the taxpayers 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.[19] For illness or incapacity to constitute reasonable cause, the taxpayer must show incapacitation to such a degree that he or she could not file a return on time.[20] A court also may allow a taxpayer who is caring for another person to establish reasonable cause if providing the care prevents the taxpayer from filing a return on time.[21] However, the court disallowed reasonable cause and found willful neglect where a taxpayer engaged in other business ventures during a claimed period of illness.[22] Similarly, where the taxpayer's medical condition and treatment do not affect the taxpayer's ability to file a return for a different tax year, the court will not find reasonable cause.[23] We found no cases in which a taxpayer successfully established reasonable cause because of a medical illness.
- **Mistaken Belief as to Filing Obligation:** Often, taxpayers mistakenly believe they are not required to file returns. If a taxpayer's mistaken belief about the filing requirement is based on an incomplete and flawed reading of a tax code provision, the taxpayer does not have reasonable cause.[24] A taxpayer may not rely on the mistaken assumption that tax withholdings relieved the taxpayer from filing a return because he or she owed no further tax.[25] A court also declined to find reasonable cause where the taxpayer argued that she mistakenly relied on an alleged agreement with her spouse to include her on a joint return.[26]

19 *See, e.g., Harbour v. Comm'r*, T.C. Memo. 1991-532 (the taxpayer's coma occurring the month before the due date of his tax return was a reasonable cause for failing to timely file).

20 *Williams v. Comm'r*, 16 T.C. 893, 905-06 (1951), *acq.*, 1951-2 C.B. 1.

21 *See Tomlinson v. Comm'r*, T.C. Summ. Op. 2007-210 (the taxpayer's care of her dependent brother was not sufficient for reasonable cause when the taxpayer engaged in other business activities and the care ended several months prior to the extended due date of the return).

22 *McClain v. Comm'r*, T.C. Summ. Op. 2007-175.

23 *Kopty v. Comm'r*, T.C. Memo. 2007-343, *appeal docketed*, No. 08-1171 (D.C. Cir. Apr. 30, 2008).

24 *Ballmer v. Comm'r*, T.C. Memo. 2007-295.

25 *Joubert v. Comm'r*, T.C. Memo. 2007-292.

26 *Conner v. Comm'r*, T.C. Summ. Op. 2007-131.

- **Reliance on Agent:** The Supreme Court, in *United States v. Boyle*, held that taxpayers have a non-delegable duty to file a return on time, and a taxpayer's reliance on an agent does not excuse a failure to file.[27] Thus, a taxpayer's failure to file due to criminal embezzlement by a bookkeeper was not reasonable cause.[28] Consistent with the *Boyle* line of reasoning, the Tax Court did not find reasonable cause where an executor was completely disengaged from preparation of the estate tax return and relied entirely on an estate attorney to handle all aspects of preparing and filing the return.[29] Similarly, the court rejected a taxpayer's reasonable cause claim when the taxpayer failed to show he relied on professional advice regarding the duty to file despite the court recognizing the reasoned advice of a professional might establish reasonable cause.[30]
- **"Zero Return" Filers and Other Frivolous Arguments:** Under the longstanding four-part test articulated in *Beard v. Commissioner*, for a document to be a valid return it must: (1) purport to be a return; (2) be signed under penalties of perjury; (3) contain sufficient data to calculate the tax liability; and (4) represent an honest and reasonable attempt to satisfy the requirements of the tax laws.[31] Some taxpayers claim no obligation to pay taxes by filing returns reporting zero income when they have earned substantial wages accurately reported on a Form W-2, *Wage and Tax Statement*.[32] A "zero return" does not constitute a tax return for purposes of the failure to file penalty of IRC § 6651(a)(1).[33] In addition, any departure from the jurat above the signature block provided in IRS forms invalidates a document purporting to be a return under the *Beard* test.[34] In addition to the failure to file penalty, the courts imposed a frivolous issue penalty on 12 of the 24 taxpayers who presented frivolous arguments.[35]
- **Overpayment of previous tax liability:** One taxpayer argued the failure to file penalty was improper because he was entitled to a refund for an overpayment of tax for the previous year.[36] He argued the refund was sufficient to cover his liability and therefore he was not required to file a return.[37] However, because the taxpayer submitted his claim for the refund after the three-year limitation established by IRC § 6511(b)(2)(A), the Tax Court remanded the issue to the IRS Office of Appeals to determine whether the taxpayer was entitled to a suspension of that time limit.[38]

27 469 U.S. 241, 252 (1985).

28 *A Better Plumbing Service, Inc. v. U.S.*, 533 F. Supp. 2d 1233, 1244 (N.D. Ga. 2008) (reliance on corporate agent may only be reasonable cause where the agent makes it objectively impossible for the taxpayer to meet its obligations).

29 *Estate of Zlotowski v. Comm'r*, T.C. Memo. 2007-203.

30 *New York Guangdong Finance, Inc. v. Comm'r*, T.C. Memo. 2008-62 at 11.

31 *Beard v. Comm'r*, 82 T.C. 766, 777 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986).

32 *Cabirac v. Comm'r*, T.C. Memo. 2008-142 (also holding that the failure to pay penalty under section 6651(a)(2) is inapplicable to a zero return when the IRS does not prepare a substitute for return (SFR) in accordance with IRC § 6020(b)); *Phillips v. Comm'r*, T.C. Memo. 2008-9.

33 *Phillips v. Comm'r*, T.C. Memo. 2008-9 at 3.

34 *Green v. Comm'r*, T.C. Memo. 2008-130.

35 See Most Litigated Issue, *Frivolous Issues Penalty and Related Appellate-Level Sanctions Under Internal Revenue Code Section 6673, infra.*

36 *Perkins v. Comm'r*, T.C. Memo. 2008-103.

37 *Id.* at 4.

38 *Perkins v. Comm'r*, T.C. Memo. 2008-103 at 9.

Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the Commissioner proved the taxpayers had a tax liability, had no withholding credits, and did not make any estimated tax payments for that year.[39] Although the court recognized that it lacked jurisdiction to rule on the issue, the Tax Court in *Alston v. Commissioner* indicated a taxpayer would be subject to the estimated tax penalty if he or she failed to make a required installment even if the taxpayer's total payments exceeded his or her total tax liability.[40] In six of the cases where the taxpayers prevailed on the estimated tax penalty, their success was a result of the IRS either conceding the issue or failing to produce evidence that the taxpayer filed a return for the preceding year and had a corresponding liability.

Conclusion

The United States tax system relies on taxpayers voluntarily filing accurate returns and paying their taxes. Penalties attempt 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 implemented to encourage voluntary compliance and deter noncompliance.[41]

The IRS should determine whether these penalties positively influence 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.[42] This proposal would broaden the definition of reasonable cause by 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.

39 *See Bray v. Comm'r*, T.C. Memo. 2008-113.

40 T.C. Summ. Op. 2007-155 at 2 n.9.

41 *See* Policy Statement 20-1 (formerly P-1-18), Internal Revenue Manual (IRM) 1.2.20.1.1 (Aug. 28, 2007); *see also United States v. Boyle*, 469 U.S. 241, 245 (1985) ("Congress' purpose in the prescribed civil penalty was to ensure timely filing of tax returns to the end that tax liability will be ascertained and paid promptly.").

42 *See* 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). Although the IRS has provided for a one-time administrative waiver of the penalty in IRM 20.1.1.3.5.1(Feb. 22, 2008), the National Taxpayer Advocate continues to recommend a statutory waiver similar to IRC § 6656(c).

MLI #8

Relief from Joint and Several Liability Under Internal Revenue Code Section 6015

Summary

Married couples may elect to file their federal income tax returns jointly or separately. Spouses filing joint returns are jointly and severally liable for any deficiency[1] or tax due. Joint and several liability enables the IRS to collect the entire amount due from either taxpayer.[2]

Internal Revenue Code (IRC) § 6015 provides three avenues for relief from joint and several liability. IRC § 6015(b) provides "traditional" relief for deficiencies. IRC § 6015(c) also provides relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together, by allocating the liability between each spouse. IRC § 6015(f) provides "equitable" relief from both deficiencies and underpayments, but 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 50 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2007, and May 31, 2008. Procedural issues and the merits of the taxpayer's claim were frequent subjects of litigation. Although the cases produced no substantive changes in the law, the court continued to resolve jurisdictional questions stemming from passage of the Tax Relief and Health Care Act of 2006 (TRHCA).[3] TRHCA amended IRC § 6015(e) to provide that the U.S. Tax Court has jurisdiction in stand-alone cases[4] to review IRC § 6015(f) determinations where no deficiency has been asserted.[5] The number of cases involving procedural issues has diminished this year. This decrease is likely due to the passage of TRHCA expressly providing that the Tax Court has jurisdiction to decide IRC § 6015(f) cases where no deficiency had been asserted.

1 IRC § 6013(d)(3). We use the terms "deficiency" and "understatement" interchangeably for purposes of this discussion and the case table in Appendix III, even though IRC § 6015(b)(1)(D) and IRC § 6015(f) expressly use the term "deficiency" and IRC § 6015(b)(1)(B) refers to an "understatement of tax." The terms are nearly identical, but there are sometimes semantic differences. Compare IRC § 6211 (defining "deficiency" as the excess of the taxpayer's correct liability over the amount shown on the return, adjusted for other assessments and rebates) with IRC § 6662(d)(2)(A) (defining "understatement" as the excess of the amount of tax required to be shown on the return over the amount of the tax imposed which is shown on the return, reduced by any rebate).

2 The National Taxpayer Advocate, in the 2005 Annual Report to Congress, proposed legislation that would eliminate joint and several liability for joint filers. *See* National Taxpayer Advocate 2005 Annual Report to Congress 407.

3 Pub. L. No. 109-432, Div. C, § 408(a), (c), 120 Stat. 2922, 3061-62 (2006).

4 The filing of a Tax Court petition in response to the final notice of determination or after the IRC § 6015 claim is pending for six months is often referred to as a stand-alone proceeding because jurisdiction is predicated on IRC § 6015(e) and not deficiency jurisdiction under IRC § 6213.

5 TRHCA also modified IRC § 6015(e)(1)(B), the provision regarding collection restrictions, to include IRC § 6015(f) claims. As a result, the IRS is now prohibited by law from pursuing certain collection activity against taxpayers who request relief only under IRC § 6015(f), and the period of limitations on collection is likewise suspended while the collection restrictions remain in effect. If, however, an IRC § 6015 claim was filed before the December 20, 2006, effective date of the amendment, the period of limitations on collection will be suspended beginning on December 20, 2006, and not from the date the claim was originally filed. Notice CC-2007-13 (June 8, 2007).

In response to several recent district court decisions which did not allow a taxpayer to raise IRC § 6015 as a defense, the National Taxpayer Advocate proposed in the 2007 Annual Report to Congress that IRC § 6015 be amended to, among other things, clarify that taxpayers may raise relief from joint and several liability as an affirmative defense in any proceeding brought under any provision of Title 26 or in any case under Title 11 of the United States Code.[6] The issue of whether a taxpayer can raise IRC § 6015 as a defense in district court proceeding remains the subject of litigation and is discussed in several case summaries below.[7]

Present Law

Traditional Innocent Spouse Relief Under IRC § 6015(b)

IRC § 6015(b) provides that a requesting spouse shall be partially or fully relieved from joint and several liability, pursuant to procedures established by the Secretary if the requesting spouse can demonstrate that:

1. A joint return was filed;
2. There was an understatement of tax[8] attributable to erroneous items[9] of the nonrequesting spouse;
3. Upon signing the return, the requesting spouse did not know or have reason to know of the understatement;
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[10] with respect to him or her.

6 National Taxpayer Advocate 2007 Annual Report to Congress 466. *See also United States v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007) (holding that the district court only has jurisdiction to consider an IRC § 6015 claim in the context of a refund suit and exclusive jurisdiction for review of the claim lies with the Tax Court in all other circumstances); *United States v. Cawog*, 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. July 5, 2007) (holding that exclusive jurisdiction to review an IRC § 6015 determination lies with the Tax Court and refusing to allow the taxpayer to raise the defense in the foreclosure action).

7 *United States v. Bucy*, 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007) (holding that IRC § 6015(f) could not be raised as a defense in a suit to reduce assessment to judgment); *United States v. Wilson*, 100 A.F.T.R.2d (RIA) 6849 (E.D. Ark. 2007) *appeal docketed* No. 08-1242 (8th Cir. Jan. 29, 2008) *appeal dismissed* (Feb. 27, 2008) (holding that IRC § 6015 could not be raised as a defense in an erroneous refund suit); *Walker v. United States*, 101 A.F.T.R.2d (RIA) 1013 (D.N.J. 2008) (holding that the taxpayer is not entitled to raise IRC § 6015 as a defense in a quiet title action because a taxpayer cannot challenge the validity of the underlying tax liability in this type of proceeding).

8 There is an understatement of tax when the amount of tax required to be shown on the return is greater than the amount of tax actually shown on the return. *See* IRC §§ 6015(b)(3); 6662(d)(2)(A).

9 An erroneous item is any income, deduction, credit, or basis that is omitted from or incorrectly reported on the joint return. *See* Treas. Reg. § 1.6015-1(h)(4).

10 Not all actions that involve collection will trigger the two-year limitations period. Under the regulations, only the following four events constitute "collection activity" that will commence the two-year period: (1) an IRC § 6330 notice; (2) an offset of an overpayment of the requesting spouse against the joint income tax liability under IRC § 6402; (3) the filing of a suit by the United States against the requesting spouse for the collection of the joint tax liability; and (4) the filing of a claim by the United States to collect the joint tax liability in a court proceeding in which the requesting spouse is a party or which involves property of the requesting spouse. Treas. Reg. § 1.6015-5(b)(2).

Allocation of Liability Under IRC § 6015(c)

IRC § 6015(c) provides that the requesting spouse shall be relieved from liability for deficiencies allocable to the nonrequesting spouse, pursuant to procedures established by the Secretary. To obtain relief under this section, the requesting spouse must demonstrate that:

1. A joint return was filed;
2. At the time relief was elected, the joint filers were unmarried, legally separated, widowed or had 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 him or her.[11]

This election allocates to each joint filer that portion of the deficiency on the joint return attributable to each 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 he or she signed the return, the requesting taxpayer had "actual knowledge" of any item giving rise to the deficiency.[12] Additionally, relief is not available for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.[13]

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides that the Secretary may relieve a taxpayer from liability for both deficiencies and underpayments[14] where the taxpayer demonstrates that:

1. Relief under IRC § 6015(b) or (c) is unavailable;
2. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency; and
3. The election was made within two years after the IRS began collection activities[15] with respect to the taxpayer.

Revenue Procedure 2003-61 lists some of the factors the IRS considers in determining whether equitable relief is appropriate.[16] 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 liability for deficiencies

11 See note 10, *supra*, for a discussion of what constitutes "collection activity" under IRC § 6015.

12 IRC § 6015(c)(3)(C).

13 IRC §§ 6015(c)(4); 6015(d)(3)(C).

14 An underpayment of tax occurs when the tax is properly shown on the return but is not paid. *Washington v. Comm'r*, 120 T.C. 137, 158-59 (2003).

15 Treas. Reg. § 1.6015-5(b). See note 10, *supra*, for a discussion of what constitutes "collection activity" under IRC § 6015.

16 Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447.

in tax, IRC § 6015(f) provides equitable relief from liability for both deficiencies and underpayments.

Rights of Nonrequesting Spouse

The individual with whom the requesting spouse filed the joint return is generally referred to as a "nonrequesting spouse." IRC § 6015 has conferred certain rights on the nonrequesting spouse. The nonrequesting spouse must be notified and given an opportunity to participate in any administrative proceedings concerning a claim under IRC § 6015.[17] And if during the administrative process full or partial relief is granted to the requesting spouse, the nonrequesting spouse can file a protest and receive an administrative conference in Appeals.[18] However, the Appeals decision is the final decision with respect to the nonrequesting spouse. The nonrequesting spouse does not have the right to petition the Tax Court in response to the IRS's administrative determination regarding IRC § 6015 relief.[19] If, however, the requesting spouse files a Tax Court petition, the nonrequesting spouse must receive notice of the proceeding and has an unconditional right to intervene in the Tax Court proceeding.[20] The nonrequesting spouse may intervene to dispute or support the requesting spouse's claim for relief.[21] The nonrequesting spouse who has intervened in the Tax Court proceeding, however, has no standing to appeal the Tax Court's decision to the United States Court of Appeals.[22]

Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*, which the IRS revised in June 2007 to reduce taxpayer mistakes and to speed processing.[23] After reviewing the request, the IRS issues a final notice of determination, granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails this notice to file a petition with the Tax Court.[24] However, the taxpayer can still petition the court if he or she does not receive a final notice of determination within six months of filing Form 8857.[25] The taxpayer may also raise relief from joint and several liability in a collection due process (CDP) proceeding,[26] a deficiency proceeding,[27]

17 IRC § 6015(h)(2).

18 Rev. Proc. 2003-19, 2003-5 C.B. 371 (Feb. 3, 2003).

19 IRC § 7442; *Maier v. Comm'r*, 119 T.C. 267 (2002), *aff'd* 360 F.3d 361 (2d Cir. 2004) (holding that there are no provisions in IRC § 6015 that allow the nonrequesting spouse to petition the Tax Court from a notice of determination).

20 *Van Arsdalen v. Comm'r*, 123 T.C. 135 (2004).

21 *Id.*

22 *Baranowicz v. Comm'r*, 432 F.3d 972 (9th Cir. 2005).

23 *See* IRS Form 8857, *Request for Innocent Spouse Relief*, Instructions (June 2007).

24 IRC § 6015(e)(1)(A)(ii).

25 IRC § 6015(e)(1)(A)(i)(II).

26 IRC §§ 6320(c); 6330(c)(2)(A)(i).

27 IRC § 6213; *Corson v. Comm'r,* 114 T.C. 354, 363 (2000).

a bankruptcy proceeding,[28] or a refund suit.[29] The issue of whether relief from joint and several liability can be raised as a defense in various district court proceedings has been the subject of litigation that will be discussed later.

Analysis of Litigated Cases

We analyzed 50 opinions issued between June 1, 2007, and May 31, 2008. Forty-two cases were decided in the Tax Court, two were decided in the Court of Appeals for the Ninth Circuit, and the Sixth and Seventh Circuits each decided one case. Finally, three cases were decided in U.S. District Courts and one in the Bankruptcy Court. Seventy-six percent of the cases (38 of 50) were decided in favor of the IRS, 22 percent (11 of 50) in favor of the taxpayer and two percent (one of 50) ended in split decisions. In 54 percent (27 of 50) of the cases, the taxpayers were *pro se* (*i.e.*, they represented themselves). The nonrequesting spouse intervened in ten percent of the cases (five of 50).

Seventy-two percent of the cases (36 of 50) involved an analysis of whether to grant relief, a 15 percent increase from last year. Thirty-four percent (17 cases) involved procedural issues, with 76 percent (13 of 17) of these cases decided in favor of the IRS and 24 percent (four of 17) in favor of the taxpayer (including one case where only the intervenor opposed granting relief and that was dismissed for failure to prosecute).[30]

Of the 36 cases decided on the merits, 72 percent (26 of 36) were decided in favor of the IRS, 25 percent (nine of 36) in favor of the taxpayer, and in three percent (one case) the court split its decision. See Table 8 in Appendix lll for a detailed breakdown of the cases.

Procedural Issues

This year saw a reduction in the number of cases involving procedural issues.[31] Last year, the issue of whether the Tax Court has jurisdiction to review IRC § 6015(f) determinations in stand-alone proceedings was frequently litigated.[32] This year, the procedural issues were more diverse. The courts addressed questions such as whether the court may consider evidence introduced at trial which was not part of the administrative record,[33] the extent of

28 11 U.S.C.A. §§ 502, 505(a)(1). *See, e.g., Hinckley v. United States*, 256 B.R. 814 (Bankr. M.D. Fla. 2000).

29 IRC § 7422.

30 These percentages do not add up to 100 because some cases involved more than one issue.

31 In the 2007 report, 43 percent of the cases involved procedural issues whereas only 34 percent of the cases in this year's report are procedural in nature. *See* National Taxpayer Advocate 2007 Report to Congress 629.

32 In the 2007 report, 60 percent of the procedural cases addressed the Tax Court's ability to hear stand-alone IRC § 6015(f) cases. *See* National Taxpayer Advocate 2007 Report to Congress 626-633.

33 *See, e.g., Porter v. Comm'r*, 130 T.C. No.10 (2008) (holding that the Tax Court may consider evidence introduced at trial which was not included in the administrative record in reviewing denial of IRC § 6015(f) relief).

the rights of intervening spouses,[34] and whether IRC § 6015 could be raised as an affirmative defense in proceedings outside the Tax Court.[35]

Porter v. Commissioner

In *Porter v. Commissioner*,[36] the Tax Court held that in determining whether a taxpayer is eligible for relief under IRC § 6015(f) the court may consider evidence introduced at trial which was not included in the administrative record.[37] In this case, the IRS issued a notice of determination denying the taxpayer's request for relief under IRC § 6015(f), and the taxpayer filed a Tax Court petition seeking review of the determination under IRC § 6015(e). The IRS argued the Tax Court should limit the record to only the evidence considered by the IRS when it made its IRC § 6015(f) determination. The court disagreed, finding that the Administrative Procedure Act, [38] which limits the scope of judicial review to the administrative record, was not applicable to Tax Court proceedings, including IRC § 6015 proceedings. Further, the court found the use of the word "determine" in IRC § 6015 is similar to the use of the word "redetermination" in IRC § 6213(a) under which it is unquestioned that the court conducts trials *de novo* (*i.e.,* considers evidence introduced at trial which was not included in the administrative record). The court concluded the use of this term meant that Congress intended the court to have *de novo* review authority for IRC § 6015 cases. Although a case involving this issue is pending in the U.S. Court of Appeals for the 11th Circuit, no Court of Appeals has yet ruled on this issue.[39]

Green v. Commissioner

In *Green v. Commissioner*,[40] the Tax Court held that it lacked jurisdiction under IRC § 6015(e) to review a denial of IRC § 6015(f) claim for tax years for which the liability was paid in full prior to December 20, 2006. As discussed previously, TRHCA[41] amended IRC § 6015(e)(1) to provide for Tax Court review "[i]n the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply, *or in the case of an individual who requests equitable relief under subsection (f)*" (emphasis

34 *See, e.g., Edwards v. Comm'r*, T.C. Summ. Op. 2007-193 which involved a tax year before the effective date of TRHCA (holding that the Tax Court does not have jurisdiction to review the IRS's decision to grant IRC § 6015 relief to the electing spouse in a stand-alone proceeding and that the non-electing spouse is only afforded a right to notice and an opportunity to intervene once the electing spouse has initiated a proceeding in court under IRC § 6015(e)); *Fain v. Comm'r,* 129 T.C. 89 (2007) (holding that a nonrequesting spouse's right to intervene survives death).

35 *See, e.g., U.S. v. Bucy*, 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007) (holding that the taxpayer was not entitled to raise IRC § 6015(f) as a defense in a suit to reduce assessment to judgment because he had not raised the IRC § 6015(f) claim administratively prior to commencement of suit); *Walker v. U.S.*, 101 A.F.T.R.2d (RIA) 1013 (D.N.J. 2008) (holding that the taxpayer was not entitled to raise IRC § 6015 as a defense in a quiet title action because the taxpayer cannot normally challenge the validity of the underlying tax liability in this type of proceeding); *Waggoner v. U.S.*, 100 A.F.T.R.2d (RIA) 6426 (Bankr. N.D. Tex. 2007) (holding that the taxpayer could not use an innocent spouse defense to counter a motion to vacate a default judgment).

36 130 T.C. No.10 (2008).

37 This holding is consistent with the Tax Court's prior holding in *Ewing v. Comm'r*, 122 T.C. 32 (2004), *vacated on jurisdictional grounds*, 439 F.3d 1009 (9th Cir. 2006).

38 5 U.S.C. §§ 551-559, 701-706 (2000).

39 *See Neal v. Comm'r*, T.C. Memo. 2005-201, *appeal docketed*, No. 06-14357-JJ (11th Cir. Aug. 10, 2006).

40 T.C. Memo. 2008-28.

41 Pub. L. No. 109-432, Div. C, § 408(a) and (c), 120 Stat. 2922, 3061-62 (2006).

added). The amendment, however, applies only with respect to liability for taxes arising or remaining unpaid on or after December 20, 2006. The Tax Court, therefore, cannot review IRC § 6015(f) determinations where the liability arose and was paid before that date.[42] Consequently, in *Green*, because the IRS never issued a notice of deficiency and the taxpayer's liabilities did not arise or remain unpaid on or after December 20, 2006, the Tax Court lacked jurisdiction over the taxpayer's claim.

United States v. Wilson

In *United States v. Wilson*,[43] the government filed suit against a husband and wife, seeking recovery of an erroneous refund. The wife, among other things, argued she was entitled to the refund as an innocent spouse under IRC § 6015(f). The court concluded that in a suit to recover an erroneous refund under IRC § 7405, a taxpayer could not raise IRC § 6015(f) because IRC § 6015 relief is only available with respect to an "unpaid tax or deficiency" and in this case the government does not attempt to collect or reduce to judgment any unpaid tax or deficiency, but rather seeks a judgment to recover its erroneous payment of a refund.

Walker v. United States

In *Walker v. United States*,[44] the district court held that in a quiet title action filed against the United States under 28 U.S.C. §§ 1346(a)(1) and 2410(a)(1), the taxpayer may contest the procedures followed by the IRS in filing its tax liens but may not contest the underlying tax liability.[45] Thus, the court did not have jurisdiction to consider the taxpayer's request for relief under IRC § 6015 as such a request pertains directly to the underlying tax liability.

United States v. Bucy

In *United States v. Bucy*,[46] the District Court for the Southern District of West Virginia held the taxpayer was not entitled to relief under IRC § 6015 because the taxpayer provided no evidence to support a claim under IRC § 6015(b) or (c). The court also held that the exclusive means of seeking equitable relief under IRC § 6015(f) is for the taxpayer to file a timely claim with the IRS and if the claim is denied to seek review of the claim in the Tax Court in a stand-alone proceeding where jurisdiction is predicated on IRC § 6015(e). The court did not address the fact that the statutory language of IRC § 6015(e)(1)(A) expressly provides that jurisdiction under IRC § 6015(e) is not exclusive, but rather is "[i]n addition to any other remedy provided by law." In contrast, the Tax Court held in *Thurner v.*

42 *See Bock v. Comm'r*, T.C. Memo. 2007-41; *Smith v. Comm'r*, T.C. Memo. 2007-117. *See also* Notice CC- 2007-13 (June 8, 2007) (providing procedures for Chief Counsel attorneys handling cases affected by the new legislation).

43 100 A.F.T.R.2d (RIA) 6849 (E.D. Ark. 2007) *appeal docketed*, No. 08-1242 (8th Cir. Jan. 29, 2008), *appeal dismissed* (Feb. 27, 2008).

44 101 A.F.T.R.2d (RIA) 1013 (D.N.J. 2008).

45 *See Elias v. Connett*, 908 F.2d 521, 527 (9th Cir. 1990) (holding that in a quiet title action where jurisdiction is predicated on 28 U.S.C. § 2410, a taxpayer cannot collaterally attack the merits of the tax assessment); *Pollack v. United States*, 819 F.2d 144, 145 (6th Cir. 1987) (holding that in an action under 28 U.S.C. 2410, the parties cannot challenge the underlying liability).

46 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007).

Commissioner[47] that *res judicata* barred the taxpayer from raising IRC § 6015 as a defense in the Tax Court proceeding because the taxpayer could have raised IRC § 6015 as a defense in a prior collection suit. These decisions, if read together, would preclude this taxpayer from raising relief under IRC § 6015(f) as a defense at all, as the district court contends it lacks the authority to consider the defense and it must raised in Tax Court, while the Tax Court contends *res judicata* would bar consideration of the defense in Tax Court as the defense could have been raised in the collection suit. The National Taxpayer Advocate disagrees with the *Bucy* decision and believes a taxpayer should be able to raise relief under IRC § 6015 as a defense in a collection suit, and has thus recommended that Congress enact legislation to clarify that a taxpayer can raise this defense in a collection suit.[48]

Petrane v. Commissioner

In *Petrane v. Commissioner*,[49] the taxpayer filed a Tax Court petition seeking review of the IRS's denial of her IRC § 6015 claim under IRC § 6015(e) and requesting that the proceeding be conducted under IRC § 7463 as a "small tax case."[50] The total amount of tax, penalty, and interest for which the taxpayer sought relief did not exceed $50,000 for any single year, but the total tax, penalty, and interest at issue for all the years did exceed $50,000.

IRC § 7463(f)(1) provides that if a petitioner files "a petition to the Tax Court under IRC § 6015(e) in which the amount of relief sought does not exceed $50,000" the case may be heard as a small tax case. The IRS argued and the Tax Court agreed that the dollar limitation in IRC § 7463(f)(1) references an aggregate amount rather than an amount determined by reference to a discrete taxable year. Accordingly, the Tax Court held that for a case under IRC § 6015(e) to come within the dollar limitation prescribed in IRC § 7463(f)(1), "the amount of paid and unpaid tax, interest, and penalties, including accrued but unassessed interest and penalties, for which relief is sought" must not exceed the $50,000 threshold, and the date the petition is filed is the date on which the amount of aggregate relief should be calculated. Because the taxpayer's aggregate tax liability in *Petrane* for the years at issue on the date of the petition exceeded $50,000, the case did not qualify as a small tax case under IRC § 7463(f)(1).

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 factor 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 courts'

47 121 T.C. 43 (2003).

48 National Taxpayer Advocate 2007 Annual Report to Congress 466.

49 129 T.C. 1 (2007).

50 Small tax cases, often referred to as "S" cases, as discussed in IRC § 7463, are limited to certain types of cases involving $50,000 or less. Proceedings in "S" cases are less formal than in a regular Tax Court case, and as a result often lead to speedier disposition of the case. "S" case decisions are not appealable.

analyses.[51] Actual or constructive knowledge was a factor in 30 of the 38 decisions on the merits. These cases suggest that determining what a taxpayer knew or should have known will continue to generate a significant amount of controversy as long as joint filers are taxed on their combined incomes and continue to be jointly and severally liable for the tax that must be shown on the return. The National Taxpayer Advocate has proposed legislation that would eliminate joint and several liability for joint filers in the first instance and would tax each spouse only on his or her own income. Adoption of such a proposal would eliminate the need for innocent spouse relief and the attendant inquiry into a spouse's knowledge.[52]

Conclusion

The passage of the TRHCA amendments, which provided the Tax Court with jurisdiction to review IRC § 6015(f) determinations in stand-alone cases where no deficiency has been asserted, decreased the amount of litigation regarding procedural issues in this area. The procedural issue of whether the court can look beyond the administrative record in reviewing IRC § 6015(f) determinations will continue to generate litigation, as a U.S. Court of Appeals has yet to consider the issue.

Further, the alarming trend of restricting a taxpayer's ability to raise IRC § 6015 as a defense in district court proceedings continued, as evidenced by the three district court decisions that prohibited the taxpayer from raising IRC § 6015 as a defense. Last year, in response to several similar district court decisions limiting the taxpayer's ability to raise innocent spouse relief, the National Taxpayer Advocate proposed that IRC § 6015 be amended to, among other things, clarify that taxpayers may raise relief from joint and several liability as an affirmative defense in district court proceedings.[53] In light of the increasing number of district court opinions that preclude taxpayers from raising innocent spouse relief as a defense, passage of the legislative correction proposed in the 2007 Annual Report may be the only means of ensuring that taxpayers can raise innocent spouse relief as a defense when engaged in tax litigation with the government in district court cases.

51 *See* IRC § 6015(b)(1)(C); § 6015(c)(3)(C); Rev. Proc. 2003-61, 2003-2 C.B. 296 §§ 4.02(1)(b) and 4.03(2)(a)(iii).

52 National Taxpayer Advocate 2005 Annual Report to Congress 407.

53 National Taxpayer Advocate 2007 Annual Report to Congress 466.

MLI #9

Frivolous Issues Penalty Under Internal Revenue Code Section 6673 and Related Appellate-Level Sanctions

Summary

During the 12 months between June 1, 2007, and May 31, 2008, the federal courts issued decisions in at least 45 cases involving the Internal Revenue Code (IRC) § 6673 "frivolous issues" penalty and at least nine 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, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.[2] In 12 of the 38 cases involving IRC § 6673, the United States Tax Court decided not to impose the penalty but warned taxpayers they could face sanctions in the future for similar conduct.[3] Similarly, we identified one case at the appellate level where the court did not impose a sanction under IRC § 7482(c)(4) or any other authority, but the court did warn the taxpayer that similar future conduct will result in a sanction.[4] Nonetheless, we include these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

Present Law

The U.S. 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.[5] The maximum penalty is $25,000.[6] In some cases, the IRS requests that the Tax Court impose the penalty;[7] in other cases, the Court exercises its discretion, *sua sponte*,[8] to impose the

1 In five cases, the U.S. Courts of Appeals both affirmed the imposition of the IRC § 6673 penalty and addressed the issue of an additional sanction against the taxpayer for filing a frivolous appeal. Thus, the total number of cases we identified as involving frivolous claims is 49.

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., Anderson v. Comm'r*, T.C. Memo. 2007-265, *appeal docketed* (1st Cir. Jan. 22, 2008).

4 *See Dunn v. IRS*, 99 A.F.T.R.2d (RIA) 3464 (E.D. Mich. 2007).

5 IRC § 6673(a)(1)(A), (B), and (C).

6 IRC § 6673(a)(1).

7 The standards for the IRS's decision to seek sanctions under IRC § 6673(a)(1) are found in the Chief Counsel Directives Manual. *See* Internal Revenue Manual (IRM) 35.10.2 (Aug. 11, 2004). For sanctions of opposing counsel, under IRC § 6673(a)(2), all requests for sanctions are reviewed by the designated agency sanctions officer under Executive Order 12988 on Civil Justice Reform. This review ensures uniformity on a national basis. *See, e.g.*, IRM 35.10.2 (Aug. 11, 2004).

8 *"Sua sponte"* is a term that means without prompting or suggestion. Thus, for conduct that the Tax Court finds particularly offensive, the 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., Boggs v. Comm'r*, T.C. Memo. 2008-81. In this case, the Tax Court imposed a penalty of $10,000 because the court had repeatedly warned the taxpayers that position was frivolous. Taxpayers argued that they had no income, just a return of human capital.

penalty. Taxpayers who institute an action pursuant to IRC § 7433[9] in a U.S. District Court for damages against the United States could be subject to a maximum penalty of $10,000 if the Court determines the taxpayer's position in the proceedings is frivolous or groundless.[10]

In addition, IRC § 7482(c)(4),[11] § 1927 of Title 28 of the U.S. Code,[12] and Rule 38 of the Federal Rules of Appellate Procedure[13] (among other laws and rules of procedure) authorize federal courts to impose penalties against taxpayers or attorneys 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 list of cases in Table 9 of Appendix lll includes nine cases we identified in which U.S. Courts of Appeals considered sanctions under other authorities.

Analysis of Litigated Cases

We analyzed 45 opinions issued between June 1, 2007, and May 31, 2008, which addressed the IRC § 6673 penalty. Thirty-eight of these opinions were issued by the Tax Court and seven 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 all of the seven cases they decided. A detailed listing of all cases is presented in Table 9 of Appendix lll. In 26 cases, the Tax Court imposed a penalty under IRC § 6673, with the amounts ranging from $1,000 to $25,000. We identified only four cases that involved business taxpayers (*i.e.*, a taxpayer filing a Form 1040, *U.S. Individual Income Tax Return*, with a Schedule C, E, or F). Four taxpayers were represented by attorneys; all other taxpayers appeared *pro se*. The taxpayers in these cases presented a wide variety of arguments that the courts have generally rejected on numerous occasions. Upon encountering these arguments, the courts almost invariably cited the language set forth in *Crain v. Commissioner:*

> We perceive no need to refute these arguments with somber reasoning and copious citation of precedent; to do so might suggest that these arguments have some colorable merit. The constitutionality of our income tax system – including the role played

9 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.

10 IRC § 6673(b)(1).

11 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 and the appeal was instituted or maintained primarily for delay or the taxpayer's position in the appeal was frivolous or groundless.

12 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.

13 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.

within that system by the Internal Revenue Service and the Tax Court – has long been established.[14]

Among the cases we reviewed, taxpayers raised the following issues the Tax Court has deemed frivolous 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 taxpayers maintained the same frivolous positions):

- **Citizens of certain states are not part of the United States:** At least two taxpayers argued the states in which they reside are not part of the United States, and therefore they are not U.S. residents subject to income taxes.[15]
- **IRS forms and notices violate the Paperwork Reduction Act:** Several taxpayers argued the forms and notices they received (or allegedly received) violated the Paperwork Reduction Act.[16]
- **Failure to prosecute:** Taxpayers in at least four cases failed to prosecute the case and were assessed the frivolous issues penalty for instituting a suit for the purposes of delay.[17]
- **IRS forms do not display a valid Office of Management and Budget (OMB) control number:** At least four taxpayers argued that tax forms were invalid because they do not display an OMB control number.[18]
- **Income is a return of human capital:** In *Boggs v. Commissioner*, the taxpayers argued that depreciation of human life in exchange for labor hours should be treated similarly to depreciation on machinery allowed for corporations.[19] As such, the taxpayer argued that income is a private contract in exchange for the loss of hours of life and not taxable under the 16th Amendment.[20] At least two other taxpayers made similar arguments based on the theory that income is a return of human capital or an exchange for the depreciation of the human body.[21]
- **Income earned is not taxable income:** Taxpayers in at least 11 cases argued that they did not have any taxable income based on their interpretation of the IRC or the Constitution. In *Connolly v. Commissioner*, the taxpayer argued he was not engaged in the trade or business of cotton or distilled spirits in the tax years in question and therefore he had no taxable income because only the revenue made from involvement

14 *Crain v. Comm'r,* 737 F. 2d 1417, 1417-18 (5th Cir. 1984).

15 *See, e.g., Williamson, et. al., U.S. v.,* 244 Fed. Appx. 900 (10th Cir. 2007), *aff'g* 97 A.F.T.R.2d (RIA) 810 (D.N.M. 2005).

16 *See, e.g., Moore v. Comm'r,* T.C. Memo. 2007-200.

17 *See, e.g., Long v. Comm'r,* T.C. Memo. 2008-1.

18 *See, e.g., Colorado Mufflers Unlimited, Inc. v. Comm'r,* T.C. Memo. 2007-222.

19 *Boggs v. Comm'r,* T.C. Memo. 2008-81.

20 *Id.*

21 *See, e.g., Richards v. Comm'r,* 101 A.F.T.R.2d (RIA) 1637 (10th Cir. 2008).

in those trades or businesses is taxable.[22] The taxpayer in *Rhodes v. Commissioner* asserted that compensation in exchange for services is not taxable under the 16th Amendment to the Constitution unless it is apportioned [23]

- **The income tax is unconstitutional:** At least two cases presented the argument that the income tax is unconstitutional or that the 16th Amendment as a whole is unconstitutional.[24]

Conclusion

Taxpayers in the cases analyzed this year presented the same arguments raised and repeated year after year, which the courts routinely and universally reject.[25] The taxpayer avoided the IRC § 6673 penalty in only seven of the cases where the IRS requested the penalty, demonstrating the willingness of the courts to impose a penalty when the taxpayer makes frivolous arguments or institutes a case merely for the purpose of delay. Where the IRS has not requested the penalty, the court often raises the issue *sua sponte* and in many cases chooses to impose the penalty or caution the taxpayer that similar future behavior will result in a penalty.[26] Finally, the U.S. Courts of Appeals have shown their willingness to uphold the penalties imposed by the Tax Court without fail in the cases analyzed for the period between June 1, 2007, and May 31, 2008, and will often impose further appellate level sanctions on taxpayers who assert frivolous arguments.

22 *Connolly v. Comm'r*, T.C. Memo. 2008-95.

23 *Rhodes v. Comm'r*, T.C. Memo. 2007-206, *appeal docketed*, No. 08-60093 (5th Cir. Jan. 22, 2008), *appeal dismissed* (Apr. 9, 2008).

24 *See Williamson, et. al., U.S. v.*, 244 Fed. Appx. 900 (10th Cir. 2007), *aff'g* 97 A.F.T.R.2d (RIA) 810 (D.N.M. 2005); *Richards v. Comm'r,* 101 A.F.T.R.2d (RIA) 1637 (10th Cir. 2008).

25 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 599-603.

26 *See, e.g., Boggs v. Comm'r*, T.C. Memo. 2008-81.

MLI #10

Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, And 151

Summary

Because family status issues center around the exemptions, credits, and filing status claimed on federal tax returns, litigated cases in this area often involve multiple issues with similar factual determinations. This report combines the following issues into a single "family status" category:

- Head of household filing status;[1]
- Child tax credit;[2]
- Earned Income Tax Credit (EITC);[3] and
- Dependency exemption.[4]

We reviewed 34 federal court opinions issued between June 1, 2007, and May 31, 2008. Over the past two years, the number of family status cases has declined. For example, in the National Taxpayer Advocate's 2007 Annual Report to Congress, we reviewed 41 family status cases[5] and the 2006 Annual Report covered 46 cases.[6] Many of these cases included multiple family status issues, with the determination of one issue often affecting others. For example, a denial of the dependency exemption will lead to the summary denial of the child tax credit and may jeopardize eligibility for head of household filing status.

Present Law

Uniform Definition of Qualifying Child

Before 2005, the Internal Revenue Code (IRC) contained multiple definitions of a "child" for purposes of filing status, deductions, and tax credits associated with dependent children.[7] These family status provisions potentially affect 81.4 million taxpayers and 79.6 million children.[8] Effective for tax years after December 31, 2004, the Working Families Tax Relief

1 Internal Revenue Code (IRC) § 2(b).

2 IRC § 24.

3 IRC § 32.

4 IRC § 151.

5 National Taxpayer Advocate 2007 Annual Report to Congress 660.

6 National Taxpayer Advocate 2006 Annual Report to Congress 555.

7 *E.g.*, IRC § 2(b) (head of household); IRC § 21 (child and dependent care credit); IRC § 24 (child tax credit); IRC § 32 (EITC); IRC § 151 (dependency exemption).

8 IRS Compliance Data Warehouse, Individual Returns Transaction File for Tax Year 2006.

Act (WFTRA)[9] established a uniform definition of a qualifying child (UDOC) with respect to five family status provisions: head of household filing status, the child tax credit, the child and dependent care credit, the EITC, and the dependency deduction.[10] The intent of the UDOC legislation was to bring about some uniformity for the vast majority of taxpayers who had to meet multiple tests to determine if they were eligible to claim an exemption, credit, or filing status under the basic family status provisions.[11] Under UDOC, a dependent must be either a "qualifying child" or a "qualifying relative."[12] 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 claimed 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 descendant 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.[13]
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.[14]
3. **Age Test.** The child must be under a certain age, depending on the tax benefit claimed, to be a qualifying child.[15]
4. **Support Test**. The child cannot provide more than half of his or her own support during the year.[16]

Qualifying Relative

An individual who does not meet the requirements for a qualifying child may still be claimed as a dependent if he or she meets the requirements for a qualifying relative. Again, four tests must be met to claim someone as a qualifying relative.

9 The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004).

10 Further, UDOC applies to determining whether a taxpayer qualifies for an income inclusion under IRC § 129.

11 Nina E. Olson, *Uniform Qualifying Child Definition: Uniformity for Most Taxpayers*, 111 Tax Notes 225 (Apr. 10, 2006). *See also* National Taxpayer Advocate 2006 Annual Report to Congress 463.

12 IRC § 152(a).

13 IRC §§ 152(c)(1)(A); 152(c)(2); 152(f)(1).

14 IRC §§ 152(c)(1)(B); 152(f)(6); Treas. Reg. § 1.152-2(a)(2)(ii).

15 IRC § 152(c)(1)(C).

16 IRC § 152(c)(1)(D).

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.[17]
2. **Gross Income Test.** An individual must have gross income below the amount allowed for a personal exemption for the taxable year.[18]
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.[19]
4. **Not a Qualifying Child.** In general, an individual may not be a qualifying child of the taxpayer or of any other taxpayer for the taxable year.[20] IRS Notice 2008-5 provides additional guidance as to when an individual is a qualifying relative.[21]

The taxpayer can claim a personal exemption deduction for a dependent who meets the tests of a qualifying relative.[22]

Tie-Breaker Rule

Sometimes a child meets the tests to be a qualifying child for more than one person. However, only one taxpayer can claim that child as a qualifying child. If multiple taxpayers meet the test with respect to 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 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.[23] Until 2005, these tie-breaker

17 IRC §§ 152(d)(1)(A); 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.

18 IRC § 152(d)(1)(B).

19 IRC § 152(d)(1)(C).

20 IRC § 152(d)(1)(D).

21 *See* Notice 2008-5, 2008-2 I.R.B. 1. The purpose of this notice is to clarify that an individual is not a qualifying child of "any other taxpayer" if the individual's parent (or other person with respect to whom the individual is defined as a qualifying child) is not required by IRC § 6012 to file an income tax return and (i) does not file a return, or (ii) files solely to obtain a refund of withheld taxes. Therefore, if an individual is not a qualifying child of anyone else and meets all other requirements of IRC §§ 151 and 152, the individual would be considered a qualifying relative, and the taxpayer could claim the qualifying relative as a dependent.

22 IRC §§ 152(d); 151(c).

23 IRC § 152(c)(4).

rules applied only to a qualifying child for the EITC, but they now cover the five family status provisions mentioned earlier. Generally, the same taxpayer is entitled to all of the applicable family status benefits with respect to the same qualifying child – or to put it another way, generally taxpayers may not "split the baby" and divide the family status benefits among themselves.[24]

TABLE 3.10.1, 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 parents,	Parent with whom the child lived for the longer period of time during the year. 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 of 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 for the year 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 releases the claim to the dependency exemption in a written declaration that the noncustodial parent attaches to the noncustodial parent's tax return.[25]

A custodial parent is the parent having custody of the child for the greater part of the calendar year.[26] The noncustodial parent is the other parent.[27] The special rule for divorced or separated parents allows the noncustodial parent to claim the dependency exemption and child tax credit; it does not allow the noncustodial parent to claim head of household filing status, the credit for child and dependent care expenses, or the EITC. Only the custodial parent can claim the child as a qualifying child for these three tax benefits.

24 *See* Notice 2006-86, 2006-2 C.B. 680. This notice provides interim guidance to clarify the rule under IRC § 152(c)(4), as amended by WFTRA, for determining which taxpayer may claim a qualifying child when two or more taxpayers claim the same child, and discusses the IRC § 152(e) exception to the prohibition against "splitting the baby" which is only available for divorced or separated parents.

25 IRC § 152(e); Notice 2006-86, 2006-2 C.B. 680. *See also* Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents* (used to release the dependency exemption to the noncustodial parent). The custodial parent may, in lieu of Form 8332, use a similar written statement that meets the requirements of the form. Treas. Reg. § 1.152-4(e)(1) requires that the declaration include an unconditional statement that the custodial parent will not claim the child as a dependent for the years covered by the declaration.

26 IRC § 152(e)(4)(A).

27 IRC § 152(e)(4)(B).

Further, the statute does not define "custody." When a child resides with one parent for part of the day and the other parent for the rest of the day, it can be difficult to calculate how much time is spent in the custody of each parent. Under regulations published on July 2, 2008, the custodial parent is the one who resides with the child for the greater number of nights during the calendar year.[28] The regulations also adopt the rule enunciated by the Tax Court in *King v. Commissioner*[29] that the IRC § 152(e) special rules for divorced or separated parents also apply to parents who were never married to each other.[30]

Analysis of Litigated Cases

Most of the cases litigated during this period were small Tax Court cases.[31] A majority of the cases discussed address factual disputes and not novel issues of law.

Pro Se Analysis

Taxpayers were represented by counsel in only one of the 34 cases litigated this year, even though many cases were highly fact-specific and involved a complicated web of statutory provisions. Out of all the cases, only one taxpayer prevailed in full and that taxpayer appeared *pro se*. It appears that many taxpayers did not understand the complex family status provisions or know what evidence to submit; thus, the assistance of counsel might have affected the courts' rulings. A detailed list of all family status cases analyzed appears in Table 10 in Appendix III.

Cases Decided Where UDOC Applied

For the first time since Congress enacted UDOC, courts are applying this definition when determining family status issues. UDOC applied in six of the 34 cases we reviewed.[32] UDOC appears to have made the analysis of the issues easier for the court by establishing one definition of a "qualifying child" with respect to head of household filing status, the child tax credit, the EITC, and the dependency deduction. Not only does the UDOC seem to simplify the Court's analysis, but it reduces the burden on taxpayers who only need to establish the existence of a "qualifying child" under one standard, rather than several under prior law.

For example, in *Worota v. Commissioner*,[33] a case governed by UDOC, the *pro se* taxpayer's three relatives moved from Ethiopia to the United States and lived with the taxpayer in his

28 Treas. Reg. § 1.152-4(d)(1).

29 121 T.C. 245 (2003).

30 Treas. Reg. § 1.152-4(b)(2)(C).

31 In certain tax disputes involving $50,000 or less, taxpayers may elect to have their cases 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 in these cases cannot be appealed or cited as precedent. *See* IRC § 7463.

32 *See Felix v. Comm'r*, T.C. Memo 2008-96; *Harris v. Comm'r*, T.C. Summ. Op. 2007-202; *Holmes v. Comm'r*, T.C. Summ. Op. 2008-47; *Marshall v. Comm'r*, T.C. Summ. Op. 2008-31; *Ruben v. Comm'r*, T.C. Summ. Op. 2008-38; and *Worota v. Comm'r*, T.C. Summ. Op. 2008-52.

33 T.C. Summ. Op. 2008-52.

apartment from June 1, 2005, through December 31, 2005. The taxpayer claimed a dependency exemption, the EITC, and the child tax credit for the relatives on his 2005 return. Under UDOC, in order for the taxpayer to establish entitlement to these family status provisions, he had to establish that the relatives were either qualifying relatives or qualifying children under IRC § 152. The IRS contended the relatives did not meet the IRC § 152 residency requirement because they did not intend to stay in the United States. The court, however, found that although the relatives returned to Ethiopia in 2006, the U.S. residency requirement was met because at the time the relatives lived with the taxpayer, they did in fact intend to become U.S. citizens. The court further found that each of the relatives met all of the tests to be either a qualifying child or a qualifying relative under IRC § 152, and therefore, the taxpayer was entitled to all three family status provisions.

Head of Household Filing Status – IRC § 2(b)

We reviewed 12 cases involving head of household status, with no taxpayers prevailing on this issue. In many cases, the taxpayer was confused about the eligibility requirements for the various family status provisions. For instance, in *Buah v. Commissioner*,[34] the taxpayer claimed head of household filing status, even though she was married at the end of the tax year. The court found the taxpayer ineligible for head of household filing status because the law dictates that a taxpayer cannot be married at the close of the taxable year to be eligible.[35] In *Felix v. Commissioner*,[36] the taxpayer claimed head of household filing status but failed to provide any evidence to establish that her home was the principal place of abode of the child for more than half of the taxable year, which is an eligibility requirement. The Tax Court, therefore, denied the taxpayer head of household filing status.

Child Tax Credit

We reviewed 18 cases involving the child tax credit; two taxpayers prevailed on this issue with respect to one of the tax years at issue. To claim the child tax credit, the taxpayer must be able to claim the child as a dependent on his or her tax return.[37] In *Kore v. Commissioner*,[38] the taxpayer was granted the child tax credit in 2003 but not 2004, because the taxpayer was entitled to claim his nephew as a dependent in 2003, but not in 2004.[39] In another case, the Tax Court denied the child tax credit because the taxpayer's income exceeded the dollar limits set forth in IRC § 24(b)(1).[40]

34 T.C. Summ. Op. 2007-183.

35 *Buah v. Comm'r*, T.C. Summ. Op. 2007-183.

36 T.C. Memo. 2008-96.

37 *Kore v. Comm'r*, T.C. Summ. Op. 2007-109.

38 T.C. Summ. Op. 2007-109.

39 *Kore v. Comm'r*, T.C. Summ. Op. 2007-109.

40 *Kold-Warren v. Comm'r*, T.C. Summ. Op. 2007-197.

Earned Income Tax Credit

We reviewed 14 cases involving the EITC during the reporting period, with one taxpayer prevailing on this issue. Taxpayers appeared *pro se* in all 14 cases. Several themes appear throughout the EITC cases.

- The taxpayer could not prove the child lived at the taxpayer's principal place of abode for at least half of the taxable year;
- The taxpayer was married and did not file a joint return during the tax year he or she claimed the EITC; and
- The taxpayer exceeded the adjusted gross income limitation.

In *Anderson v. Commissioner*,[41] the court held that the taxpayer, who was married at the close of 2004, was not eligible for the EITC for 2004 because a married taxpayer must file a joint return to be eligible for the credit unless an exception is met.[42] An exception is available under IRC § 7703(b), where a married person living apart from his or her spouse will not be considered married for the purposes of entitlement to the EITC if the taxpayer, among other things, can establish that he or she was entitled to claim a dependency exemption for his or her dependent and if the taxpayer's home was the principal place of abode for the dependent for more than half of the year. In this case, the taxpayer could not establish that these requirements were met and was thus considered married at the close of the taxable year and ineligible for the EITC.

Dependency Exemption – IRC § 151

We reviewed 27 cases involving the dependency exemption, with two taxpayers prevailing. Taxpayers appeared *pro se* in all of these cases except one, with the IRS prevailing in the single case where the taxpayer was represented.[43]

In *Boltinghouse v. Commissioner*,[44] the Tax Court denied the dependency exemption deduction under IRC § 152(a) for the *pro se* taxpayer's daughter, who claimed a dependency exemption for herself on her own tax return. The court denied the exemption because the taxpayer failed to maintain and provide sufficient records establishing the total amount of support he provided to his daughter in the year in question.[45] The court further held that the taxpayer, who is divorced, did not qualify for the special rule for divorced parents under

41 T.C. Memo. 2008-37.

42 *See* IRC § 32(d).

43 *Ward v. Comm'r*, T.C. Summ. Op. 2008-54.

44 T.C. Memo. 2007-324.

45 *See Boltinghouse v. Comm'r*, T.C. Memo. 2007-324. Note that UDOC has modified the support test. Under UDOC, a taxpayer may claim a dependency exemption for a child if the child has not provided more than half of his or her own support. *See* IRC § 152(c)(1)(D).

IRC § 152(e) because the child was not in the custody of one or both the child's parents for more than half of the calendar year.[46]

To determine what constitutes "custody" for purposes of IRC § 152(e), the Treasury Regulations provide that we must look to state law.[47] A child is treated as residing with neither parent if the child is emancipated under state law.[48] The National Taxpayer Advocate is concerned that the special rule for divorced parents under IRC § 152(e) is dependent upon the state law definition of custody. However, under UDOC, the taxpayer may be able to claim a dependency exemption for his college-bound daughter if she meets the requirements of a qualifying relative under IRC § 152(d)(1).

In *Chamberlain v. Commissioner*,[49] the Tax Court held the taxpayer was not entitled to a dependency exemption because he failed to attach a valid Form 8332, *Release of Claim to Exemption for Child of Divorce or Separated Parents*, to his return. The court held a noncustodial parent is only entitled to the exemption when he or she attaches a valid form to the return. The court also found the IRS's past acceptance of returns that did not conform to this requirement did not estop the IRS from disallowing the dependency exemption in the tax year before the court.[50] Estoppel is only available as a defense where the IRS committed fraud and the taxpayer relied on the fraud to his or her detriment.[51]

Conclusion

Family status provisions still seem to be a confusing area for taxpayers. However, over the past few years, the number of family status cases has dropped significantly. We reviewed 34 cases this year, down from 41 in the 2007 Annual Report[52] and 46 in the 2006 report.[53] This decline seems to indicate that UDOC may be having a positive impact. Additionally, it will be interesting to see if the new rules surrounding custody of a child will also help simplify family status provisions for taxpayers.[54]

Although these changes are a step in the right direction, and seem to have a positive effect, the family status provisions of the tax code still contain 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

46 *See Boltinghouse v. Comm'r*, T.C. Memo. 2007-324; IRC § 152(e)(1)(B).

47 *See* Treas. Reg. §1.152-4(d)(1).

48 *See* Treas. Reg. §1.152-4(c).

49 T.C. Memo. 2007-178.

50 Estoppel precludes a person from asserting a fact or a right or prevents one from denying a fact.

51 *See Chamberlain v. Comm'r*, T.C. Memo. 2007-178.

52 National Taxpayer Advocate 2007 Annual Report to Congress 660.

53 National Taxpayer Advocate 2006 Annual Report to Congress 555.

54 *See* Treas. Reg. § 1.152-4(b)(2)(C).

requirements or how to properly satisfy them. Further, such taxpayers often lack legal representation when they go before the courts, which may adversely affect the outcomes of their cases. In an effort to build on the improvements made by UDOC and reduce complexity of these provisions even more, the National Taxpayer Advocate made a legislative recommendation in her 2005 Annual Report to Congress on how to restructure the requirements governing these provisions to make them easier for taxpayers to understand.[55] The National Taxpayer Advocate has updated her 2005 recommendation in this report, once again highlighting the importance of creating a less complex and convoluted tax system.[56]

55 National Taxpayer Advocate 2005 Annual Report to Congress 397. This proposal included the following recommendations: (1) combine the exemptions, child tax credit, and part of the EITC and head of household filing status into a refundable Family Credit comprising two components – one for the taxpayer (and his or her spouse) and one for whomever is the "main caregiver" of a child or children based on a per-child amount; (2) separate the Child and Dependent Care Credits into two credits; (3) eliminate head-of-household filing status; (4) modify the EITC so that it provides a refundable credit to low income workers based solely on the taxpayer's earned income and is available to workers age 18 and over, regardless of the existence of children in the household; (5) permit married taxpayers who have a legal and binding separation agreement and who live separate and apart as of the last day of the calendar year to be considered "not married" for purposes of filing status; and (6) provide a separate credit for noncustodial parents.

56 *See* Legislative Recommendation, *Tax Reform for Families, supra.*

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 (FY) 2008 presented several challenges for TAS case advocacy.[2] IRS activities (*e.g.*, enforcement actions such as levies issued or returns selected for audit) as well as external factors (including new legislation, natural disasters, and the general economic environment) affected TAS case levels. Case receipts continued to rise, largely due to an influx of cases related to the Economic Stimulus Act of 2008.[3] While the volume of cases TAS received directly from taxpayers and their representatives increased, the largest number of FY 2008 cases came from referrals from IRS operating divisions and functions (39.9 percent).[4] Table 4.1 below shows the sources of TAS receipts.

TABLE 4.1, FY 2008 TAS Case Receipts by Volume and Percentage[5]

How TAS Received Each Case	Servicewide Volume	Servicewide Percentage
Referral from Operating Division / Function	109,380	39.9%
NTA Toll-Free[6]	79,091	28.9%
Correspondence	37,764	13.8%
Congressional to TAS	21,101	7.7%
Taxpayer Calls TAS	14,865	5.4%
Referred at Taxpayer Request	5,543	2.0%
Walk-in	4,230	1.5%
ASK-TAS1[7]	1,081	0.4%
Congressional to Function	996	0.4%
Totals	**274,051**	**100%**

1 IRC § 7803(c)(2)(B)(ii).

2 TAS and the IRS operate on a fiscal year. FY 2008 began on Oct. 1, 2007 and ended on Sept. 30, 2008.

3 Economic Stimulus Act, Pub. L. No. 110-185 (2008).

4 Taxpayer Advocate Management Information System (TAMIS) data, obtained from the Business Performance Management System (BPMS) (Sept. 30, 2008).

5 TAMIS data obtained from BPMS (Sept. 30, 2008).

6 The NTA toll-free telephone number (1-877-777-4778) is answered at six call sites, and is staffed by Wage and Investment (W&I) division employees. These assistors answer calls, discuss problems with the taxpayers, research IRS and TAS systems, and try to resolve the issues while talking with the taxpayers. If the assistor cannot resolve a case and it meets TAS criteria, a TAS case is added to TAMIS and immediately transferred to the appropriate office.

7 The ASK-TAS1 toll-free number (1-877-275-8271) is printed on TAS marketing materials and publications used in targeted outreach efforts. Calls to this number are answered by TAS employees.

Case Criteria

TAS structured its case acceptance criteria to allow the organization to fulfill its mission,[8] protect taxpayer rights, prevent burden, and work for the equitable treatment of taxpayers. Case criteria fall into four main categories:

- Economic burden;
- Systemic burden;
- Best interest of the taxpayer; and
- Public policy.

Table 4.2 breaks down TAS case receipts by criteria code.

TABLE 4.2, FY 2008 TAS Case Receipts[9]

Economic Burden Receipts			
Criteria Code	**Description**	**Number of Cases**	**Percentage of Cases**
1	The taxpayer is experiencing economic harm or is about to suffer economic harm.	58,409	21.3%
2	The taxpayer is facing an immediate threat of adverse action.	19,957	7.3%
3	The taxpayer will incur significant costs if relief is not granted (including fees for professional representation).	7,011	2.6%
4	The taxpayer will suffer irreparable injury or long-term adverse impact if relief is not granted.	7,033	2.6%
Total Economic Burden Cases		**92,410**	**33.7%**

Systemic Burden Receipts			
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.	64,962	23.7%
6	The taxpayer has not received a response or resolution to their problem or inquiry by the date promised.	27,678	10.1%
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.	88,480	32.3%
Total Systemic Burden Cases		**181,120**	**66.1%**

Best Interest of the Taxpayer Receipts			
Criteria Code	**Description**	**Number of Cases**	**Percentage of Cases**
8	The manner in which the tax laws are being administered raises considerations of equity, or has impaired or will impair taxpayers' rights.	484	0.2%

8 The TAS mission statement is, "As an independent organization within the IRS, we help taxpayers resolve problems with the IRS and recommend changes to prevent the problems."

9 TAMIS data obtained from BPMS (Sept. 30, 2008).

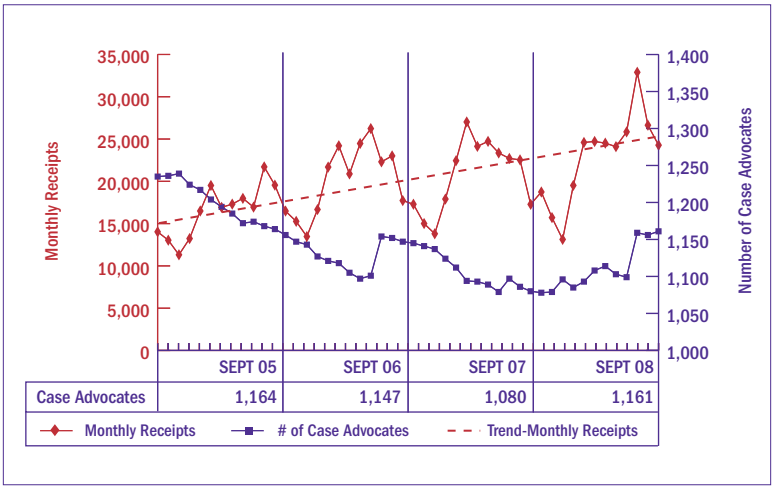
Public Policy Receipts			
Criteria Code	Description	Number of Cases	Percentage of Cases
9	The National Taxpayer Advocate determines compelling public policy warrants assistance to an individual or group of taxpayers.	37	0.01%

Total Case Receipts		
Description	Number of Cases	Percentage of Cases
Total Case Receipts	**274,051**	**100%**

Case Receipts

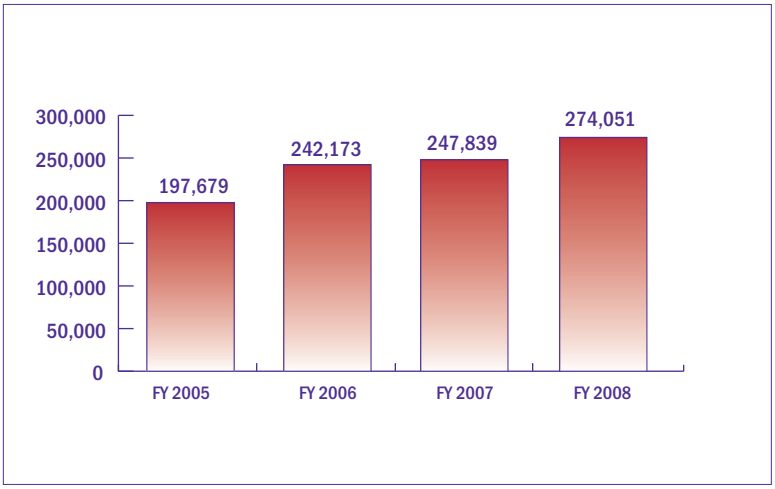
TAS continues to experience an upward trend in receipts. Chart 4.3 below illustrates that receipts have risen 38.6 percent since FY 2005, while the number of case advocates needed to work these cases declined until FY 2008. TAS conducted a major hiring initiative in FY 2008, filling 214 case advocate positions and 43 intake advocate positions, bringing staffing levels close to what they were at the end of FY 2005.

CHART 4.3, Monthly TAS Case Receipts and the Number of Case Advocates from October 2004 to September 2008[10]



10 TAMIS data obtained from BPMS (Sept. 30, 2008).

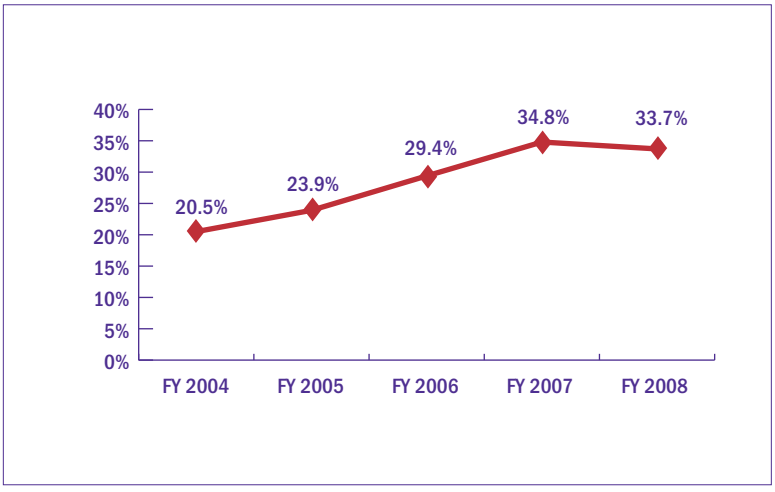
CHART 4.4, Total TAS Case Receipts[11]



Economic Burden

Prior to FY 2008, the percentage of economic burden cases increased each year. As shown in Chart 4.5, the percentage of economic burden cases dipped from 34.8 percent in FY 2007 to 33.7 percent in FY 2008, but the volume of cases received in FY 2008 still increased by 6,149, or 7.1 percent, over the previous year. TAS procedures require that case advocates respond immediately to taxpayers' requests for assistance in economic burden cases.

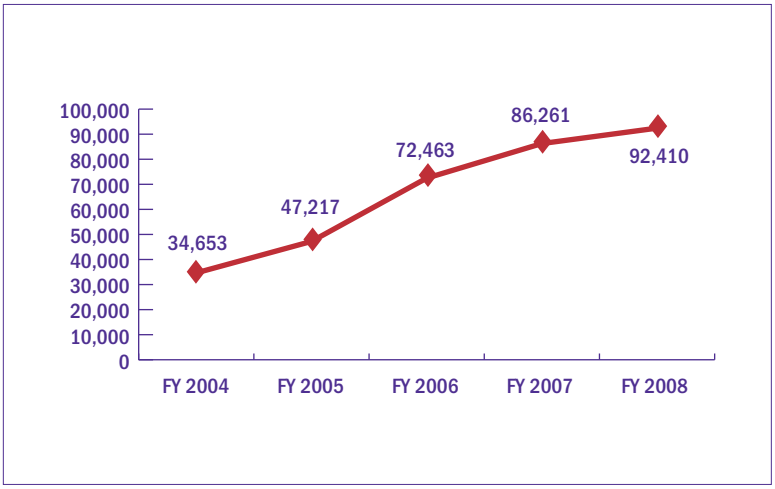
CHART 4.5, TAS Economic Burden Receipts as a Percentage of Total Receipts[12]



11 TAMIS data obtained from BPMS (Sept. 30, 2008).

12 *Id.*

CHART 4.6, TAS Economic Burden Case Receipts[13]



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 failed to operate as intended or failed to resolve the taxpayer's problem. Systemic burden receipts declined as a percentage of the total volume of TAS cases in the previous three fiscal years, but rose in volume by 19,855 cases in FY 2008. Charts 4.7 and 4.8 below illustrate the growth. The increase is largely due to the influx of cases related to IRS delays in processing economic stimulus payment (ESP) inquiries. In 2008, TAS received 25,759 cases related to ESP issues, of which more than 75 percent involved systemic burden.[14] The Wage and Investment (W&I) division's Accounts Management (AM) operation had to shift resources from working inventory to answering calls related to ESP.[15] The diversion of resources to administer ESPs caused delays in processing time, leading taxpayers to contact TAS for assistance.[16]

13 TAMIS data obtained from BPMS (Sept. 30, 2008).

14 Because ESP-related cases can involve a variety of primary issue codes, TAS identified and tracked them with a special case code. Data obtained from TAMIS (Oct. 1, 2008) (including only cases received in FY 2008 and marked as ESP-related as of Oct. 1, 2008). Criteria code data of ESP receipts obtained from TAMIS on Dec. 3, 2008 showed 80 percent of the FY 2008 receipts involved systemic burden.

15 W&I, *Business Performance Review* 21 (Oct. 30, 2008).

16 For more details about AM inventories and ESP cases in TAS, see *Trends in Case Advocacy, infra.*

CHART 4.7, Systemic Burden Receipts as a Percentage of Total Receipts[17]

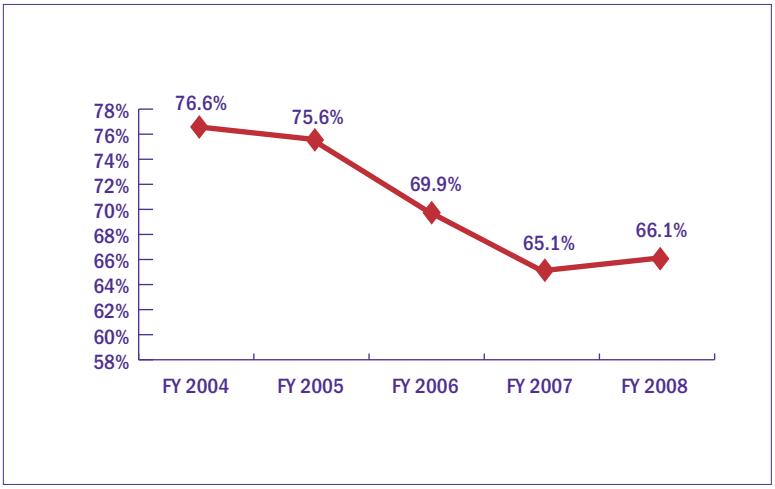
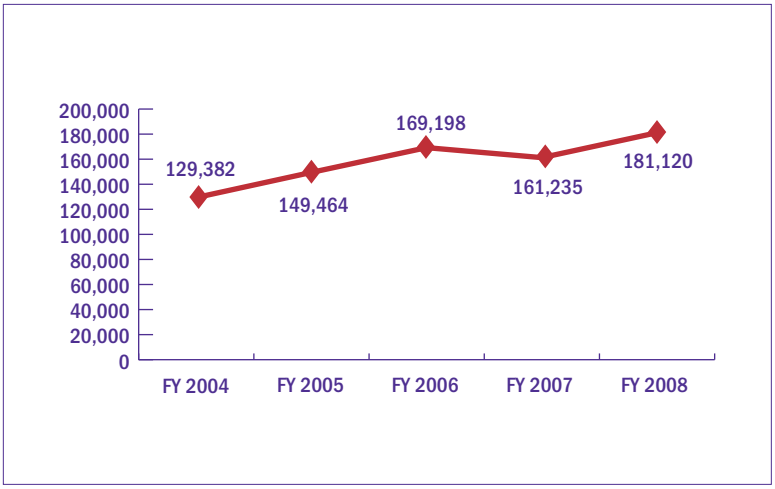


CHART 4.8, Systemic Burden Case Receipts[18]



Best Interest of the Taxpayer

TAS accepts cases in situations where the manner in which the tax laws are administered raises considerations of equity, or has impaired or will impair taxpayer rights. Acceptance of these cases provides that taxpayers receive fair and equitable treatment, and protects their rights in situations where no other case acceptance criteria apply. TAS received 484 cases in this category in FY 2008,[19] 81 percent of which related to IRS compliance and

17 TAMIS data obtained from BPMS (Sept. 30, 2008).

18 *Id.*

19 TAMIS data obtained from BPMS (Oct. 1, 2008).

enforcement activities (*e.g.*, audits, criminal investigations, levies, and liens),[20] compared to 75 percent in FY 2007.[21]

Public Policy

TAS accepts cases in this category when the National Taxpayer Advocate determines compelling public policy warrants assistance to an individual or group of taxpayers because the manner in which the tax laws are being administered raises considerations of equity, and has impaired or will impair taxpayer rights. TAS accepts cases under the public policy standard only when the taxpayer's situation does not fall under any other criteria. In FY 2008, TAS received 37 public policy cases, a decrease of 57 percent from the 86 cases accepted under this criterion in FY 2007.[22] Thirty-six of the FY 2008 cases pertained to the IRS's Private Debt Collection (PDC) initiative,[23] and one related to the Refund Crimes Identity Theft Pilot Program.[24]

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. Table 4.9 illustrates the top 15 issues taxpayers faced when seeking TAS assistance in FY 2008.

20 Data obtained from TAMIS (Oct. 1, 2008).

21 *See* National Taxpayer Advocate 2007 Annual Report to Congress 647.

22 *Id.*

23 The American Jobs Creation Act of 2004 allows the IRS to use private collection agencies (PCAs) as an additional resource to help collect delinquent federal taxes. *See* Status Update, *The IRS's Private Debt Collection Initiative Is Failing in Most Respects*, *supra*.

24 In 2008, TAS participated in a pilot program with the Criminal Investigation (CI) function and the IRS Office of Privacy, Information Protection and Data Security (PIPDS) for taxpayers identified by the IRS as victims of identity theft. The letters sent to these taxpayers directed them to call the ASKTAS1 telephone line if they had any questions. The National Taxpayer Advocate authorized intake advocates to accept these CI pilot cases into TAS under criterion 9 if the cases did not meet other criteria.

TABLE 4.9, Top 15 Issues Received in TAS (FY 2008)[25]

Rank	Description of Issue	FY 08 Cases	FY 07 Cases	% Change
1	Processing Amended Returns	21,963	16,267	35%
2	Levies (including the Federal Payment Levy Program)[26]	17,082	18,665	-8.5%
3	Other Refund Inquiries/Issues	14,817	4,631	220%
4	Injured Spouse Claim	14,238	8,295	71.6%
5	Earned Income Tax Credit (EITC) – Revenue Protection Strategy Claims	13,489	16,081	-16.1%
6	Reconsideration of Substitute for Return under IRC § 6020(b)[27] and Audits[28]	12,419	12,331	0.7%
7	Expedite Refund Request	11,376	9,627	18.2%
8	Criminal Investigation	10,152	11,846	-14.3%
9	Processing Original Return	10,021	9,290	7.9%
10	Automated Underreporter Examination Completed[29]	9,594	9,125	5.1%
11	Open Audit	9,232	8,729	5.8%
12	Combined Annual Wage Reporting (CAWR)[30] and Federal Unemployment Tax Act (FUTA)[31]	8,928	7,123	25.3%
13	Stolen Identity	7,147	3,327	114.8%
14	IRS Offset	6,461	4,836	33.6%
15	Installment Agreements	5,969	5,197	14.9%

Trends in Case Advocacy

A variety of factors influence TAS's workload, including new IRS initiatives, changes in legislation or IRS practices, consolidation and centralization of IRS work processes, and increased IRS emphasis on compliance activities. TAS experienced an increase in customer service-related issues in FY 2008. While compliance-related cases increased overall, TAS experienced a decrease in certain compliance-related issues, including levies, the Earned Income Tax Credit (EITC), and criminal investigation. This reversal of prior trends is due largely to the impact of stimulus payments on inventories for both the IRS and TAS, as well

25 TAMIS data obtained from BPMS (Sept. 30, 2007 and Sept. 30, 2008).

26 The Federal Payment Levy Program (FPLP) is a systemic collection enforcement tool where certain delinquent taxpayers are matched to their federal payments disbursed by Treasury's Financial Management Service (FMS) which are levied. Each week, the IRS creates a file of certain balance due accounts and transmits the file to FMS's Treasury Offset Program. FMS transmits a weekly file back to the IRS listing those that matched. FPLP will subsequently transmit levies on accounts that had matched.

27 IRC § 6020(b) allows the IRS to prepare a return on behalf of the taxpayer based on its own knowledge and other data, and assess the tax after providing notice to the taxpayer.

28 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).

29 The Automated Underreporter program matches taxpayer income and deductions submitted by third parties against amounts reported on the taxpayer's return.

30 CAWR is a document-matching program that compares the federal income tax withheld, advance EITC, Medicare wages, Social Security wages, and Social Security tips reported to the IRS against that reported to the Social Security Administration.

31 FUTA provides for cooperation between state and federal governments in the establishment and administration of unemployment insurance. Under this dual system, the employer is subject to a payroll tax levied by the federal and state governments. The IRS uses the FUTA Certification program to verify with the states that the credit claimed on IRS forms was actually paid into the states' unemployment funds.

as the shifting of IRS resources from compliance activities to answering ESP-related phone inquiries.[32] The following issues illustrate the downstream effect of such events on TAS receipts.

Effect of the Economic Stimulus Act of 2008 on TAS Case Receipts

Passage of the Economic Stimulus Act of 2008 in February challenged the IRS to develop and implement programming while simultaneously running a tax filing season.[33] In response to a flood of taxpayer calls,[34] the IRS transferred employees from its Accounts Management and Automated Collection System (ACS) functions to assist in answering these calls. As the IRS was forced to shift employees to help in answering phones, AM experienced a decline in productivity in processing taxpayer correspondence.[35] Correspondence related to accounts more than doubled, creating potentially significant burdens for affected taxpayers.[36] Consequently, more taxpayers waited longer to resolve their issues, which qualified them for TAS help. The backlogs in AM had a significant impact on TAS cases, as TAS received 25,759 cases related to the ESP in FY 2008, which is more than any other issue.[37] Table 4.10 and Chart 4.11 below illustrate the impact on TAS receipts for a variety of issue codes related to ESP.

TABLE 4.10, TAS Receipts Related to ESP With High Percentage Increases

Receipts by Issue	FY 2008 Receipts	FY 2007 Receipts	% Change
Other Refund Inquiries/Issues	14,817	4,631	**220.0%**
Injured Spouse Claim	14,238	8,295	**71.6%**
Processing Amended Returns	21,963	16,267	**35.0%**
IRS Offset	6,461	4,836	**33.6%**
Expedite Refund Request	11,376	9,627	**18.2%**
Totals	**68,855**	**43,656**	**57.7%**

AM case receipts involving adjustments to taxpayer accounts rose by 1.5 million in FY 2008.[38] To address the increase, AM alerted all IRS employees on August 6, 2008, that due

32 W&I, *Business Performance Review* 11 (Oct. 30, 2008).

33 Economic Stimulus Act, Pub. L. No. 110-185 (2008).

34 In FY 2008, the IRS received 48.9 million "dialed number attempts" on its Rebate Hotline (established Mar. 3, 2008) concerning ESP. The number of "dialed number attempts" that resulted in a conversation with a live assistor was 5.5 million. IRS, Joint Operations Center (JOC), *Snapshot Reports: Product Line Detail: Rebate Hotline (Economic Stimulus Payments) 866-234-2942* (week ending Sept. 30, 2008). About 21.9 million additional callers were assisted through automation. In general, the JOC tracks the IRS's performance on its toll-free lines based on "net [call] attempts" rather than "dialed number attempts." The Joint Operations Center report dated September 30, 2008, reported a call volume to Customer Accounts Services of 150.6 million in FY 2008 compared to 67.3 million in FY 2007.

35 *The Status of Economic Stimulus Payments: Hearing Before the Subcomm. on Oversight and Social Security of the H. Comm. on Ways and Means*, 110th Cong. (June 19, 2008) (testimony of Nina E. Olson, National Taxpayer Advocate).

36 *Id.*

37 Because ESP-related cases can involve a variety of primary issue codes, TAS identified and tracked them with a special case code. Data obtained from TAMIS on Oct. 1, 2008 (including only cases received in FY 2008 and marked as ESP-related as of Oct. 1, 2008).

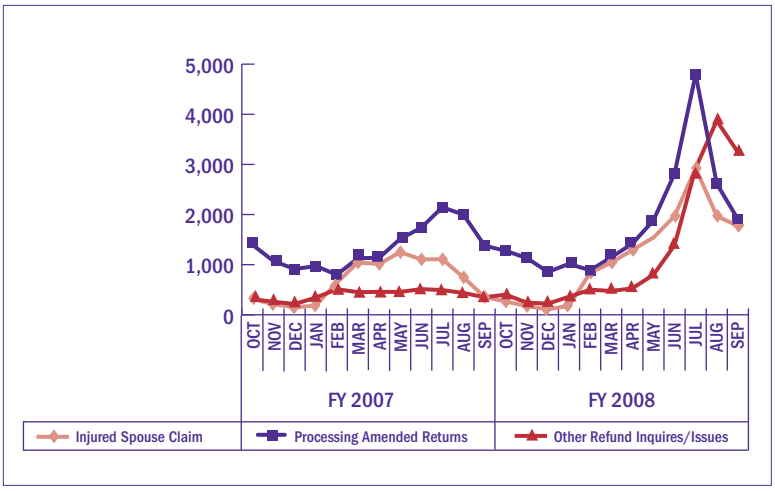
38 IRS Joint Operations Center, *Adjustments Inventory Report, July-September Fiscal Year Comparison* (including total receipts for both individual and business accounts). In FY 2008, individual adjustment account receipts exceeded FY 2007 levels by 1.3 million.

to the unusually high volume of amended returns and injured spouse claims, the normal processing time of eight to 12 weeks would be extended by four weeks. On September 27, 2008, W&I reported the overall AM adjustments inventory level was 725,943 compared to 480,292 for the same period in 2007.[39]

AM's unexpected volume and increased processing time of amended returns caused an increase in TAS receipts. AM redirected resources to handle call volume, contributing to case processing delays and increased taxpayer burden. In response to AM's announcement of the increased processing time, the NTA toll-free line also began advising taxpayers that the IRS would need an additional four weeks to process their amended returns. TAS amended return receipts began to decline, coinciding with AM's initiatives to handle the volume of work, and AM eventually rescinded the additional processing time on November 20, 2008. Although its ESP receipts peaked in July, TAS is still receiving ESP cases, with more than 9,000 of them coming to TAS since October 1, 2008.[40]

Chart 4.11 below, while demonstrating the same post-filing season peak phenomenon of injured spouse, amended return, and refund inquiry case receipts for both periods, also reflects an increase in these receipts for FY 2008. In particular, the dramatic increase in refund inquiry cases received from June through September reflects the impact of ESP on TAS inventory.

CHART 4.11, Processing Amended Returns, Injured Spouse Claims, and Other Refund Inquiries/Issues Receipts[41]



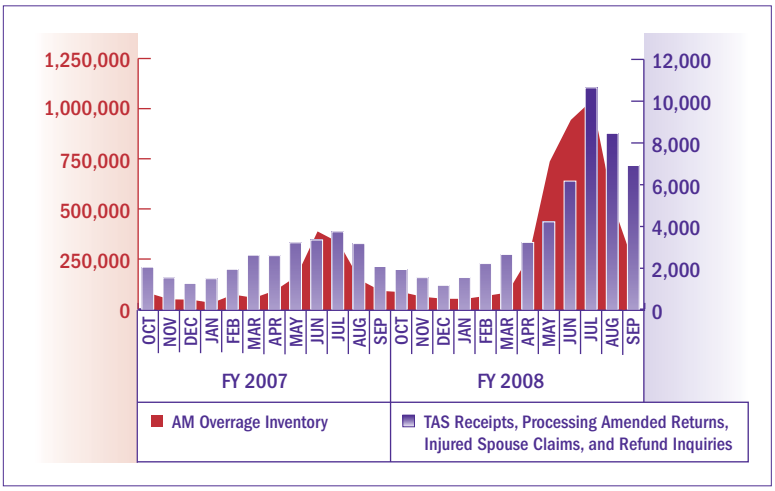
39 W&I, *Business Performance Review* 20 (Oct. 30, 2008).

40 Data obtained from TAMIS (Nov. 26, 2008).

41 TAMIS data obtained from BPMS (Sept. 30, 2008).

Chart 4.12 below shows the volume of receipts by month against the number of cases identified by AM as "overage" and not worked timely. TAS received higher volumes of cases during the times when AM overage was highest.

CHART 4.12, Accounts Management Overage Comparison to TAS Amended Return, Injured Spouse, and Refund Inquiry Receipts, FY 2007- 2008[42]



AM processing delays added to taxpayer frustration. High inventories of unanswered correspondence and submissions have a negative impact on taxpayers and in the long term may reduce compliance by angry and frustrated taxpayers.[43]

Congressional Casework

TAS independently reviews all tax account inquiries sent to the IRS by members of Congress. TAS received 22,097 such inquiries in FY 2008, a 126 percent increase from the previous fiscal year, caused primarily by the Economic Stimulus Act of 2008.[44] Over 46 percent of congressional receipts in FY 2008 involved ESP-related issues.[45] Table 4.13 highlights the top ten issues in congressional cases for FY 2008.

42 Accounts Management data obtained from IRS Joint Operations Center, *Adjustments Inventory Report, Overage Comparison* FY 2007 through FY 2008. TAS receipt data obtained from BPMS (Sept. 30, 2008) (including total receipts involving Processing Amended Returns, Injured Spouse Claims, and Other Refund Inquiries).

43 *The Status of Economic Stimulus Payments: Hearing Before the Subcomm. on Oversight and Social Security of the H. Comm. on Ways and Means*, 110th Cong. (June 19, 2008) (testimony of Nina E. Olson, National Taxpayer Advocate).

44 TAMIS data obtained from BPMS (Sept. 30, 2008).

45 Data obtained from TAMIS (Oct. 1, 2008) (including only cases that were received in FY 2008 and marked as ESP-related as of Oct. 1, 2008).

TABLE 4.13, Top Ten Issues in Congressional Cases, FY 2008[46]

Issue	Number
Other Refund Inquiries/Issues	8,228
Levies (including the Federal Payment Levy Program)	889
Account/Notice Inquiry	842
Expedite Refund Request	751
Processing Original Returns	703
Processing Amended Returns	703
Open Audit (Not Revenue Protection Strategy or EITC)	540
Failure to File Penalty/ Failure to Pay Penalty	502
Reconsideration of Substitute for Return under IRC § 6020(b) and Audits	438
Automated Underreporter Examination in Process	432

Table 4.14 illustrates TAS congressional receipts from FY 2005 to FY 2008 and the number of 2008 ESP congressional cases.

TABLE 4.14, Congressional Receipts, FY 2005-2008[47]

	FY 08	FY 07	FY 06	FY 05	%Change FY 07-FY 08	FY 08 ESP Congressional Cases[48]
Congressional Receipts	22,097	9,779	10,873	11,509	126.0%	10,320
Total Case Receipts	274,051	247,839	242,173	197,679	10.6%	
% of Total Receipts	**8.1%**	**3.9%**	**4.5%**	**5.8%**		**46.7%**

Stolen Identity Cases Increase

TAS stolen identity case receipts continued to rise throughout FY 2008, increasing by 114.8 percent over FY 2007.[49] Stolen identity cases can involve a number of issues, including refund inquiries, duplicate return filing conditions, Automated Underreporter, substitute for return (SFR), mixed entities,[50] levies, etc. TAS case advocates use Primary Issue Code 425, Stolen Identity, to code all cases involving tax-related identity theft. Chart 4.15 displays the steady increase in stolen identity cases.

46 TAMIS data obtained from BPMS (Sept. 30, 2008).

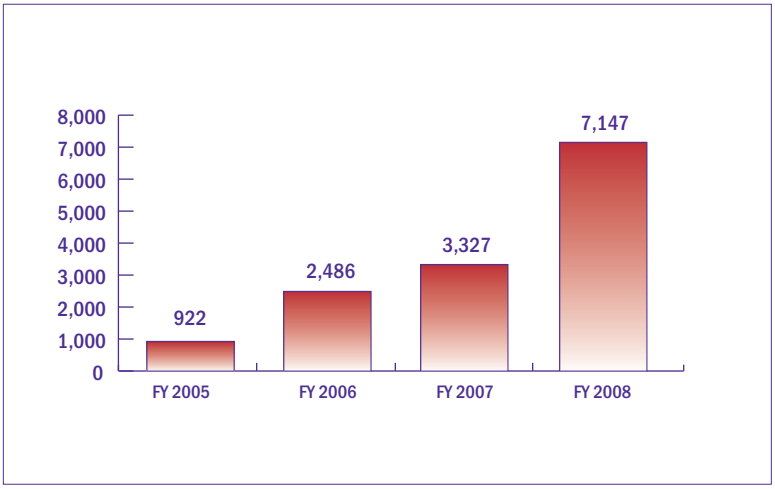
47 *Id.*

48 Data obtained from TAMIS (Oct. 1, 2008) (including only cases that were received in FY 2008 and marked as ESP-related as of Oct. 1, 2008).

49 TAMIS data obtained from BPMS (Sept. 30, 2008).

50 Cases involving multiple taxpayers using the same Taxpayer Identification Number (TIN) are classified as mixed entity or scrambled SSN cases. *See* Internal Revenue Manual 21.6.2.4.2 (Jan. 22, 2008).

CHART 4.15, TAS Stolen Identity Receipts, FY 2005-2008[51]



The IRS has established an indicator to track the number of taxpayers and accounts affected by this growing problem.[52] From January 1 through September 19, 2008, the IRS placed the identity theft indicator on 17,897 taxpayer accounts.[53] This indicator alerts IRS personnel viewing the account that the taxpayer has substantiated that he or she is a victim of tax-related identity theft. Beginning in January 2009, the IRS will have an additional indicator for taxpayers who have substantiated an identity theft incident, but do not yet have a tax-related consequence.

As recommended in the National Taxpayer Advocate's 2007 Annual Report to Congress, the IRS has taken steps towards being proactive in dealing with taxpayers affected by identity theft.[54] The IRS established an Identity Protection Specialized Unit, as well as a toll-free hotline to assist taxpayers with identity theft issues. The hotline, if properly administered, should reduce the number of taxpayers coming to TAS for help in resolving these issues.[55]

Earned Income Tax Credit Cases Decline

The Small Business Self-Employed (SB/SE) division reported a 6.1 percent reduction in EITC audit closures from October 1, 2007, through June 30, 2008 compared to the same

51 TAMIS data obtained from BPMS (Sept. 30, 2008).

52 In 2007, the Federal Trade Commission (FTC) received 258,427 complaints of identity theft, an increase over the 246,124 complaints received in 2006. *See* FTC website, http://www.ftc.gov/opa/2008/02/fraud.pdf.

53 PIPDS, Identity Theft and Incident Management (ITIM), *Incident Tracking System Report* (Sept. 19, 2008).

54 National Taxpayer Advocate 2007 Annual Report to Congress 108.

55 *See* Most Serious Problem, *IRS Process Improvements to Assist Victims of Identity Theft, supra.*

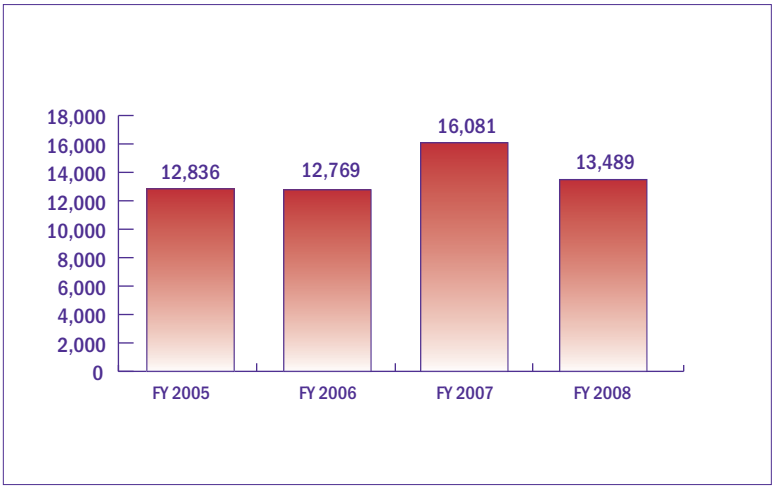
period in FY 2007.[56] W&I reported an 11.3 percent decrease in EITC audits in FY 2008 compared to FY 2007.[57] Table 4.16 below illustrates these trends.

TABLE 4.16, EITC Audit Activity for W&I and SB/SE, FY 2007 and FY 2008[58]

		FY 2008 10/1/07–06/30/08	FY 2007 10/01/06–06/30/07	% Change
SB/SE	EITC Audit Closures	105,656	112,478	-6.1%
		FY 2008 10/1/07–09/30/08	FY 2007 10/01/06–09/30/07	% Change
W&I	EITC Returns Audited	313,769	353,958	-11.3%

TAS received 13,489 cases involving EITC in FY 2008 compared to 16,081 in FY 2007, a decrease of 16.1 percent.[59] In FY 2008, TAS provided full or partial relief to taxpayers in 47.2 percent of TAS EITC cases.[60] TAS closed 42.2 percent of these cases in FY 2008 with no relief because the taxpayers could not provide the documentation required by the IRS to substantiate their eligibility for the credit.[61] As discussed in the 2007 Annual Report, many low income taxpayers face significant barriers in obtaining sufficient documentation, and thus cannot prove eligibility.[62] Chart 4.17 illustrates TAS EITC case levels for the last four fiscal years.

CHART 4.17, TAS EITC Receipts, FY 2005-2008[63]



56 SB/SE, *Business Performance Review* 28 (Aug. 12, 2008)

57 W&I *Business Performance Review* 25 (Aug. 7, 2008).

58 W&I, *Business Performance Review* 11 (Oct. 30, 2008); SB/SE *Business Performance Review* 4 (Aug. 12, 2008).

59 TAMIS data obtained from BPMS (Sept. 30, 2008).

60 *Id.*

61 *Id.*

62 National Taxpayer Advocate 2007 Annual Report to Congress 225.

63 TAMIS data obtained from BPMS (Sept. 30, 2008).

Combined Annual Wage Reporting/Federal Unemployment Tax Act Cases

The IRS and the Social Security Administration (SSA) jointly administer the Combined Annual Wage Reporting (CAWR) document-matching program, which is designed to ensure that employers report the correct amount of wages, pay the proper amount of taxes, and properly credit the individual employee's Social Security account. The Federal Unemployment Tax Act (FUTA) provides for cooperation between state and federal governments in the establishment and administration of unemployment insurance. Under this dual system, the employer is subject to a payroll tax levied by the federal and state governments. The IRS uses the FUTA Certification program to verify with the states that the credit claimed on IRS forms was actually paid into the states' unemployment funds.

TAS receipts related to CAWR and FUTA issues have risen continually since FY 2005. Chart 4.18 below tracks these receipts by month from FY 2005 through FY 2008. While monthly receipts began to decline in the last half of FY 2008, total receipts for FY 2008 (8,928 cases) were 25.3 percent higher than FY 2007 receipts (7,123 cases) and 263.7 percent higher than FY 2005 receipts (2,455 cases).[64] The problems that cause TAS casework include delays in case resolution due to a lack of proper inventory management controls, CAWR notices that are unclear and do not necessarily help employers comply, and improper assessments of penalties.[65] In FY 2008, CAWR ranked as the number one issue in cases closed within TAS for large and midsize businesses, tax-exempt organizations, and government entities.[66] TAS and SB/SE have established a team to study the effect of the CAWR program on TAS receipts, review CAWR processes, identify systemic problems, and discuss potential solutions.[67] TAS identified CAWR as a Most Serious Problem in the 2007 Annual Report and it remains a Most Serious Problem in 2008.[68]

64 TAMIS data obtained from BPMS (Sept. 30, 2008).

65 *See* Most Serious Problem, *Inefficiencies in the Administration of the Combined Annual Wage Reporting (CAWR) Program Impose Substantial Burden on Employers and Waste IRS Resources*, *supra*.

66 CAWR is the fourth most common issue driving small business employers to TAS. The relief rates in CAWR cases are 82.5 percent for the Large and Mid-Sized Business Division (LMSB), 88.7 percent for TE/GE, and 86.5 percent for SB/SE. *See* TAS Technical Analysis and Guidance response to research request (Nov. 10, 2008); TAS, *Business Performance Review 4th Quarter FY 2008*.

67 *See* National Taxpayer Advocate 2007 Annual Report to Congress 651.

68 *See* Most Serious Problem, *Inefficiencies in the Administration of the Combined Annual Wage Reporting (CAWR) Program Impose Substantial Burden on Employers and Waste IRS Resources*, *supra*.

CHART 4.18, TAS CAWR/FUTA Monthly Receipts, FY 2005-2008[69]

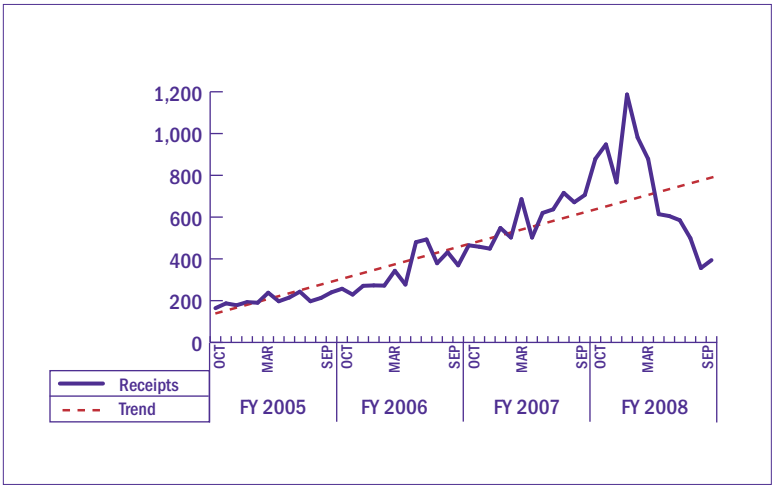
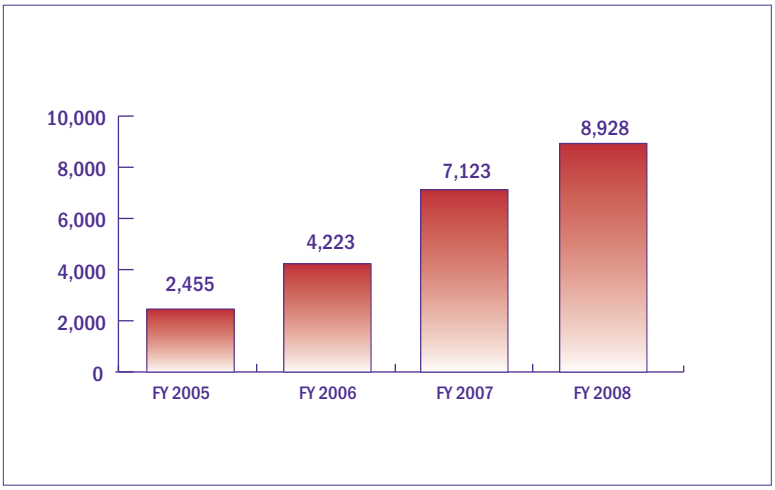


CHART 4.19, TAS CAWR/FUTA Cumulative Receipts Thru September, FY 2005-FY 2008[70]



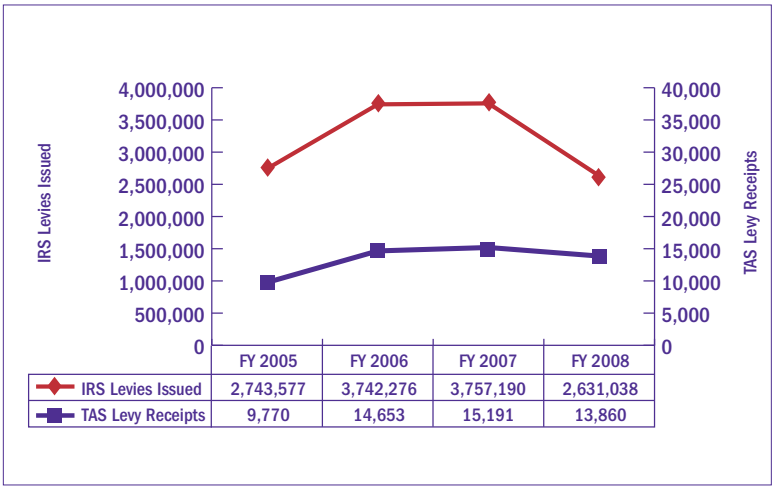
69 TAMIS data obtained from BPMS (Sept. 30, 2008).

70 TAMIS data obtained from BPMS (Sept. 30, 2008).

Levy Cases

In the last four fiscal years, TAS levy case receipts have reflected the numbers of levies issued by the IRS. Chart 4.20 below illustrates this trend.

CHART 4.20, IRS Levies and TAS Levy Receipts, FY 2005-2008[71]



	FY 2005	FY 2006	FY 2007	FY 2008
IRS Levies Issued	2,743,577	3,742,276	3,757,190	2,631,038
TAS Levy Receipts	9,770	14,653	15,191	13,860

During peak filing season weeks in 2008, the ACS "turned off" levies and notices so ACS employees could answer ESP-related calls through July 9, 2008.[72] The IRS reported a 30 percent decrease in levies issued, while TAS experienced an 8.5 percent decrease in total levy cases, receiving 17,082 cases in FY 2008 compared to 18,665 in FY 2007.[73]

The IRS also issues levies systemically through the Federal Payment Levy Program (FPLP). The FPLP is an automated system that matches IRS records against those of the government's Financial Management Service and allows continuous levies to be issued for up to 15 percent of federal payments due to taxpayers who have unpaid federal tax liabilities. As discussed in the 2007 Annual Report to Congress, the bulk of FPLP levy payments received have historically been related to Social Security benefits. Although the IRS initially used an income filter to systemically exclude from the FPLP those taxpayers with income below a specified threshold, the IRS gradually phased out the filter and eliminated it altogether in January 2006.[74] The law limits FPLP levies to only 15 percent of each Social Security payment, but the remainder may not be enough to avoid a financial hardship, considering that Social Security provides at least half of the total income for 64 percent of beneficiaries

71 IRS levy data from 2007 IRS Data Book (excluding levies issued through FPLP). TAS data obtained from BPMS (Sept. 30, 2008) (excluding FPLP receipts).

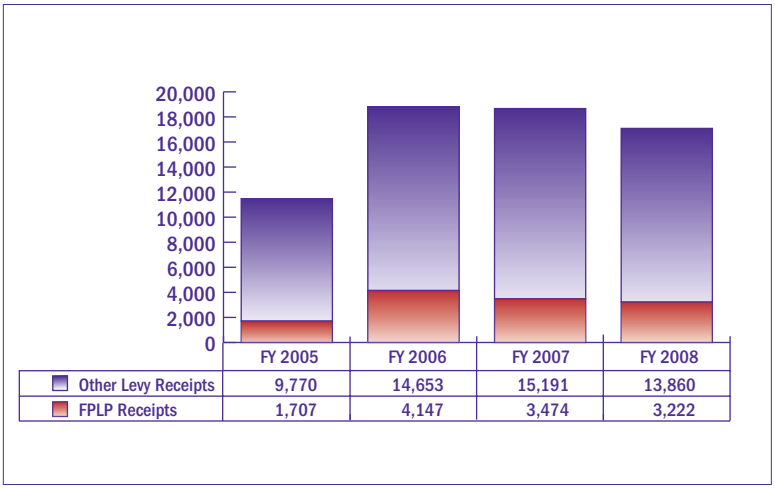
72 W&I, *Business Performance Review* 16 (Aug. 7, 2008).

73 TAMIS data obtained from BPMS (Sept. 30, 2008) (including FPLP receipts).

74 National Taxpayer Advocate 2007 Annual Report to Congress 225.

aged 65 or over.[75] TAS received 3,222 FPLP cases during FY 2008 and 90 percent of them impacted recipients of Social Security benefits.[76] TAS research is developing a mathematical model to filter out taxpayers unlikely to be able to afford the FPLP levy.[77]

CHART 4.21, Total TAS Levy Case Receipts, FY 2005-2008[78]



	FY 2005	FY 2006	FY 2007	FY 2008
Other Levy Receipts	9,770	14,653	15,191	13,860
FPLP Receipts	1,707	4,147	3,474	3,222

Case Closures

In FY 2008, TAS closed 260,439 cases received in FY 2008 or prior years, providing full or partial relief to the taxpayer in 72.6 percent of these cases. The number of cases closed increased 6.1 percent over FY 2007, lagging behind the overall increase (10.8 percent) in cases received.[79] Table 4.22 shows the disposition of cases closed in FY 2008.

75 Social Security Administration, *Fast Facts & Figures About Social Security 2008* (Sept. 2008).

76 TAMIS data obtained from BPMS (Sept. 30, 2008).

77 See *Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*, Volume II, *infra.*

78 TAMIS data obtained from BPMS (Sept. 30, 2008).

79 *Id.*

TABLE 4.22, TAS Case Disposition Types for FY 2008[80]

Type of Relief	Number	%
Relief Provided to Taxpayer	**189,046**	**72.59%**
Full relief	176,209	67.66%
Partial relief	12,787	4.91%
Taxpayer Assistance Order (TAO)[81] issued - IRS complied	47	0.01%
TAO issued - IRS appealed, TAO sustained	3	0.01%
No Relief Provided to Taxpayer	**71,393**	**27.41%**
TAO issued - IRS appealed, TAO rescinded	8	0.01%
No relief (no response from taxpayer)	35,401	13.59%
Relief provided prior to TAS intervention	14,526	5.58%
Relief not required (taxpayer rescinded request)	3,530	1.36%
No relief (hardship not validated)	845	0.01%
Relief not required (hardship not related to internal revenue laws)	1,276	0.01%
No relief (tax law precluded relief)	1,913	0.73%
Other	13,894	5.33%
Total TAS Cases Closed	**260,439**	**100%**
TAOs Issued[82]	68	0.01% of total closures

Operations Assistance Requests

TAS uses Operations Assistance Requests (OARs) to obtain assistance from an IRS operating division or function to complete an action when TAS does not have the statutory or delegated authority to take the action(s) required to resolve taxpayers' problems. Table 4.23 highlights the OARs issued and closed in FY 2008 and the average number of days it took the IRS to complete the OARs.

80 TAOs are only reflected in the Relief/No Relief figures if the case was also closed on TAMIS by Sept. 30, 2008. The table reflects closed cases, and not all TAOs issued in 2008 resulted in closed cases. TAOs may be closed even while the underlying cases remain open until fully resolved. Of the 35 TAOs showing as issued under W&I, four were issued to CI and one to Appeals. They appear under TAOs issued to W&I because they involved W&I taxpayers.

81 IRC § 7811 authorizes the National Taxpayer Advocate to issue a 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. TAS may issue a TAO to direct the IRS to take an action, cease an action, or refrain from taking an action in a case. A TAO may, among other things, 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.

82 Of the 68 TAOs issued in FY 2008, four remained open at the end of September 2008. Closed TAOs are only reflected in the Relief/No Relief figures if the cases were also closed on TAMIS by Sept. 30, 2008. Total TAO relief closures will not match TAOs issued.

TABLE 4.23, OAR Activity for FY 2008[83]

Operating Division/Function	OARs Issued	OARs Rejected	OARs Completed	Average Age of Completed OARs (Days)
W&I	125,514	9,715	110,964	16.5
SB/SE	86,225	10,258	77,445	17.6
Criminal Investigation	12,643	574	11,101	21.5
TE/GE	1,121	89	988	38.7
Appeals	838	117	707	36.3
LMSB	105	11	94	41.8
Total	**226,446**	**20,764**	**201,299**	**17.4**

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. TAS may issue a TAO to direct the IRS to take an action, cease an action, or refrain from taking an action in a case.[84] A TAO, among other things, may 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. If the National Taxpayer Advocate issues, sustains, or amends a TAO, only the Commissioner or Deputy Commissioner can rescind or modify the TAO.[85] TAS issued 68 TAOs during FY 2008, compared to 27 in FY 2007, an increase of 152 percent.[86] Table 4.24 summarizes the issues.

83 TAMIS data obtained from BPMS (Sept. 30, 2008).

84 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.

85 IRC § 7811(c).

86 *See* National Taxpayer Advocate 2007 Annual Report to Congress 660.

TABLE 4.24, Taxpayer Assistance Orders Issued in FY 2008[87]

Issue Description	Number
Refund Issues[88]	11
Levy	10
Identity Theft	6
Offer In Compromise – Effective Tax Administration	4
Request for Reconsideration of Audit/Substitute for Return or IRC § 6020 (b) Assessment	4
Seizure & Sale	4
Offer In Compromise – Doubt as to Collectability	3
Other Technical, Procedural or Statute Issues	3
Injured Spouse Claims	2
Lien Release	2
Processing Amended Returns	2
Refund Statute Expiration Date	2
Revenue Protection Strategy (EITC) Claim	2
Application for Exempt Status	1
Bankruptcy	1
Criminal Investigation	1
Exam Appeals	1
Failure to File/ Failure to Pay Penalty	1
Innocent Spouse	1
Installment Agreement	1
Multiple/Mixed Entity	1
Open Audit	1
Other Collection Issues	1
Other Document Processing Issues	1
Trust Fund Recovery Penalty	1
Unable to Pay - Currently not Collectible	1
Total	**68**

The IRS complied with 53 TAOs, TAS rescinded 11, and four remained open at the close of FY 2008.[89]

87 TAO information is manually tracked by TAS National Headquarters staff.

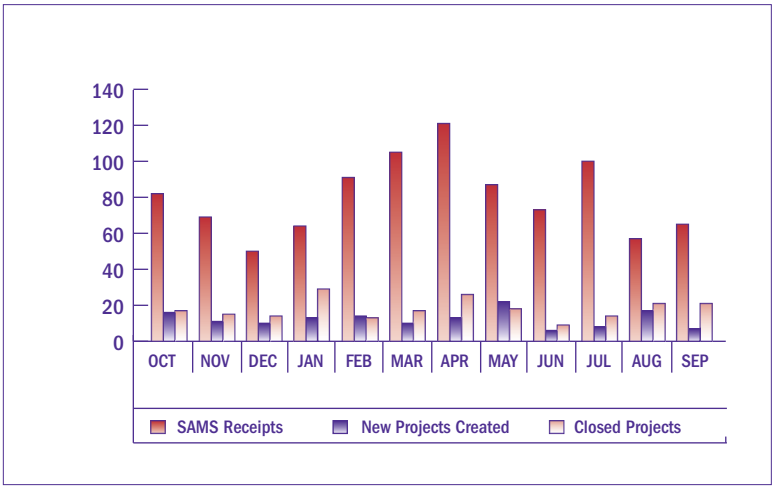
88 Includes Lost/Stolen Refunds, Expedite Refund Requests, Returned/Stopped Refunds, Direct Deposit, and Other Refund Issues.

89 Seven of the complied TAOs and three of the rescinded TAOs were issued on cases that are still open in TAS and are not reflected in Table 4.22, TAS Case Dispositions for FY 2008, *supra*.

Systemic Advocacy Receipts and Projects

The TAS Office of Systemic Advocacy receives, reviews, assigns, and tracks advocacy work through the Systemic Advocacy Management System (SAMS), a web-based application available to IRS employees and the public.[90] Systemic Advocacy employees review and evaluate all issue submissions and apply criteria that categorize and develop the issues into projects when appropriate, or incorporate new issues into existing projects. Table 4.25 illustrates SAMS monthly issue receipts, new advocacy projects created from receipts, and closed projects for fiscal year 2008.

TABLE 4.25, FY 2008 SAMS Receipts, New Projects, and Closed Projects



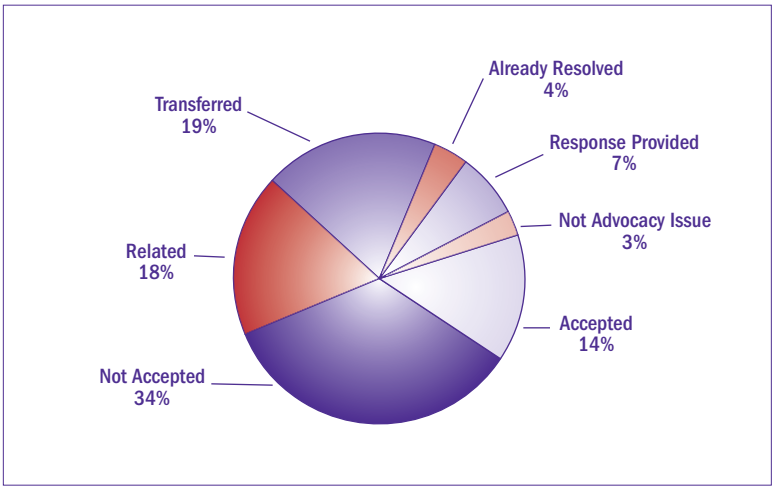
From October 1, 2007 through September 30, 2008, Systemic Advocacy received 964 issues on SAMS, a decrease of approximately 21 percent from the previous fiscal year. Most of the submissions came to TAS during and immediately after the filing season (January through May). The public (taxpayers, academics, and tax professionals) submitted approximately 34 percent (325) of all systemic advocacy issues received in FY 2008, which represents a slight decrease from the 35 percent (425) received via the public Internet in FY 2007. TAS and other IRS employees submitted the remaining issues directly into SAMS using the IRS intranet.

Systemic Advocacy does not consider all submissions for development into projects. Some are individual taxpayer account issues rather than systemic problems, or are tax law or procedural questions, matters that have already been or are being resolved, or that relate to other federal agencies or state tax agencies. These issues are marked accordingly on SAMS,

90 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 website at http://www.irs.gov/advocate.

but are not elevated for project consideration. Chart 4.26 below illustrates the disposition of FY 2008 submissions by percentage.

CHART 4.26, FY 2008 Closing Disposition of SAMS Receipts[91]



Systemic Advocacy reviews all issue submissions, using established criteria to prioritize inventory and develop advocacy projects. SAMS program managers 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 likelihood that Systemic Advocacy is using its resources to work the most important projects. Even though most submissions do not become projects, Systemic Advocacy continually assesses all submissions to identify trends and gain a comprehensive understanding of problems.

During FY 2008, Systemic Advocacy developed approximately 15 percent of submissions into new projects.[92] Chart 4.27 illustrates the top categories of new projects, which account for 72 of the 147 total projects created in FY 2008. Systemic Advocacy also closed 214 projects during this period.

91 *Related* issues are those for which a project already exists or is under consideration. *Transferred* issues 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 those for which a procedural remedy is in place or the National Taxpayer Advocate has already proposed a legislative recommendation. 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*. The total does not add to 100 percent due to rounding.

92 Some advocacy issues accepted in FY 2008 were not yet developed into projects by the end of the fiscal year. In addition, some issues accepted in FY 2007 were not made into projects until FY 2008, resulting in the difference in percentage between issues accepted (14 percent) and projects created (15 percent) in FY 2008.

CHART 4.27, Top Systemic Advocacy Project Categories for FY 2008

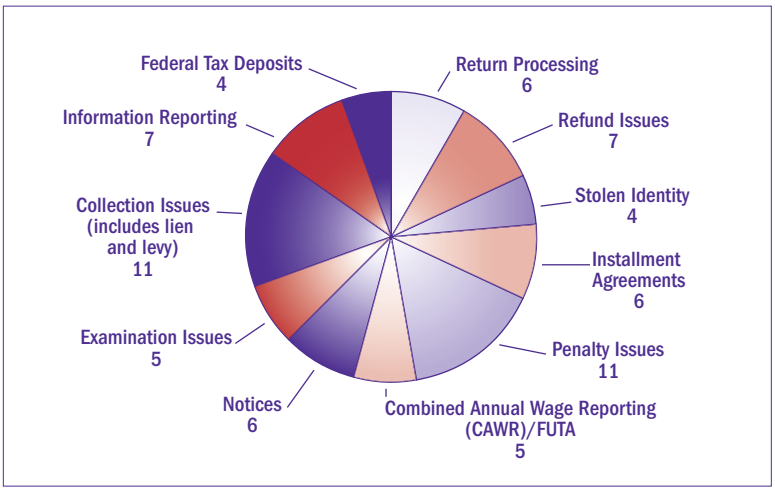


Table 4.28 below outlines the Top 25 systemic issue topics in SAMS by major issue (MI) codes that correspond to tracking on TAMIS, the TAS database of individual taxpayer cases. Some of the advocacy issues do not directly match with TAMIS MI Codes because cases usually relate to problems with customer service or taxpayer accounts. For example, no TAMIS MI code exactly matches the SAMS keyword "Notices," which usually deals with notice clarity. Systemic issues often address problems with tax law interpretation, lack of published guidance[93] or difficulty (either by the IRS or by taxpayers) in applying tax law.

93 Published guidance includes Treasury Regulations, Revenue Rulings and Procedures, and Notices.

TABLE 4.28, Top 25 Issues Received on SAMS in FY 2008

Core Issue Code	Description	FY 08 Receipts
000-090	Refund Issues[94]	109
600	Examination Issues	53
425	Stolen Identity	52
N/A	Form or Publication Issue	43
500	Penalty Issues	41
990	Access to the IRS	37
310	Return Processing[95]	32
751	Installment Agreements	28
N/A	Case Processing	26
700	Collection Issues	25
110	Notices	25
390	Information Reporting	19
400	Entity Issues	18
100	Service	18
330	Amended Return	17
340	Injured Spouse Claim (Form 8379)	17
N/A	Instructions	17
150	Copies of Tax Returns/ Transcripts	16
720	Lien	16
675	CAWR	14
710	Levy	14
N/A	Credits (Tax)	12
200	Payments/Account Credits	11
190	Employment Tax Issues	10
230	Federal Tax Deposits	10

Eight of the top ten advocacy issues from FY 2007 remain in the top ten this year, including Refund Issues, Examination Issues, Stolen Identity, Penalty Issues, Return Processing, Installment Agreements, Notices, and Case Processing. Refund issues accounted for approximately 11 percent of all advocacy submissions during FY 2008, primarily because those regarding economic stimulus payments, which the government disbursed in 2008, fall into this category.[96]

94 All refund issue keywords were consolidated and include refund freezes, offsets, and direct deposits. "Refund Issues" also includes lost or stolen refunds, erroneous refunds, and issues pertaining to the Refund Statute Expiration Date or statute of limitations.

95 Keywords "Return Processing" and "Original Return" were combined to create one issue referring to the processing of original tax returns (*i.e.*, not amended returns).

96 Eighty-six advocacy submissions concerned the economic stimulus payments and 60 (69.8 percent) were classified as refund issues and had "Refund" as the keyword.

Offers in compromise (OIC) and Service dropped from the top ten, replaced by Collection Issues, Access to the IRS, and Form/Publication Issues.[97] Service remains a frequently reported issue at fourteenth, while OICs dropped from the top 25 issue list completely.

Low Income Taxpayer Clinics

The Low Income Taxpayer Clinic (LITC) grant program is now in its eleventh year of operation (for fiscal year 2009). IRC § 7526 authorizes the program to award matching grant funds of up to $100,000 per year to qualifying organizations that represent low income taxpayers involved in controversies with the IRS, and to organizations that provide education and outreach on the rights and responsibilities of individual taxpayers who speak English as a second language (ESL). Clinics must provide services free or for a nominal fee. An organization may be:

1. A clinical program at an accredited law, business, or accounting school in which students represent low income taxpayers in controversies with the IRS; or
2. An organization described in IRC § 501(c) and exempt from tax under IRC § 501(a).

LITCs reduce taxpayer uncertainty and errors by clarifying tax law responsibilities and representing low income taxpayers who cannot afford to pay for assistance in meeting their tax obligations. The clinics provide the help that low income taxpayers need, while protecting and preserving their rights. The LITCs also offer effective communication to low income taxpayers and education to the underserved ESL population.

LITC Grant Awards

The National Taxpayer Advocate's goal in awarding LITC grants for 2008 was to place a clinic in each state, the District of Columbia, Puerto Rico, and Guam. The LITC Program Office received 191 applications and awarded nearly $9 million in grants to 154 non-profit organizations and accredited academic institutions. On March 24, 2008, the National Taxpayer Advocate announced the IRS would accept applications for a part-year LITC matching grant from organizations to provide assistance and representation to taxpayers in the underserved target areas of Los Angeles, California; Central Oregon; Boise, Idaho; Minneapolis, Minnesota; Reno and Las Vegas, Nevada; St. Louis, Missouri; Brownsville and Laredo, Texas; Southwest Florida; New Mexico; Colorado; Mississippi; and Northeast Pennsylvania. TAS subsequently awarded grants to seven organizations during this supplemental period.

97 Collection Issues and Notices tied for tenth on the list, thus 11 issues appear on the list.

LITC Oversight

TAS is working to address concerns raised by clinics and by the Treasury Inspector General for Tax Administration and continues to improve the administration and oversight of the program. Specifically, TAS has:

- Clarified program standards and guidelines to make them easier for applicants to understand and eliminated requests for duplicate information, thereby streamlining the application process;
- Emphasized the importance of face-to-face contact as the primary means of educating taxpayers, while still recognizing the value of pamphlets, brochures, and other advertisements provided they include substantive information; and
- Developed and implemented procedures for following up with grantees that have not filed required reports.

In 2008, TAS revised the 2009 Publication 3319, *Low Income Taxpayer Clinic Grant Application Package*. The improvements include:

- Clarifying the charging of expenses related to attendance at the annual LITC Conference;
- Clarifying the allowance of refreshment and memorabilia purchases; and
- Eliminating as redundant the requirement to provide a complete financial narrative in the annual report, because clinics already must explain and itemize actual program costs for all expenses.

TAS is working to provide consistent information to clinics by establishing an LITC website on the IRS site (IRS.gov). The site would allow the Program Office to answer frequently asked questions and share important events, best practices, and products such as brochures, intake forms, and customer satisfaction surveys.

LITC Monitoring and Visits

TAS periodically performs on-site assistance visits to selected LITCs to confirm that they fulfill their grant requirements. Each new clinic will receive a visit during its first year of LITC funding. In calendar year 2008:

- Each new clinic funded received an on-site assistance visit from the LITC Program Office;
- Almost every clinic funded was visited by the Local Taxpayer Advocate in the state where the clinic is based; and

- The LITC Program Office completed on-site assistance visits to roughly 45 percent of the clinics funded, or 68 visits altogether.[98]

Compliance Reviews

TAS has established procedures to check for federal tax compliance before awarding LITC grants. Before awarding the 2008 grants, TAS verified that each grantee was compliant with all federal tax obligations and conducted follow up checks during the 2008 grant cycle. TAS worked closely with the Office of Chief Counsel to develop formal procedures to prevent unauthorized disclosure of tax information when TAS contacts a clinic regarding noncompliance.

Performance Measures

TAS is developing performance measures to gauge the success of LITCs in serving eligible low income and ESL populations. Measures to assess customer satisfaction, quality of service, timeliness of service, number of taxpayers assisted, and types of service provided will help TAS and other stakeholders evaluate the benefits provided by the LITC program in comparison to the funds expended.

In FY 2008, the LITC Program Office proposed a set of measures related to the number of taxpayers assisted and customer satisfaction, reflecting the work of a team of TAS and LITC Program Office employees and clinic directors. The National Taxpayer Advocate determined the clinics needed additional measures to assess the types of services provided (*i.e.*, current and emerging needs of the eligible populations), the effectiveness of program plans as they relate to this "needs assessment," and the quality of services. TAS is working to complete and refine these additional measures.

Taxpayer Advocacy Panel: Town Hall Meetings

The National Taxpayer Advocate collaborated with the Taxpayer Advocacy Panel (TAP) again in 2008 to afford taxpayers an opportunity to voice concerns and make suggestions to improve taxpayer service and satisfaction. TAP hosted a series of town hall meetings in a forum environment that allowed attendees to focus on customer service needs and how the IRS should address them. All of these events were free and open to the public, with the objectives of:

- Conducting outreach for TAP and educating citizens on the value of advisory committees;
- Gathering timely suggestions for changes based on current and future customer service needs;
- Soliciting potential grassroots issues based on products that could be improved; and

98 Data taken from the LITC 2008 Database.

- Validating the overall level of taxpayer satisfaction.

The town halls took place in three cities selected to draw maximum turnout and diversity. Table 4.29 below shows these locations and dates.

TABLE 4.29, TAP Town Hall Meetings 2008

City	Location	Date
Birmingham, AL	Homewood Public Library	February 21, 2008
Durham, NC	Durham County Public Library	March 13, 2008
Springfield, IL	Lincoln Land Community College	May 6, 2008

The meetings gave taxpayers an opportunity to engage in conversation with the National Taxpayer Advocate and TAP members on a variety of tax issues that affect their lives. Meetings included introductions of TAP members, an overview of the program, recruitment, and success stories. The National Taxpayer Advocate served as the keynote speaker, explaining the role of the office of the Taxpayer Advocate. Participants then were asked about IRS taxpayer service, their level of satisfaction with the service, and how to improve it. After each session, attendees were invited to participate in focus groups hosted by TAP members to solicit potential grassroots issues that the panel could explore and present to the IRS.

The attendance at the town halls varied, but the response from attendees was consistent: the IRS should remain true to the focus of providing quality customer service and making improvements in a variety of areas. Participants value the time afforded them to have a dialogue with the National Taxpayer Advocate on tax issues. TAP members feel these meetings have been an excellent venue to perform outreach and solicit issues, and the National Taxpayer Advocate has committed to making town halls a priority so that taxpayers' voices can be heard and action taken.

Examination of Taxpayer Assistance Centers

In December 2007, the IRS's Director of Field Assistance asked the TAP to continue the Taxpayer Assistance Center (TAC) issue committee for an additional year. The committee, one of several TAP committees that deal with specific issues, was assigned to examine the tax return preparation process in the TACs, including the system of making appointments for return preparation. Taxpayers who qualify for return preparation assistance and come to TACs with all the necessary information must make appointments and return later to have their returns done. This process often poses problems for the customer, the TAC employees, and the IRS.

The committee members visited their local TACs, interviewing the site managers, talking with employees, and familiarizing themselves with the appointment and return preparation processes. These visits covered large, medium, and small sites in several states. The

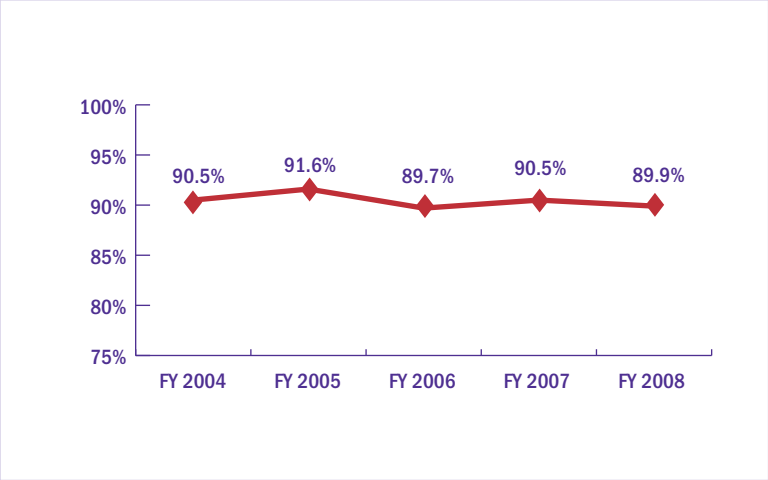
committee delivered a report and recommendations for improvement to the Director of Field Assistance in November 2008.

TAS Quality Standards and Measurements

TAS Closed Case Quality

Since its inception, TAS has measured the quality of assistance it provides to taxpayers. The measures include accuracy, timeliness of actions, and communication components. Chart 4.30 illustrates recent quality rates.

CHART 4.30, TAS Case Quality, FY 2004 – FY 2008

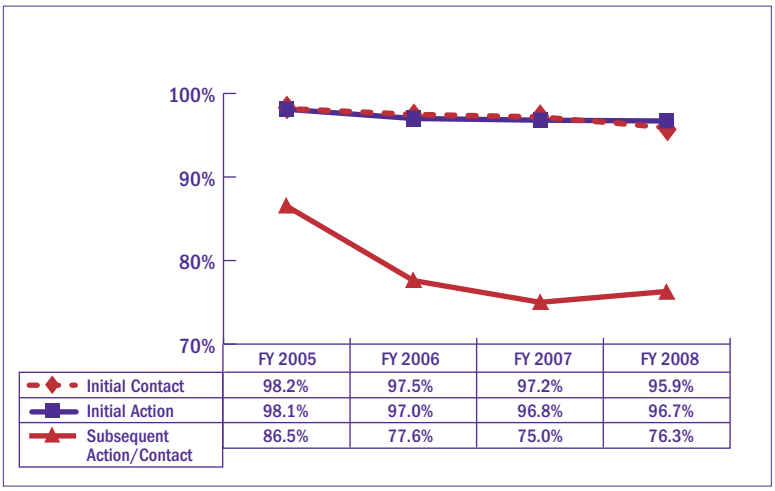


As shown above, TAS's overall quality rate has remained constant, at near 90 percent, for the last five years.[99] Consistently maintaining this level of quality is a remarkable accomplishment considering the significant increase in case receipts, the growing complexity of case issues, and the reduced staffing TAS has experienced over the last several years.

99 Data obtained from BPMS (Nov. 25, 2008).

A major focus of TAS's quality system is taking timely actions as measured by quality standards one through three, shown in Chart 4.31 below.

CHART 4.31, TAS Case Quality Timeliness Standards FY 2005 – 2008



	FY 2005	FY 2006	FY 2007	FY 2008
Initial Contact	98.2%	97.5%	97.2%	95.9%
Initial Action	98.1%	97.0%	96.8%	96.7%
Subsequent Action/Contact	86.5%	77.6%	75.0%	76.3%

TAS continues to perform strongly in initial contact and taking timely initial actions (standards one and two, respectively) and has seen a small improvement in timely subsequent actions (standard three) during FY 2008.

New Case Quality Standards

TAS has nearly completed an effort to redesign and enhance case quality measurement standards to address the changes in casework and processing that have occurred since TAS began operating in 2000. TAS leadership solicited all employees for recommendations about the future quality standards and conducted final focus group sessions in September 2008.

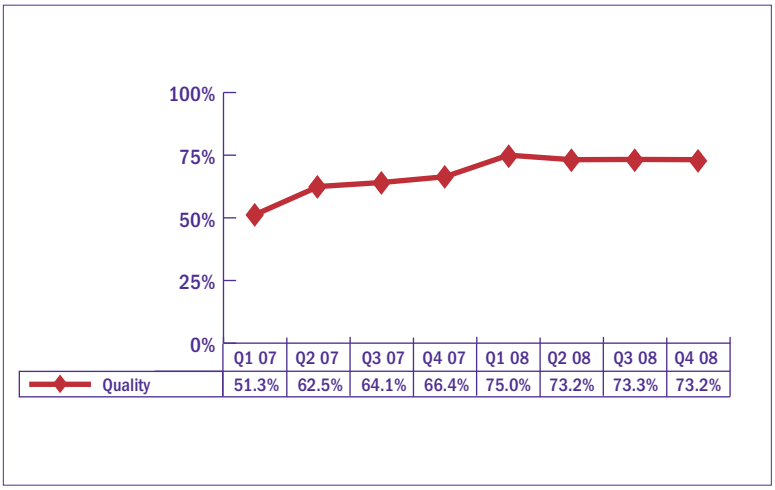
TAS will test the standards, develop a database, create an application guide, and brief employees on the standards in FY 2009. The new quality attributes should be fully implemented in FY 2010.

TAS Systemic Advocacy Product Quality

In October 2006, TAS began evaluating the quality of Systemic Advocacy products through monthly assessments of timeliness, accuracy, and communication components. As shown in Chart 4.32 below, the cumulative quality rate for Systemic Advocacy increased significantly during FY 2008 as compared to FY 2007, its baseline year.[100]

[100] TAS, *Systemic Advocacy Quality Review* (Nov. 25, 2008).

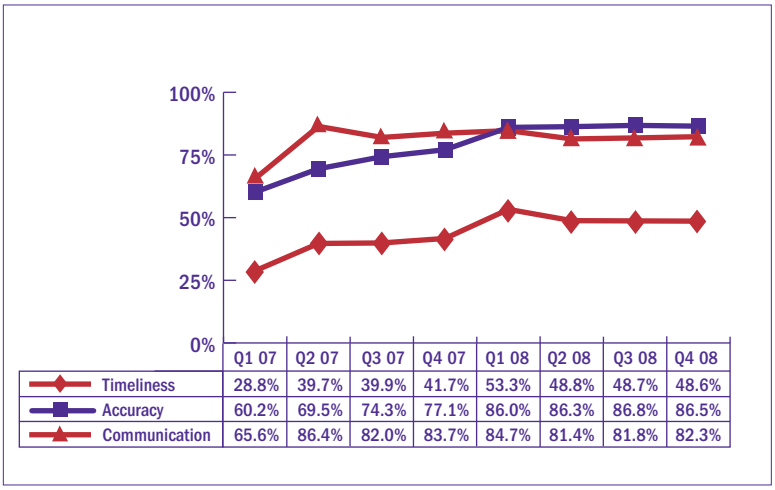
CHART 4.32, Systemic Advocacy Cumulative Product Quality by Quarter, FY 2007 – 2008



	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08
Quality	51.3%	62.5%	64.1%	66.4%	75.0%	73.2%	73.3%	73.2%

The quality rate for each of the three broad components of timeliness, accuracy, and communication within Systemic Advocacy has improved significantly since the review began in October 2006, as shown in Chart 4.33 below.

CHART 4.33, Systemic Advocacy Cumulative Quality Rate by Category, FY 2007 – 2008



	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08
Timeliness	28.8%	39.7%	39.9%	41.7%	53.3%	48.8%	48.7%	48.6%
Accuracy	60.2%	69.5%	74.3%	77.1%	86.0%	86.3%	86.8%	86.5%
Communication	65.6%	86.4%	82.0%	83.7%	84.7%	81.4%	81.8%	82.3%

A close alliance between Systemic Advocacy management and the Quality staff, as well as managerial review and involvement in processing Systemic Advocacy work, led to the improvement in FY 2008.

Appendix One

Top 25 Case Advocacy Issues for FY 2008 by TAMIS* Receipts

Issue Code	Description	FY 2008
330	Processing Amended Returns	21,963
71X	Levies	17,082
090	Other Refund Inquiries/Issues	14,817
340	Injured Spouse Claim	14,238
63X-640	Earned Income Tax Credit (EITC)	13,489
620	Reconsideration of Substitute for Return under IRC § 6020(b) and Audits	12,419
020	Expedite Refund Request	11,376
95X	Criminal Investigation	10,152
310	Processing Original Return	10,021
670	Closed Automated Underreporter	9,594
610	Open Audit	9,232
675-677	CAWR/FUTA	8,928
425	Stolen Identity	7,147
060	IRS Offset	6,461
75X	Installment Agreements	5,969
790	Other Collection Issues	5,598
210	Missing/Incorrect Payments	4,859
72X	Liens	4,794
660	Open Automated Underreporter	4,575
520	FTF/FTP Penalties	4,573
390	Other Document Processing Issues	4,511
040	Returned/Stopped Refunds	4,412
150	Copies of Returns/Administrative Files/Examination Reports	3,872
010	Lost or Stolen Refunds	3,775
540	Civil Penalties Other Than TFRP	3,773
Total: Top 25 Cases		**217,630**
Total: All FY 2008 TAS Cases		**274,051**

*Taxpayer Advocate Management Information System.

Portfolio Advisor Assignments

Issue Name	Portfolio Owner	Location	Phone Number
Military Issues	Douts, K	AK	907-271-6297
Carryback/Carryforward Claims	Hawkins, D	AL	205-912-5634
Levy [Hardship determination linked to release of levy]	Wilde, B	AR	501-396-5820
Mixed and Scrambled TINs	Murphy, M	AZ	602-207-8074
Tax Forums	Sawyer, M	CA-FSC	559-442-6419
Practitioner Priority Services	Curran, D	CA-LA	213-576-3016
DFO*	Tam, J	CA-OAK	510-637-3068
Tax Forums	Adams, C	CA-LAG	949-389-4790
CSEDs	Sherwood, T	CO	303-603-4601
Interest Computations: Abatement of Interest	Romano, F	CT	860-756-4550
Appeals: Nondocketed Inventory, ADR, CDP	Leith, J	DC-LTA	202-874-0766
Employment Tax Policy	Garvin, W	DE	302-286-1545
Examination Strategy	Revel-Addis, B	FL-JAX	904-665-0523
Multilingual Initiative/Outreach to ESL TPs	Puig, J	FL-FTL	954-423-7676
Audit Reconsiderations	Carey, W	GA-ATC	770-936-4543
DFO	Browne, R	GA-ATL	404-338-8085
US Territories and Possessions	James, G	HI	808-539-2855
Withholding Compliance	DeTimmerman, T	IA	515-564-6880
Innocent Spouse Relief: IRC § 6015	Knowles, J	ID	208-387-2827 x 272
EITC Compliance	Taylor, S	IL-CHI	312-566-3801
DFO	Adams, M	KS	316-352-7505
Office of Professional Responsibility	Juarez, V	IL-SPR	217-862-6348
Centralized Lien Filing and Releases	Diehl, J	KY-CSC	859-669-4013
Excise Tax	Diehl, J	KY-CSC	859-669-4013
EITC: Outreach, Education, Financial Literacy low income	Campbell, D	KY-LOU	502-572-2201 313-628-3670
LITC	Lewis, C	LA	504-558-3468
DFO	Fallacaro, B	MA-BOS	617-316-2692
Failure to Deposit Penalty	Seeley, S	MA-ANC	978-474-9560
Private Debt Collection	Votta, P	MD	410-962-9065
Automated Underreporter	Boucher, D	ME	207-622-8577
ITIN Outreach	Blount, P	MI	313-628-3664
Nonfiler Strategy (SFR)	Warren, J	MN	651-312-4371
Economic Stimulus Package	Mings, L	MO-KCC	816-291-9001
Electronic Tax Administration (ETA)	Guinn, P	MO-STL	317-685-7799
DFO	Thompson, T	MT	406-441-1044
Disaster Response and Recovery	Washington, J	MS	601-292-4810
Notice Clarity	Juncewicz, T	NC	336-378-2141

*Designated Federal Official. The DFO is an individual designated for each advisory committee of the Taxpayer Advocacy Panel (TAP). The DFO serves as the Treasury's agent for all matters related to the committee's activities.

Appendix Two

Issue Name	Portfolio Owner	Location	Phone Number
Amended Returns/Claims	Foard, L	ND	701-239-5400 x 234
IRS Training on Taxpayers Rights	Hickey, M	NE	401-221-7420
Federal Payment Levy Program & Communications	Simmons, M	NH	603-433-0753
Federal Tax Liens including Lien Release, Lien Withdrawal, Lien Subordination, Lien Discharge	Lauterbach, L	NJ	973-921-4376
TAS Confidentiality/IRC 6103	Rolon, J	NM	505-837-5522
Tip Reporting	Grant, D	NV	702-868-5180
Preparer Penalties	Greene, S	NY-ALB	518-427-5412
Front-line Readiness	Kitson, A	NY-BLY	718-488-3501
Identity Theft	Fuentes, B	NY-BSC	631-654-6687
Indian Tribal Government Issues	Wirth, B	NY-BUF	716-686-4850
Allowable Living Expenses	Spisak, J	NY-MAN	212-436-1010
Processing: Documents/Payments	Davis, S	OH-CLE	216-522-8241
Tax Exempt Entities: EO Applications & Determinations	Esrig, B	OH-CIN	513-263-3249
Seizure and Sale - Foreclosures on Equity	Hensley, D	OK	405--297-4139
Penalties (e.g., Failure to Pay, Abatements, Adjustments, and Estimated Tax)	Keating, J	OR	503-326-7816
DFO	Lombardo, L	PA-PHIL	215-861-1237
Bankruptcy Processing Issues	Mettlen, A	PA-PITT	412-395-6423
Correspondence Exam	Blinn, F	PA-PSC	215-516-2525
International Taxpayers	Vargas, C	PR	787-522-8950
Accessing Taxpayer Files	Benedetti, E	RI	401-528-1916
Returned/Stopped Refunds	Owens, S	SC	803-765-5300
Cancellation of Debt	Mings, L	MO-KCC	816-291-9001
EO Education and Outreach	Finnesand, M	SD	605-377-1596
Automated Substitute for Return (ASFR)	Wess, D	TN-MSC	901-395-1700
Criminal Investigation Freezes	Wess, D	TN-MSC	901-395-1700
DFO	Martin, B	TN-NVL	615-250-6015
ITIN Processing	Caballero, A	TX-AUC	512-460-4652
Automated Collection System (ACS)	McDermitt, M	TX-AUS	512-499-5970
Installment Agreements: Processing	Sanders, W	TX-DAL	214-413-6520
OIC (Field, ETA, COIC)	Sonnack, B	TX-HOU	713-209-4801
CAWR/FUTA	Polson, R	UT-OSC	801-620-3000
Transcript Delivery System	Cooper-Aguilar, S	UT-SLC	801-799-6962
Trust Fund Recovery Penalty	Campbell, M	VA	804-916-3500
Communications Liaison Group	Campbell, Finnesand, Hickey, James, Martin, Sawyer, Simmons, Washington	VA, SD, IA, HI, SC, CA, NH, MS	
Taxpayer Assistance Centers (TACs)	Fett, B	VT	802-859-1056
Alternative Minimum Tax (AMT)	McDonnel, T	WA	206-220-5704
E-Services	McQuin, S	WI	414-231-2391
Injured Spouse	Post, T	WV	304-420-8695
CADE	Logan, A	WY	307-633-0881

Table 1 Gross Income Under IRC § 61 and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (But Not Sole Proprietorships)			
Albert v. Comm'r, T.C. Summ. Op. 2007-162	Unreported gambling income	No	IRS
Amarasinghe v. Comm'r, T.C. Memo. 2007-333, *aff'd by* 101 A.F.T.R.2d (RIA) 2661 (4th Cir. 2008)	TP (ex-husband) withdrew pension funds to settle alimony and child support obligations and did not report the entire amount as income. TP (ex-wife) reported entire alimony payment as income	Yes	Split
Arberg v. Comm'r, T.C. Memo. 2007-244	Unreported capital gains income	No	IRS
Arias v. Comm'r, T.C. Summ. Op. 2007-189	Unreported distribution from trust	Yes	IRS
Atkin v. Comm'r, T.C. Memo. 2008-93	Unreported distribution from retirement account	Yes	IRS
Ballmer v. Comm'r, T.C. Memo. 2007-295	Settlement proceeds under IRC 104(a)(2)	No	IRS
Barber v. Comm'r, T.C. Memo. 2007-338	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Barber v. Comm'r, T.C. Memo. 2007-344	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Barrett v. Comm'r, 100 A.F.T.R.2d (RIA) 6934 (W.D. Okla. 2007), *appeal docketed* No. 08-6017 (Feb. 1, 2008)	Income earned from Native American Tribe	No	IRS
Benavides v. U.S., 497 F.3d 526 (5th Cir. 2007), *aff'g* 97 A.F.T.R.2d (RIA) 1512 (S.D. Tex. 2006), *petition for reh'g denied* (Sept. 14, 2007)	Settlement proceeds under IRC 104(a)(2)	No	IRS
Black v. Comm'r, T.C. Memo. 2007-364	Unreported items of income	Yes	IRS
Boggs v. Comm'r, T.C. Memo. 2008-81	Unreported income	Yes	IRS
Boone v. Comm'r, T.C. Memo. 2007-214	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Booth v. Comm'r, T.C. Memo. 2007-253	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Brown v. Comm'r, T.C. Summ. Op. 2007-166	Unreported income earned in Antarctica excludible under IRC 911	Yes	IRS
Burns v. Comm'r, T.C. Memo. 2007-271, *appeal docketed*, No. 08-70394 (9th Cir. Jan. 16, 2008)	Unreported reward income	No	IRS
Burton v. Comm'r, T.C. Memo. 2007-274	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Burton v. Comm'r, T.C. Memo. 2007-285	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Bussell v. Comm'r, 262 Fed. Appx. 770 (9th Cir. 2007), *aff'g* T.C. Memo. 2005-77, *petition for panel reh'g and reh'g en banc denied* (Apr. 7, 2008)	Unreported dividend income	Yes	IRS
Byers v. Comm'r, T.C. Memo. 2007-331, *appeal docketed*, No. 08-2016 (8th Cir. Apr. 28, 2008)	Unreported wage income	Yes	IRS
Cabirac v. Comm'r, T.C. Memo. 2008-142	Unreported wage income and retirement plan income	Yes	IRS
Callahan v. Comm'r, T.C. Memo. 2007-301, *appeal docketed* (7th Cir. Aug. 11, 2008), *motion to vacate or revise decision denied* (May 9, 2008)	Unreported compensation for services, dividend income, and interest income	Yes	IRS
Cameron v. Comm'r, T.C. Memo. 2007-260	Unreported items of income	Yes	IRS
Cephers v. Comm'r, T.C. Memo. 2008-57	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Charpentier v. Comm'r, T.C. Memo. 2007-314	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Clark v. Comm'r, T.C. Memo. 2007-172	Unreported income	Yes	Split
Clark v. Comm'r, T.C. Memo. 2008-71	Unreported income earned in international waters under IRC 911	No	IRS
Conner v. Comm'r, T.C. Summ. Op. 2007-131	Unreported wage income and capital gains income	Yes	IRS

Appendix Three

Table 1: Gross Income Under IRC § 61 and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Connors v. Comm'r, 101 A.F.T.R.2d (RIA) 2230 (2d Cir. 2008), *aff'g* T.C. Memo. 2006-239	Disability benefits under IRC 104(a)(3) and 105(a)	No	IRS
Cooper v. Comm'r, T.C. Memo. 2007-215	Unreported income earned in Antarctica excludible under IRC 911.	No	IRS
Cotler v. Comm'r, T.C. Memo. 2007-283	Disability benefits under IRC 104(a)(3)	No	TP
Cotten v. Comm'r, T.C. Memo. 2007-275	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Davis v. Comm'r, T.C. Memo. 2007-280	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Dietsche v. Comm'r, T.C. Memo. 2007-250	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Dietsche v. Comm'r, T.C. Memo. 2007-248	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Diller v. Comm'r, T.C. Summ. Op. 2007-146	Settlement proceeds under IRC 104(a)(2)	Yes	IRS
Dominguez v. Comm'r, T.C. Memo. 2007-230	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Drake v. Comm'r, T.C. Memo. 2007-279	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Drake v. Comm'r, T.C. Memo. 2007-287	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Dunkin, Comm'r v., 500 F.3d 1065 (9th Cir. 2007), *rev'g* 124 T.C. 180 (2005)	Unreported pension income	Yes	IRS
Dunne v. Comm'r, T.C. Memo. 2007-229	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Dyer v. Comm'r, T.C. Summ. Op. 2008-23	Unreported insurance income	Yes	TP
Eckersley v. Comm'r, T.C. Memo. 2007-282, *appeal docketed* No. 08-70934 (9th Cir. Feb. 25, 2008)	Unreported settlement income	No	IRS
Edwards v. Comm'r, T.C. Summ. Op. 2007-193	Unreported wage income, dividend income, and retirement plan distribution income	Yes	IRS
Elliott v. Comm'r, T.C. Memo. 2007-321	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Everett v. Comm'r, T.C. Memo. 2007-252	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Fabre v. Comm'r, T.C. Memo. 2007-319	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Gagliardi v. Comm'r, T.C. Memo. 2008-10	Unreported gambling income	No	TP
Garner v. Comm'r, T.C. Memo. 2007-231	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Giammatteo v. Comm'r, T.C. Memo. 2007-307	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Gibson v. Comm'r, T.C. Memo. 2007-224	Settlement proceeds under IRC 104(a)(2)	No	IRS
Gober v. Comm'r, T.C. Memo. 2008-110	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Gomez v. Comm'r, T.C. Memo. 2008-76	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Grant v. Comm'r, T.C. Memo. 2007-318	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Gravelle v. Comm'r, T.C. Memo. 2007-196	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Green v. Comm'r, 507 F.3d 857 (5th Cir. 2007), *aff'g* T.C. Memo. 2005-250, *petition for reh'g denied* (Jan. 10, 2008)	Settlement proceeds under IRC 104(a)(2)	No	IRS
Green v. Comm'r, T.C. Memo. 2007-217, *motion to vacate decision denied* (Oct. 25, 2007)	Unreported Social Security income	Yes	IRS
Green v. Comm'r, T.C. Memo. 2007-262	Unreported income	Yes	IRS
Green v. Comm'r, T.C. Memo. 2008-130	Disability benefits under IRC 104(a) and 105(a)	No	IRS
Hahn v. Comm'r, T.C. Memo. 2008-47	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Halliburton v. Comm'r, T.C. Summ. Op. 2007-203	Unreported settlement income and distribution from retirement plan	Yes	IRS
Hamann v. Comm'r, T.C. Memo. 2007-246	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Hardwick v. Comm'r, T.C. Memo. 2007-359	Unreported gambling income	No	IRS
Harper v. Comm'r, T.C. Summ. Op. 2007-133	Unreported non-employee compensation and cancellation of indebtedness income	Yes	IRS
Hawkins v. Comm'r, T.C. Memo. 2007-286, *appeal docketed* No. 07-74384 (Nov. 13, 2007)	Settlement proceeds under IRC 104(a)(2)	Yes	IRS

Table 1: Gross Income Under IRC § 61 and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Hicks v. Comm'r, T.C. Memo. 2007-197	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Hightower v. Comm'r, 266 Fed. Appx. 646 (9th Cir. 2008), *aff'g* T.C. Memo. 2005-274, *petition for reh'g en banc denied* (Apr. 28, 2008)	Unreported income from stock buyout	Yes	IRS
Hinson v. Comm'r, T.C. Summ. Op. 2007-92	Unreported income	Yes	IRS
Howard v. Comm'r, T.C. Memo. 2007-313	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Hulse v. Comm'r, T.C. Memo. 2007-186	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Ito v. Comm'r, T.C. Summ. Op. 2008-37	Unreported tip income	Yes	IRS
Jackson v. Comm'r, T.C. Memo. 2007-373	Unreported gambling income	Yes	IRS
Joss v. Comm'r, T.C. Memo. 2007-255	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Joubert v. Comm'r, T.C. Memo. 2007-292	Unreported pension income and unreported Social Security income	Yes	IRS
Kanofsky v. Comm'r, 101 A.F.T.R.2d (RIA) 1501 (3rd Cir. 2008), *aff'g* T.C. Memo. 2006-79, *petition for reh'g en banc denied* (June 4, 2008)	Unreported income	Yes	IRS
Keith v. Comm'r, T.C. Summ. Op. 2007-214	Cancellation of debt income insolvency under IRC 108(a)(1)(B)	No	Split
Kemper v. Comm'r, T.C. Memo. 2007-353	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Key v. Comm'r, T.C. Memo. 2007-190	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Kopty v. Comm'r, T.C. Memo. 2007-343, *appeal docketed* No. 08-1171 (D.C. Cir. Apr. 24, 2008)	Unreported distribution from retirement account	Yes	IRS
Kosinski v. Comm'r, T.C. Memo. 2007-173, *aff'd* by U.S. App. LEXIS 18617 (6th Cir. 2008)	Unreported flow-through income	No	IRS
Kosinski v. Comm'r, U.S. App. LEXIS 18617 (6th Cir. 2008), *aff'g* T.C. Memo. 2007-173	Unreported flow-through income	No	IRS
Kunze v. Comm'r, T.C. Memo. 2007-179	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Langroudi v. Comm'r, T.C. Summ. Op. 2007-156	Income exempt under Belgian tax treaty	Yes	IRS
Larsen v. Comm'r, T.C. Memo. 2008-73	Unreported employee compensation	No	IRS
Lemke v. Comm'r, T.C. Memo. 2008-19	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Lemon v. Comm'r, T.C. Memo. 2007-345	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Lemon v. Comm'r, T.C. Memo. 2008-107	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Lynch v. Comm'r, T.C. Memo. 2008-97	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Macala v. Comm'r, T.C. Summ. Op. 2008-7	Unreported income earned in Antarctica excludible under IRC 911	Yes	IRS
MacMurray v. Comm'r, T.C. Summ. Op. 2007-118	Settlement proceeds under IRC 104(a)(2)	Yes	IRS
Mandeville v. Comm'r, T.C. Memo. 2007-332	Unreported wage income and capital gains income	Yes	IRS
Martin v. Comm'r, T.C. Memo. 2008-22	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
McCaffray v. Comm'r, T.C. Memo. 2008-49	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
McDonald v. Comm'r, T.C. Memo. 2007-358	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
McDonald v. Comm'r, T.C. Memo. 2008-11	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
McGowan v. Comm'r, T.C. Memo. 2008-125	Unreported wage income, non-employee compensation, rental income, and interest income	Yes	IRS
McPike v. Comm'r, T.C. Memo. 2008-12	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
McQuiston v. Comm'r, T.C. Memo. 2008-20	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Messina v. Comm'r, 232 Fed. Appx. 254 (4th Cir. 2007), *superseding* 219 Fed. Appx. 328 (4th Cir. 2007), *aff'g in part and vacating and remanding in part* T.C. Memo. 2006-107	Settlement proceeds	Yes	Split
Mezrah v. Comm'r, T.C. Memo. 2008-123	Unreported cancellation of indebtedness income	No	IRS

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Table 1: Gross Income Under IRC § 61 and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Michaelis v. Comm'r, T.C. Memo. 2008-77	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Miller v. Comm'r, T.C. Memo. 2008-51	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Mills v. Comm'r, T.C. Memo. 2007-270, *appeal docketed* No. 07-14812 (11th Cir. Oct. 9, 2007), *appeal dismissed* (Nov. 15, 2007), *appeal reinstated* (Dec. 3, 2007), *appeal dismissed* (Jan. 22, 2008)	Unreported non-employee compensation and interest income	Yes	IRS
Minor v. Comm'r, T.C. Memo. 2008-35	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Minor v. Comm'r, T.C. Memo. 2008-104	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Minton v. Comm'r, T.C. Memo. 2007-372, *appeal docketed* No. 08-60284 (5th Cir. Mar. 25, 2008)	Unreported ordinary shareholder income	No	IRS
Murphy v. IRS, 493 F.3d 170 (D.C. Cir. 2007), *rev'g* 460 F.3d 79 (D.C. Cir. 2006), *aff'g* 362 F. Supp. 2d 206 (D.D.C. 2005), *vacated* 99 A.F.T.R.2d (RIA) 396 (D.C. Cir. 2006), *reh'g en banc denied* 100 A.F.T.R.2d (RIA) 6049 (D.C. Cir. 2007), *cert. denied*, 128 S. Ct. 2050 (Apr. 21, 2008)	Settlement proceeds under IRC 104(a)(2)	No	IRS
Naber v. Comm'r, T.C. Memo. 2008-23	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Nevins v. Comm'r, T.C. Memo. 2007-187	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Newcomb v. Comm'r, T.C. Memo. 2007-245	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Nordquist v. Comm'r, T.C. Memo. 2008-52	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Nossaman v. Comm'r, T.C. Memo. 2008-106	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Nossaman v. Comm'r, T.C. Memo. 2008-42	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Novitsky v. Comm'r, T.C. Memo. 2007-257	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Odelugo v. Comm'r, T.C. Memo. 2008-92	Unreported non-employee compensation income, interest income, and retirement plan distribution income	No	Split
Osborne v. Comm'r, T.C. Memo. 2008-40	Unreported income	Yes	IRS
Owens v. Comm'r, T.C. Memo. 2007-357	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Patrick v. Comm'r, T.C. Summ. Op. 2008-17	Unreported gambling income	Yes	IRS
Payne v. Comm'r, T.C. Memo. 2008-66, *appeal docketed* No. 08-2396 (8th Cir. June 17, 2008)	Unreported cancellation of indebtedness income	Yes	IRS
Perano v. Comm'r, 130 T.C. No. 8, 2008 WL 1968807 (U.S. Tax Ct.), Tax Ct. Rep. Dec. (RIA) 130.8	Unreported controlled foreign corporation income	No	IRS
Pettit v. Comm'r, T.C. Memo. 2008-87	Settlement proceeds under IRC 104(a)(2)	No	IRS
Phelps v. Comm'r, T.C. Memo. 2008-86	Settlement proceeds under IRC 104(a)(2)	Yes	IRS
Phillips v. Comm'r, T.C. Memo. 2008-9	Unreported wage income and dividend income	Yes	IRS
Platt v. Comm'r, T.C. Memo. 2008-17	Payments under divorce decree were not excludible from ex-husband's income and not includible in ex-wife's income	No	Split
Polone v. Comm'r, 505 F.3d 966 (9th Cir. 2007), *withdrawing and superseding* 479 F.3d 1019 (9th Cir. 2007), 449 F.3d 1041 (9th Cir. 2006) *withdrawn and superseded*, *aff'g* T.C. Memo. 2003-339, *cert. denied*, 128 S. Ct. 1720 (Mar. 24, 2008)	Settlement proceeds under IRC 104(a)(2)	No	IRS
Popper v. Comm'r, T.C. Summ. Op. 2007-115	Unreported income	Yes	IRS
Prentiss v. Comm'r, T.C. Memo. 2007-308	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Proctor v. Comm'r, 129 T.C. 92 (2007), *appeal docketed* No. 08-12016 (11th Cir. Apr. 14, 2008), *appeal dismissed* (June 20, 2008)	Child support and alimony payments	Yes	Split
Przewoznik v. Comm'r, T.C. Summ. Op. 2008-50	Alimony income	No	IRS
Raga v. Comm'r, T.C. Summ. Op. 2008-46	Unreported alimony income	No	IRS

Table 1: Gross Income Under IRC § 61 and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Randall v. Comm'r, 100 A.F.T.R.2d (RIA) 6946 (10th Cir. 2007), *aff'g* T.C. Memo. 2007-1	Unreported non-employee compensation	Yes	IRS
Randall v. Comm'r, T.C. Memo. 2008-138	Unreported non-employee compensation	Yes	IRS
Ranson v. Comm'r, T.C. Memo. 2007-329	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Reeves v. Comm'r, T.C. Memo. 2007-273	Unreported constructive dividends	Yes	TP
Richards v. Comm'r, 101 A.F.T.R.2d (RIA) 1637 (10th Cir. 2008)	Unreported wage income	Yes	IRS
Richardson v. Comm'r, 509 F.3d 736 (6th Cir. 2007) *aff'g* T.C. Memo. 2006-69, *petition for rehearing by panel denied* 2008 U.S. App. LEXIS 2944 (Feb. 4, 2008)	Unreported income	No	IRS
Rhodes v. Comm'r, T.C. Memo. 2007-206, *appeal docketed* No. 08-60093 (5th Cir. Jan. 22, 2008), *appeal dismissed* (Apr. 15, 2008)	Unreported wage income, capital gains income, and distribution from retirement plan	Yes	IRS
Robinson v. Comm'r, T.C. Memo. 2007-212	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Rogers v. Comm'r, T.C. Memo. 2008-32	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Rogers v. Comm'r, T.C. Memo. 2008-98	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Role v. Comm'r, T.C. Memo. 2007-356	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Rue v. Comm'r, T.C. Memo. 2007-228	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Runels v. Comm'r, T.C. Summ. Op. 2008-10	Unreported self-employment income, unreported dividend income, and unreported capital gains income	Yes	IRS
Rusten v. Comm'r, T.C. Summ. Op. 2008-16	Unreported self-employment income earned in Canada	Yes	IRS
Savage v. Comm'r, T.C. Memo. 2007-288	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Schneider v. Comm'r, T.C. Memo. 2007-213	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Schoolcraft-Burkey v. Comm'r, T.C. Summ. Op. 2007-126	Settlement proceeds under IRC 104(a)(2)	Yes	IRS
Seaman v. Comm'r, T.C. Memo. 2007-189	Unreported interest income and retirement plan distributions	Yes	IRS
Self v. Comm'r, T.C. Memo. 2007-199	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Seman v. Comm'r, T.C. Memo. 2007-352	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Shaw v. Comm'r, T.C. Memo. 2007-195	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Sheid v. Comm'r, T.C. Memo. 2007-198	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Smith v. Comm'r, T.C. Summ. Op. 2007-106	Settlement proceeds under IRC 104(a)(2)	Yes	IRS
Smith v. Comm'r, T.C. Memo. 2007-267	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Snyder v. Comm'r, T.C. Memo. 2007-232	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Stevens v. Comm'r, T.C. Memo. 2007-322	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Stevens v. Comm'r, T.C. Memo. 2007-251	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Stevens v. Comm'r, T.C. Memo. 2007-330	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Stone v. Comm'r, T.C. Memo. 2007-216	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Straus v. Comm'r, T.C. Summ. Op. 2007-107	Unreported interest income and cash withdrawal from life insurance policy	Yes	IRS
Sundin v. Comm'r, T.C. Memo. 2007-185	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Sundin v. Comm'r, T.C. Memo. 2007-191	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Swanson v. Comm'r, T.C. Memo. 2007-337	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Talmage v. Comm'r, T.C. Memo. 2008-34, *appeal docketed* No. 08-73152 (9th Cir. July 14, 2008)	Unreported income, unreported capital gains income, unreported foreign earned income	No	Split
Tateosian v. Comm'r, T.C. Memo. 2008-101	Disability benefits under IRC 104(a)(1)	No	IRS
Teske v. Comm'r, T.C. Memo. 2007-268	Unreported income earned in Antarctica excludible under IRC 911	No	IRS

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Table 1: Gross Income Under IRC § 61 and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Teske v. Comm'r, T.C. Memo. 2007-258	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Teske v. Comm'r, T.C. Memo. 2007-284	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Teuscher v. Comm'r, T.C. Memo. 2007-247	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Theurer v. Comm'r, T.C. Memo. 2008-61, *appeal docketed* No. 08-71699 (9th Cir. Apr. 11, 2008)	Unreported alimony income	No	IRS
Thomas v. Comm'r, T.C. Summ. Op. 2007-110	Disability benefits includible under IRC 105	Yes	IRS
Thompson v. Comm'r, T.C. Memo. 2007-327, *appeal docketed* No. 07-3917 (8th Cir. Dec. 10, 2007)	Unreported distribution from retirement account	Yes	IRS
Thompson v. Comm'r, T.C. Memo. 2008-31	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Tudor v. Comm'r, T.C. Memo. 2007-256	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Vaitonis v. Comm'r, T.C. Memo. 2007-290	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Vogt v. Comm'r, T.C. Memo. 2007-209, *appeal docketed* No. 08-71133 (9th Cir. Mar. 12, 2008)	Unreported partnership distribution income, Social Security income, dividend income, wage income, distribution from retirement plan, non-employee compensation, capital gains income, and other income	Yes	IRS
Ward v. Comm'r, T.C. Summ. Op. 2007-144	Unreported wage income	Yes	IRS
Wargo v. Comm'r, T.C. Memo. 2008-50	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Watson v. Comm'r, T.C. Memo. 2007-146, *aff'd* by 101 A.F.T.R.2d (RIA) 2109 (5th Cir. 2008)	Unreported compensation for services, social security income, retirement plan distribution, and interest income	Yes	Split
Watson v. Comm'r, 101 A.F.T.R.2d (RIA) 2109 (5th Cir. 2008), *aff'g* T.C. Memo. 2007-146	Unreported pension income and unreported compensation for services	Yes	IRS
Weiss v. Comm'r, 129 T.C. 175 (2007)	Unreported dividend income	Yes	IRS
Wheeler v. Comm'r, 521 F.3d 1289 (10th Cir. 2008), *aff'g* 127 T.C. 200 (2006)	Unreported income	Yes	IRS
White v. Comm'r, T.C. Memo. 2008-53	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Winslow v. Comm'r, T.C. Memo. 2008-43	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Wipperfurth v. Comm'r, T.C. Memo. 2007-259	Unreported wage income, interest income, dividend income, and disability income	Yes	IRS
Womack v. Comm'r, 510 F.3d 1295 (11th Cir. 2007), *aff'g* T.C. Memo. 2006-240	Unreported lottery winnings	No	IRS
Wright, Estate of, v. Comm'r, T.C. Memo. 2007-278	Settlement proceeds under IRC 104(a)(2)	No	Split
Yamasaki v. Comm'r, T.C. Memo. 2008-7	Unreported income earned in Antarctica excludible under IRC 911	Yes	IRS
Young v. Comm'r, T.C. Memo. 2008-48	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Young v. Comm'r, T.C. Memo. 2008-108	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Zimmerman v. Comm'r, T.C. Memo. 2008-36	Unreported income earned in Antarctica excludible under IRC 911	No	IRS
Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)			
Bigler v. Comm'r, T.C. Memo. 2008-133	S Corporation must include full amount of income earned at the time earned regardless of future credits to customers on returned items	No	IRS
Cargill v. Comm'r, 101 A.F.T.R.2d (RIA) 1528 (11th Cir. 2008), petition for reh'g denied (June 4, 2008)	Unreported income	Yes	IRS
Deangelis, et al., v. Comm'r, T.C. Memo. 2007-360, *appeal docketed* No. 08-1143 (2nd Cir. Mar. 3, 2008), *appeal withdrawn without prejudice* (2d Cir. June 13, 2008)	Unreported income	No	TP
Ellis v. Comm'r, T.C. Memo. 2007-207, *appeal docketed* (10th Cir. Dec. 26, 2007)	Unreported income	No	IRS

Table 1: Gross Income Under IRC § 61 and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Haney v. Comm'r, T.C. Memo. 2007-238	Unreported business income	No	IRS
Industrial Elec. and Instrumentation, Inc. v. Comm'r, T.C. Memo. 2008-84 (no docket available as of Sept. 12, 2008)	Unreported income	No	IRS
Karns Prime & Fancy Food, Ltd. v. Comm'r, 494 F.3d 404 (3rd Cir. 2007), *aff'g* T.C. Memo. 2005-233	Unreported income	No	IRS
King v. Comm'r, 252 Fed. Appx. 951 (11th Cir. 2007) *aff'g* T.C. Memo. 2006-112	Unreported income	No	IRS
Lai v. Comm'r, T.C. Memo. 2007-165	Unreported cash income	No	Split
LeBloch v. Comm'r, T.C. Memo. 2007-145, *appeal docketed* No. 07-74364 (9th Cir. Oct. 26, 2007)	Unreported income	Yes	Split
McCammon v. Comm'r, T.C. Memo. 2008-114, *appeal docketed* No. 08-1638 (4th Cir. May 29, 2008), *appeal dismissed* (4th Cir. Aug. 1, 2008)	Unreported interest income, dividend income, and wage income	Yes	IRS
Monk v. Comm'r, T.C. Memo. 2008-64	Unreported business income	No	TP
Negret v. Comm'r, T.C. Summ. Op. 2008-26	Unreported Schedule C income	Yes	IRS
Sparkman v. Comm'r, 509 F.3d 1149 (9th Cir. 2007), *aff'g* T.C. Memo. 2005-136	Unreported income	No	IRS

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Table 2 Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

Case Citation	Lien or Levy	Issue	*Pro Se*	Decision
Individual Taxpayers				
Adams v. IRS, 2008 WL 769059 (E.D. La.)	Levy	TP must request CDP hearing to obtain relief	No	IRS
Amtower v. Comm'r, T.C. Memo. 2008-88	Levy	Inability to challenge underlying tax liability	No	IRS
Anderson v. Comm'r, T.C. Memo. 2007-265	Levy	Frivolous issues; Inability to challenge underlying tax liability; IRC 6673 penalty threatened	Yes	IRS
Arbogast v. Comm'r, 100 A.F.T.R.2d (RIA) 5005 (E.D. Pa. 2007)	Levy	Inability to challenge underlying tax liability	Yes	IRS
Ashlock v. Comm'r, T.C. Memo. 2008-58	Lien	Property awarded in divorce deemed "dissipated" property	No	IRS
Awlachew v. Comm'r, T.C. Memo. 2007-365	Lien	Inability to challenge underlying tax liability	Yes	IRS
Ballard v. Comm'r, T.C. Memo. 2007-159	Levy	No notice of deficiency sent	Yes	IRS
Balser v. Comm'r, T.C. Summ. Op. 2007-123	Levy	No right to claim abatement of underlying liability	No	IRS
Baltic v. Comm'r, 129 T.C. No. 19 (2007)	Both	Inability to challenge underlying tax liability	No	IRS
Barry v. US, 101 A.F.T.R.2d (RIA) 1460 (M.D. Fla. 2008), *motion denied* 2008 U.S. Dist. Lexis 41959 (M.D. Fla. 2008)	Levy	Frivolous issues; Taxpayer failed to raise non-frivolous challenges to his tax liability; Frivolous return penalty imposed by the IRS upheld	Yes	IRS
Bartley v. US, 100 A.F.T.R.2d (RIA) 5574, *cert. for interlocutory appeal denied* by 2008 U.S. Dist. Lexis 39153 (W.D.N.Y. 2008)	Levy	Inability to challenge underlying tax liability; Frivolous return penalty may be challenged	Yes	IRS
Bergevin v. Comm'r, T.C. Memo. 2008-6	Levy	Offer in compromise (OIC) rejection case	No	IRS
Black v. Comm'r, T.C. Summ. Op. 2007-188	Lien	Not entitled to removal of tax lien	Yes	IRS
Blosser v. Comm'r, T.C. Memo. 2007-323	Levy	IRS failure to consider issues raised at hearing	No	TP
Bond v. Comm'r, T.C. Memo. 2007-240	Both	Inability to challenge underlying tax liability	Yes	IRS
Bray v. Comm'r, T.C. Memo. 2008-113	Lien	Inability to challenge underlying tax liability and no abuse of discretion in upholding the notice of federal tax lien (NFTL)	No	IRS
Broderick v. Comm'r, T.C. Memo. 2008-2	Both	Inability to challenge underlying tax liability	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2008-3	Levy	Inability to challenge underlying tax liability	Yes	IRS
Bruce v. Comm'r, T.C. Memo. 2007-161	Lien	Inability to challenge underlying tax liability	No	IRS
Bussell v. Comm'r, 130 T.C. No. 13 (2008)	Lien	Tax liabilities not discharged in bankruptcy; Notice of determination was proper by the IRS	Yes	IRS
Butti v. Comm'r, T.C. Memo. 2008-82	Levy	IRS could not show that the original notice of determination was delivered	Yes	TP
Callahan v. Comm'r, 130 T.C. No. 3 (2008)	Levy	TPs (H&W) may challenge the frivolous position claim; no summary judgment	Yes	TPs (H&W)
Caple v. Comm'r, T.C. Summ. Op. 2007-206	Levy	Inability to challenge underlying tax liability; No abuse of discretion in rejecting OIC	Yes	IRS
Castleman v. Comm'r, T.C. Memo 2007-143	Lien	Inability to challenge underlying tax liability	Yes	IRS
Cherbanaeff v. Comm'r, 77 Fed. Cl. 490 (2007), *appeal dismissed* 2007 U.S. App. Lexis 26950 (Fed. Cir. Oct. 17, 2007)	Levy	Court lacks jurisdiction to review rejection of OIC	No	IRS
Coleman v. Comm'r, T.C. Memo. 2007-263	Both	Inability to challenge underlying tax liability	Yes	IRS
Connolly v. Comm'r, T.C. Memo. 2008-95	Levy	Frivolous Issue; TP failed to raise a legitimate challenge to underlying tax liability; IRC 6673 penalty imposed ($2,500)	Yes	IRS

Table 2: Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

Case Citation	Lien or Levy	Issue	*Pro Se*	Decision
Cotler v. Comm'r, T.C. Memo. 2007-283	Lien	Disability payments excludible from gross income under IRC 104(a)(3)	No	TP
Cox v. Comm'r, 514 F.3d 1119 (10th Cir. 2008) *overruling* T.C. No. 21733-03L and 14693-04L	Levy	IRS appeals officer not required to recuse him or herself unless he or she has previously made an official decision on a taxpayer's liability	No	IRS
Creamer v. Comm'r, T.C. Memo. 2007-266	Levy	Frivolous arguments; Inability to challenge underlying tax liability; IRC 6673 penalty imposed ($2,500)	Yes	IRS
Daniels v. U.S., 77 Fed. Cl. 251 (2007), *aff'd* by 2008 U.S. App. Lexis 5135 (Mar. 10, 2008)	Both	Court lacks subject matter jurisdiction	No	IRS
Davis v. Comm'r, T.C. Memo. 2007-160	Lien	Frivolous arguments; IRC 6673 penalty imposed ($2,000)	Yes	IRS
Davis v. Comm'r, T.C. Memo. 2007-201	Both	Frivolous issues; IRC 6673 penalty against TP ($7,500) and counsel ($25,800)	No	IRS
Deese, Estate of v. Comm'r, T.C. Memo. 2007-362	Lien	Inability to challenge underlying tax liability	No	IRS
DiCindio v. Comm'r, 265 Fed. Appx. 138 (3d Cir. 2008) *aff'g* in part T.C. Memo. 2007-77	Levy	Case remanded for years where no final notice of determination was sent; affirmed in all other respects	Yes	IRS
Diffee v. Comm'r, T.C. Memo. 2007-304	Levy	No abuse of discretion by appeals officer	No	IRS
D'Onofrio v. Comm'r, T.C. Memo. 2008-25	Levy	Frivolous issues; Inability to challenge underlying tax liability; TP refused delivery of notice of intent to levy; No discussion of IRC 6673 penalty	Yes	IRS
Downing v. Comm'r, T.C. Memo. 2007-291	Lien	Notice of intent to levy deemed invalid because they were not sent to correct address	No	TP
Drake v. Comm'r, 511 F.3d 65 (1st Cir. 2007) *aff'g* T.C. Memo. 2006-151	Levy	No settlement for OIC was reached	No	IRS
Eisler v. Comm'r, T.C. Summ. Op. 2007-171	Levy	Lack of jurisdiction; Wrong zip code insufficient to invalidate notice of intent to levy	Yes	IRS
Eliason v. U.S., 2008 U.S. Dist. Lexis 34976 (D.D.C.)	Levy	TP failed to show that he requested CDP hearing	Yes	IRS
Ellison v. Comm'r, 101 A.F.T.R.2d (RIA) 1661 (S.D. W. Va. 2008)	Levy	IRS levy during bankruptcy is automatically void	No	TP
Enax v. Comm'r, T.C. Memo. 2008-116	Levy	Frivolous issues; IRC 6673 penalty imposed ($2,500)	Yes	IRS
Fangonilo v. Comm'r, T.C. Memo. 2008-75	Levy	TP failed to submit acceptable OIC amount	No	IRS
Filipovich v. Comm'r, T.C. Summ. Op. 2008-58	Lien	Inability to challenge underlying tax liability	Yes	IRS
Foley v. Comm'r, T.C. Memo. 2007-242	Levy	Collection alternative not appropriate	No	IRS
Follum v. Comm'r, T.C. Memo. 2007-164, *aff'd* by 2008 U.S. App. Lexis 4507 (4th Cir. Mar. 3, 2008)	Lien	TP challenged underlying liability	Yes	IRS
Follum v. U.S., 100 A.F.T.R.2d (RIA) 5837 (E.D.N.C. 2007), *aff'd* by 2008 U.S. App. Lexis 4506 (4th Cir. 2008)	Both	Court lacks subject matter jurisdiction	Yes	IRS
Fransen v. Comm'r, T.C. Memo. 2007-237	Lien	Non filer; Inability to challenge underlying tax liability	Yes	IRS
Gardner v. Peters, 2008 U.S. App. Lexis 11656 (9th Cir. 2008), *aff'g* 2006 U.S. Dist. Lexis 51638 (D. Ariz. 2006)	Levy	Request for hearing denied; only equivalent hearing available	No	IRS
Gazi v. Comm'r, T.C. Memo. 2007-342	Levy	Inability to challenge underlying tax liability	No	IRS
Giamelli v. Comm'r, 129 T.C. No. 14 (2007)	Levy	Inability to challenge underlying tax liability because the issue was not properly raised during appeals hearing	No	IRS
Gillespie v. Comm'r, T.C. Memo. 2007-202, *aff'd* 2008 U.S. App. Lexis 19770 (7th Cir. 2008)	Levy	Frivolous issues; IRC 6673 penalty against TP ($15,000) and counsel ($12,798)	No	IRS
Ginsberg v. Comm'r, 130 T.C. No. 7 (2008)	Levy	Court lacked jurisdiction because it did not have jurisdiction over original notice of deficiency	No	IRS
Golub v. Comm'r, T.C. Memo 2008-122	Both	TP petition for review was submitted timely	Yes	TP

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Table 2: Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

Case Citation	Lien or Levy	Issue	*Pro Se*	Decision
Graham v. Comm'r, T.C. Memo 2008-129	Lien	TP failed to timely submit request for IRC 6330 hearing; IRS improperly denied TP request for hearing for later tax years	No	Split
Griffin v. Comm'r, T.C. Summ. Op. 2007-173	Both	TP waived right to challenge underlying tax liability	Yes	IRS
Grover v. Comm'r, T.C. Memo 2007-176	Levy	Late filed petition; court lacks jurisdiction to hear case	Yes	IRS
Gudenau v. Gonzalez, 100 A.F.T.R.2d (RIA) 6135 (D. Haw. 2007)	Levy	Frivolous issues; Court lacks subject matter jurisdiction; No discussion of penalty	Yes	IRS
Hallinan v. U.S., 498 F. Supp. 2d. 315 (D.D.C. 2007), *appeal dismissed* 2007 U.S. App. Lexis 28445 (D.C. Cir. Dec. 4, 2007)	Levy	Inability to challenge underlying tax liability	Yes	IRS
Hardie v. Comm'r, T.C. Memo. 2007-335	Levy	TP failed to show that appeals erred in determining liability	Yes	IRS
Haynes v. Comm'r, T.C. Summ. Op. 2007-160	Both	Inability to challenge underlying tax liability	Yes	IRS
Heitzman v. U.S., 100 A.F.T.R.2d (RIA) 6590 (W.D. Wash. 2007)	Levy	Frivolous issues; No Tax Court jurisdiction because of sovereign immunity; No discussion of IRC 6673 penalty	Yes	IRS
Hernandez v. Comm'r, 2008 U.S. App. Lexis 9948 (9th Cir. 2008), *aff'g* Tax Ct. No. 21228-05L	Levy	Inability to challenge underlying tax liability	Yes	IRS
Hess v. Comm'r, T.C. Summ. Op. 2008-9	Levy	Inability to challenge underlying tax liability	Yes	IRS
Hoffenberg v. Comm'r, T.C. Memo. 2008-139	Levy	Inability to challenge underlying tax liability; Frivolous return penalty	Yes	IRS
Hoffenberg v. U.S., 100 A.F.T.R.2d (RIA) 6489 (W.D. Tenn. 2007)	Levy	Frivolous issues; no abuse of discretion because notice and demand letter was sent to TP	Yes	IRS
Hollen v. Comm'r, T.C. Memo. 2007-235	Both	No abuse of discretion in issuing notices	Yes	IRS
Holloway v. Comm'r, T.C. Memo. 2007-175	Levy	No abuse of discretion in failing to consider former wife's innocent spouse determination	Yes	IRS
Hopkins v. Comm'r, T.C. Summ. Op. 2007-145	Lien	TP offered no new information to consider	Yes	IRS
Hovind v. Comm'r, 228 Fed. Appx. 966 (11th Cir. 2007), *aff'g* Tax Ct. No. 11894-05L	Levy	TP waived right to challenge underlying tax liability	No	IRS
Hult v. Comm'r, T.C. Memo. 2007-302	Lien	No abuse of discretion in rejecting installment agreement (IA); TP failed to offer challenge to federal tax lien	Yes	IRS
Imarah v. Comm'r, T.C. Memo. 2008-137	Lien	TP argued tax liability was discharged in bankruptcy; Appeals officer failed to consider the effect of bankruptcy	No	TP
Jones v. Comm'r, T.C. Memo. 2007-142	Levy	Inability to challenge underlying tax liability	No	IRS
Jumaa v. Comm'r, T.C. Memo. 2007-192	Levy	TP failed to challenge underlying tax liability	Yes	IRS
Kelby v. Comm'r, 130 T.C. No. 6 (2008)	Levy	Last supplemental notice covers all previous notices; no need for separate review	No	IRS
Kennedy v. Comm'r, T.C. Memo. 2008-33	Both	Notice not sent to proper address	Yes	TP
Kirch v. Comm'r, T.C. Memo. 2007-276	Levy	No mark to market election	Yes	IRS
Klein v. Comm'r, T.C. Memo. 2007-325	Levy	No abuse of discretion in OIC rejection	No	IRS
Kohler v. Comm'r, T.C. Memo. 2008-127	Levy	TP failed to show that return was timely filed	Yes	IRS
Kradman v. Comm'r, T.C. Memo. 2008-132	Lien	Reliance on failure to pay current taxes to reject OIC not an abuse of discretion	Yes	IRS
Kuykendall v. Comm'r, 129 T.C. No. 9 (2007)	Levy	12 days not sufficient time to file tax court petition; TPs can challenge underlying tax liability	Yes	TPs (H&W)
Leahy v. Comm'r, 129 T.C. No. 8 (2007)	Levy	Case not eligible to continue under IRC 7463	Yes	IRS
Limor v. Comm'r, T.C. Summ. Op. 2007-177	Levy	Inability to challenge underlying tax liability	Yes	IRS
Lloyd v. Comm'r, T.C. Memo. 2008-15	Levy	No abuse of discretion in using three -year period to determine income potential	No	IRS

Table 2: Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

Case Citation	Lien or Levy	Issue	*Pro Se*	Decision
Long v. Comm'r, T.C. Memo. 2008-1	Both	Frivolous issues; IRC 6673 penalty denied; TP willfully failed to comply with court rules; Case dismissed for failure to prosecute	Yes	IRS
Mahoney v. Comm'r, T.C. Memo. 2007-233	Levy	TP failed to challenge collection action	No	IRS
Malan v. Comm'r, 261 Fed. Appx 117 (10th Cir. 2008), *aff'g* Tax Ct. No. 23642-06L	Levy	Frivolous issues; IRC 6673 penalty imposed ($2,000)	Yes	IRS
Manousos v. Comm'r, T.C. Summ. Op. 2007-159	Levy	Inability to challenge underlying tax liability: no evidence TP did not receive original notice of deficiency	Yes	IRS
Marshall v. U.S., 100 A.F.T.R.2d (RIA) 6622 (M.D. Fla. 2007)	Levy	Inability to challenge underlying tax liability	No	IRS
McClure v. Comm'r, T.C. Memo. 2008-136	Lien	Inability to challenge underlying tax liability	Yes	IRS
McFarland v. Comm'r, T.C. Summ. Op. 2008-59	Levy	Frivolous issues; Inability to challenge underlying tax liability; IRC 6673 penalty imposed ($3,500)	Yes	IRS
McGowan v. Comm'r, T.C. Memo. 2008-125	Levy	Frivolous issues; inability to challenge underlying tax liability; IRC 6673 penalty threatened	Yes	IRS
Miles v. Comm'r, T.C. Memo. 2007-208	Lien	Chapter 7 bankruptcy does not extinguish pre-petition federal tax lien	No	IRS
Monsif v. Comm'r, 100 A.F.T.R.2d (RIA) 5443 (D. Conn. 2007)	Levy	Inability to challenge underlying tax liability	Yes	IRS
Moore v. Comm'r, T.C. Memo. 2007-200	Levy	Frivolous issues; Inability to challenge underlying tax liability; IRC 6673 penalty threatened	Yes	IRS
Mootz v. Comm'r, T.C. Memo. 2007-303	Lien	No abuse of discretion in rejection of OIC or IA	Yes	IRS
Musto v. IRS, 101 A.F.T.R.2d (RIA) 1301 (D.N.J. 2008)	Lien	Inability to challenge underlying tax liability; No abuse of discretion	No	IRS
Newton v. Comm'r, T.C. Memo. 2007-264	Levy	No abuse of discretion in rejecting OIC	Yes	IRS
Nitschke v. Comm'r, T.C. Memo. 2008-143	Lien	Frivolous issues; IRC 6673 penalty imposed ($10,000)	Yes	IRS
O'Daniel v. Comm'r, T.C. Memo. 2008-119	Lien	Inability to challenge interest assessment because issue not raised during hearing	Yes	IRS
Orling v. Comm'r, T.C. Summ. Op. 2007-157	Levy	Inability to challenge underlying tax liability	Yes	IRS
Oropeza v. Comm'r, T.C. Memo. 2008-94	Levy	Frivolous issues; IRC 6673 penalty imposed ($10,000)	Yes	IRS
Patridge, U.S. v., 507 F.3d 1092 (7th Cir. 2007), *aff'g* 2006 U.S. Dist. Lexis 68938 (C.D. Ill. 2006), *aff'g* Tax Ct. No. 1551-06L (2006)	Levy	Tax evasion; Inability to challenge underlying tax liability	No	IRS
Pavlica v. Comm'r, T.C. Memo. 2007-163	Levy	No abuse of discretion in rejecting IA	No	IRS
Perkins v. Comm'r, 129 T.C. No. 7	Levy	Frivolous Issues; TP challenges to underlying tax liability were groundless; No grounds for remand since underlying arguments were frivolous	Yes	IRS
Perkins v. Comm'r, T.C. Memo. 2008-103	Levy	Abuse of discretion for failure to consider "financial disability;" remand to IRS Appeals	Yes	TP
Perrotta v. Comm'r, 100 A.F.T.R.2d (RIA) 5972 (M.D. Fla. 2007)	Unclear	Court lacks jurisdiction	No	IRS
Poindexter v. Comm'r, T.C. Memo. 2008-99	Levy	No abuse of discretion in rejecting OIC	No	IRS
Pickell v. Comm'r, T.C. Memo. 2008-60	Levy	Court lacks jurisdiction since TP failed to request hearing and since no notice of determination had been sent	Yes	IRS
Powers v. Comm'r, 100 A.F.T.R.2d (RIA) 6054 (D. N.J. 2007), *appeal dismissed* 2007 U.S. App. Lexis 29250 (3d Cir. 2007)	Lien	Frivolous issues; No discussion of IRC 6673 penalty	Yes	IRS
Pragasam v. Comm'r, 239 Fed. Appx. 325 (9th Cir. 2007), *aff'g* T.C. Memo. 2006-86	Lien	Inability to challenge underlying liability; Appeal filed late and nominee has no right to appeal	Yes	IRS
Pragasam, U.S. v., 2007 U.S. App. Lexis 14917 (9th Cir. 2007), *aff'g* D.C. No. Cv-06-03299-RGK (C.D. Cal.)	Levy	Court lacks jurisdiction	Yes	IRS

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Table 2: Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

Case Citation	Lien or Levy	Issue	*Pro Se*	Decision
Prakasam v. Comm'r, 246 Fed. Appx. 531 (9th Cir. 2007), *aff'g* T.C. Memo. 2006-53	Lien	Inability to challenge underlying tax liability because request was late	Yes	IRS
Prater v. Comm'r, T.C. Memo. 2007-241	Levy	IA denied; no financial information provided	No	IRS
Richmond v. Comm'r, T.C. Memo. 2008-59	Levy	Inability to challenge underlying tax liability	No	IRS
Robinson v. Comm'r, T.C. Summ. Op. 2008-48	Levy	TP failed to present evidence of abuse of discretion	Yes	IRS
Rodger v. U.S., 101 A.F.T.R.2d (RIA) 932 (N.D. Tex. 2007)	Levy	No abuse of discretion in rejecting IA	No	IRS
Rosenbaum v. Comm'r, 100 A.F.T.R.2d (RIA) 5210 (W.D. Tex. 2007)	Levy	Court lacks jurisdiction; TP did not exhaust administrative remedies	Yes	IRS
Russ v. Comm'r, T.C. Summ. Op. 2008-21	Lien	No abuse of discretion in rejecting OIC	Yes	IRS
Russell v. U.S., 78 Fed. Cl. 281 (2007)	Levy	Court lacks subject matter jurisdiction	Yes	IRS
S & M Trust No. 1 v. Comm'r, T.C. Memo. 2008-72	Lien	Nominees/Transferees not entitled to CDP	No	IRS
Salazar v. Comm'r, T.C. Memo. 2008-38	Levy	No abuse of discretion in rejecting OIC	No	IRS
Salmassi v. Comm'r, T.C. Memo. 2007-261	Lien	TP could pay the tax in full	Yes	IRS
Samuel v. Comm'r, T.C. Memo. 2007-312	Both	Abuse of discretion in rejecting OIC; "dissipated assets" should not be used in OIC calculation; remand to IRS appeals	No	TP
Scharringhausen v. Comm'r, T.C. Memo. 2008-26	Lien	No abuse of discretion in rejecting OIC	No	IRS
Schlosser v. Comm'r, T.C. Memo. 2007-297	Both	Frivolous issue; TP's claims dismissed; IRC 6673 penalty imposed ($1,000)	Yes	IRS
Schlosser v. Comm'r, T.C. Memo. 2007-298	Both	Frivolous issue; TP's claims dismissed; IRC 6673 penalty imposed ($1,000)	Yes	IRS
Schwartz v. Comm'r, T.C. Memo. 2007-155	Levy	No abuse of discretion in rejecting IA	Yes	IRS
Schwartz v. Comm'r, T.C. Memo. 2008-117	Levy	No abuse of discretion in rejecting OIC; house value debated	No	IRS
Scott v. Comm'r, 262 Fed. Appx. 597 (5th Cir. 2008), *aff'g* T.C. Memo. 2007-91	Both	No abuse of discretion	Yes	IRS
Seidel v. U.S., 100 A.F.T.R.2d. (RIA) 5200 (N.D. Cal. 2007)	Levy	Injunction to stop levy denied	No	IRS
Severo v. Comm'r, 129 T.C. No. 17	Both	Court lacks jurisdiction; tax liability not discharged in bankruptcy	Yes	IRS
Shane v. U.S., 2008 U.S. Dist. Lexis 1253 (D.D.C.)	Levy	TP failed to show that he requested a CDP hearing	Yes	IRS
Shere v. Comm'r, T.C. Memo. 2008-8	Levy	TP failed to request hearing	Yes	IRS
Silverman v. Comm'r, T.C. Memo. 2007-316	Levy	Frivolous issues; Inability to challenge underlying tax liability; No IRC 6673 penalty discussion	Yes	IRS
Singleton v. Comm'r, T.C. Summ. Op. 2008-43	Levy	Court lacks subject matter jurisdiction	Yes	IRS
Smith v. Comm'r, T.C. Memo. 2007-221	Levy	TP withdrew CDP petition upon entering into IA	Yes	IRS
Smith v. Comm'r, T.C. Summ. Op. 2007-187	Levy	No abuse of discretion in rejecting OIC	No	IRS
Smith v. Everson, 101 A.F.T.R.2d (RIA) 1479 (E.D.N.Y. 2008)	Levy	Lack of jurisdiction because TP failed to exhaust administrative remedies	No	IRS
Spahr v. U.S., 501 F. Supp. 2d. 92 (D.D.C. 2007)	Lien	TP failed to show that he requested a CDP hearing	Yes	IRS
Staso v. U.S., 538 F. Supp. 2d 1335 (D. Kans. 2008)	Levy	Statute of limitation tolled during bankruptcy and OIC	No	IRS
Sullivan v. U.S., 100 A.F.T.R.2d (RIA) 6204 (E.D. Pa. 2007)	Levy	No abuse of discretion in assessing Trust Fund Recovery Penalty (TFRP)	No	IRS
Taliaferro v. Comm'r, 101 A.F.T.R.2d (RIA) 1595 (11th Cir. 2008), *aff'g* T.C. No. 15721-06S	Levy	Failure to state a claim	Yes	IRS
Thomas v. Comm'r, T.C. Memo. 2007-269	Levy	Inability to challenge underlying tax liability	No	IRS
Thomas v. Comm'r, T.C. Memo. 2008-4	Levy	Inability to challenge underlying tax liability	No	IRS
Thompson v. Comm'r, T.C. Summ. Op. 2008-39	Levy	IRC 6015 filing deadline passed	No	IRS

Table 2: Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

Case Citation	Lien or Levy	Issue	*Pro Se*	Decision
Torczon v. Sage, 100 A.F.T.R.2d (RIA) 6215 (D. Ida. 2007)	Levy	Court lacks subject matter jurisdiction	Yes	IRS
Ulloa v. U.S., 100 A.F.T.R.2d (RIA) 6119 (N.D.N.Y. 2007)	Levy	Summary judgment denied; complaint dismissed in part	Yes	Split
Ulloa v. U.S., 100 A.F.T.R.2d (RIA) 6122 (N.D.N.Y. 2007)	Levy	Court lacks subject matter jurisdiction	Yes	IRS
Upchurch v. Comm'r, T.C. Memo. 2007-181	Both	Inability to challenge underlying tax liability because TP did not challenge notice of deficiency	No	IRS
Wagenknecht v. U.S., 509 F.3d 729 (6th Cir. 2007), *aff'g* 2006 U.S. Dist. Lexis 34892 (N.D. Ohio 2006)	Levy	Court lacks subject matter jurisdiction; TP's claim not dismissed on the merits	Yes	Split
Wallace v. Comm'r, T.C. Summ. Op. 2007-147	Levy	TP failed to prove that payment was made timely	Yes	IRS
Ward v. Comm'r, T.C. Summ. Op. 2007-144	Levy	Notice was properly given	Yes	IRS
Ward v. Comm'r, T.C. Memo. 2007-374	Levy	Tax court lacks jurisdiction to hear case for penalty abatement	No	IRS
Waterhouse v. U.S., 100 A.F.T.R.2d (RIA) 5815 (E.D. Cal. 2007)	Levy	Court lacks subject matter jurisdiction	No	IRS
Wesselman v. U.S., 501 F. Supp. 2d. 98 (D.D.C. 2007)	Lien	Court lacks jurisdiction; sovereign immunity	Yes	IRS
West v. Comm'r, T.C. Memo. 2008-30	Levy	TP lack of compliance in rejecting OIC	No	IRS
Westby v. Comm'r, T.C. Memo. 2007-194	Levy	Inability to challenge underlying tax liability	Yes	IRS
Williams v. Comm'r, T.C. Memo. 2007-162	Lien	Tax lien reflected all TP overpayments	Yes	IRS
Wood v. Comm'r, T.C. Memo. 2007-225	Levy	Frivolous issues; IRC 6673 penalty imposed ($5,000)	Yes	IRS
Wood v. Comm'r, 229 Fed. Appx. 897 (11th Cir. 2007), *aff'g* T.C. Memo. 2006-203	Levy	Frivolous issues; Inability to challenge underlying tax liability; Court upheld IRC 6673 penalty imposed by Tax Court ($1,000)	Yes	IRS
Worman v. Comm'r, T.C. Summ. Op. 2007-128	Lien	Court lacks jurisdiction because no notice of determination sent	Yes	IRS
Wos v. U.S., 100 A.F.T.R.2d (RIA) 6952 (N.D. Ill. 2007), *aff'd* by 2008 U.S. App. Lexis 16080 (7th Cir. 2008)	Levy	Frivolous issues; court lacks subject matter jurisdiction; no IRC 6673 penalty discussion	Yes	IRS
Business Taxpayers				
C&W Mechanical Contractors, Inc. v. U.S., 101 A.F.T.R.2d (RIA) 1825 (11th Cir. 2008), *aff'g* 2007 U.S. Dist. Lexis 23059 (N.D. Ga.)	Lien	Application of payments; impartial hearing	No	IRS
Don Johnson Motors, Inc. v. U.S., 532 F. Supp. 2d 844 (S.D. Tex. 2007)	Lien	IRS failed to consider third party testimony in CDP hearing; Remand	No	TP
Dr. James G. Hood, D.D.S., M.S., P.S. v. U.S., 100 A.F.T.R.2d (RIA) 6790 (E.D. Wash. 2007)	Levy	No abuse of discretion in rejecting OIC	No	IRS
Fallu Productions, Inc. v. U.S., 2008 U.S. Dist. Lexis 10194 (S.D.N.Y)	Levy	No due process violation by requiring electronic payment	No	IRS
Fifty Below Sales and Marketing, Inc. v. U.S., 497 F.3d 828 (8th Cir. 2007)	Levy	No abuse of discretion in rejecting IA	No	IRS
Follum v. Comm'r, T.C. Memo. 2007-164	Lien	Prior claim not considered	Yes	IRS
Kieft Bros. West, Inc. v. Comm'r, 101 A.F.T.R.2d (RIA) 1900 (D. Colo. 2008)	Levy	TP failed to stay current on tax obligations; IA rejected	No	IRS
L & L Holding Co. v. U.S., 101 A.F.T.R.2d (RIA) 2081 (W.D. La. 2008)	Lien	Employment taxes; Disregarded entities	No	IRS
Living Care Alternatives of Kirkersville, Inc. v. U.S., 247 Fed. Appx. 687 (6th Cir. 2007), *aff'g* 2005 U.S. Dist. Lexis 22446 (S.D. Ohio 2005) and *Living Care Alternatives of Utica v. U.S.*, 411 F.3d 621 (6th Cir. Ohio 2005)	Both	Inability to challenge underlying tax liability; collateral estoppel	No	IRS
Lofgren Trucking Service, Inc. v. U.S., 508 F. Supp. 2d 734 (D. Minn. 2007)	Levy	IRS abused discretion; Incurring "new" tax obligations does not preclude IA for past tax debts; Remand	No	TP
Otto's E-Z Clean Enterprises v. Comm'r, T.C. Memo. 2008-54	Levy	TP failed to raise challenge to IRS appeals determination	No	IRS
Peter D. Dahlin Attorney at Law, P.S. v. Comm'r, T.C. Memo. 2007-310	Levy	Frivolous issues; TP failed to timely request face to face hearing; no IRC 6673 penalty discussion	No	IRS

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Table 2: Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

Case Citation	Lien or Levy	Issue	*Pro Se*	Decision
Shelter Mutual Insurance v. Gregory, 2008 U.S. Dist. Lexis 1963 (M.D. Tenn.)	Lien	Enforcing tax liens inappropriate while CDP hearing is pending	No	TP
Stearn & Co., L.L.C. v. U.S., 499 F. Supp. 2d 899 (E.D. Mich. 2007)	Levy	Disregarded entity; state law versus federal tax obligations	No	IRS
Vollmer Electric Co. v. U.S., 100 A.F.T.R.2d (RIA) 5214 (W.D. Tex. 2007)	Lien	TP failed to file and amend required forms	No	IRS

Table 3 Summons Enforcement Under IRC §§ 7602, 7604, and 7609

Case Citation	Issue(s)	*Pro Se*	Decision
Adamowicz v. U.S., 100 A.F.T.R.2d 6275 (E.D.N.Y. 2007)	*Powell* requirements satisfied	No	IRS
Bandy v. U.S., 101 A.F.T.R.2d 1916 (D. Kan. 2008)	*Powell* requirements satisfied; Fair Debt Collection Practices Act does not apply to tax liability; Fourth Amendment not violated	Yes	IRS
Basham v. U.S., 100 A.F.T.R.2d (RIA) 6784 (E.D. Mo. 2007)	*Powell* requirements satisfied; No jurisdiction because 3rd party out of district	Yes	IRS
Bates v. U.S., 2007 U.S. Dist. LEXIS 75038 (E.D. Cal. 2007), *adopted* by 2007 U.S. Dist. Lexis 81049 (E.D. Cal. 2007)	No jurisdiction because TP not entitled to notice	Yes	IRS
Bell v. U.S., 101 A.F.T.R.2d (RIA) 2173 (4th Cir. 2008), *aff'g* 100 A.F.T.R.2d (RIA) 6403 (D. Md. 2007)	*Powell* requirements satisfied; no jurisdiction because improper service	Yes	IRS
Bogue v. U.S., 101 A.F.T.R.2d (RIA) 1652 (E.D.N.C. 2007)	No jurisdiction because 3rd parties not in district, petition untimely filed, improper service	Yes	IRS
Boudreau v. U.S., 101 A.F.T.R.2d (RIA) 809 (D. Or. 2008)	*Powell* requirements satisfied, no jurisdiction because improper service	Yes	IRS
Browning v. U.S., 101 A.FT.R.2d (RIA) 1707 (D.N.H. 2008)	*Powell* requirements satisfied; second examination is valid purpose	No	IRS
Daniel v. U.S., 101 A.F.T.R.2d (RIA) 1541 (D. Ariz. 2008)	No jurisdiction because motion to quash inapplicable to criminal investigations	Yes	IRS
Elmes v. U.S., 101 A.F.T.R.2d (RIA) 727 (11th Cir. 2008), *aff'g* 99 A.F.T.R.2d (RIA) 1659	*Powell* requirements satisfied; IRS may issue summons to bank concerning citizen of Virgin Islands	No	IRS
Gartner v. U.S., 259 Fed. Appx. 514 (3d Cir. 2007)	*Powell* requirements satisfied	Yes	IRS
Gertz v. IRS, 101 A.F.T.R.2d (RIA) 2234 (N.D. Ind. 2008)	Joint account holder not entitled to 3rd party notice if not named in summons; IRM 25.5.3.6.8 does not apply	No	IRS
Grant v. Comm'r, 100 A.F.T.R.2d (RIA) 5327 (E.D. Ky. 2007)	No jurisdiction because improper service, no notice required for summons in aid of collection	Yes	IRS
Heger v. Martinez, 100 A.F.T.R.2d (RIA) 6287 (N.D. Cal. 2007)	*Powell* requirements satisfied; no jurisdiction because untimely filed; no notice required	Yes	IRS
Hennessy v. C.I.R., 100 A.F.T.R.2d (RIA) 7055 (E.D. Mich. 2007), *adopting* 100 A.F.T.R.2d (RIA) 5130 (E.D. Mich. 2007)	*Powell* requirements satisfied; criminal investigation not improper purpose	Yes	IRS
Hopkins v. IRS, 101 A.F.T.R.2d (RIA) 1906 (D.N.M. 2008), *appeal docketed*, No. 08-2127 (10th Cir. June 6, 2008)	*Powell* requirements satisfied; criminal investigation not improper purpose; frivolous arguments	Yes	IRS
Hubbard v. U.S., 258 Fed. Appx. 922 (8th Cir. 2008)	No due process violation	Yes	IRS
Huffman v. U.S., 100 A.F.T.R.2d (RIA) 7089 (S.D. Fla. 2007)	No notice required for summons in aid of collection; no attorney-client privilege for bank statements; petition to enforce stayed pending bankruptcy	Yes	Split (TP motion to quash dismissed, IRS motion to enforce dismissed pending bankruptcy)
Jones v. Comm'r, 100 A.F.T.R.2d (RIA) 6554 (D. Md. 2007)	No jurisdiction because untimely; frivolous	Yes	IRS
Luongo v. U.S., 2008 WL 1326953 (M.D. Fla. 2008)	No jurisdiction because improper service	No	IRS
Miles, J. v. U.S., 101 A.F.T.R.2d (RIA) 709 (E.D. Va. 2008)	No jurisdiction because improper service; criminal investigation; not a summons to a 3rd party	Yes	IRS
Miles, K. v. U.S., 2008 WL 302313 (E.D. Va. 2008)	No jurisdiction because improper service; criminal investigation; not a summons to a 3rd party	Yes	IRS
Mitchell v. Thomas, 239 Fed. Appx. 56 (5th Cir. 2007)	*Powell* requirements satisfied; evidentiary hearing only required when substantial deficiencies in summons presented	Yes	IRS
Neuger v. U.S., 100 A.F.T.R.2d (RIA) 6265 (D. Colo. 2007)	*Powell* requirements satisfied; frivolous argument that Title 26 not positive law	Yes	IRS
Neuger v. U.S., 2008 WL 697342 (D. Colo. 2008)	No jurisdiction because petition untimely filed	Yes	IRS

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Table 3: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

Case Citation	Issue(s)	*Pro Se*	Decision
O'Connor v. Comm'r, 2007 WL 2900559 (E.D. Tex. 2007)	*Powell* requirements satisfied; no jurisdiction because TP not entitled to notice for summons in aid of collection	Yes	IRS
O'Connor v. IRS, 2007 WL 2077099 (E.D. Tex. 2007), adopting 99 A.F.T.R.2d (RIA) 3489 (E.D. Tex. 2007)	*Powell* requirements satisfied; no jurisdiction because improper service; TP not entitled to notice for summons in aid of collection	Yes	IRS
Palmer v. U.S., 101 A.F.T.R.2d (RIA) 623 (E.D. Tenn. 2008)	*Powell* requirements satisfied; no Fourth Amendment violation	Yes	IRS
Patetta v. U.S., 101 A.F.T.R.2d (RIA) 847 (D.N.J. 2007)	*Powell* requirements satisfied; no jurisdiction	Yes	IRS
Paul v. U.S., 2007 WL 3005325 (M.D. Ala. 2007)	*Powell* requirements satisfied	Yes	IRS
Phillips v. Comm'r, 99 A.F.T.R.2d (RIA) 3487 (D. Ariz. 2007)	*Powell* requirements satisfied	Yes	IRS
Pretscher v. Garza, 100 A.F.T.R.2d (RIA) 6346 (N.D. Cal. 2007)	*Powell* requirements satisfied; no jurisdiction because TP not entitled to notice	Yes	IRS
Redeker-Barry v. U.S., 101 A.F.T.R.2d (RIA) 1219 (M.D. Fla. 2008), *adopted* by 2008 WL 2385510 (M.D. Fla. 2008)	*Powell* requirements satisfied	Yes	IRS
Redeker-Barry v. U.S., 2008 WL 976609 (M.D. Fla. 2008)	Moot; no actual dispute	Yes	IRS
Rosenberg v. U.S., 100 A.F.T.R.2d (RIA) 7096 (S.D. Fla. 2007)	*Powell* requirements satisfied	No	IRS
Schulz v. U.S., 240 Fed. Appx. 167 (8th Cir. 2007)	*Powell* requirements satisfied; evidentiary hearing only required when substantial deficiencies in summons presented	Yes	IRS
Sherbondy v. U.S., 100 A.F.T.R.2d (RIA) 6224 (D. Colo. 2007)	No jurisdiction because TP not entitled to notice for summons in aid of collection	No	IRS
Speelman v. U.S., 2008 WL 148935 (S.D. Ohio 2008)	*Powell* requirements satisfied; criminal investigation not an improper purpose	Yes	IRS
Stewart v. U.S., 511 F.3d 1251(9th Cir. 2007)	*Powell* requirements satisfied; no jurisdiction because joint account owner not entitled to notice of summons if not named in summons	Yes	IRS
Thompson v. U.S., 100 A.F.T.R.2d (RIA) 6133 (S.D. Ohio 2007)	Moot; summons withdrawn	Yes	IRS
Thompson v. U.S., 2007 WL 1891167 (D.D.C. 2007)	Moot; summons withdrawn	No	IRS
Tift v. Comm'r., 101 A.F.T.R.2d (RIA) 2645 (W. D. Wash. 2008)	Moot; summons withdrawn	Yes	IRS
U.S. v. Aspenleiter, 100 A.F.T.R.2d (RIA) 6991 (M.D. Fla. 2007), *adopting* 100 A.F.T.R.2d (RIA) 6551 (M.D. Fla. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Aubert, 2008 WL 1995452 (D.N.H. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Barile, 2007 U.S. Dist. LEXIS 84393 (N.D.N.Y 2007)	*Powell* requirements satisfied; Fifth Amendment privilege waived by failure to follow procedural rules	Yes	IRS
U.S. v. Bennett, 101 A.F.T.R.2d (RIA) 339 (D. Colo. 2007), *adopting* 101 A.F.T.R.2d (RIA) 334 (D. Colo. 2007)	Motion for contempt sanctions under IRC 7604(b)	Yes	IRS
U.S. v. Benoit, 101 A.F.T.R.2d 2167 (9th Cir. 2008) *aff'g* 98 A.F.T.R.2d (RIA) 6328 (S.D. Cal. 2006)	No blanket Fifth Amendment violation; no violation of due process if provided notice and opportunity to respond	Yes	IRS
U.S. v. Bowers, 259 Fed. Appx. 89 (10th Cir. 2007)	No blanket Fifth Amendment privilege	Yes	IRS
U.S. v. Bright, 2008 WL 351215 (D. Haw. 2008)	Motion to stay enforcement; *Hilton* factors not met.	Yes	IRS
U.S. v. Bright, 100 A.F.T.R.2d (RIA) 5905 (D. Haw. 2007), *adopting* 100 A.F.T.R.2d (RIA) 6109 (D. Haw. 2007) *reh'g denied* 100 A.F.T.R.2d (RIA) 6615 (D. Haw. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Brown, 101 A.F.T.R.2d (RIA) 1118 (D. Utah 2008), *adopting as modified* 101 A.F.T.R.2d (RIA) 1117 (D. Utah 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Cornwall, 2008 WL 1904649 (D. Utah 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Craner, 2008 WL 1957812 (D. Utah), *adopting* 101 A.F.T.R.2d (RIA) 619 (D. Utah 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Craner, 101 A.F.T.R.2d (RIA) 2584 (D. Utah 2008)	Motion for contempt sanctions under IRC 7604(b)	Yes	IRS
U.S. v. Decanter, 2007 WL 2302341 (W.D. Mich. 2007)	*Powell* requirements satisfied; frivolous arguments	Yes	IRS

Table 3: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

Case Citation	Issue(s)	*Pro Se*	Decision
U.S. v. Depolo, 101 A.F.T.R.2d (RIA) 2528 (N.D. Tex. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Elkins, 2008 U.S. Dist. LEXIS 35747 (E.D. Cal. 2008), *adopting* 2008 U.S. Dist. LEXIS 27418 (E.D. Cal. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Ford, 100 A.F.T.R.2d (RIA) 6281 (D.N.M. 2008), *aff'd* 514 F.3d 1047 (10th Cir. 2008)	Frivolous arguments concerning IRS agent's authority to issue summons, validity of IRS forms, and others	Yes	IRS
U.S. v. Franklin, 101 A.F.T.R.2d (RIA) 629 (D. Utah 2008), *adopting* 101 A.F.T.R.2d (RIA) 627 (ED. Utah 2007)	*Powell* requirements satisfied; No blanket Fifth Amendment privilege	Yes	IRS
U.S. v. Gippetti, 248 Fed. Appx. 382 (3d Cir. 2007)	TP not entitled to evidentiary hearing to refute IRS prima facie case after losing Fifth Amendment argument	No	IRS
U.S. v. Haas, 2008 U.S. Dist. LEXIS 24691 (D. Utah 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Hanrahan, 2008 U.S. Dist. LEXIS 26188 (C.D. Cal 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Harmer, 101 A.F.T.R.2d (RIA) 946 (E.D. Cal.), *adopting* 2008 U.S. Dist. LEXIS 20125 (E.D. Cal. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Heric, 2007 WL 2434036 (W.D. Mich. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Hicks, 2008 WL 2165972 (D.N.H. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Hines, 101 A.F.T.R.2d (RIA) 2185 (M.D. Fla. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Hines, 241 Fed. Appx. 998 (4th Cir. 2007), *adopting* 2005 WL 5949763 (M.D.N.C. 2005)	*Powell* requirements satisfied	No	IRS
U.S. v. Hodges, 256 Fed. Appx. 313 (11th Cir. 2007)	*Powell* requirements satisfied; frivolous arguments concerning applicability of tax laws and personal jurisdiction	Yes	IRS
U.S. v. Jacobson, 2008 WL 877620 (D. Utah)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Johnson, 2008 WL 793221 (D. Utah)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Kehoe, 2008 WL 2401567 (D.N.H. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Laguardin, 100 A.F.T.R.2d (RIA) 5068 (N.D. Cal. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Laubly, 100 A.F.T.R.2d (RIA) 6948 (E.D. Cal. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Laubly, 2008 WL 268904 (E.D. Cal. 2008), *adopting* 100 A.F.T.R.2d (RIA) 7021 (E.D. Cal. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Mahoney, 101 A.F.T.R.2d (RIA) 456 (E.D. Cal. 2008), *adopting* 101 A.F.T.R.2d 365 (E.D. Cal. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Maniscalco, 101 A.F.T.R.2d 1720 (2d Cir. 2008)	*Powell* requirements satisfied; frivolous jurisdictional arguments	Yes	IRS
U.S. v. McBride, 101 A.F.T.R.2d (RIA) 413 (D. Utah 2007) *adopted by* 101 A.F.T.R.2d (RIA) 415 (D. Utah 2007) *vacated* Nov. 7, 2007, *and adopted by* 2008 WL 248706 (D. Utah 2008)	*Powell* requirements satisfied; frivolous arguments	Yes	IRS
U.S. v. McHenry, 101 A.F.T.R.2d (RIA) 2190 (E. D. Va. 2008)	*Powell* requirements satisfied; IRC 6501 statute of limitations only applies to assessments, not summons enforcement; no Fourth Amendment probable cause requirement; motion to quash improper when individual is subject of summons	No	IRS
U.S. v. Moore, 101 A.F.T.R.2d (RIA) 347 (W.D. Mo. 2007), *adopting* 101 A.F.T.R.2d (RIA) 348 (W.D. Mo. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Morse, 100 A.F.T.R.2d (RIA) 6834 (D. Minn. 2007)	Criminal trial motion to suppress documents obtained through IRS summons; summons issued before referral to Department of Justice	No	IRS
U.S. v. Morse, 2007 WL 3379771 (M.D. Fla. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Mower, 101 A.F.T.R.2d (RIA) 412 (D. Utah 2007)	Motion for contempt sanctions under IRC 7604(b)	No	IRS
U.S. v. Mower, 99 A.F.T.R.2d(RIA) 3459 (D. Utah 2007)	*Powell* requirements satisfied	No	IRS

Appendix Three

Table 3: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

Case Citation	Issue(s)	*Pro Se*	Decision
U.S. v. Nelson, 2008 WL 821595 (D. Utah 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Paul, 2008 WL 618894 (M.D. Fla. 2008)	*Powell* requirements satisfied; frivolous arguments concerning applicability of tax laws and personal jurisdiction	Yes	IRS
U.S. v. Penta, 2007 WL 4458888 (D.N.H. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Pitts, 101 A.F.T.R.2d (RIA) 1768 (N.D. Tex. 2008)	*Powell* requirements satisfied; summons enforcement hearing not proper venue to contest underlying liability	Yes	IRS
U.S. v. Praetzel, 101 A.F.T.R.2d (RIA) 351 (D. Haw. 2007), *adopting* 101 A.F.T.R.2d (RIA) 350 (D. Haw. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Rima, 258 Fed. Appx. 70 (8th Cir. 2007)	Moot: District Court dismissed enforcement action	No	IRS
U.S. v. Rozelle, 2007 WL 2814913 (W.D. Mich. 2007)	*Powell* requirements satisfied; frivolous arguments claiming summons only proper for ATF taxes	Yes	IRS
U.S. v. Saad, 2008 WL 596817 (E.D. Mich. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Sarno, 2008 WL 1782386 (D.N.H. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Schlabach, 2008 U.S. Dist. LEXIS 41353 (E.D. Wash. 2008), *adopted* by 2008 U.S. Dist. LEXIS 46862 (E.D. Wash. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Seither, 101 A.F.T.R.2d (RIA) 1422 (M.D. Fla. 2008)	TP did not contest	Yes	IRS
U.S. v. Snodgrass, 2007 WL 2540422 (W.D. Mich. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Snowden, 2008 WL 2169524 (E.D. Cal. 2008)	*Powell* requirements satisfied; arrest warrant issued pursuant to IRC 7604(b) for failure to appear	Yes	IRS
U.S. v. Spencer, 101 A.F.T.R.2d (RIA) 1116 (D. Utah 2008)	Enforcement granted	No	IRS
U.S. v. Stafford, 101 A.F.T.R.2d (RIA) 1695 (5th Cir. 2008)	*Powell* requirements satisfied; no blanket Fifth Amendment privilege	Yes	IRS
U.S. v. Stamm, 2008 WL 793277 (D. Utah 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Stoesser, 101 A.F.T.R.2d (RIA) 781(D.N.M. 2008)	*Powell* requirements satisfied; no blanket Fifth Amendment privilege	Yes	IRS
U.S. v. Strickland, 2008 WL 1925013 (W.D. Mo. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Summers, 101 A.F.T.R.2d (RIA) 1012 (W.D. Mo. 2008), *adopting* 101 A.F.T.R.2d (RIA) 1011 (W.D. Mo. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Swiler, 2007 WL 2540707 (W.D. Mich. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Takashiba, 101 A.F.T.R.2d (RIA) 352 (D. Haw. 2007), *adopting* 101 A.F.T.R.2d (RIA) 351 (D. Haw. 2007)	Enforcement granted	Yes	IRS
U.S. v. Tervort, 2008 WL 131342 (E.D. Cal. 2008), *adopting* 100 A.F.T.R.2d (RIA) 6955 (E.D. Cal. 2007)	*Powell* requirements satisfied; no right to jury trial in enforcement hearing; magistrate may hear case so long as district judge may review de novo	Yes	IRS
U.S. v. Valencia, 100 A.F.T.R.2d (RIA) 5936 (D. Utah 2007), *adopting* 100 A.F.T.R.2d (RIA) 5935 (D. Utah 2007)	*Powell* requirements satisfied; frivolous arguments	Yes	IRS
U.S. v. Walters, 2008 WL 821597 (D. Utah 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Ward, 101 A.F.T.R.2d (RIA) 354 (M.D. Fla. 2007), *adopting* 101 A.F.T.R.2d (RIA) 353 (M.D. Fla. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Watson, 2007 U.S. Dist. LEXIS 84970 (N.D. Cal. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Wise, 101 A.F.T.R.2d (RIA) 356 (M.D. Fla. 2007), *adopting* 101 A.F.T.R.2d (RIA) 355 (M.D. Fla. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Yoshimura, 2007 U.S. Dist. LEXIS 40505 (D. Haw. 2007)	*Powell* requirements satisfied	Yes	IRS
Vento v. U.S., 100 A.F.T.R.2d (RIA) 5190 (D.P.R. 2007)	*Powell* requirements satisfied	No	IRS
Vento v. U.S., 100 A.F.T.R.2d (RIA) 5277 (D.V.I. 2007)	*Powell* requirements satisfied	No	IRS

Table 3: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

Case Citation	Issue(s)	*Pro Se*	Decision
Zaccardi v. U.S., 2007 U.S. Dist. LEXIS 81466 (D. Utah 2007), *reh'g denied* 101 A.F.T.R.2d (RIA) 626 (D. Utah 2008)	*Powell* requirements satisfied	Yes	IRS
Business Taxpayers			
Bodensee Fund, LLC v. U.S., 101 A.F.T.R.2d (RIA) 2092 (E.D. Pa. 2008)	Requesting documents from TP that have already been received from TP's agent was legitimate purpose for summons	No	IRS
Good Karma, LLC v. U.S., 546 F. Supp. 2d 597 (N.D. Ill. 2008)	*Powell* requirements satisfied; First and Fifth Amendments not violated	No	IRS
Ironwood Trading, LLC v. U.S., 101 A.F.T.R.2d (RIA) 1483 (M.D. Fla. 2008), *appeal docketed*, No. 08-12879 (11th Cir. May 22, 2008)	*Powell* requirements satisfied; administrative deficiencies not prejudicial; TPs could not specifically identify data in IRS possession sufficiently to overcome *Powell*	No	IRS
Khan v. U.S., 537 F. Supp. 2d 944 (N.D. Ill. 2008), *appeal docketed*, No. 08-1743 (7th Cir. Mar. 27, 2008)	No evidence presented regarding whether 3rd party to whom the summons was issued was subject to a Dept. of Justice investigation	No	TP
Lana Vento Charitable Trust v. U.S., 2007 WL 1815688 (D. Utah 2007)	*Powell* requirements satisfied; no jurisdiction because improper service	No	IRS
Lyons Trading, LLC v. U.S., 101 A.F.T.R.2d (RIA) 837 (E.D. Tenn. 2008), *appeal docketed*, No. 08-5313 (6th Cir. Mar.13, 2008)	*Powell* requirements satisfied; TP claimed institutional harassment, discovery in anticipation of litigation; *Powell* standards trump FRCP 8; no constitutional violation	No	IRS
Lyons Trading, LLC v. U.S., 2008 WL 918503 (E.D. Tenn. 2008)	Motion to stay enforcement; *Hilton* factors not met.	No	IRS
Moore v. Wells Fargo Bank, 100 A.F.T.R.2d (RIA) 6216 (N.D. Cal. 2007)	*Powell* requirements satisfied; no notice required for summons in aid of collection	Yes	IRS
Regions Financial Corp. v. U.S., 101 A.F.T.R.2d (RIA) 2179 (N.D. Ala. 2008)	*Powell* requirements satisfied; work product privilege applies to documents analyzing potential tax litigation	No	TP
Rosingana v. U.S., 2008 WL 746489 (E.D. Cal. 2008), *adopting* 101 A.F.T.R.2d (RIA) 625 (E.D. Cal. 2008)	No jurisdiction because TP not entitled to notice	Yes	IRS
Sterling Trading, LLC v. U.S., 101 A.F.T.R.2d (RIA) 1544 (C.D. Cal 2008), *appeal docketed*, No. 08-55735 (11th Cir. May 1, 2008)	*Powell* requirements satisfied; TP claimed institutional harassment, discovery in anticipation of litigation; no constitutional violations	No	IRS
Stoffels v. Hegarty, 101 A.F.T.R.2d 2008-989 (10th Cir. 2008) *aff'g* 99 A.F.T.R.2d 2007-2088	*Powell* requirements satisfied; no evidence that referral to Dept. of Justice had been made or that summons issued in bad faith	Yes	IRS
U.S. v. Asero, 2007 WL 2994283 (E.D.N.Y. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. BDO Seidman, LLP, 492 F.3d 806 (7th Cir. 2007), *aff'd in part, vacated and remanded in part* 2007 U.S. App. LEXIS 15796 (7th Cir. 2007)	Review of lower courts determination of the attorney-client and tax practitioner-client privilege	No	Split (Remanded for tax-fraud exception, vacated with respect to tax shelter exception)
U.S. v. Cohen, 100 A.F.T.R.2d (RIA) 5006 (N.D. Cal. 2007) *reopening* 97 A.F.T.R.2d (RIA) 1002 (N.D. Cal. 2005)	Reliance on advice from attorney as a defense waives attorney-client privilege	No	IRS
U.S. v. Craner, 101 A.F.T.R.2d (RIA) 640 (D. Utah 2008), *aff'd* 101 A.F.T.R. 2d (RIA) 610 (D. Utah 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Doyle, 100 A.F.T.R.2d (RIA) 5949 (D. Kan. 2007)	*Powell* requirements satisfied; TP denied possession of documents	No	Split (TP for certain documents they did not possess, IRS everything else)
U.S. v. Hiley, 100 A.F.T.R.2d (RIA) 6224 (S.D. Cal. 2007)	*Powell* requirements satisfied; assisting foreign tax investigation legitimate purpose for summons	No	IRS
U.S. v. Jackson, 101 A.F.T.R.2d (RIA) 345 (S.D. Ala. 2007), *adopting* 101 A.F.T.R.2d (RIA) 342 (S.D. Ala. 2007)	*Powell* requirements satisfied	Yes	IRS

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Table 3: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

Case Citation	Issue(s)	*Pro Se*	Decision
U.S. v. Jimenez, 2008 WL 952983 (N.D. Tex 2008)	*Powell* requirements satisfied.	Yes	IRS
U.S. v. Jimmy D. Rodeback, Jr's Custom Muffler & Brake., 2008 U.S. Dist. LEXIS 24692 (D. Utah 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Johnson, 101 A.F.T.R.2d (RIA) 639 (D. Utah 2008), *adopting* 101 A.F.T.R.2d (RIA) 611 (D. Utah. 2007)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Laubly, 101 A.F.T.R.2d (RIA) 1012 (E.D. Cal. 2008)	*Powell* requirements satisfied; no constitutional violation; frivolous arguments	Yes	IRS
U.S. v. Lee, Goddard & Duffy, LLP, 528 F. Supp. 2d 1005 (C.D. Cal. 2008) *motion for stay pending appeal denied* 553 F. Supp. 2d 1005 (C.D. Cal. 2008)	*Powell* requirements satisfied	No	IRS
U.S. v. Liddell, 100 A.F.T.R.2d (RIA) 5580 (D. Haw. 2007), *adopting* 100 A.F.T.R.2d (RIA) 6105 (D. Haw. 2007), *reh'g denied* 101 A.F.T.R.2d (RIA) 346 (D. Haw. 2007)	*Powell* requirements satisfied; no blanket Fifth Amendment privilege	Yes	IRS
U.S. v. Martinez, 101 A.F.T.R.2d (RIA) 953 (D. Minn. 2008), *adopting* 101 A.F.T.R.2d (RIA) 952 (D. Minn. 2008)	*Powell* requirements satisfied	Yes	IRS
U.S. v. Open Access Technology Intern., Inc., 2007 WL 2110320 (D. Minn. 2007), *adopting* 2007 WL 2128354 (D. Minn. 2007)	*Powell* requirements satisfied	No	IRS
U.S. v. Rinehart, 539 F. Supp. 2d 1334 (W.D. Okla. 2008)	*Powell* requirements satisfied; TP asserted Fifth Amendment violation	No	Split (TP for specific Fifth Amendment assertions,IRS summons enforced.)
U.S. v. Textron, 507 F. Supp. 2d 138 (D.R.I. 2007), *appeal docketed*, No. 07-2631 (Oct. 31, 2007)	*Powell* requirements satisfied; work product privilege not waived by disclosure to independent auditor	No	TP
U.S. v. Wealth and Tax Advisory Services, Inc., 526 F.3d 528 (9th Cir. 2008)	Reversed lower court and found draft memorandum included in summons	No	IRS
U.S. v. Windsor Capital Corp., 524 F. Supp. 2d 74 (D. Mass. 2007)	Review of lower courts determination of the attorney-client privilege	No	Split (TP some documents, IRS some documents)
Valero Energy Corp. v. U.S., 100 A.F.T.R.2d (RIA) 6473 (N.D. Ill. 2007)	*Powell* requirements satisfied; TP asserted work-product and tax practitioner-client privilege	No	split (TP tax practitioner-client privilege, IRS all else)

Table 4 Trade or Business Expenses Under IRC § 162(a) and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (But Not Sole Proprietorships)			
Akers v. Comm'r, T.C. Memo. 2007-296, *appeal transferred to* 2d Cir., No. 08-1218 (2d Cir. Mar. 18, 2008)	Deductions allowed for expenses properly substantiated; deductions denied for computer maintenance expenses because computer fully depreciated	Yes	Split
Albers v. Comm'r, T.C. Memo. 2007-144	Deductions denied for health insurance premiums and medical costs not incurred or not ordinary and necessary	No	IRS
Arberg v. Comm'r, T.C. Memo. 2007-244	Deductions denied for expenses not substantiated	No	IRS
Balla v. Comm'r, T.C. Memo. 2008-18	Deductions allowed for travel and employee business expenses incurred while away from home and properly substantiated; deductions allowed for meals and incidental expenses incurred while away from home; deductions denied for miscellaneous expenses not substantiated or not ordinary and necessary	No	Split
Bogue v. Comm'r, T.C. Memo. 2007-150	Deductions denied for expenses while not away from home and expenses personal in nature; deductions denied for expenses not substantiated; some employee business deductions estimated under *Cohan* rule	Yes	Split
Boltinghouse v. Comm'r, T.C. Memo. 2007-324, *appeal dismissed*, No. 08-1195 (4th Cir. Apr. 24, 2008)	Deductions denied for expenses not substantiated; deductions for medical expenses partly allowed	Yes	Split
Buah v. Comm'r, T.C. Summ. Op. 2007-183	Deductions denied for expenses not substantiated; deductions for medical expenses not exceeding the seven and half percent floor of IRC 213(a) denied	Yes	IRS
Cargill v. Comm'r, 272 Fed. Appx. 756 (11th Cir. 2008)	Affirmed Tax Court decision denying deductions for expenses not substantiated.	Yes	IRS
Claborne v. Comm'r, T.C. Summ. Op. 2007-172	Deductions denied for expenses not substantiated	Yes	IRS
Clark v. Comm'r, T.C. Memo. 2008-71	Deductions denied for meal expenses not paid or incurred	No	IRS
Cornelius v. Comm'r, T.C. Summ. Op. 2008-42	Deductions denied for expenses while not away from home and expenses personal in nature	Yes	IRS
Falodun v. Comm'r, T.C. Summ. Op. 2008-5	Deductions denied for expenses not substantiated or personal in nature	Yes	IRS
Farran v. Comm'r, T.C. Memo. 2007-151	Deductions denied for expenses while not away from home and expenses personal in nature; deductions denied for expenses not substantiated; some business deductions estimated under *Cohan* rule; deductions allowed for expenses properly substantiated	Yes	Split
Fo v. Comm'r, T.C. Summ. Op. 2008-25	Deductions denied for expenses not incurred, not substantiated or personal in nature; deductions allowed for substantiated expenses	Yes	Split
Foster v. Comm'r, T.C. Summ. Op. 2008-22	Deductions denied for educational expenses incurred to qualify for a new trade or business; expenses personal in nature or capital expenditures not deductible	No	IRS
Hager v. Comm'r, T.C. Summ. Op. 2007-198	Deductions denied for travel, home office and miscellaneous expenses not substantiated and could not be estimated under *Cohan* rule; deductions for business use of home denied because TP did not use a portion of a dwelling regularly and exclusively for business	Yes	IRS
Kolapo v. Comm'r, T.C. Summ. Op. 2007-142	Deductions denied for miscellaneous expenses not substantiated or personal in nature	Yes	IRS
McKeown v. Comm'r, T.C. Summ. Op. 2007-95	No travel expense deductions because TP had no "tax home"; deductions denied for unreimbursed employee business expenses not substantiated; no deduction for expenses personal in nature; deductions allowed for certain expenses estimated under *Cohan* rule	Yes	Split
Riley v. Comm'r, T.C. Memo. 2007-153	Deductions denied for expenses while not away from home and expenses personal in nature; deductions denied for expenses not substantiated; deductions allowed for certain expenses estimated under *Cohan* rule	Yes	Split
Schubert v. Comm'r, T.C. Summ. Op. 2008-24	Deductions denied for unreimbursed employee expenses not substantiated; miscellaneous itemized deductions not exceeding two percent floor of IRC 67(a) denied	Yes	IRS

Table 4: Trade or Business Expenses Under IRC § 162(a) and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Sizelove v. Comm'r, T.C. Summ. Op. 2008-15	Deductions denied for miscellaneous expenses not substantiated; deductions denied for home office expenses because TP not engaged in active trade or business; deductions for medical expenses not exceeding the seven and half percent floor of IRC § 213(a) denied	Yes	IRS
Snead v. Comm'r, T.C. Summ. Op. 2008-57	Deductions denied for expenses not ordinary and necessary or personal in nature; deductions denied for expenses not substantiated; deductions allowed for certain expenses estimated under *Cohan* rule; deductions for medical expenses not exceeding the seven and half percent floor of IRC 213(a) denied	Yes	Split
Stensgaard v. Comm'r, T.C. Summ. Op. 2007-150	Deductions denied for expenses not substantiated	Yes	IRS
Stephens v. Comm'r, T.C. Summ. Op. 2007-94	No travel expense deductions because TP had no "tax home"	Yes	IRS
Stockwell v. Comm'r, T.C. Memo. 2007-149	Deductions denied for expenses while not away from home and expenses personal in nature; deductions denied for expenses not substantiated; some employee business deductions estimated under *Cohan* rule	Yes	Split
Thompson v. Comm'r, T.C. Memo. 2007-174	Deductions denied for educational expenses incurred to qualify for a new trade or business	No	IRS
Wasik v. Comm'r, T.C. Memo. 2007-148	Deductions denied for expenses while not away from home and expenses personal in nature; deductions denied for expenses not substantiated; some employee business deductions estimated under *Cohan* rule; deductions allowed for some travel expenses incurred while away from home	Yes	Split
White v. Comm'r, T.C. Summ. Op. 2007-199	Deductions denied for expenses not substantiated and personal in nature; deductions allowed for certain expenses estimated under *Cohan* rule	Yes	Split
Wilbert v. Comm'r, T.C. Memo. 2007-152, *appeal docketed*, No. 08-2169 (7th Cir. May 6, 2008)	No travel expense deductions because TP had no "tax home"; deductions allowed for certain expenses estimated under *Cohan* rule	Yes	Split
Williams v. Comm'r, T.C. Summ. Op. 2007-102	Deductions denied for expenses not substantiated; deductions for medical expenses not exceeding the seven and half percent floor of IRC 213(a) denied	Yes	IRS
Woodard v. Comm'r, T.C. Summ. Op. 2008-45	Deductions for medical expenses not exceeding the seven and half percent floor of IRC 213(a) denied; deductions denied for expenses not substantiated	Yes	IRS
Xiong v. Comm'r, T.C. Summ. Op. 2007-96	Deductions denied for travel expenses while TP was not traveling away from his tax home; deductions denied for expenses not substantiated or personal in nature; deductions for business use of home denied because TP not involved in separate trade or business	Yes	IRS
Yanke v. Comm'r, T.C. Memo. 2008-131	Deductions denied for travel expenses while TP was not traveling away from his tax home	Yes	IRS
Zbylut v. Comm'r, T.C. Memo. 2008-44	Deductions allowed for travel and incidental expenses properly substantiated and incurred while away from home; deductions denied for miscellaneous expenses not substantiated or personal in nature	No	Split
Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships - Schedules C, E, F)			
Agbaniyaka v. Comm'r, T.C. Memo. 2007-300	Deduction denied for arts and crafts activity because TPs (H&W) not engaged in trade or business activity with continuity, regularity, and with the primary purpose of deriving income and profit; deductions denied for educational expenses and miscellaneous unreimbursed employee expenses not substantiated and not actually paid or incurred	Yes	IRS
Albers v. Comm'r, T.C. Memo. 2007-144	Deductions denied for health insurance premiums and medical costs claimed under "employee benefit programs" not ordinary and necessary, and not actually paid or incurred by business	No	IRS
Arnold v. Comm'r, T.C. Memo. 2007-168	Deductions denied for expenses not substantiated and could not be estimated under *Cohan* rule	Yes	IRS
BB&T Corp. v. U.S., 523 F.3d 461 (4th Cir. 2008), *rehearing en banc denied* (4th Cir. June 27, 2008)	Deductions denied for rent and related expenses associated with the corporation's participation in a lease-in/lease-out (LILO) sham transaction because the transaction not in substance an ordinary and necessary business expense.	No	IRS
Benson v. Comm'r, T.C. Summ. Op. 2008-29	Deductions denied for activity that was not engaged in for profit; deductions denied for expenses not reasonable or necessary	Yes	IRS
Berryman v. Comm'r, T.C. Summ. Op. 2007-138	Deductions denied for marketing activity that was not engaged in for profit	Yes	IRS

Table 4: Trade or Business Expenses Under IRC § 162(a) and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Black v. Comm'r, T.C. Memo. 2007-364	Deductions denied for miscellaneous expenditures personal in nature and not properly substantiated	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2007-135	Duplication deductions for rent expenses denied	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2007-141	Duplication deduction for repayment of loan principal denied	Yes	IRS
Burkley v. Comm'r, T.C. Summ. Op. 2008-20	Deductions denied for expenses not substantiated	Yes	IRS
Burski v. Comm'r, T.C. Summ. Op. 2007-212	Deductions denied for travel expenses while not away from home	Yes	IRS
Cameron v. Comm'r, T.C. Memo. 2007-260	Deductions denied because TP's stock trading activity was not regular, continuous, and frequent enough to be considered a trade or business; deductions denied for activity not engaged in for profit; deductions for education expenses and seminar attendance denied under IRC 274(h)(7)	Yes	IRS
Colvin v. Comm'r, T.C. Memo. 2007-157, *aff'd* by 2008-2 U.S. Tax Cas. (CCH) P50,450 (5th Cir. 2008)	Deductions denied for expenses not substantiated	Yes	IRS
Conopco, Inc. v. U.S., 100 A.F.T.R.2d (RIA) 5296 (D.N.J. 2007), *appeal docketed*, No. 07-3564 (2d Cir. Aug. 30, 2007)	Deductions denied for amounts paid or incurred by a corporation in connection with the reacquisition of its stock under IRC 162(k)	No	IRS
Derby v. Comm'r, T.C. Memo. 2008-45	Deductions denied for expenses not substantiated and could not be estimated under *Cohan* rule	No	IRS
Diller v. Comm'r, T.C. Summ. Op. 2007-146	Deductions denied for expenses not substantiated and for activity not engaged in for profit	Yes	IRS
Dunne v. Comm'r, T.C. Memo. 2008-63	Deductions denied for legal expenses not substantiated	No	IRS
Edwards v. Comm'r, T.C. Summ. Op. 2007-182	Deductions denied for compensation and transportation expenses not substantiated	No	IRS
Ellis v. Comm'r, T.C. Memo. 2007-207, *appeal docketed* (10th Cir. Dec. 26, 2008)	Deductions denief for expenses not substantiated and could not be estimated under *Cohan* rule	No	IRS
Enbridge Energy Co. v. U.S., 553 F. Supp. 2d 716 (S.D. Tex. 2008), *appeal docketed*, No. 08-20261 (5th Cir. May 16, 2008)	Deductions denied for amortization and depreciation based on inflated basis in abusive tax shelter transaction; expenses not ordinary and necessary	No	IRS
Eyler v. Comm'r, T.C. Memo. 2007-350	Deductions denied for spouse's health insurance premiums personal in nature; expenses not ordinary and necessary	No	IRS
E. J. Harrison & Sons, Inc. v. Comm'r, 270 Fed. Appx. 667 (9th Cir. 2008), *aff'g* T.C. Memo. 2006-133, *on remand from* 138 Fed. Appx. 994 (9th Cir. 2005), *aff'g in part and rev'g in part* T.C. Memo. 2003-239	Tax Court's prior determination of deductions for reasonable compensation affirmed	No	IRS
Fisher v. Comm'r, T.C. Summ. Op. 2008-35	Deductions denied for expenses not substantiated	Yes	IRS
Follum v. Comm'r, T.C. Memo. 2007-164, *aff'd* by267 Fed. Appx. 309 (4th Cir. 2008)	Deductions denied for fishing activity that was not engaged in for profit	Yes	IRS
Frahm v. Comm'r, T.C. Memo. 2007-351	Deductions allowed for TPs (H&W) health insurance premiums and medical expenses according to employee benefits program; expenses ordinary and necessary; expenses not subject to 60 percent limitation of IRC 162(l)	No	TPs
General Mills, Inc. v. U.S., 101 A.F.T.R.2d (RIA) 550 (D. Minn. 2008), *appeal docketed*, No. 08-1638 (8th Cir. Mar. 21, 2008)	Deductions allowed for cash distribution redemptive dividends paid to employees in satisfaction of corporation's obligation to repurchase stock under IRC 162(k)	No	TP
Glotov v. Comm'r, T.C. Memo. 2007-147	Deductions denied for software development expenses and depreciation because TP not engaged in trade or business with the primary purpose of deriving profit	Yes	IRS
Green v. Comm'r, 507 F.3d 857 (5th Cir. 2007), *aff'g* T.C. Memo. 2005-250	Deductions denied for expenses in collecting a personal judgment not incurred in carrying on any trade or business; deductions denied for exemplary damages expenses not ordinary and necessary	No	IRS

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Table 4: Trade or Business Expenses Under IRC § 162(a) and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Haney v. Comm'r, T.C. Memo. 2007-238	Deductions denied for expenses not substantiated and personal in nature; deductions denied because auto racing activity did not constitute trade or business activity entered into for profit	No	IRS
Jackson v. Comm'r, T.C. Summ. Op. 2007-208	Deductions denied for expenses not substantiated or personal in nature; deductions denied for activity not engaged in for profit	Yes	IRS
Jackson v. Comm'r, T.C. Memo. 2008-70	Deductions denied for expenses not substantiated, previously deducted, not incurred, or personal in nature; start-up expenses cannot be amortized when election not filed under IRC 195	Yes	IRS
Kanofsky v. Comm'r, 101 A.F.T.R.2d (RIA) 1501 (3d Cir. 2008), *aff'g* T.C. Memo. 2006-79, *rehearing enbanc denied* (3d Cir. June 4, 2008)	Deductions denied because TP not actively engaged in a trade or business	Yes	IRS
Keating v. Comm'r, T.C. Memo. 2007-309, *appeal docketed*, No. 08-1266 (8th Cir. Jan. 28, 2008)	Deductions denied for horse breeding activity that was not engaged in for profit	No	IRS
Keita v. Comm'r, T.C. Summ. Op. 2007-154	Deductions denied for expenses not substantiated; deductions denied for business use of home not regular and exclusive	Yes	IRS
Kerr-Mcgee Corp. v. United States, 77 Fed. Cl. 309 (2007)	Deductions allowed for environmental remediation costs under IRC 198 if TP caused the contamination; remediation expenses increasing value of the property and not ordinary and necessary should be capitalized under IRC 263	No	Split
Knight v. Comm'r, 128 S. Ct. 782 (2008)	Deductions denied for investment advisory fees paid by the trust in excess of the two-percent floor since IRC 67(e)(1) only allows full deductibility if the costs would not have been incurred if the property were not held in trust	No	IRS
Knowles v. Comm'r, T.C. Summ. Op. 2008-40	Deductions allowed for expenses ordinary and necessary; deductions denied for expenses personal in nature	Yes	Split
Knudsen v. Comm'r, T.C. Memo. 2007-340	Deductions denied for exotic animal breeding activities because TPs not engaged in trade or business for profit	No	IRS
Kurtz v. Comm'r, T.C. Memo. 2008-111, *reconsideration denied* (T.C. July 7, 2008)	Deductions for meals and incidental expenses (M & IE) limited to 50 percent of applicable M & IE rates under IRC 274(n)	No	IRS
Larvadain v. Comm'r, T.C. Summ. Op. 2007-196	Deductions denied for advertising car and truck, legal/professional, and other office expenses not substantiated; deductions for business use of home denied because TP did not use a portion of a dwelling regularly and exclusively for business	No	IRS
Lease v. Comm'r, T.C. Summ. Op. 2008-11	Deductions allowed for travel expenses properly substantiated; deductions denied for expenses not substantiated	Yes	Split
Lebloch v. Comm'r, T.C. Memo. 2007-145, *appeal docketed*, No. 07-74364 (9th Cir. 2007)	Deductions denied for travel, home office, and miscellaneous expenses not substantiated; deductions denied for travel abroad expenses personal in nature; deductions for business use of home denied because TPs (H&W) did not use a portion of a dwelling regularly and exclusively for business	No	IRS
Lockett v. Comm'r, T.C. Memo. 2008-5, *appeal transferred to* 11th Cir., No. 08-12466 (D.C. Cir. May 2, 2008)	Deductions denied for expenses not substantiated	Yes	IRS
Maciel v. Comm'r, 489 F.3d 1018 (9th Cir. 2007), *rev'g in part*, T.C. Memo. 2004-28	Deductions allowed for racing activity expenses properly substantiated	No	TP
Mallin v. Comm'r, T.C. Summ. Op. 2008-13	Deductions allowed for woodworking expenses ordinary and necessary; deductions for business use of home exceeding gross income from the business denied according to IRC 280A(c)(5)	Yes	Split
McClain v. Comm'r, T.C. Summ. Op. 2007-175	Deductions denied for expenses related to various business activities when TP not engaged in rental activity with a profit motive and the expenses not ordinary and necessary; deductions denied for start-up expenditures under IRC 195(a)	Yes	IRS
Meyer v. Comm'r, T.C. Summ. Op. 2007-181	Deductions denied for corporate expenses not incurred by TP in individual capacity	Yes	IRS
Mohammadpour v. Comm'r, Summ. Op. 2007-163	Deductions for gambling losses denied because TP not engaged in gambling as a trade or business activity for profit	Yes	IRS
Moreira v. Comm'r, T.C. Memo. 2008-105	Deductions denied for expenses not substantiated	Yes	IRS
Morris v. Comm'r, T.C. Memo. 2008-65	Deductions denied for expenses not substantiated	Yes	IRS

Table 4: Trade or Business Expenses Under IRC § 162(a) and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Myers v. Comm'r, T.C. Summ. Op. 2007-194	Deductions allowed for gambling activity conducted with continuity, regularity, and the primary purpose of earning a profit	No	TP
Myrick v. Comm'r, T.C. Summ. Op. 2007-143	Deduction denied for event planning activity because TP not engaged in trade or business activity with continuity, regularity, and with the primary purpose of deriving income and profit	Yes	IRS
Myrick v. Comm'r, T.C. Summ. Op. 2007-184	Deductions denied for expenses not substantiated or personal in nature; some deductions allowed for properly substantiated expenses	Yes	Split
Negret v. Comm'r, T.C. Summ. Op. 2008-26	Deductions denied for vehicle insurance expenses not substantiated and when a standard mileage rate used.	Yes	IRS
Odelugo v. Comm'r, T.C. Memo. 2008-92	Deductions denied for expenses not substantiated, personal in nature, or not ordinary and necessary	No	IRS
Oji v. Comm'r, T.C. Memo. 2008-85	Deductions denied for expenses not substantiated	Yes	IRS
Osborne v. Comm'r, T.C. Memo. 2008-40	Deductions denied for expenses not substantiated	Yes	IRS
Oswandel v. Comm'r, T.C. Memo. 2007-183	Deductions denied for ministerial activities because TPs not engaged in trade or business for profit; deductions denied for expenses not substantiated	Yes	IRS
Pearson v. Comm'r, T.C. Memo. 2007-341	Deductions denied for expenses not substantiated or not actually incurred	Yes	IRS
Rovell v. Comm'r, T.C. Summ. Op. 2007-113	Deductions denied for expenses not substantiated; deductions allowed for state income taxes properly substantiated	Yes	Split
Royster v. Comm'r, T.C. Summ. Op. 2007-151	Deductions denied for expenses not substantiated and for activity not engaged in for profit	Yes	IRS
Rozzano v. Comm'r, T.C. Memo. 2007-177	Deductions allowed for expenses attributable to the horse boarding activities engaged in for profit	No	TP
Runels v. Comm'r, T.C. Summ. Op. 2008-10	Deductions denied for expenses not substantiated or personal in nature	Yes	IRS
Schoolcraft-Burkey v. Comm'r, T.C. Summ. Op. 2007-126	Deductions denied for expenses not substantiated, but allowed for substantiated expenses; deductions denied for expenses not incurred or paid	Yes	Split
Showler v. Comm'r, T.C. Summ. Op. 2008-8	Deductions denied for expenses not substantiated; deductions allowed for substantiated expenses	Yes	Split
Singh v. Comm'r, T.C. Memo. 2008-68	Deductions denied for expenses personal in nature	Yes	IRS
Sita v. Comm'r, T.C. Memo. 2007-363, *appeal reinstated*, No. 08-1764 (7th Cir. May 19, 2008)	Deductions denied for expenses not substantiated	Yes	IRS
Smith v. Comm'r, T.C. Memo. 2007-368, *appeal docketed*, No. 08-72402 (9th Cir. May 23, 2008)	Deductions denied for horse and dog breeding activities not engaged in for profit; deductions allowed for cow and dairy farm activity engaged in for profit	No	Split
Stephens v. Comm'r, T.C. Summ. Op. 2008-18	Deductions denied for out-of-pocket medical care expenses not ordinary and necessary; Deductions for health insurance premiums only 60% deductible under IRC 162(l)	No	IRS
Tarter v. Comm'r, T.C. Memo. 2007-320	Deductions denied for expenses not substantiated	No	IRS
Tash v. Comm'r, T.C. Memo. 2008-120	Deductions allowed for payroll expenses estimated under *Cohan* rule; deductions denied for expenses not substantiated	No	Split
Tomlinson v. Comm'r, T.C. Summ. Op. 2007-210	Deductions denied for medical expenses not substantiated; deductions denied for miscellaneous expenses because TP not engaged in active trade or business	Yes	IRS
Tripp v. Comm'r, T.C. Summ. Op. 2007-174	Deductions allowed for partnership losses and partnership salary expenses not substantiated but corroborated by TPs credible evidence	Yes	TP
Tyson Foods, Inc. v. Comm'r, T.C. Memo. 2007-188	Deductions denied for expenses not substantiated and could not be estimated under Cohan rule	No	IRS
Universal Mktg. v. Comm'r, T.C. Memo. 2007-305	Deductions denied for executive compensation not reasonable; deductions denied for incidental materials and supplies not substantiated	Yes	IRS
Vigil v. Comm'r, T.C. Summ. Op. 2008-6	Deductions denied for travel, meals, and entertainment expenses not substantiated	Yes	IRS
Vitamin Vill., Inc. v. Comm'r, T.C. Memo. 2007-272	Deductions allowed for reasonable compensation paid to corporation's sole executive and shareholder; deductions allowed for ordinary and necessary advertising expenses	Yes	Split

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Table 4: Trade or Business Expenses Under IRC § 162(a) and Related Sections

Case Citation	Issue(s)	*Pro Se*	Decision
Vogt v. Comm'r, T.C. Memo. 2007-209, *appeal docketed*, No. 08-71133 (9th Cir. Mar. 12, 2008)	Deductions denied for expenses not substantiated	Yes	IRS
V.R. Deangelis M.D.P.C. v. Comm'r, T.C. Memo. 2007-360, *appeal docketed*, No. 08-1143 (2d Cir. Mar. 3, 2008)	Deduction denied for life insurance premium expenses not ordinary and necessary	No	IRS
Walker v. Comm'r, T.C. Summ. Op. 2008-41	No travel expense deductions because TP had no "tax home"	Yes	IRS
Walters v. Comm'r, T.C. Summ. Op. 2007-167	Deductions denied for mileage expenses not substantiated	Yes	IRS
Yip v. Comm'r, T.C. Memo. 2007-139	Deductions denied for expenses not substantiated	Yes	IRS

Table 5 Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)

Case Citation	Issue(s)	*Pro Se*	Decision
Individual Taxpayer (But Not Sole Proprietorships)			
Atkin v. Comm'r, T.C. Memo. 2008-93	6662(b)(1) & (2) - Failed to roll over IRA account	Yes	IRS
Barrett v. U.S., 100 A.F.T.R.2d (RIA) 6934 (W.D. Okla. 2007), *appeal docketed*, No. 08-6017 (10th Cir. Feb. 1, 2008)	6662(b)(1) - Claimed that work paid for from tax-free fund is not taxable	No	IRS
Boggs v. Comm'r, T.C. Memo. 2008-81, *appeal docketed*, No. 08-1907 (6th Cir. June 30, 2008)	6662(b)(1) & (2) - TPs (H&W) claiming deduction for loss of "Human Capital"	Yes	IRS
Cabirac v. Comm'r, T.C. Memo. 2008-142	6662(b)(2) - TP failed to report substantial income	Yes	IRS
Clark v. Comm'r, T.C. Memo. 2008-71	6662(b)(1) & (2) - Negligently prepared returns and claimed income for work in international waters as foreign income	No	IRS
Dawson v. Comm'r, T.C. Summ. Op. 2008-17	6662(b)(1) - TPs (H&W) reasonably attempted to comply with their reporting requirements by offsetting gambling winnings with gambling losses	Yes	TP
Foster v. Comm'r, T.C. Summ. Op. 2008-22	6662(b)(1) - Failed to show good faith or reasonable cause in deducting education expenses	No	IRS
G. Kierstead Family Holdings Trust v. Comm'r, T.C. Memo. 2007-158	6662(b)(1) - TP failed to prove reliance on professional and failed to assert any other basis for relief	No	IRS
Gagliardi v. Comm'r, T.C. Memo. 2008-10.	6662(b)(2) - TP reasonably and in good faith relied on his preparer to report gambling wins and losses	No	TP
Gibson v. Comm'r, T.C. Memo. 2007-224	6662(b)(1) & (2) - TP reasonably relied on tax attorney's advice	No	TP
Green v. Comm'r, 100 A.F.T.R.2d (RIA) 6562 (5th Cir. 2007), *aff'g* T.C. Memo. 2005-250, *reh'g denied* (Jan. 10, 2008)	6662(b)(2) - Failed to pay taxes on settlement and deducted legal fees of obtaining settlement	No	IRS
Green v. Comm'r, T.C. Memo. 2007-217	6662(b)(1) - TP negligently failed to include settlement income	Yes	IRS
Hynes v. Comm'r, T.C. Summ. Op. 2008-1	6662(b)(2) - TP's good faith at the time the return was filed controls rather than the action he took after he received the notice of deficiency	Yes	IRS
Ito v. Comm'r, T.C. Summ. Op. 2008-37	6662(b)(1) - Failure to report tip income and kept no records	Yes	IRS
Keith v. Comm'r, T.C. Summ. Op. 2007-214	6662(b)(2) - Understatement less than threshold amount for the imposition of penalty for discharge of indebtedness	No	TP
Kovachevich v. Comm'r, T.C. Summ. Op. 2007-179	6662(b)(1) - TP failed to make a reasonable attempt to ascertain correctness of deductions	Yes	IRS
Langroudi v. Comm'r, T.C. Summ. Op. 2007-156	6662(b)(1) - TP not liable because of the intricate and complicated nature of the tax treaty with Belgium, reported all income	Yes	TP
Larsen v. Comm'r, T.C. Memo. 2008-73	6662(b)(1) & (2) - Claimed money from employer was a gift	No	IRS
MacMurray v. Comm'r, T.C. Summ. Op. 2007-118	6662(b)(2) - TP, a former IRS lawyer did not make reasonable inquiry to see if position was correct	Yes	IRS
Mezrah v. Comm'r, T.C. Memo. 2008-123	6662(b)(1) - Failed to show that partnership interest had been gifted to son, but showed reliance on tax professional for passive activity loss	No	Split
Muller v. Comm'r, T.C. Summ. Op. 2007-207	6662(b)(2) - No reliance, TPs (H&W) did not provide preparer with information about IRA distributions	Yes	IRS
Neal v. Comm'r, T.C. Summ. Op. 2007-209	6662(b)(1) & (2) - TP failed to maintain adequate records and is therefore negligent	Yes	IRS
Oswandel v. Comm'r, T.C. Memo. 2007-183	6662(b)(1) - Lack of accurate records with no reasonable cause and good faith	Yes	IRS
Pedersen v. Comm'r, T.C. Summ. Op. 2007-161	6662(b)(1) & (2) - TP negligent for not examining his return cannot demonstrate reasonable cause or good faith for the underpayment	Yes	IRS
Perkins v. Comm'r, T.C. Memo. 2008-41	6662(b)(1) & (2) - TP reasonably relied on a tax attorney in failing to report alimony payments	No	TP

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Table 5: Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)

Case Citation	Issue(s)	*Pro Se*	Decision
Pettit v. Comm'r, T.C. Memo. 2008-87	6662(b)(1) & (2) - TPs (H&W) reasonably and in good faith relied on the preparer regarding settlement income	No	TP
Randall v. Comm'r, 100 A.F.T.R.2d (RIA) 6946 (10th Cir. 2007), *aff'g* T.C. Memo. 2007-1	6662(b)(1) - Failed to report 1099 income and no attempt to comply with the Code	Yes	IRS
Randall v. Comm'r, T.C. Memo. 2008-138	6662(b)(1) & (2) - Failure to report substantial amounts of income	Yes	IRS
Rector, Estate of v. Comm'r, T.C. Memo. 2007-367	6662(b)(1) - Estate did not properly report gifts	No	IRS
Schoolcraft-Burkey v. Comm'r, T.C. Summ. Op. 2007-126	6662(b)(2) - TP negligently failed to report settlement income	Yes	IRS
Schubert v. Comm'r, T.C. Summ. Op. 2008-24	6662(b)(1) - Lack of adequate records	Yes	IRS
Smith v. Comm'r, T.C. Summ. Op. 2007-106	6662(b)(1) -TP's circumstances (homelessness, health, & technical law) were reasonable cause	Yes	TP
Snead v. Comm'r, T.C. Summ. Op. 2008-57	6662(b)(1) - Failed to provide complete information to tax professional	Yes	IRS
Straus v. Comm'r, T.C. Summ. Op. 2007-107	6662(b)(1) & (2) - TPs (H&W) did not act with reasonable cause by failing to inquire about the taxability of the life insurance distribution	Yes	IRS
Talmage v. Comm'r, T.C. Memo 2008-34	6662(b)(1) - TP not liable because fraud penalty already assessed against her spouse, resulting in impermissible stacking	No	TP
Tateosian v. Comm'r, T.C. Memo. 2008-101	6662(b)(1) - Changes in the law and TP's pension caused confusion, TP acted with reasonable cause and good faith	No	TP
Theurer v. Comm'r, T.C. Memo. 2008-61	6662(b)(2) - TP failed to include alimony in her taxable income	No	IRS
Thompson, Estate of v. Comm'r, 100 A.F.T.R.2d (RIA) 5792 (2d Cir. 2007), *vacating and remanding* T.C. Memo. 2004-174, *cert. denied*, 128 S. Ct. 2932 (June 16, 2008)	6662(b) - Remanded to determine reasonable cause and good faith	No	Remanded
Thompson v. Comm'r, T.C. Memo. 2007-174	6662(b)(1) - TP made reasonable attempt to comply with IRS laws by obtaining software to aid him in his return preparation	No	TP
Thompson v. Comm'r, T.C. Memo. 2007-327, *appeal docketed*, No. 07-3917 (8th Cir. Dec. 10, 2007)	6662(b)(2) - TP did not address 6662 arguments	Yes	IRS
Woodard v. Comm'r, T.C. Summ. Op. 2008-45	6662(b)(2) - Failure to produce any documentation or records or explain reasoning for deductions	Yes	IRS
Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships - Schedule C, E, F)			
Agbaniyaka v. Comm'r, T.C. Memo. 2007-300	6662(b)(1) - TP, a trained revenue agent, failed to maintain sufficient records to support deductions	Yes	IRS
Akers v. Comm'r, T.C. Memo. 2007-296, *appeal docketed*, No. 08-1186 (Fed. Cir. Jan. 24, 2008), *appeal transferred*, 273 Fed. Appx. 915 (Fed. Cir. Mar. 10, 2008), *appeal docketed*, No. 08-1218 (2d Cir. Mar. 18, 2008)	6662(b)(1) & (2) - TP failed to maintain adequate records to substantiate claimed deductions.	No	IRS
Arberg v. Comm'r, T.C. Memo. 2007-244	6662(b)(1) & (2) - TP failed to produce any records substantiating deductions	No	IRS
Arnold v. Comm'r, T.C. Memo. 2007-168	6662(b)(1) & (2) - TPs (H&W) failed to show that they had reasonable cause or acted in good faith for their deductions	Yes	IRS
AWG Leasing Trust v. U.S., 101 A.F.T.R.2d (RIA) 2397 (N.D. Ohio 2008)	6662(b)(1) - SILO transaction, trust did not carry burden of reasonable cause defense, court sustains accuracy-related penalties to partnership's returns. Individual partners may assert reasonable cause defense in partner-level refund action	No	IRS
Berryman v. Comm'r, T.C. Summ. Op. 2007-138	6662(b)(1) - Deductions of personal items	Yes	IRS
Bigler v. Comm'r, T.C. Memo. 2008-133	6662(b)(2) -TPs kept detailed and accurate records and acted with reasonable cause and in good faith	No	TP
Black v. Comm'r, T.C. Memo. 2007-364	6662(b)(1) & (2) - TP is not liable for the underpayments of tax due to fraud by spouse	Yes	TP
Brown v. Comm'r, T.C. Summ. Op. 2007-135	6662(b)(1) - Many errors and irregularities of TPs (H&W) show negligence	Yes	IRS

Table 5: Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)

Case Citation	Issue(s)	*Pro Se*	Decision
Burkley v. Comm'r, T.C. Summ. Op. 2008-20	6662(b)(2) - TP acknowledges deficiency and unreasonably relied on tax preparer who was not an accountant or familiar with tax software	Yes	IRS
Enbridge Energy Co., Inc. v. U.S., 101 A.F.T.R.2d (RIA) 1733 (S.D. Tex. 2008), *appeal docketed*, No. 08-20261 (5th Cir. Apr. 24, 2008)	6662(b)(1) & (2) - TP knowingly engaged in a scheme to obfuscate the real transaction and cannot claim reliance on tax professional.	No	IRS
Farah v. Comm'r, T.C. Memo. 2007-369	6662(b)(1) - TPs (H&W) failed to prove they reasonably relied on a competent tax professional and failed to assert any other basis for relief.	No	IRS
Glotov v. Comm'r, T.C. Memo. 2007-147	6662(b)(1) - TP took business deductions but no business	Yes	IRS
Jackson v. Comm'r, T.C. Memo. 2008-70	6662(b)(1) - TP failed to substantiate and ascertain the correctness of deductions	Yes	IRS
Jade Trading, LLC v. U.S., 100 A.F.T.R.2d (RIA) 7123 (Fed. Cl. 2007), *reconsideration denied by* 101 A.F.T.R.2d (RIA) 1411 (Fed. Cl. 2008)	6662(b)(1) & (2) - Application of penalties at the partnership level is affirmed without consideration of the reasonable cause defenses, which may be raised in any partner level proceedings.	No	IRS
Jade Trading, LLC v. U.S., 101 A.F.T.R.2d (RIA) 1411 (Fed. Cl. 2008), *denying reconsideration of* 100 A.F.T.R.2d (RIA) 7123 (Fed. Cl. 2007)	6662(b)(1) - TP did not demonstrate a manifest error of law in the Court's application of the negligence penalty; application of penalties at the partnership level affirmed.	No	IRS
King v. Comm'r, 100 A.F.T.R.2d (RIA) 6481 (11th Cir. 2007), *aff'g* T.C. Memo. 2006-112	6662(b)(1) - Failure to provide complete information to tax professional	No	IRS
Kopty v. Comm'r, T.C. Memo. 2007-343, *appeal docketed*, No. 08-1171 (D.C. Cir. Apr. 29, 2008)	6662(b)(1) - Failure to report IRA distributions and dividends shows negligence or disregard of rules or regulations	Yes	IRS
Lai v. Comm'r, T.C. Memo. 2007-165	6662(b)(1) & (2) - TP failed to report tip income to tax preparer	No	IRS
Litman v. U.S., 100 A.F.T.R.2d (RIA) 5716 (Fed. Cl. 2007), *amended by* 100 A.F.T.R.2d (RIA) 6733 (Fed. Cl. 2007), *amended and supplemented by* 101 A.F.T.R.2d (RIA) 1395 (Fed. Cl. 2008)	6662(b)(1) - TPs acted with reasonable cause and in good faith	No	TP
Litman v. U.S., 101 A.F.T.R.2d (RIA) 1395 (Fed. Cl. 2008), *amending and supplementing* 100 A.F.T.R.2d (RIA) 6733 (Fed. Cl. 2007), *amending* 100 A.F.T.R.2d (RIA) 5716 (Fed. Cl. 2007)	6662(b)(1) - TP carried its burden of showing entitlement to the defenses of 6664(c) because TP acted upon a reasonable cause and in good faith	No	TP
McCammon v. Comm'r, T.C. Memo. 2008-114	6662(b)(2) - TP failed to produce sufficient evidence for deductions	Yes	IRS
Monk v. Comm'r, T.C. Memo. 2008-64	6662 - Mistake was the result of accountant's understandable error	No	TP
Moreira v. Comm'r, T.C. Memo. 2008-105	6662(b)(1) - TP failed to keep adequate records	Yes	IRS
Myrick v. Comm'r, T.C. Summ. Op. 2007-143	6662(b)(1) - TP failed to maintain adequate records to substantiate deductions	Yes	IRS
Myrick v. Comm'r, T.C. Summ. Op. 2007-184	6662(b)(1) - TP failed to maintain accounting records and keep receipts or attempt to recreate records	Yes	IRS
Nelson v. Comm'r, 130 T.C. No. 5, WL 540331 (Feb. 28, 2008)	6662(b)(1) - TPs acted in good faith and with reasonable cause based on the complicated nature of section 451(d)	No	TP
Neufeld v. Comm'r, T.C. Memo. 2008-79	6662(b)(2) - TPs (H&W) failed to oversee their tax preparer	Yes	IRS
Oria v. Comm'r, T.C. Memo. 2007-226	6662(b)(1) - TPs (H&W) were negligent and failed to show reasonable cause or act in good faith in relying on accountant	No	IRS
Osborne v. Comm'r, T.C. Memo. 2008-40	6662(b)(1) - TPs (H&W) failed to report income, maintain adequate business records, or exercise due care in reporting their income and expenses.	Yes	IRS
Prudhomme v. Comm'r, T.C. Memo. 2008-83, *appeal docketed*, No. 08-60449 (5th Cir. May 16, 2008)	6662(b)(2) – TPs (H&W) failed to provide their preparers with adequate information	No	IRS
Ramirez v. Comm'r, T.C. Memo. 2007-347	6662(b)(2) - Gross discrepancies between the tax reported and the tax actually owed	Yes	IRS
Royster v. Comm'r, T.C. Summ. Op. 2007-151	6662(b)(2) - TP failed to maintain adequate records to substantiate claimed deductions	Yes	IRS
Runels v. Comm'r, T.C. Summ. Op. 2008-10	6662(b)(1) & (2) - TPs (H&W) underreported income, overstated deductions and failed to show reasonable cause	Yes	IRS

Appendix Three

Table 5: Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)

Case Citation	Issue(s)	*Pro Se*	Decision
Rusten v. Comm'r, T.C. Summ. Op. 2008-16	6662(b)(1) & (2) - Reasonable cause because unusual circumstances and complicated nature of foreign tax	Yes	TP
Sala v. U.S., 552 F. Supp. 2d 1167 (D. Colo. 2008), *motion for new trial denied*, 102 A.F.T.R.2d (RIA) 5292 (2008)	6662(b) - TP filed a qualified amended return and the IRS is not allowed to offset any excess interest payments made by TP with an accuracy-related penalty	No	TP
Smith v. Comm'r, T.C. Memo. 2007-154, *appeal docketed*, No. 07-14376 (11th Cir. Sept. 13, 2007), *appeal dismissed* (Nov. 7, 2007).	6662(b)(1) - TP's reliance on her tax professional was reasonable and she showed good faith	No	TP
Smith v. Comm'r, T.C. Memo. 2007-368, *appeal docketed*, No. 08-72402 (9th Cir. May 23, 2008)	6662(b)(1) & (2) - TPs had reasonable cause for their noncash charitable contribution deductions but negligent in their disallowed schedule F losses.	No	TP
Sparkman v. Comm'r, 100 A.F.T.R.2d (RIA) 6961 (9th Cir. 2007), *aff'g* T.C. Memo. 2005-136	6662(b)(1) - Sham business, disallowed depreciation losses and charitable donation deductions	No	IRS
Tarter v. Comm'r, T.C. Memo. 2007-320	6662(b)(1) - TPs (H&W) failed to persuade court that failure to maintain records was excused by reasonable cause and good faith	No	IRS
Tash v. Comm'r, T.C. Memo. 2008-120	6662(b)(2) - TP provided no evidence establishing tax preparer as a competent tax professional and did not provide preparer with all information.	No	IRS
Tripp v. Comm'r, T.C. Summ. Op. 2007-174	6662(b)(1) - TP entitled to deductions for losses	Yes	TP
Vigil v. Comm'r, T.C. Summ. Op. 2008-6	6662(b)(2) - TP failed on the disallowed business expense deductions but prevailed on the section 1401 self-employment exemption because of reliance on preparer	Yes	Split
Vogt v. Comm'r, T.C. Memo. 2007-209, *appeal docketed*, No. 08-71133 (9th Cir. Mar. 12, 2008)	6662(b)(1) - Noncompliant TP negligent for failing to report partnership distribution	Yes	IRS
Walker v. Comm'r, T.C. Summ. Op. 2008-41	6662(b)(2) - TPs (H&W) failed to bear the burden of proving that they had reasonable cause and acted in good faith	Yes	IRS
Xiong v. Comm'r, T.C. Summ. Op. 2007-96	6662(b)(1) & (2) - TP did not make a reasonable attempt to comply with rules and regulations regarding certain business deductions but was not found negligent or to have disregarded rules for home office deductions	Yes	Split

Table 6 Civil Damages for Certain Unauthorized Collection Actions Under IRC § 7433

Case Citation	Issue(s)	*Pro Se*	Decision
Individual v. Business Status Unclear from Court Opinion			
In re Abate, 101 A.F.T.R.2d (RIA) 1806 (D.N.J. 2008), *vacating*, No. 05-19745, 2007 Bankr. LEXIS 2139 (Bankr. D.N.J. May 29, 2007)	Dismissed for failure to exhaust administrative remedies; bankruptcy court reversed	No	IRS
Aderinto v. Tax Payer Advocate (IRS), 2008 WL 2077910 (D.S.C. 2008)	Dismissed for failure to allege IRS engaged in wrongful collection activity and failure to exhaust administrative remedies	Yes	IRS
Al-Sharif v. Bradley, 101 A.F.T.R.2d (RIA) 1238 (S.D. Ga. 2008, *appeal docketed*, No. 08-10741F (11th Cir. Feb. 26, 2008)	Dismissed for failure to exhaust administrative remedies; claim untimely	Yes	IRS
Anderson v. U.S., 100 A.F.T.R.2d (RIA) 5249 (D.D.C. 2007), *appeal dismissed*, 2008 U.S. App. LEXIS 5322, No. 07-5283 (D.C. Cir. Mar. 6, 2008)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Bean v. U.S., 538 F. Supp. 2d 220 (D.D.C. 2008)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection; must allege grounds for damage claim with specificity	Yes	IRS
Bennett v. U.S., 100 A.F.T.R.2d (RIA) 5133 (W.D. Va. 2007), *aff'd, per curiam*, 267 Fed. Appx. 212 (4th Cir. 2008)	Dismissed on the merits for failure to show any IRS violation of statutes or regulations related to collection actions; dismissed damage claims seeking to challenge improper assessment; IRC 7433 applies only to improper collection	Yes	IRS
Bennett v. U.S., 530 F. Supp. 2d 340 (D.D.C. 2008), *denying reconsideration*, 462 F. Supp. 2d 35 (D.D.C. 2006)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
U.S. v. Berk, 374 B.R. 385 (D. Mass. 2007)	Counterclaim dismissed for failure to exhaust administrative remedies	Yes	IRS
In re Bloodworth, 2008 Bankr. LEXIS 1922 (M.D. Fla. 2008)	Claims arising from the violation of the automatic stay provision dismissed for failure to exhaust administrative remedies	No	IRS
Bryant v. U.S., 527 F. Supp. 2d 137 (D.D.C. 2007)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection; must allege grounds for damage claim with specificity	Yes	IRS
Cherbanaeff v. U.S., 77 Fed. Cl. 490 (2007), *appeal dismissed by*, 253 Fed. Appx. 23 (Fed. Cir. 2007), *appeal reinstated by*, 257 Fed. Appx. 275 (Fed. Cir. 2007)	Dismissed for lack of jurisdiction because action filed in wrong court; jurisdiction over action under IRC 7433 lies exclusively with the district court; claims arising from the violation of the automatic stay provision dismissed because proper forum for this type of action is the bankruptcy court	No	IRS
Chocallo v. IRS, 100 A.F.T.R.2d (RIA) 5253 (E.D. Pa. 2007), *dismissed by*, 101 A.F.T.R.2d (RIA) 406 (E.D. Pa. 2008), *appeal docketed*, No. 08-1660 (3d Cir. Apr. 2, 2008)	Dismissed for failure to exhaust administrative remedies; claim timely	Yes	Split
Curfman v. U.S., 100 A.F.T.R.2d (RIA) 5071 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Delvecchio v. Smith, 101 A.F.T.R.2d (RIA) 2011 (S.D. Fla. 2008)	Dismissed for failure to exhaust administrative remedies; claims also untimely	Yes	IRS
Diebel v. U.S., 100 A.F.T.R.2d (RIA) 5305 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Dorn v. U.S., 249 Fed. Appx. 164 (11th Cir. 2007), *aff'g, per curiam*, 99 A.F.T.R.2d (RIA) 1495 (M.D. Fla. 2007), *petition for certiorari filed*, No. 07-1445, 76 USLW 3630 (May 12, 2008)	Affirmed dismissal for failure to exhaust administrative remedies	Yes	IRS
Dye v. U.S., 516 F. Supp. 2d 61(D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies.	Yes	IRS
Eastman v. U.S., 101 A.F.T.R.2d (RIA) 1566 (W.D. Ark. 2008)	Claim filed after the filing of administrative claim and within the two-year statute of limitations not dismissed	Yes	TP
Eleson v. U.S., 518 F. Supp. 2d 279 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS

Appendix Three

Table 6: Civil Damages for Certain Unauthorized Collection Actions Under IRC § 7433

Case Citation	Issue(s)	*Pro Se*	Decision
Eliason v. U.S., 101 A.F.T.R.2d (RIA) 2052 (D.D.C. 2008)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection; must allege grounds for damage claim with specificity	Yes	IRS
Evans-Hoke v. Paulson, 503 F. Supp. 2d 83 (D.D.C. 2007)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection	Yes	IRS
Falck v. U.S., 99 A.F.T.R.2d (RIA) 3323 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Goodwin v. U.S., 99 A.F.T.R.2d (RIA) 3145 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Guthery v. U.S., 507 F. Supp. 2d 111 (D.D.C. 2007), *case dismissed by*, No. 06-176, 2008 U.S. Dist. LEXIS 48653 (D.D.C. June 26, 2008)	Motion to dismiss for failure to exhaust administrative remedies denied	Yes	TP
Hallinan v. U.S., 498 F. Supp. 2d 315 (D.D.C. 2007), *appeal dismissed by* 2007 U.S. App. LEXIS 28445 (D.C. Cir. Dec. 4, 2007)	Dismissed for failure to exhaust administrative remedies; validity of regulation requiring exhaustion upheld	Yes	IRS
Henry v. U.S.A., 101 A.F.T.R.2d (RIA) 565 (N.D. Ill. 2007)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection; must allege grounds for damage claim with specificity	Yes	IRS
Henry v. U.S., 101 A.F.T.R.2d (RIA) 2098 (7th Cir. 2008), *aff'g* No. 06 C 7087 (N.D. Ill. Aug. 20, 2007)	Affirmed lower court's dismissal on other grounds; damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection	Yes	IRS
Jaeger v. U.S., 524 F. Supp. 2d 60 (D.D.C. 2007)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection; must allege grounds for damage claim with specificity	Yes	IRS
Kimball v. Lucas, 101 A.F.T.R.2d (RIA) 1319 (D. Idaho 2008), *appeal docketed*, No. 08-35324 (9th Cir. Apr. 28, 2008)	Dismissed untimely claim	No	IRS
Koerner v. U.S., 246 F.R.D. 45 (D.D.C. 2007)	Dismissed damage claims unrelated to IRS collection activity; IRC 7433 applies only to improper collection; must allege grounds for damage claim with specificity	Yes	IRS
Kovacs v. U.S., 383 B.R. 90 (Bankr. E.D. Wis. 2007), *vacated and remanded by*, 2008 U.S. Dist. LEXIS 50283, Nos. 07-CV-1064, 07-CV-1069 (E.D. Wis. June 2, 2008)	Administrative remedies exhausted; IRS's breach of bankruptcy discharge was the cause of damages; damages awarded	No	TP
Lindsey v. U.S., 532 F. Supp. 2d 144 (D.D.C. 2008); *prior action*, 448 F. Supp. 2d 37 (D.D.C. 2006), *dismissed with prejudice*, 100 A.F.T.R.2d (RIA) 5220 (D.D.C. 2007)	Motion for reconsideration granted in part; failure to exhaust administrative remedies not basis for dismissal, but an affirmative defense according to Jones v. Bock, 549 U.S. 199 (2007); must file proof of properly executed service	Yes	TP
Lockard v. U.S., 101 A.F.T.R.2d (RIA) 763 (E.D. Mich. 2008)	Dismissed for failure to exhaust administrative remedies	No	IRS
Locke v. U.S., 77 Fed. Cl. 460 (2007), *appeal dismissed*, 253 Fed. Appx. 23 (Fed. Cir. 2007), *appeal reinstated*, 257 Fed. Appx. 275 (Fed. Cir. 2007)	Dismissed for lack of jurisdiction because action filed in wrong court; jurisdiction over IRC 7433 claims lies exclusively with the district court	No	IRS
Ludvigson v. U.S., 525 F. Supp. 2d 55 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Lutz v. U.S., 100 A.F.T.R.2d (RIA) 5114 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Lykens v. U.S., 523 F. Supp. 2d 26 (D.D.C. 2008), *denying motion for relief from judgment*, 98 A.F.T.R.2d (RIA) 7919 (D.D.C. 2006)	Dismissed for failure to exhaust administrative remedies; validity of regulation requiring exhaustion upheld	Yes	IRS
Martens v. U.S., 100 A.F.T.R.2d (RIA) 5125 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies; validity of regulations requiring exhaustion upheld	Yes	IRS
McFarland-Bey v. Everson, 100 A.F.T.R.2d (RIA) 6647 (N.D. Ill. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Miller v. U.S., 100 A.F.T.R.2d (RIA) 5264 (D.D.C. 2007), *reconsideration denied by*, 531 F. Supp. 2d 70 (D.D.C. 2008)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Olender v. U.S., 100 A.F.T.R.2d (RIA) 6047 (M.D. Fla. 2007), *summary judgment granted by*, 101 A.F.T.R.2d (RIA) 2519 (M.D. Fla. 2008)	All available administrative remedies exhausted; actual economic damages recoverable	Yes	TP

Table 6: Civil Damages for Certain Unauthorized Collection Actions Under IRC § 7433

Case Citation	Issue(s)	*Pro Se*	Decision
Pollinger v. U.S., 539 F. Supp. 2d 242 (D.D.C. 2008), *dismissed without prejudice*, No. 06-1885 (D.D.C. Apr. 16, 2008)	Dismissed damage claims seeking to challenge improper assessment and other actions not specifically related to the collection of income tax; IRC 7433 applies only to improper collection; failure to exhaust administrative remedies not proven	Yes	Split
Rae v. U.S., 530 F. Supp. 2d 127 (D.D.C. 2008)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Radcliffe v. U.S., 519 F. Supp. 2d 84 (D.D.C. 2007)	Dismissed for failure to allege sufficient facts to support claim; must allege grounds for damage claim with specificity	Yes	IRS
Reading v. U.S., 506 F. Supp. 2d 13 (D.D.C. 2007), *denying reconsideration*, 99 A.F.T.R.2d (RIA) 1547 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Romashko v. U.S., 100 A.F.T.R.2d (RIA) 6181 (D.D.C. 2007), *appeal docketed*, No. 07-5393 (D.C. Cir. Dec. 5, 2007)	Dismissed for failure to exhaust administrative remedies; dismissed damage claims unrelated to IRS collection activity; IRC 7433 applies only to improper collection	Yes	IRS
Rosenbaum v. Comm'r, 100 A.F.T.R.2d (RIA) 5210 (W.D. Tex. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Rotte v. U.S., 101 A.F.T.R.2d (RIA) 2273 (S.D. Fla. 2008), *adopted by*, No. 07-14029, 2008 U.S. Dist. LEXIS 49991 (S.D. Fla. May 14, 2008)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Russell v. U.S., 78 Fed. Cl. 281 (2007)	Dismissed for lack of jurisdiction because action filed in wrong court; jurisdiction over IRC 7433 claims lies exclusively with the district court; transferred to the district court	Yes	IRS
Sande v. U.S., 101 A.F.T.R.2d (RIA) 1705 (M.D. Fla. 2008)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection	No	IRS
Sande v. U.S., 101 A.F.T.R.2d (RIA) 2362 (M.D. Fla. 2008)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection	No	IRS
Santoro v. U.S., 101 A.F.T.R.2d (RIA) 2347 (E.D. Tex. 2008), *adopted by*, 2008-1 U.S. Tax Cas. (CCH) P50,404 (E.D. Tex. 2008)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection; dismissed untimely claims barred by statute of limitations; timely claims dismissed for failure to exhaust administrative remedies	Yes	IRS
Scott v. U.S., 2008 WL 1885481 (D.C. Cir. 2008), *remanding for reconsideration, per curiam*, 100 A.F.T.R.2d (RIA) 5876 (D.D.C. 2007), *petition for rehearing filed*, No. 07-5310 (D.C. Cir. June 9, 2008)	Motion for reconsideration granted in part; failure to exhaust administrative remedies not basis for dismissal, but an affirmative defense according to Jones v. Bock, 549 U.S. 199 (2007)	Yes	TP
Scott v. U.S., 100 A.F.T.R.2d (RIA) 5876 (D.D.C. 2007), *remanded by*, 2008 WL 1885481 (D.C. Cir. 2008)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Shane v. U.S., 101 A.F.T.R.2d (RIA) 449 (D.D.C. 2008)	Dismissed damage claims seeking to challenge improper assessment and other actions not specifically related to the collection of income tax; IRC 7433 applies only to improper collection; must allege grounds for damage claim with specificity; failure to exhaust administrative remedies not proven	Yes	Split
Smith v. U.S., 2007 WL 1944461 (N.D. Tex. 2007), *reaffirmed by*, No. 3-07-CV-0313-D, 2007 WL 1834842 (N.D. Tex. June 25, 2008), *appeal docketed*, No. 08-10288 (5th Cir. Apr. 11, 2008)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection	Yes	IRS
Spahr v. U.S., 501 F. Supp. 2d 92 (D.D.C. 2007)	Dismissed damage claims unrelated to IRS collection activity; IRC 7433 applies only to improper collection; other claims dismissed for failure to allege IRS engaged in wrongful collection activity	Yes	IRS
U.S. v. Speelman, No. 3:06cv322, 2008 WL 281583 (S.D. Ohio Jan. 31, 2008)	Counterclaim dismissed for failure to exhaust administrative remedies	Yes	IRS
Stickney v. IRS, 263 Fed. Appx. 616 (9th Cir. 2008), *vacating and remanding for dismissal*, 93 A.F.T.R.2d (RIA) 2020 (N.D. Cal. 2004)	IRC 7433 applies only to the direct taxpayer and not to third parties	No	IRS
Stuler v. U.S., 101 A.F.T.R.2d (RIA) 1772 (W.D. Pa. 2008)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Thrasher v. U.S., 2008 U.S. Dist. LEXIS 9092 (D.D.C. 2008)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection; claim untimely	Yes	IRS

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Table 6: Civil Damages for Certain Unauthorized Collection Actions Under IRC § 7433

Case Citation	Issue(s)	*Pro Se*	Decision
Wesselman v. U.S., 498 F. Supp. 2d 326 (D.D.C. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Wesselman v. U.S., 501 F. Supp. 2d 98 (D.D.C. 2007)	Dismissed damage claims unrelated to IRS collection activity; IRC 7433 applies only to improper collection; other claims dismissed for failure to allege IRS engaged in wrongful collection activity	Yes	IRS
Williams v. IRS, 2007-2 U.S. Tax Cas. (CCH) P50,568 (E.D. Mo. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Wos v. IRS, 100 A.F.T.R.2d (RIA) 6952 (N.D. Ill. 2007), *appeal docketed*, No. 08-1225 (7th Cir. Feb. 21, 2008)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
U.S. v. Wrubleski, 101 A.F.T.R.2d (RIA) 1552 (S.D. Fla. 2008)	Counterclaim dismissed for failure to exhaust administrative remedies	Yes	IRS
Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships - Schedules C, E, F)			
Acacia Corporate Mgmt., LLC v. U.S., 101 A.F.T.R.2d (RIA) 772 (E.D. Cal. 2008)	IRC 7433 applies only to the direct taxpayer and not to third parties	Yes	IRS
Cox v. U.S., 101 A.F.T.R.2d (RIA) 991 (E.D. Cal. 2008)	Claim untimely; dismissed for failure to timely plead damages and exhaust administrative remedies	No	IRS
Don Johnson Motors, Inc. v. U.S., 532 F. Supp. 2d 844 (S.D. Tex. 2007), *appeal docketed*, No. 08-40509 (5th Cir. May 23, 2008)	Reconsideration of IRC 7433 claim denied for failure to exhaust administrative remedies; claim failed on the merits; filing of the lien proper	No	IRS
Gessert v. U.S., 100 A.F.T.R.2d (RIA) 5514, 2007 WL 2319876 (E.D. Wis. 2007), *denying reconsideration*, 99 A.F.T.R.2d (RIA) 1968 (E.D. Wis. 2007)	Claim untimely; must allege grounds for damage claim with specificity	No	IRS
Krasemann v. U.S., 101 A.F.T.R.2d (RIA) 2490 (D. Ariz. 2008)	Dismissed for failure to allege actual, direct economic damages; failure to exhaust administrative remedies; only taxpayer has standing to bring action	No	IRS
Looney v. U.S., 544 F. Supp. 2d 574 (S.D. Tex. 2008), *appeal docketed*, No. 08-20266 (5th Cir. June 13, 2008)	Dismissed damage claim seeking to challenge improper assessment; IRC 7433 applies only to improper collection; administrative remedies not exhausted; automatic stay not violated	No	IRS
Scharringhausen v. U.S., 101 A.F.T.R.2d (RIA) 1023 (S.D. Cal. 2008)	Dismissed legally insufficient claim; must allege the particular statute or regulation that the IRS allegedly disregarded; granted leave to amend	No	IRS
Spotts v. U.S., 100 A.F.T.R.2d (RIA) 5287 (E.D. Ky. 2007)	Dismissed for failure to exhaust administrative remedies	Yes	IRS
Stephens v. U.S., 100 A.F.T.R.2d (RIA) 6771(S.D. Ga. 2007), *adopted by*, 101 A.F.T.R.2d (RIA) 1119 (S.D. Ga. 2007)	Dismissed for failure to allege grounds for damage claim with specificity	Yes	IRS
Stephens v. U.S., 514 F. Supp. 2d 70 (D.D.C. 2007), *appeal dismissed by*, No. 07-5353, 2008 U.S. App. LEXIS 5768 (D.C. Cir. May 20, 2008)	Dismissed for failure to allege grounds for damage claim with specificity	Yes	IRS
Storage & Office Sys., LLC v. U.S., 100 A.F.T.R.2d (RIA) 5683 (S.D. Ind. 2007)	Dismissed for failure to exhaust administrative remedies	No	IRS
Waterhouse v. U.S., 100 A.F.T.R.2d (RIA) 5815 (E.D. Cal. 2007)	Dismissed for failure to exhaust administrative remedies	No	IRS

Table 7 Failure to File Penalty Under IRC § 6651(a)(1) and Estimated Tax Penalty Under IRC § 6654

Case Citation	Issue(s)	*Pro Se*	Decision
Alston v. Comm'r, T.C. Summ. Op. 2007-155	6654; Overpayment of estimated tax as defense	Yes	IRS
Ballmer v. Comm'r, T.C. Memo. 2007-295	6651(a)(1), 6654; Nonfiler; No estimated tax penalty if no proof that tax was owed for prior tax year; No reasonable cause for failure to file	No	Split (IRS 6651, TP 6654)
Boltinghouse v. Comm'r, T.C. Memo. 2007-324, *appeal docketed*, No. 08-1195 (4th Cir. Feb. 15, 2008), *appeal dismissed* (Apr. 18, 2008)	6651(a)(1), 6654; Notification from the IRS that a "zero" return is not a valid return as reasonable cause for failing to file	Yes	IRS
Bray v. Comm'r, T.C. Memo. 2008-113	6651(a)(1), 6654; Belief employer would file return as reasonable cause or exception	No	IRS
Byers v. Comm'r, T.C. Memo. 2007-331, *appeal docketed*, No. 08-2016 (8th Cir. May 5, 2008)	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	Yes	IRS
Cabirac v. Comm'r, T.C. Memo. 2008-142	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	Yes	IRS
Callahan v. Comm'r, T.C. Memo. 2007-301	6651(a)(1), 6654; Nonfilers (H&W); No evidence of reasonable cause or exception presented	Yes	IRS
Clark v. Comm'r, T.C. Memo. 2007-172	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented; IRS failed to meet burden with respect to section 6654	Yes	Split (IRS 6651(a)(1); TP 6654)
Conner v. Comm'r, T.C. Summ. Op. 2007-131	6651(a)(1), 6654; Belief ex-spouse filed joint return as reasonable cause	Yes	IRS
Connors v. Comm'r, 101 A.F.T.R.2d (RIA) 2230 (2d Cir. 2008), *aff'g* T.C. Memo. 2006-239	6651(a)(1); Nonfiler; No evidence of reasonable cause presented	No	IRS
Cornelius v. Comm'r, T.C. Summ. Op. 2008-42	6651(a)(1); No evidence of reasonable cause presented	Yes	IRS
Cowan, U.S. v., 535 F. Supp. 2d 1135 (D. Haw. 2008)	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	Yes	IRS
DeSabato v. U.S., 538 F. Supp. 2d 422 (D. Mass. 2008)	6651(a)(1); Reliance on IRS agent's oral statement as reasonable cause	No	IRS
Dodge v. Comm'r, T.C. Memo. 2007-236, *appeal docketed*, No. 08-1233 (8th Cir. Jan. 28, 2008)	6651(a)(1), 6654; Nonfiler; Alleged noncompliance of Form 1040 with the Paperwork Reduction Act as reasonable cause or exception	Yes	IRS
Gagliardi v. Comm'r, T.C. Memo. 2008-10	6651(a)(1); No evidence of reasonable cause presented	No	IRS
Green v. Comm'r, T.C. Memo. 2007-262	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	Yes	IRS
Green v. Comm'r, T.C. Memo. 2008-130, *appeal docketed*, No. 08-60907 (5th Cir. Sept. 23, 2008)	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	No	IRS
Hager v. Comm'r, T.C. Summ. Op. 2007-198	6651(a)(1); Belief no tax owed as reasonable cause	Yes	IRS
Halliburton v. Comm'r, T.C. Summ. Op. 2007-203	6651(a)(1), 6654; No evidence of reasonable cause presented; IRS produced no evidence of prior year's tax liability for estimated taxes	Yes	Split (IRS 6651(a)(1); TP 6654)
Hazel v. Comm'r, T.C. Memo. 2008-134	6651(a)(1), 6654; Alcoholism and drug use as reasonable cause or exception	No	Split (IRS 6651(a)(1); TP 6654)
Jahn v. Comm'r, T.C. Memo. 2008-141	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	Yes	IRS
Joubert v. Comm'r, T.C. Memo. 2007-292	6651(a)(1), 6654; Belief no tax owed as reasonable cause or exception	Yes	IRS
Kirch v. Comm'r, T.C. Memo. 2007-276	6651(a)(1); No evidence of reasonable cause presented	Yes	IRS
Klein v. Comm'r, T.C. Memo. 2007-325	6651(a)(1), 6654; Personal/marital problems as reasonable cause or exception	No	IRS
Lewis v. Comm'r, 523 F.3d 1272 (10th Cir. 2008), *aff'g* T.C. Memo. 2007-44	6651(a)(1), 6654; Nonfiler; Alleged noncompliance of Form 1040 with the Paperwork Reduction Act as reasonable cause or exception	Yes	IRS

Appendix Three

Table 7: Failure to File Penalty Under IRC § 6651(a)(1) and Estimated Tax Penalty Under IRC § 6654

Case Citation	Issue(s)	*Pro Se*	Decision
Mandeville v. Comm'r, T.C. Memo. 2007-332	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	Yes	IRS
McGowan v. Comm'r, T.C. Memo. 2008-125	6651(a)(1); Nonfiler; No evidence of reasonable cause presented	Yes	IRS
Mills v. Comm'r, T.C. Memo. 2007-270, *appeal docketed*, No. 07-14812 (11th Cir. Oct. 18, 2007), *appeal dismissed* (Jan. 16, 2008)	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	Yes	IRS
Nitschke v. Comm'r, T.C. Memo. 2008-143	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	Yes	IRS
Perkins v. Comm'r, T.C. Memo. 2008-103	6651(a)(1), 6654; Application of refund to tax liability to abate penalties	Yes	Remanded to determine whether statute of limitations met for refund
Phillips v. Comm'r, T.C. Memo. 2008-9	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	Yes	IRS
Pierce v. Comm'r, T.C. Memo. 2008-109	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	Yes	IRS
Rhodes v. Comm'r, T.C. Memo. 2007-206, *appeal docketed*, No. 08-60093 (5th Cir. Jan. 29, 2008), *appeal dismissed* (Apr. 9, 2008)	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	Yes	IRS
Richards v. Comm'r, 273 Fed. Appx. 728 (10th Cir. 2008)	6651(a)(1); No evidence of reasonable cause presented	Yes	IRS
Schiff v. Comm'r, T.C. Summ. Op. 2007-148	6651(a)(1), 6654; No evidence of reasonable cause or exception presented; IRS failed to meet burden with respect to section 6654 penalty for 2002	Yes	Split (IRS 6651, TP 6654 for 2002, IRS 6654 for 2003)
Talmage v. Comm'r, T.C. Memo. 2008-34, *appeal docketed*, No. 08-73152 (9th Cir. July 22, 2008)	6651(a)(1); Emotional distress due to divorce as reasonable cause	No	IRS
Theurer v. Comm'r, T.C. Memo. 2008-61, *appeal docketed*, No. 08-71699 (9th Cir. Apr. 23, 2008)	6654; No applicable exceptions	No	IRS
Ward v. Comm'r, T.C. Summ. Op. 2007-144	6651(a)(1), 6654; Nonfiler; No evidence of reasonable cause or exception presented	Yes	IRS
Watson v. Comm'r, T.C. Memo. 2007-146, *aff'd*, 277 Fed. Appx. 450 (5th Cir. 2008)	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	Yes	Split (IRS 6651 for 1998 and 1999; IRS 6654 for 1999; TP 6651 for 2001 and 2002)
White v. Comm'r, T.C. Summ. Op. 2007-100	6651(a)(1); Innocent Spouse Relief as reasonable cause	Yes	IRS
Wipperfurth v. Comm'r, T.C. Memo. 2007-259	6651(a)(1); Nonfiler; No evidence of reasonable cause presented	Yes	IRS
Wolcott v. Comm'r, T.C. Memo. 2007-315, *appeal docketed*, No. 08-1366 (6th Cir. Mar. 20, 2008)	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	Yes	IRS
Zlotowski, Estate of v. Comm'r, T.C. Memo. 2007-203	6651(a)(1); Reliance on estate attorney as reasonable cause	No	IRS
Business cases			
A Better Plumbing Service, Inc. v. U.S., 533 F. Supp. 2d 1233 (N.D. Ga. 2008)	6651(a)(1); Reliance on accountant as reasonable cause	No	IRS
Anderson v. Comm'r, T.C. Memo. 2007-265, *appeal docketed sub nom., Latos v. Comm'r*, No. 08-1138 (1st Cir. Jan. 29, 2008)	6654; Employer's failure to withhold taxes as exception	Yes	IRS
Arnold v. Comm'r, T.C. Memo. 2007-168	6651(a)(1); Poor health as reasonable cause	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2007-135	6651(a)(1); No evidence of claimed extension	Yes	IRS

Table 7: Failure to File Penalty Under IRC § 6651(a)(1) and Estimated Tax Penalty Under IRC § 6654

Case Citation	Issue(s)	*Pro Se*	Decision
Bynum v. Comm'r, T.C. Memo. 2008-14	6651(a)(1); Poor health as reasonable cause	Yes	IRS
Diller v. Comm'r, T.C. Summ. Op. 2007-146	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	Yes	IRS
Dunne v. Comm'r, T.C. Memo. 2008-63	6651(a)(1); Ongoing litigation, reliance on professional advice, incomplete information as reasonable causes	No	IRS
Edwards v. Comm'r, T.C. Summ. Op. 2007-182	6651(a)(1), 6654; Nonfiler; Reliance on preparer as reasonable cause or exception	No	IRS
Ellis v. Comm'r, T.C. Memo. 2007-207, *appeal docketed*, No. 08-9000 (10th Cir. Dec. 28, 2007)	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	No	IRS
Jackson v. Comm'r, T.C. Summ. Op. 2007-208	6651(a)(1); No evidence of reasonable cause presented	Yes	IRS
Kopty v. Comm'r, T.C. Memo. 2007-343, *appeal docketed*, No. 08-1171 (D.C. Cir. Apr. 29, 2008)	6651(a)(1); Medical condition, lack of information as reasonable causes	Yes	IRS
McClain v. Comm'r, T.C. Summ. Op. 2007-175	6651(a)(1), Poor health as reasonable cause	Yes	IRS
Moreira v. Comm'r, T.C. Memo. 2008-105	6651(a)(1); No evidence of reasonable cause presented	Yes	IRS
New York Guangdong Finance, Inc. v. Comm'r, T.C. Memo. 2008-62, *appeal docketed*, No. 08-60792 (5th Cir. Aug. 12, 2008)	6651(a)(1); Reliance on professional advice as reasonable cause	No	IRS
Odelugo v. Comm'r, T.C. Memo. 2008-92	6651(a)(1), 6654; Incomplete information, too busy at work as reasonable causes or exception	No	Split (TP for penalties in excess of those alleged in answer, IRS for remainder)
Pearson v. Comm'r, T.C. Memo. 2007-341	6651(a)(1), 6654; Nonfiler; Belief no return necessary as reasonable cause; IRS failed to meet burden with respect to section 6654 penalty for 1999	Yes	Split (IRS 6651(a)(1), IRS 6654 for 2000-2003; TP 6654 for 1999)
Prudhomme v. Comm'r, T.C. Memo. 2008-83, *appeal docketed*, No. 08-60449 (5th Cir. May 16, 2008)	6651(a)(1); No evidence of reasonable cause presented	No	IRS
Ramirez v. Comm'r, T.C. Memo. 2007-346	6651(a)(1); Reliance on preparer as reasonable cause	Yes	IRS
Tarter v. Comm'r, T.C. Memo. 2007-320	6651(a)(1); No evidence of reasonable cause presented	No	IRS
Tomlinson v. Comm'r, T.C. Summ. Op. 2007-210	6651(a)(1); Caring for sick relative as reasonable cause	Yes	IRS
VanZant v. Comm'r, T.C. Summ. Op. 2007-195	6651(a)(1); No evidence of reasonable cause presented	Yes	IRS
Vigil v. Comm'r, T.C. Summ. Op. 2008-6	6651(a)(1); Reliance on accountant as reasonable cause	Yes	IRS
Vogt v. Comm'r, T.C. Memo. 2007-209, *appeal docketed*, No. 08-71133 (9th Cir. Mar. 14, 2008)	6651(a)(1), 6654; No evidence of reasonable cause or exception presented	Yes	IRS

Appendix Three

Table 8 Relief from Joint and Several Liability Under IRC § 6015

Case Citation	Issue(s)	*Pro Se*	Intervenor	Decision
Adkison v. Comm'r, 129 T.C. 97 (2007), *appeal docketed*, No. 08-70485 (9th Cir. Feb. 6, 2008)	6015(c); jurisdiction due to partnership proceeding in district court	No	No	IRS
Barrera v. Comm'r, T.C. Summ. Op. 2007-180	6015(f) (underpayment)	No	No	IRS
Beatty v. Comm'r, T.C. Memo. 2007-167	6015(f) (underpayment)	No	No	TP
Billings v. Comm'r, T.C. Memo. 2007-234, *rehearing after* Tax Relief and Health Care Act 2006, Pub. L. No. 109-431, 120 Stat. 2922, 3061 (2006), *Billings v. Comm'r*,127 T.C. 2 (2006)	6015(f); T.C. jurisdiction post Tax Relief and Health Care Act (TRHCA)	No	No	TP
Bishop v. Comm'r, T.C. Summ. Op. 2008-33	6015(f); intervenor	No	Yes	TP*
Bucy, U.S. v., 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007)	6015(f) (underpayment)	No	No	IRS
Casula v. Comm'r, T.C. Summ. Op. 2008-49	6015(f) (underpayment)	No	No	IRS
Christensen v. Comm'r, 101 A.F.T.R.2d (RIA) 1795 (9th Cir. 2008) *affirming* T.C. Memo. 2005-299	6015(f); relief is only available to joint filers	No	No	IRS
Christman v. Comm'r, T.C. Summ. Op. 2007-178	6015(f) (underpayment)	No	No	IRS
Clarke-Lewis v. Comm'r, T.C. Memo. 2008-14	6015(b), (c), (f) (underpayment)	Yes	No	IRS
Conner v. Comm'r, T.C. Summ. Op. 2007-131	6015 (understatement); relief only available for joint filers	Yes	No	IRS
Devlin v. Comm'r, T.C. Summ. Op. 2007-201	6015(f) (underpayment)	Yes	No	IRS
Dowell v. Comm'r, T.C. Memo. 2007-326	6015(f) (understatement)	Yes	No	Split
Dunne g. Comm'r, T.C. Memo. 2008-63, *reconsideration requested* (May 27, 2008)	6015(b) & (f) (understatement)	No	No	IRS
Edwards v. Comm'r, T.C. Summ. Op. 2007-193	6015; Tax Court has no jurisdiction to review IRS determination to grant relief to an electing spouse for a non-electing spouse	Yes	No	IRS
Eller v. Comm'r, T.C. Summ. Op. 2007-215	6015(c)	No	No	TP
Elliott v. Comm'r, T.C. Summ. Op. 2007-111	6015(b), (c), (f) (understatement)	Yes	No	IRS
Fain v. Comm'r, 129 T.C. 89 (2007)	nonrequesting spouse's right to intervene survives death	No	Yes	TP
Freulich v. Comm'r, T.C. Summ. Op. 2007-124	6015(b), (c), (f) (understatement)	Yes	No	IRS
Gilmer v. Comm'r, T.C. Summ. Op. 2007-132	6015(b), (c), (f) (understatement)	Yes	Yes, but conceded claim at trial	IRS
Golden v. Comm'r, T.C. Memo. 2007-299 (2007), *appeal docketed*, No. 07-2429 (6th Cir. Nov. 14, 2007)	6015(b), (c), (f) (understatement)	Yes	No	IRS
Gonce v. Comm'r, T.C. Memo. 2007-328	6015(b), (c), (f) (understatement)	Yes	No	IRS
Green v. Comm'r, T.C. Memo. 2008-28	6015(e) (jurisdiction) & 6015(f) (understatement)	No	No	IRS
Hopkins v. Comm'r, T.C. Summ. Op. 2007-145	6015(f) (underpayment)	Yes	No	IRS
Huynh v. Comm'r, 101 A.F.T.R.2d (RIA) 2073 (9th Cir. 2008) *affirming* T.C. Memo. 2006-180, *reh'g en banc requested* (June 12, 2008)	6015(g)(2) (res judicata)	Yes	No	IRS
Juell v. Comm'r, T.C. Memo. 2007-219	6015(b); intervenor objects	Yes	Yes	TP
Kosinski v. Comm'r, T.C. Memo. 2007-173, *appeal docketed* No. 07-2136 (6th Cir. Sept. 21, 2007)	6015(b)	No	No	IRS
Kunsman v. Comm'r, T.C. Summ. Op. 2007-168	6015(b), (c), (f) (understatement)	yes	No	IRS
Lepordo v. Comm'r, T.C. Summ. Op. 2008-4	6015(c) & (f) (understatement)	Yes	No	IRS

Table 8: Relief from Joint and Several Liability Under IRC § 6015

Case Citation	Issue(s)	*Pro Se*	Intervenor	Decision
Lippitz, Estate of v. Comm'r, T.C. Memo. 2007-293	TP is entitled to litigation fees because she was the prevailing party, and IRS was not substantially justified in continuing the suit under 7430	No	No	TP
Menendez v. Comm'r, T.C. Memo. 2007-193	6015(c); intervenor	Yes	Yes	TP
Moore v. Comm'r, T.C. Memo. 2007-156	6015(g) res judicata	Yes	No	IRS
Munsinger v. Comm'r, T.C. Summ. Op. 2007-158	6015(b), (c), (f)	Yes	No	IRS
Nihiser v. Comm'r, T.C. Memo. 2008-135	6015(f) (underpayment)	No	No	TP
Pacheco v. Comm'r, T.C. Summ. Op. 2007-125	6015(c) (underpayment)	No	No	IRS
Petrane v. Comm'r, 129 T.C. 1 (2007)	7463(f)(1) (designation as "small tax case")	No	No	IRS
Porter v. Comm'r, 130 T.C. No. 10 (2008)	6015(f); court may consider evidence introduced at trial which was not included in the administrative record.	Yes	No	TP
Richardson v. Comm'r, 100 A.F.T.R.2d (RIA) 6970 (6th Cir. 2007) *affirming* T.C. Memo. 2006-69, *petition for reh'g denied* (6th Cir. Feb. 26, 2008)	6015(b) (understatement)	No	No	IRS
Schmick v. Comm'r, T.C. Memo. 2007-220	6015; 7463(f)(1) (designation as "small tax case")	Yes	No	IRS
Schroeder v. Comm'r, T.C. Summ. Op. 2007-204	6015(b)	Yes	No	IRS
Schwendeman v. Comm'r, T.C. Memo. 2007-227	6015(b), (c), (f) (understatement)	Yes	No	IRS
Thompson v. Comm'r, T.C. Summ. Op. 2008-39	6015(f); Treas. Reg. § 1.6015-5(b)(1) (statute of limitations)	No	No	IRS
Thurner v. Comm'r, 100 A.F.T.R.2d (RIA) 6774 (7th Cir. 2007), *petition for reh'g and reh'g en banc denied* (Feb. 11, 2008), *petition for cert filed* No. 07-1543 (May 8, 2008)	Pending appeal related to 6015 defense does not preclude discovery of TP's financial situation	Yes	No	IRS
Velez v. Comm'r, T.C. Summ. Op. 2008-19	6015(f) (underpayment)	Yes	No	IRS
Waggoner v. U.S., 100 A.F.T.R.2d (RIA) 6426 (Bankr. N.D. Tex. 2007).	Motion to set aside default judgment	No	No	IRS
Walker v. U.S., 101 A.F.T.R.2d (RIA) 1013 (D.N.J. 2008)	No jurisdiction for 6015 relief under quiet title action because 28 U.S.C. § 2410 only grants jurisdiction to hear procedural challenges but not a challenge to the underlying tax liability	No	No	IRS
White v. Comm'r, T.C. Summ. Op. 2007-100	6015(b), (c), (f) (understatement)	Yes	No	IRS
Wilson v., U.S., 100 A.F.T.R.2d (RIA) 6849 (E.D. Ark. 2007), *appeal docketed*, No. 08-1242 (8th Cir. Jan. 29, 2008), *appeal dismissed*, (Feb. 27, 2008)	6015(f): recovery of erroneous refund	No	No	IRS
Winzen v. Comm'r, T.C. Summ. Op. 2007-099	6015(f) (underpayment)	Yes	No	IRS
Ybarra v. Comm'r, T.C. Summ. Op. 2008-2	6015(f) (underpayment)	Yes	No	TP

*The IRS agreed that the TP was entitled to relief; only the intervenor was opposed.

Table 9 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)				
Boggs v. Comm'r, T.C. Memo. 2008-81	TPs (H&W) petitioned for redetermination of deficiency and argued that their income was a return of human capital and not taxable	Yes	IRS	$10, 000
Broderick v. Comm'r, T.C. Memo. 2008-2	TP opposed motion for summary disposition	Yes	TP	
Callahan v. Comm'r, T.C. Memo. 2007-301, *motion to vacate or revise denied* (May 9, 2008)	TPs (H&W) petitioned for redetermination of deficiency and argued that labor is an even exchange for money, income is not defined in the Internal Revenue Code, and other frivolous positions	Yes	IRS	$3,000
Connolly v. Comm'r, T.C. Memo. 2008-95	TP sought review of adverse CDP decision and asserted that he was not involved in the cotton or distilled spirits trade and therefore had no taxable income	Yes	IRS	$2,500
Creamer v. Comm'r, T.C. Memo. 2007-266	TP petitioned for a redetermination of a proposed levy action and argued that his wages were taxable income because he was not engaged in employment or a trade or business as defined in the IRC	Yes	IRS	$2,000
Davis v. Comm'r, T.C. Memo. 2007-201, *appeal docketed* (6th Cir. Oct. 18, 2007)	TPs petitioned for a redetermination of proposed collection actions and asserted frivolous arguments	No	IRS	$15,000
Davis v. Comm'r, T.C. Memo. 2007-160	TP petitioned for a redetermination of proposed collection activity and asserted frivolous arguments	Yes	IRS	$2,000
Enax v. Comm'r, T.C. Memo. 2008-116	TP sought review of adverse CDP determination and asserted frivolous arguments	Yes	IRS	$2,500
Gillespie v. Comm'r, T.C. Memo. 2007-202, *appeal docketed* No. 07-3577 (7th Cir. Oct. 18, 2007)	TPs petitioned for a redetermination of deficiency and asserted frivolous arguments	No	IRS	$15,000
Green v. Comm'r, T.C. Memo. 2007-262	TP petitioned for a redetermination of deficiency and asserted he is not subject to taxation because he is a resident of the state of Texas not the U.S., that notification forms were invalid because they lacked OMB control numbers, among other frivolous arguments	Yes	IRS	$2,500
Long v. Comm'r, T.C. Memo. 2008-1	TP failed to prosecute the case or cooperate with the IRS in preparing for trial	Yes	TP	
Mack v. Comm'r, T.C. Memo. 2008-29	TP petitioned for redetermination of deficiency, failed to prosecute, and asserted frivolous arguments	Yes	IRS	$2,000
Mandeville v. Comm'r, T.C. Memo. 2007-332	TP petitioned for redetermination of deficiency and asserted frivolous arguments	Yes	TP	
McDermott v. Comm'r, T.C. Memo 2007-205, *appeal docketed*, No. 07-73017 (9th Cir. Sept. 19, 2007), *motion to transfer appeal to 10th Cir. granted* No. 08-9006 (Apr. 17, 2008)	TP petitioned for redetermination of deficiency, failed to prosecute, and asserted frivolous arguments	Yes	TP	
McFarland v. Comm'r, T.C. Summ. Op. 2008-59	TP sought review of collection action and stated he was a tax protestor	Yes	IRS	$3,500
McGowan v. Comm'r, T.C. Memo. 2008-125	TP petitioned for redetermination of deficiency and asserted frivolous arguments	Yes	TP	
Mills v. Comm'r, T.C. Memo. 2007-270, *appeal docketed* No. 07-14812 (11th Cir. Oct. 9, 2007), *appeal dismissed* (Nov. 15, 2007), *appeal reinstated* (Dec. 3, 2007), *appeal dismissed* (Jan. 22, 2008)	TP petitioned for redetermination of deficiency, failed to prosecute, and asserted frivolous arguments	Yes	IRS	$5,000
Moore v. Comm'r, T.C. Memo. 2007-200	TP petitioned for a redetermination of collection activity and argued that the tax forms violated the Paperwork Reduction Act and were invalid because they did not contain OMB control numbers	Yes	IRS	$25,000
Nitschke v. Comm'r, T.C. Memo. 2008-143, *motion to vacate decision* (June 30, 2008)	TP sought review of collection action and asserted frivolous arguments	Yes	IRS	$10,000

Table 9: Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

Case Citation	Issue(s)	*Pro Se*	Decision	Amount
Oropeza v. Comm'r, T.C. Memo. 2008-94	TP sought review of collection action and challenged the validity of IRS notices	Yes	IRS	$10,000
Randall v. Comm'r, T.C. Memo. 2008-138	TP petitioned for redetermination of deficiency and argued that non-employee compensation was not taxable	Yes	IRS	$1,000
Rhodes v. Comm'r, T.C. Memo. 2007-206, *appeal docketed* No. 08-60093 (5th Cir. Jan. 22, 2008), *appeal dismissed* (Apr. 9, 2008)	TP petitioned for redetermination of deficiency and asserted that he was not a taxpayer, his wages did not constitute income, and the IRS has no jurisdiction over him	Yes	IRS	$15,000
Schlosser v. Comm'r, T.C. Memo. 2007-297, *appeal docketed* No. 07-4811 (3d Cir. Dec. 17, 2007)	TP petitioned for redetermination of collection activity and asserted frivolous arguments	Yes	IRS	$1,000
Schlosser v. Comm'r, T.C. Memo. 2007-298, *appeal docketed,* No. 07-4812 (3d Cir. Dec. 17, 2007)	TP petitioned for redetermination of collection activity and asserted frivolous arguments	Yes	IRS	$1,000
Thomas v. Comm'r, T.C. Memo. 2008-4, *appeal docketed* No. 08-70526 (9th Cir. Jan. 25, 2008), *appeal dismissed* (Mar. 28, 2008)	TP petitioned for interest abatement	No	TP	
Watson v. Comm'r, T.C. Memo. 2007-146, *appeal docketed*, (5th Cir. Oct. 15, 2007), *aff'd* by 101. A.F.T.R.2d (RIA) 2109 (5th Cir. 2008))	TP petitioned for a redetermination of deficiency and asserted that he is an independent contractor, not self-employed or an employee so he is not subject to taxation and other frivolous arguments	Yes	IRS	$15,000
Wipperfurth v. Comm'r, T.C. Memo. 2007-259	TP petitioned for redetermination of deficiency and asserted frivolous arguments	Yes	IRS	$2,500
Wolcott v. Comm'r, T.C. Memo. 2007-315, *appeal docketed* (6th Cir. Feb. 25, 2008)	TP petitioned for redetermination of deficiency and asserted that tax forms were invalid because they did not comply with the Paperwork Reduction Act	Yes	TP	
Wood v. Comm'r, T.C. Memo. 2007-225, *appeal docketed*, No. 07-15423 (11th Cir. Nov. 5, 2007), *appeal dismissed* (Apr. 18, 2008)	TP petitioned for a redetermination of collection activity and asserted frivolous arguments	Yes	IRS	$5,000
Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)				
Colorado Mufflers Unlimited, Inc. v. Comm'r, T.C. Memo. 2007-222	TP petitioned for redetermination of deficiency and asserted IRS forms were invalid because they lacked OMB control numbers and that the IRS violated the Paperwork Reduction Act	Yes	IRS	$3,000
McCammon v. Comm'r, T.C. Memo 2008-114	TP petitioned for redetermination of deficiency and argued that the tax code is too complex and HIPPA prevents her from disclosing any information about her patients, including how much she earned from treating them	Yes	IRS	$25,000
Neufeld v. Comm'r, T.C. Memo. 2008-79	TPs (H&W) petitioned for redetermination of deficiency and asserted frivolous arguments	Yes	IRS	$1,000
Reedy v. Comm'r, T.C. Memo. 2008-100	TPs (H&W) petitioned for redetermination of deficiency and asserted frivolous arguments	Yes	IRS	$15,000
Section 6673 Penalty Not Requested or Imposed but Taxpayer Warned to Stop Asserting Frivolous Arguments				
Anderson v. Comm'r, T.C. Memo. 2007-265, *appeal docketed* (1st Cir. Jan 22, 2008)	TPs (H&W) petitioned for redetermination of deficiency and argued that tax payment responsibility lays with employers not individual taxpayers.	Yes		
Arnold v. Comm'r, T.C. Memo. 2007-168, *motion to vacated or revise denied* (Nov. 1, 2007)	TPs (H&W) petitioned for redetermination of deficiency	Yes		
Harper v. Comm'r, T.C. Memo. 2007-378, *motion to vacate denied* (Jan. 2, 2008)	TP petitioned to have an earlier deficiency decision revised or vacated	Yes		
Phillips v. Comm'r, T.C. Memo. 2008-9	TP petitioned for redetermination of deficiency and asserted frivolous arguments	Yes		
Thompson v. Comm'r, T.C. Memo 2007-327, *appeal docketed*, No. 07-3917 (8th Cir. Dec. 10, 2007)	TP petitioned for redetermination of deficiency and argued that no person is liable for income tax and that there are no definitions of income and taxable in the Internal Revenue Code	Yes		

Appendix Three

Appendix Three

Table 9: Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

Case Citation	Issue(s)	*Pro Se*	Decision	Amount
U.S. Courts of Appeals' Decisions on Appeal of Section 6673 Penalties Imposed by US Tax Court				
Cargill v. Comm'r, 101 A.F.T.R.2d (RIA) 1528 (11th Cir. 2008), *petition for reh'g denied* (June 4, 2008)	Penalty affirmed	Yes	IRS	$1,000
Jay v. Comm'r, 101 A.F.T.R.2d (RIA) 2074 (9th Cir. 2008)	Penalty affirmed	Yes	IRS	Not specified
Perkins v. Comm'r, 262 Fed. Appx. 119 (11th Cir. 2008), *petition for reh'g denied* (Mar. 10, 2008)	Penalty affirmed	Yes	IRS	$5,000
Richards v. Comm'r, 101 A.F.T.R.2d (RIA) 1637 (10th Cir. 2008)	Penalty affirmed	Yes	IRS	$2,000
Webster v. Comm'r, 268 Fed. Appx. 674 (9th Cir. 2008) *aff'g* T.C. Memo. 2006-144	Penalty affirmed	Yes	IRS	$2,500
Wheeler v. Comm'r, 521 F.3d 1289 (10th Cir. 2008), *aff'g* 127 T.C. 200 (2006)	Penalty affirme	Yes	IRS	$1,500
Wood v. Comm'r, 229 Fed. Appx. 897 (11th Cir. 2007), *aff'g* T.C. Memo. 2006-203	Penalty affirmed	Yes	IRS	$1,000
U.S. Courts of Appeals' Decisions on Sanctions Under Section 7482(c)(4), FRAP Rule 38, or Other Authority				
Cargill v. Comm'r, 101 A.F.T.R.2d (RIA) 1528 (11th Cir. 2008), *petition for reh'g denied* (June 4, 2008)	TP petitioned for redetermination of deficiency and asserted she was not required to pay taxes; tax forms did not display a valid OMB control number, and other frivolous arguments	Yes	IRS	$8,000
Jay v. Comm'r, 101 A.F.T.R.2d (RIA) 2074 (9th Cir. 2008)	TP appealed dismissal for failure to state claim and asserted frivolous arguments	Yes	IRS	$8,000
Malan v. Comm'r, 261 Fed. Appx. 117 (10th Cir. 2008), *petition for cert. filed* (June 16, 2008)	TP sought review of adverse CDP decision and argued that the IRS lacked political jurisdiction over him	Yes	IRS	$2,000
Perkins v. Comm'r, 262 Fed. Appx. 119 (11th Cir. 2008), *petition for reh'g denied* (Mar. 10, 2008)	TP petitioned for redetermination of deficiency and argued that the Commissioner did not personally notify him of his duty to maintain financial records and pay taxes	Yes	IRS	$8,000
Richards v. Comm'r, 101 A.F.T.R.2d (RIA) 1637 (10th Cir. 2008)	TP petitioned for redetermination of deficiency and argued that human labor cannot be taxed, the 16th Amendment is unconstitutional, and that tax returns are not mandatory	Yes	IRS	$4,000
Spitzer, U.S. v., 100 A.F.T.R.2d (RIA) 5933 (M.D. Fla. 2007)	TP argued his income was not as a result of federal activity	Yes	IRS	$16,285
Wheeler v. Comm'r, 521 F.3d 1289 (10th Cir. 2008), *aff'g* 127 T.C. 200 (2006)	TP petitioned for redetermination of deficiency and argued that the notice of deficiency violated the Paperwork Reduction Act	Yes	TP	
Williamson, et.al., U.S. v., 244 Fed. Appx. 900 (10th Cir. 2007), *aff'g* 97 A.F.T.R.2d (RIA) 810 (D.N.M. 2005)	TPs (H&W) petitioned for redetermination of deficiency and asserted they were not liable for income tax because New Mexico is not part of the U.S., no law requires them to pay income taxes, that income tax is unconstitutional, and other frivolous arguments	No	IRS	$8,000
Section 7482(c)(4), FRAP Rule 38, or Other Authority Penalty Not Requested or Imposed but Taxpayer Warned to Stop Asserting Frivolous Arguments				
Dunn v. IRS, 99 A.F.T.R.2d (RIA) 3464 (E.D. Mich. 2007)	TP petitioned to enjoin the collection of tax and asserted he is not subject to Internal Revenue laws	Yes		

Table 10 Family Status Issues Under IRC §§ 2, 24, 32, and 151

Case Citation	Issues	*Pro Se*	Decision
Individual Taxpayers			
Anderson v. Comm'r, T.C. Memo. 2008-37	Earned Income Tax Credit (EITC)	Yes	IRS
Artayet v. Comm'r, T.C. Summ. Op. 2008-34	Child Tax Credit (CTC), Dependency Exemption	Yes	IRS
Bears v. Comm'r, T.C. Summ. Op. 2007-153	Dependency Exemption	Yes	IRS
Beltran v. Comm'r, T.C. Summ. Op. 2008-51	CTC, EITC, Filing Status	Yes	IRS
Boltinghouse v. Comm'r, T.C. Memo. 2007-324	Dependency Exemption	Yes	IRS
Buah v. Comm'r, T.C. Summ. Op. 2007-183	EITC, Filing Status	Yes	IRS
Burkley v. Comm'r, T.C. Summ. Op 2008-20.	Dependency Exemption	Yes	IRS
Chamberlain v. Comm'r, T.C. Memo. 2007-178	CTC, Dependency Exemption	Yes	IRS
Crane v. Comm'r, T.C. Summ. Op. 2007-108	CTC, Dependency Exemption	Yes	IRS
Davis v. Comm'r, T.C. Summ. Op. 2007-140	CTC, Dependency Exemption, Filing Status	Yes	IRS
Felix v. Comm'r, T.C. Memo 2008-96	Dependency Exemption, EITC, Filing Status	Yes	IRS
Finnegan v. Comm'r, T.C. Summ. Op. 2007-176	CTC, Dependency Exemption	Yes	IRS
Harris v. Comm'r, T.C. Summ. Op. 2007-202	CTC, Dependency Exemption, EITC, Filing Status	Yes	IRS
Harris v. Comm'r, T.C. Memo. Op. 2007-239	CTC, Dependency Exemption	Yes	IRS
Holmes v. Comm'r, T.C. Summ. Op. 2008-47	Dependency Exemption, EITC, Filing Status	Yes	IRS
Keene v. Comm'r, T.C. Summ. Op. 2007-186	CTC, Dependency Exemption	Yes	IRS
Kold-Warren v. Comm'r, T.C. Summ. Op. 2007-197	CTC	Yes	IRS
Kore v. Comm'r, T.C. Summ. Op. 2007-109	CTC, Dependency Exemption, EITC, Filing Status	Yes	Split
Kovachevich v. Comm'r, T.C. Summ. Op. 2007-179	Dependency Exemption	Yes	IRS
Mandeville v. Comm'r, T.C. Memo. 2007-332	Dependency Exemption	Yes	IRS
Marshall v. Comm'r, T.C. Summ. Op. 2008-31	Dependency Exemption, Filing Status	Yes	IRS
Mbanu v. Comm'r, T.C. Summ. Op. 2007-130	EITC, Filing Status	Yes	IRS
McLain v. Comm'r, T.C. Summ. Op. 2007-175	Dependency Exemption	Yes	IRS
Neal v. Comm'r, T.C. Summ. Op. 2007-209	CTC, Dependency Exemption, EITC, Filing Status	Yes	IRS
Nobles v. Comm'r, T.C. Memo. 2007-277	CTC, Dependency Exemption, EITC, Filing Status	Yes	IRS
Norman v. Comm'r, T.C. Summ. Op. 2007-170	CTC, Dependency Exemption	Yes	IRS
Redding v. Comm'r, T.C. Summ. Op. 2007-134	Dependency Exemption, EITC, Filing Status	Yes	IRS
Ruben v. Comm'r, T.C. Summ. Op. 2008-38	EITC	Yes	IRS
Schiff v. Comm'r, T.C. Summ. Op. 2007-148	Dependency Exemption	Yes	IRS
Sheltion v. Comm'r, T.C. Summ. Op. 2007-211	CTC, Dependency Exemption	Yes	IRS
Spuches v. Comm'r, T.C. Summ. Op. 2007-164	CTC, Dependency Exemption	Yes	IRS
Stensgaard v. Comm'r, T.C. Summ. Op 2007-150	EITC	Yes	IRS
Ward v. Comm'r, T.C. Summ. Op. 2008-54	CTC, Dependency Exemption	No	IRS
Worota v. Comm'r, T.C. Summ. Op. 2008-52	CTC, Dependency Exemption, EITC	Yes	TP

Appendix Four

Acronym Glossary - Annual Report to Congress 2008

Acronym	Definition
ABA	American Bar Association
ACDS	Appeals Centralized Database System
ACH	Automated Clearing House
ACS	Automated Collection System
ACT	Advisory Committee on Tax-Exempt & Government Entities
ACTC	Advance Child Tax Credit
ADA	Americans With Disabilities Act
ADR	Alternative Dispute Resolution
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
AMT	Alternative Minimum Tax
ANMF	Automated Non Master File
ANPR	Advance Notice of Proposed Rulemaking
AOIC	Automated Offer In Compromise
APO	Army Post Office
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
ATAO	Application for Taxpayer Assistance Order
ATFR	Automated Trust Fund Recovery System
ATO	Australian Taxation Office
AUR	Automated Underreporter
AUSPC	Austin Submission Processing Center
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 and Education

Appendix Four

Acronym	Definition
CAS	Customer Account Services
CAWR	Combined Annual Wage Reporting
CBO	Congressional Budget Office
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
CDW	Compliance Data Warehouse
CES	Cost Effectiveness Study
CEX	Consumer Expenditure Survey
CFf	Collection Field Function
CI	Criminal Investigation
CIDS	Centralized Inventory Distribution System
CIP	Compliance Initiative Projects
CIS	Correspondence Imaging System
CLD	Communications, Liaison and Disclosure
CNC	Currently Not Collectible
COD	Cancellation of Debt
COIC	Centralized Offer In Compromise Program
COTR	Contracting Officer's Technical Representative
CONOPS	Concept of Operations
CPE	Continuing Professional Education
CQMS	Collection Quality Management System
CRIS	Compliance Research Information System
CSED	Collection Statute Expiration Date
CSPC	Cincinatti Submission Processing Center
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
DDb	Dependent Database
DDP	Daily Delinquency Penalty
DI	Desktop Integration or Debt Indicator
DIF	Discriminant Index Function
DOD	Department of Defense

Appendix Four

Acronym	Definition
DOJ	Department of Justice
DPT	Dynamic Project Team
DRG	Desk Reference Guide
EAR	Electronic Account Resolution
EBT	Electronic Benefits Transfer
EGTRRA	Economic Growth and Tax Relief Reconciliation Act (of 2001)
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
EQRS	Embedded Quality Review System
ERIS	Enforcement Revenue Information System
ERO	Electronic Return Originator
ERSA	Employee Retirement Savings Account
ES	Estimated Tax Payments
ESL	English as a Second Language
ESOP	Employee Stock Ownership Plan
ETA	Effective Tax Administration *and* Electronic Tax Administration
ETACC	Electronic Tax Administration Advisory Committee
ETLA	Electronic Tax Law Assistance
FA	Field Assistance
FDCPA	Fair Debt Collection Practices Act
FEMA	Federal Emergency Management System
FICA	Federal Insurance Contribution Act
FLSA	Fair Labor Standards Act
FMIS	Financial Management Information System
FMS	Financial Management Service
FMV	Fair Market Value
FPAA	Final Partnership Administrative Adjustment
FOIA	Freedom Of Information Act
FPLP	Federal Payment Levy Program
FPO	Fleet Post Office
FRA	Federal Records Act
FSRP	Facilitated Self-Assistance Research Project
FTC	Federal Trade Commission
FTD	Federal Tax Deposit or Failure To Deposit
FTE	Full Time Equivalent
FTF	Failure To File

Acronym	Definition
FTI	Federal Tax Information
FTP	Failure To Pay
FTS	Fast Track Settlement
FUTA	Federal Unemployment Tax Act
FY	Fiscal Year
GCM	General Counsel Memorandum
GLD	Governmental Liaison and Disclosure
GE	Government Entities
GAO	Government Accountability Office or General Accounting Office
GPMO	Government Project Management Office
HCSR	Home Care Service Recipient
HCSW	Home Care Service Worker
IA	Installment Agreement
ICP	Integrated Case Processing
ICS	Integrated Collection System
IDAP	IDRS Decision Assisting Program
IDFP	IRS Directory for Practitioners
IDRS	Integrated Data Retrieval System
IDS	Inventory Delivery System
IMF	Individual Master File
IMRS	Issue Management Resolution System
IOAA	Independent Offices Appropriation Act
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
IRSAC	Internal Revenue Service Advisory Council
ITIM	Identity Theft Incident Management
ITIN	Individual Taxpayer Identification Number
IUUD	IDRS Unit and Unit Security Representative Database
JCT	Joint Committee on Taxation
JGTRRA	Jobs and Growth Tax Relief Reconciliation Act (of 2003)
JOC	Joint Operations Center
LILO	Lease-In / Lease-Out
LEP	Limited English Proficient
LITC	Low Income Taxpayer Clinic
LLC	Limited Liability Company
LMSB	Large & Mid-Sized Business Operating Division
LOS	Level of Service
LTA	Local Taxpayer Advocate
MAGI	Modified Adjusted Gross Income

Appendix Four

Appendix Four

Acronym	Definition
MFDRA	Mortgage Forgiveness Debt Relief Act
MFT	Master File Transaction Code
MITS	Modernization and Information Technology Services
MLI	Multilingual Initiative or Most Litigated Issue
MV&S	Modernization Vision & Strategy Process
NAEA	National Association of Enrolled Agents
NFIB	National Federation of Independent Businesses
NFTL	Notice of Federal Tax Lien
NMF	Non-Master File
NOD	Notice of Deficiency
NRP	National Research Program
NTA	National Taxpayer Advocate
OAR	Operations Assistance Request
OD	Operating Division
OIC	Offer in Compromise
OECD	Organisation for Economic Co-operation and Development
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 Responsibility
OTBR	Office of Taxpayer Burden Reduction
P&R	Probe & Response
PAYGO	Pay-As-You-Go
PCA	Private Collection Agency
PCI	Potentially Collectible Inventory
PDC	Private Debt Collection
PIPDS	Privacy, Information Protection, and Data Security
POA	Power Of Attorney
PPIA	Partial Payment Installment Agreement
PPS	Practitioner Priority Service
PRPO	Pre-Refund Program Office
PSC	Philadelphia Service Center
PSP	Payroll Service Provider
PTIN	Preparer Tax Identification Number
QAE	Quality Assurance Evaluator
RACS	Revenue Accounting Control System
RAIVS	Return and Income Verification Services
RCP	Reasonable Collection Potential
REIT	Real Estate Investment Trust
RFQ	Request For Quotations

Acronym	Definition
RGS	Report Generating Software
ROFT	Record of Federal Tax Liability
RRA 98	(Internal Revenue Service) Restructuring and Reform 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
SEC	Securities and Exchange Commission
SERP	Servicewide Electronic Research Program
SFR	Substitute for Return
SL	Stakeholder Liaison
SNOD	Statutory Notice of Deficiency
SOI	Statistics of Income
SPC	Submission Processing Center(s)
SPDER	Office of Servicewide Policy, Directives, and Electronic Research
SPEC	Stakeholder Partnership, Education & Communication
SPOC	Single Point of Contact
SRFMI	State Reverse File Matching Initiative
SSA	Social Security Administration
SSI	Supplemental Security Income
SSN	Social Security Number
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
TDA	Taxpayer Delinquent Account
TDI	Taxpayer Delinquent Investigation
TE	Tax Examiner or Tax Exempt
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TEC	Taxpayer Education and Communication
TE/GE	Tax Exempt & Government Entities Operating Division
TEI	Tax Executives Institute
TFRP	Trust Fund Recovery Penalty

Appendix Four

Acronym	Definition
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TIPRA	Tax Increase Prevention and Reconciliation Act (of 2005)
TOP	Treasury Offset Program
TOS	Terms of Service
TPPA	Third Party Payroll Agent
TRA 97	Taxpayer Relief Act of 1997
TRDA	Tip Rate Determination Agreement
TRHCA	Tax Relief and Health Care Act (of 2006)
VITA	Volunteer Income Tax Assistance
VTO	Virtual Translation Office
W & I	Wage and Investment Operating Division
WFTRA	Working Families Tax Relief Act of 2004
WOW	World of Warcraft

HEADQUARTERS

National Taxpayer Advocate
1111 Constitution Avenue NW
Room 3031, TA
Washington, DC 20224
Phone: 202-622-6100
FAX: 202-622-7854

Deputy National Taxpayer Advocate
1111 Constitution Avenue NW
Room 3039, TA
Washington, DC 20224
Phone: 202-622-4300
FAX: 202-622-7479

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 3213, TA:CA
Washington, DC 20224
Phone: 202-622-0755
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 23219
Phone: 804-916-3510
FAX: 804-916-3641

Atlanta/International
401 W. Peachtree Street NW
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: 859-669-5808

Dallas
4050 Alpha Road
MS 3000NDAL, Room 924
Dallas, TX 75244
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

Appendix Five

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: 631-447-4879

Cincinnati
201 Rivercenter Boulevard, Stop 11-G
Covington, KY 41011
Phone: 859-669-5316
FAX: 859-669-5405

Fresno
5045 E. Butler Avenue, Stop 1394
Fresno, CA 93888
Phone: 559-442-6400
FAX: 559-442-6507

Kansas City
333 W. Pershing
S-2 Stop 1005
Kansas City, MO 64108
Phone: 816-291-9000
FAX: 816-292-6003

Memphis
5333 Getwell Road, Stop 13
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
Stop 151
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
Phone: 602-207-8240
FAX: 602-207-8250

Arkansas
700 West Capitol Avenue
Stop 1005 LIT
Little Rock, AR 72201
Phone: 501-396-5978
FAX: 501-396-5766

California (Laguna Niguel)
24000 Avila Road, Room 3361
Laguna Niguel, CA 92677
Phone: 949-389-4804
FAX: 949-389-5038

California (Los Angeles)
300 N. Los Angeles Street
Room 5109, Stop 6710
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: 408-817-6852

Colorado
1999 Broadway, Stop 1005 DEN
Denver, CO 80202
Phone: 303-603-4600
FAX: 303-382-6302

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, DC 20221
Phone: 202-874-7203
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)
400 West Bay Street
Room 535A, MS TAS
Jacksonville, FL 32202
Phone: 904-665-1000
FAX: 904-665-1802

Georgia
401 W. Peachtree Street, NW
Summit Building, 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, MS 1005
Boise, ID 83724
Phone: 208-387-2827 x276
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 TA771
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

* LTA located in Oakland, California

Appendix Five

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
1616 Capitol Avenue
Suite 182
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 Boulevard
Buffalo, NY 14227
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 0-405
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: 401-528-1921
FAX: 401-528-1890

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
MC 1005HOU
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, Room 300
Burlington, VT 05401
Phone: 802-859-1052
FAX: 802-860-2006

Virginia
400 N. 8th Street, Box 25, Room 328
Richmond, VA 23219
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 Patricio Office Building
7 Tabonuco Street
Room 200
Guaynabo, PR 00966
Phone (Spanish): 787-622-8930
Phone (English): 787-622-8940
FAX: 787-622-8933

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